# Catalysts for Change in the FX Driver

The main driver that has led to a persistent decline in the US dollar through the last several months is the divergent thrust of monetary policy. It has left the Federal Reserve as a laggard in the global cycle and, in turn, has left the dollar with little support. Indeed after performing well following the announcement of QEII last November, the greenback's fall from grace can be traced, with the benefit of hindsight, to the ECB's first press conference of the year on January 13, when the hawkish signaling began.

The FOMC and Chairman Bernanke confirmed last week, as many had expected, that the current program of Treasuries will be completed as planned by the end of June. For an unspecified period after that, the Federal Reserve will continue to replace the maturing mortgage backed securities with Treasuries and thereby maintain the size of its balance sheet. Shortly after the Fed finishes QEII proper, the ECB is expected to deliver its second interest rate hike. It may very well deliver a third hike by the time the Federal Reserve begins to allow its balance sheet to shrink.

Yet as we have seen sometimes the main driver can be interrupted, mitigated and even reversed. Given market positioning, the strength of the trend and sentiment, it makes sense for investors to consider near-term catalysts that could dilute the impact of the divergent monetary policies. Here we will consider two: mounting pressure that would make a Greek restructuring imminent and developments in Spain.

**Greece**

The aid package that Greece received from the IMF/EU was calculated under the assumption that Greece would be able to return to the global capital markets in 2012. This is increasingly looking doubtful. Moreover, as was recently revealed, Greece's budget deficit in 2010 was 10.5% of GDP according to Eurostat, and not the 9.4% the government estimated in February.

Greece's 2-year yield rose from 15.75% at the end of March to 25.35% at the end of April. It finished last year near 12.25%. The 10-year yield finished April at 15.66%, a 283 bp increase over the course of the month. It was yielding just below 12.5% at the start of the year. The 5-year CDS has risen from 1003 end of the end of March to 1350 at the end of April. It finished last year near 1075.

This deterioration is taking place despite the fact that Greece is not issuing in the capital markets except for bills and it has bought back debt in the secondary market (~2 bln euros in April). Greece will need more money and the markets seem effectively closed. That leaves two potential courses. International assistance or debt restructure. The debt dynamics are under stood to be such that the former only delays the latter and the latter would likely entail some elements of the former.

Given official sentiment in Europe, the rise of political voices like the Tru Finns, and the importance of elections in Germany and France next year, the cost/benefit of a Greek restructuring is being reconsidered. Previously, the European strategy had seemed to be to treat the debt crisis as a liquidity issue to bridge the time until the European Stabilization Mechanism, which is more conducive for orderly debt restructuring, replaces in the European Financial Stabilization Facility in 2013.

The other reason that European officials wanted to "postpone" a restructuring that nearly every observer says is inevitable is in hope that creditor banks are strong enough to deal with the shock. Some officials may draw comfort from the fact that bank exposures to the sovereigns may be quite manageable. Risk-mitigation strategies, such as selling the problematic asset in the market, selling it to the ECB, which has purchased more than 75 bln euros of sovereign bonds in the secondary market over the past year, and buying insurance such as credit-default swaps may have lowered the overall exposure.

Yet the risk of a Lehman moment remains. There will be intended and unintended consequences of Greek sovereign restructuring. The conventional focus on the sovereign exposures may prove to be a distraction. In a BOE study, Greek banks, which hold the bulk of Greek bonds, will have an estimated 70% of their capital wiped out by a 50% haircut.

The larger potential channel of contagion is through the private sector, especially banks, but non-financial corporations as well. German banks, for example, are owed twice as much by the private sector in Greece, Portugal and Ireland than by the sovereigns. This is true more generally as well.

Including Spain into the analysis, the Q3 2010 BIS data showed that foreign exposure to the peripheral sovereigns was 266 bln euros, and 586 bln euros to peripheral banks and non-financial corporations (486 bln and 100 bln euros respectively).

If the market thought a Greek debt restructuring were imminent, then the divergent trajectories of monetary policies may be eclipsed as a market force. If the new month sees a continuation of the steep sell-off in Greek debt that took place in April, the euro may be more vulnerable. European bank shares may also become more sensitive to the performance of Greek debt.

**Spain**

Provided the market has confidence that the European debt crisis is contained to Ireland, Portugal and Greece, investors can focus on the divergent interest rate paths. In April, as Portugal's 2-year yield rose 329 bp and its 10-year yield rose 123 bp, Spain's 2-year yield rose 13 bp while its 10-year yield was flat.

In order to be emboldened to challenge what seems to be a firewall around Spain, investors may need a catalyst. The local and regional elections on May 22 could provide such a catalyst. Each of the 13 regions holds elections and around 8,000 municipalities go to the polls. One need not be a cynic to suspect that it is difficult to cut spending ahead of the elections.

This is particularly important in Spain were regional governments are so important. They account for half of all the public employees and 60% of government's health care expenditures, for example. More than half the regions overshot their deficit targets last year, including Catalonia, the largest region.

Last month Catalonia revealed that at almost 4% (of GDP), the 2010 deficit was 60% above its target. Its goal this year was 1.3%, but in negotiations with the government to take place after the elections this may be increased to recognize the hard reality. In addition, there is risk that new regional governments that do get elected reveal deeper deficits than have been acknowledged.

These concerns have seen some of Spain's regions be required to pay Portuguese level of interest rates. Just as we are concerned that the market should be focusing on Greek bank exposures more than Greek sovereign exposures, we are concerned that the market is under-appreciating the fiscal condition of Spain's local and regional governments. In March, when Moody's last downgraded Spain (Aa2, four notches above Portugal), it cited regional issues and followed by cutting regional ratings as well.

Roughly speaking, regional governments and their public companies account for about 135 bln euros of debt, and the local governments account for an additional 35 bln euros. This is all the more challenging because revenue associated with construction, which had fueled dramatic increases in spending, has fallen in half since the 2007 peak.

Many observers seem to be looking past these Spanish elections and toward the publication of the bank stress tests expected later in June. However, the election and its aftermath risk a test of the Spanish "firewall" taking place earlier. Opinion polls warn that the governing Socialists face a drubbing.

**Conclusion**

At the end of last year, the US 2-year Treasury yield was 20 bp below Germany's. Today it is nearly 120 bp below. To us, this represents the forces that have undermined the dollar. We indentified two of the potential factors that could eclipse this force in the weeks ahead.

If the pace of increase in Greek bond yields and CDS prices continues in May as it did in April, then it will be seen as both the cause and effect of speculation of an imminent restructuring. This may have unforeseeable consequence, especially if investors and policy makers do not appreciate the secondary effects of a sovereign restructuring.

We also bring to investors' attention the Spanish elections on May 22, which could leave the government even weaker and the magnitude of the regional debt even larger. We highlight the importance of regional and local debt burdens in assessing Spain's predicament. We warn that the de-coupling of Spain from the other parts of the periphery may be challenged ahead of the bank stress tests in late June.

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