

# S T R A T E G Y E C O N O M I C S

29 AUGUST, 2012.

## THERE WILL BE A SOROS OR PAULSON OF THE EURO CRISIS SOON

### SUMMARY

- **The euro crisis has produced no winners so far – only losers.**
- **There are no simple trades that bet against the single currency.**
- **But the opportunities will emerge in the final stages of the crisis.**

**Y**ou don't get to be a billionaire hedge fund manager by giving money back to your investors. So when Lois Bacon, one of the stars of the industry, with a 20-year track record of making stellar returns for his investors, decides that the markets are behaving so strangely even he can't read them then the rest of us should sit up and take notice.

In deciding to hand back a quarter of the money in his macro fund – about \$2 billion in total - Bacon made a telling point. The euro crisis has become so complex and so politicised that it is impossible for anyone to make any money.

But whilst it's true that the euro crisis hasn't yet produced its George Soros or John Paulson – someone who bets against the herd and wins big – that doesn't mean it won't in due course. In fact, Bacon has got this one wrong. There will be huge gains to be made by smart investors – but they are still a couple of years down the track

## **ONE: THE MERKEL MARKET**

Bacon's main beef seems to be that politicians like the German Chancellor Angela Merkel have made it impossible for the market to run its normal course. Prices and outcomes are so rigged by Presidents and Chancellors and central bankers that they no longer make any rational sense. And for that reason they become impossible to predict.

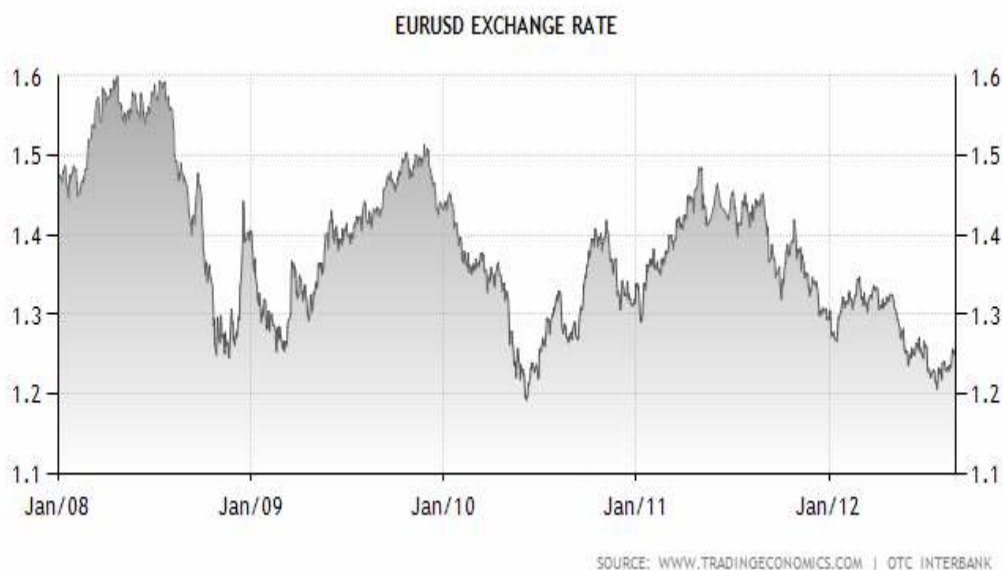
"The political involvement is so extreme — we have not seen this since the post-war era," he said in an interview. "What they are doing is trying to thwart natural market outcomes. It is amazing how important the decision-making of one person, Angela Merkel, has become to world markets."

There is an element of truth in that. It is very hard to make money when a late night summit between the French President and the Spanish Prime Minister might suddenly change the rules of the game. Yet few people will shed any tears over that. Despite what some people in the hedge fund community seem to think, the financial markets don't actually exist to enable billionaires to make out like bandits. If speculators can't make any money from the crisis that will strike most ordinary people as a good rather than a bad thing.

But in fairness Bacon is making an interesting point. So far, there hasn't been a George Soros who made a billion from betting against the fore-runner of the euro, the Exchange Rate Mechanism, in the early 1990s. Nor has there been a John Paulson who made a fortune from betting against the US sub-prime mortgage market in the last decade.

There are three of reasons for that.

One is that prices have held up surprisingly well so far. The euro itself has only inched down marginally against the dollar – from a rate of 1.35 in March to 1.23 now. That is hardly a collapse. In fact it is the kind of move it might make in a rather dull year when not much was going on. German bonds have done well, and so have French, despite plenty of predictions that country would be the next on the bond market's target list. If you were shorting Italian banks you would have done well. But that is hardly a huge market – and you would have had to have been very nimble to avoid getting burned when prices jumped back up again.



Next, anyone betting against the euro is taking on the German Treasury and the European Central Bank. Those are both institutions with very deep pockets – and certainly deeper than yours. The euro might be unsustainable in the medium-term. But big rich countries can do a lot to postpone the inevitable –and it will be some time before Europe’s elite are ready to throw in the towel on the single currency.

And thirdly, what do you trade exactly? There is no obvious instrument you can buy if you think the euro won’t be around in five years time. True, there wasn’t for the US sub-prime mortgage market although that didn’t stop some smart people finding one. So there may be a smart fund somewhere that has found the asset that will soar if the single currency breaks up. But if so they are keeping it to themselves.

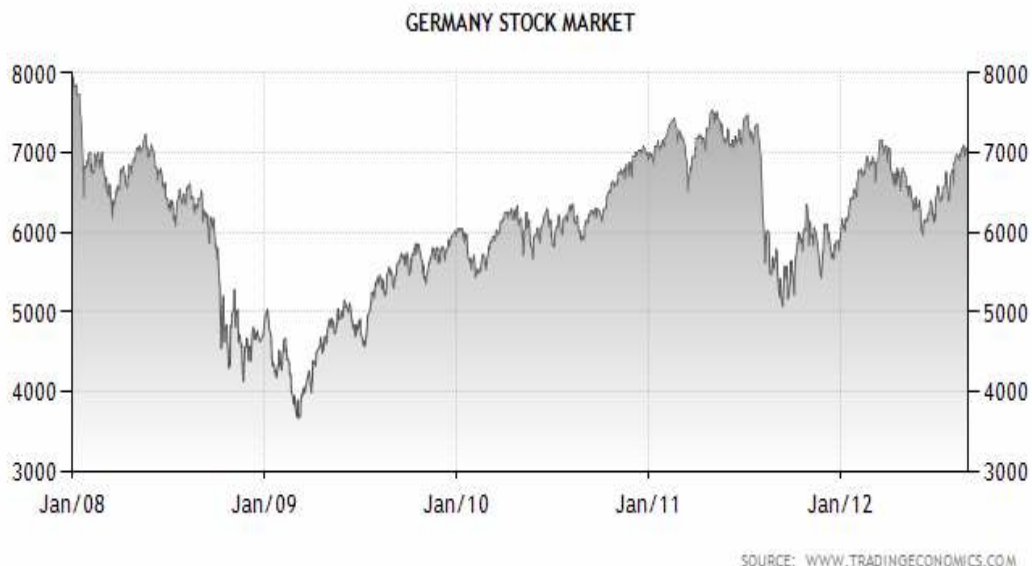
## **TWO: THE TRADES THAT WILL WORK – EVENTUALLY**

So is Bacon right? Can it really be the case that no one can trade the crisis successfully? Not quite. There will be money to be made – but not for a while.

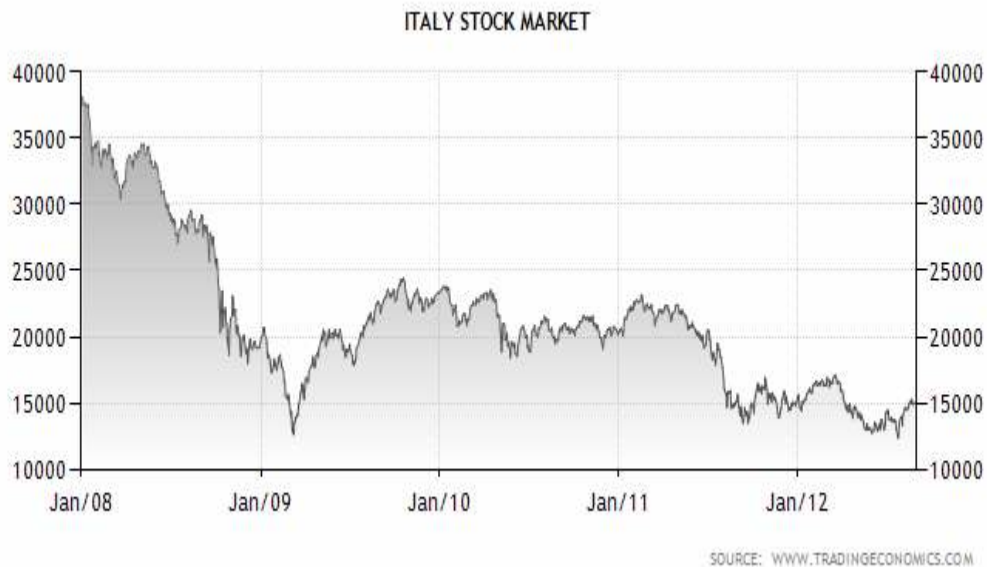
There are no strategies that will succeed during this phase of the crisis. The only real opportunities will be when the single currency finally breaks apart.

Then there will be two massive trades.

One will be selling Germany. Despite what everyone keeps saying, it will be the big loser from the crisis in the medium term. An artificially low currency has turned it into an export machine – China with sausages. With its own currency that will soar in value, its manufacturers will be wiped out. At the same time its banks will be stuck with all the losses from the debt of the peripheral countries. It will be bankrupt for a generation.



The other will be buying Spanish and Italian equities. Both countries have plenty of big successful companies – from retail to food to engineering. If they come out of the euro, they will renege on their debts or see them written off. And their new currencies will massively devalue, giving an immediate competitive boost to their domestic industries. Either would be a significant stimulus – together they will turbo-charge both economies. They will recover far faster than anyone expects. And so will their equity markets – which are already trading at bargain basement levels.



Both will be completely against the herd – which will be flocking into the new deutschemark and trashing the new peseta and lira. And both will be big winners. But that could be a couple of years away – which is probably too long a time horizon for most fund managers

- Matthew Lynn  
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## **FORECASTS**

### **THE UK ECONOMY**

	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>GROWTH:</b>	<b>-0.2%</b>	<b>0.9%</b>	<b>1.5%</b>
<b>INFLATION:</b>	<b>3.1%</b>	<b>2.9%</b>	<b>2.7%</b>
<b>UNEMPLOYMENT:</b>	<b>9.2%</b>	<b>10.2%</b>	<b>9.5%</b>

### **THE EUROZONE ECONOMY**

	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>GROWTH:</b>	<b>-0.7%</b>	<b>0.2%</b>	<b>1.2%</b>
<b>INFLATION:</b>	<b>2.0%</b>	<b>1.8%</b>	<b>1.8%</b>
<b>UNEMPLOYMENT:</b>	<b>9.4%</b>	<b>9.2%</b>	<b>9.4%</b>

### **THE GERMAN ECONOMY:**

	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>GROWTH:</b>	<b>-0.5%</b>	<b>1.0%</b>	<b>1.4%</b>
<b>INFLATION:</b>	<b>2.0%</b>	<b>2.2%</b>	<b>2.4%</b>
<b>UNEMPLOYMENT:</b>	<b>6.6%</b>	<b>6.8%</b>	<b>6.9%</b>

### **THE FRENCH ECONOMY:**

	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>GROWTH:</b>	<b>-0.7%</b>	<b>1.0%</b>	<b>1.0%</b>
<b>INFLATION:</b>	<b>1.9%</b>	<b>2.3%</b>	<b>2.6%</b>

UNEMPLOYMENT:	8.9%	8.7%	8.8%
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#### THE ITALIAN ECONOMY:

	<b>2012</b>	<b>2013</b>	<b>2014</b>
GROWTH:	-2.5%	-1.7%	0.1%
INFLATION:	2.1%	2.0%	2.1%
UNEMPLOYMENT:	8.9%	10.1%	10.7%

#### THE SPANISH ECONOMY

	<b>2012</b>	<b>2013</b>	<b>2014</b>
GROWTH:	-2.0%	-0.5%	0.6%
INFLATION:	1.9%	2.1%	2.3%
UNEMPLOYMENT:	22.3%	24.8%	25.6%

#### EXCHANGE RATES

	<b>2012</b>	<b>2013</b>	<b>2014</b>
EURO/\$1:	1.15	1.10	1.21
POUND/\$1	1.60	1.71	1.78

COMMODITIES:	<b>2012</b>	<b>2013</b>	<b>2014</b>
GOLD:	1,900	2,500	2,600
BRENT CRUDE:	125	140	150

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