Philequity Corner (May 31, 2010)
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The Demise of the Euro?

Last week, we mentioned that the sovereign debt crisis in several Eurozone members has put into question the viability of European Union's (EU) monetary system and its currency, the euro. The market continues to be incredibly bearish on the euro (down 15 percent year-to-date) due to concerns that the debt crisis could neither be mitigated nor contained. Even the announcement of a $1 trillion bailout which was intended to address EU's fiscal mess failed to stem the euro's slide.

Bailout or Not, Euro Still Doomed

The market's positive reaction to the bailout was short-lived. On the day the bailout was announced (May 10, 2010), the euro rallied 2.7 percent against the dollar. Spain's stock market jumped 14.4 percent, France's rose 9.7 percent and Germany gained 5.3 percent. Three weeks later, the euro hit new lows and is now down 3.7 percent from pre-bailout levels. Meanwhile, stocks in Spain, France and Germany also went to new lows last Tuesday before rallying to finish the week only slightly higher.

Many investors see the bailout hastening the demise of the euro. It is said to endanger the EU because it had to override its own statutes and treaty agreements to offer bailouts. After twelve years of the euro experiment, it appears that EU's policy of a single monetary policy but separate fiscal policies from each member country has broken down.

History of the Euro

The euro was established by the provisions in the Maastricht Treaty of 1992 (a.k.a. the Treaty on the European Union). The treaty was signed by the members of the European Community on February 7, 1992 in Maastricht, Netherlands. It created the European Union, the European Central Bank (ECB) and the euro currency.

In order to participate in the EU and gain the right to use the euro, each member country were required to meet strict economic criteria. Among the conditions set were a budget deficit of less than 3 percent of GDP and a debt ratio of less than 60 percent of GDP.

The exchange rates of 11 member countries were determined by the EU on December 31, 1998 based on the market rates that day against a non-EU member (principally the British pound). Years later, five other currencies were converted to the euro as their respective countries became part of the EU (see table below).

Currency	Rate per euro	Fixed on	Yielded
Austrian schilling	13.7603	12/31/1998	2002
Belgian franc	40.3399	12/31/1998	2002
Dutch guilder	2.20371	12/31/1998	2002
Finnish markka	5.94573	12/31/1998	2002
French franc	6.55957	12/31/1998	2002
German mark	1.95583	12/31/1998	2002
Irish pound	0.787564	12/31/1998	2002
Italian lira	1936.27	12/31/1998	2002
Luxembourgian franc	40.3399	12/31/1998	2002
Portugese escudo	200.482	12/31/1998	2002
Spanish peseta	166.386	12/31/1998	2002
Greek drachma	340.75	6/19/2000	2002
Slovenian tolar	239.64	7/11/2006	2007
Cypriot pound	0.585274	7/10/2007	2008
Maltese lira	0.4293	7/10/2007	2008
Slovak koruna	30.126	7/8/2008	2009

Source: Wikipedia, European Council

Initially, the euro was introduced in non-physical form (traveller's cheques, electronic banking & transfers, etc.). Actual euro notes and coins came out only on January 1, 2002.

Euro's Wild Ride

After the introduction of the euro, its exchange rate against other currencies fell heavily, especially against the US dollar. From US$1.18/€ at the start of 1999, the euro fell to a low of $0.8228/€ by October 26, 2000. Only after the appearance of the euro coins and notes on January 1, 2002 did the euro gain appreciably (see chart below).

Euro-US Dollar Rate (1999 to present)

Source: Technistock

A major factor in the euro's rise starting 2002 was the low US interest rate environment following the US recession of 2001-2002 which was further aggravated by the 9/11 World Trade Center bombing. The US Fed responded by dropping the fed funds rate to 1 percent, causing a massive flight out of the US dollar and into the euro and other currencies.

By the end of 2007, the euro was making historic highs as famous celebrities jumped on the "dollar bashing" wagon. Supermodel Gisele Bundchen started demanding that she be paid in euros. Meanwhile, rap mogul Jay-Z released a music video in which he is seen flashing euros, not dollars.

At about the same time, the OPEC was already demanding that their oil be paid in euro and not the US dollar. Also, countries like China, Russia and Japan have begun diversifying their currency reserves away from the US dollar. A few months later, just as everyone appeared to have climbed aboard the euro, the currency peaked at US$1.599/€.

Ironically, during the US subprime and credit crises, investors fled all asset classes and sought the safety of US treasuries, resulting in the appreciation of the US dollar against the euro. By late October 2008, the euro went down to a two and a half year low against the US dollar at US$1.25/€ before moving back above US$1.50/€ by November 2009.

In early 2010, concerns over the solvency of Greece and other debt-laden EU members caused a sharp drop in the euro. As of last week, the euro is back at the US$1.2273/€ level.

Back to Parity

A lot of market analysts and commentators are now pointing to euro-dollar parity. Looking back at the previous chart, we note that the major support for the euro is at US$1.18//€.

Based on technical analysis, we can surmise that a breakdown below that level would not only point to a fall towards euro-dollar parity but possibly a decline towards US$0.80//€ in the long-run.

Buffett speaks about EU Debt Crisis

Philequity officers attended Berkshire Hathaway's shareholders meeting in Omaha, Nebraska last May 1, 2010. When asked about Greece and the European debt crisis, Warren Buffet said that "Greece sets its own budget, but cannot print its own money because it shares the euro currency with 15 other countries. So that limits its options and keeps them from printing money to help with credit problems. "

"I don't know how this movie is going to end," he added. "This will be high drama in my view."

Faith in Mankind

In the same meeting, Buffett also discussed his faith in the US capitalist system and for the US to continue to prosper. In fact, in several shareholders meetings, during Q&A sessions and past interviews, he has always said that he has great faith in the human potential and the US capitalist system.

In the next two paragraphs, we quote Warren Buffett verbatim.

"The beauty of it is, the system works very well. I don't have the faintest idea what's going to happen to business or markets in the next year or two. The one thing I know is, over time, people will live better and better in this country. We have a system that works. It unleashes human potential."

"We have these interruptions in the progress of our society. But overall we move ahead, at a pretty damn rapid rate… Every period, every year, there will be a bunch of problems. But - the opportunities will win in the end. Your kids will live better than you live, and your grandchildren will live better, and we'll find more and more ways, easier and better ways, to do things we haven't even dreamed of yet."

Buffett's view of the US capitalist system and his faith in the human potential can be juxtaposed with our view of the world.

Stock markets all over the world have recently dropped precipitously. Volatility has resumed. There is fear again in all risky assets. Crude oil and other most other industrial commodities have dropped. Esteemed banking analyst Meredith Whitney, economist Nouriel Roubini (a.k.a. Dr. Doom), and Nassim Taleb (of Black Swan fame) are the stars once again. Economists are now talking about a double dip and many fear the demise of EU's monetary system and its currency, the euro.

But let history be our guide. We believe that the US, Europe, China and the rest of the world will all get their act together. Just like in previous crises such as World War 1 and World War 2, the Arab oil embargo, the Latin American sovereign debt crisis, the Asian financial crisis, the Russian debt crisis, the 9/11 World Trade Center bombing, the Middle East Wars, the SARS virus and the recent US subprime and credit crises, we believe that, in time, mankind will be able to find ways to get back on its feet and find means to recover. We have faith in mankind. Progress will continue. And the world markets will resume its upward trek after this much needed correction.

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