

Some Observations

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Then and now

- Choice made in 08Q4-09Q1 while "looking into the abyss"
...while vowing to make a change. What change?
- Since then, sadly, little has been resolved
 - **TBTF got bigger**
 - BofA, Citi then, DB, SocGen now
 - **Moral hazard** got worse
 - MBSs then ITL (vs DEM!) debt now
 - **Rating agencies** still ride high
 - FIs then, Sov's now
 - Opaqueness and ambiguity still yields **fragility**
 - level3 then, CDSs now
 - **Forbearance** still name of the game
 - CMBSs then, Sov's now

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The U.S.

- Some positives
 - Corp's flash w cash
 - Households de-lever (albeit v.v. slowly)
 - [*some*] FIs stronger
 - Stress tests not a sham (MacroPrudential)
 - Manufacturing sector buoyant
- However
 - Housing still a disaster
 - Foreclosure... no viable modification plan...
 - Unemployment may break the consumer's back
 - Political gridlock may generate austerity and hit growth

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China

- The miracle of **decoupling**
 - ... result of the mother of all **stimuli**
- 50% of GDP is investment – unsustainable
- Ghost towns, roads to nowhere, gated plants, shady stats
- ...from here to there (Chinese hegemony): a big drop, but no meltdown
- CNY CCYs reserves are likely to be [ab]used in order to bail out \$1-2.5Tril of bad debt

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Europe

- The ultimate **leadership crisis**

- New gvmt in Greece, Italy, Spain
- Past elections in Germany, future in France
- Perception of political meetings generate trading generates reality
- A self-fulfilling spiral
- For example: now waiting for the Dec9 EU Summit
 - Outline of EU departure mechanism ?
 - More signals from Germany on ECB freedom of action ?
 - ECB credit enhancement of sov auctions ?

... Markets seem to be getting numb to news

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Crisis is PATH DEPENDENT

Greece:

- Supposed to go from 10.5%def in 2010 to 8.5% in 2011
- ...looking more like 11-12%
- ...2012 gdp might drop, tax revenues will drop
- ... clearly a lost cause

Spain:

- Unemployment 22% [46% among young]
- Zombie banks
- No monetary freedom [own ccy, own interest rate]
- No fiscal freedom
- Grim future...

Perhaps Greece, Spain were in the cards, Portugal, Ireland too.
But Italy? France? Belgium? Austria?

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What to do then? avoid ibex, buy spx? Short EUR? Long GLD?

- S&P50: E=95, PE=13 → 1230
 - The good: E=100, PE=16 → P=1600 (avg pe=16)
 - The bad: E=90, PE=10 → P=900 (typical rcsn pe)
 - The ugly: E= , PE= → P= (20s 80s: pe=5-9)

- DAX PE is 13.3

But:

- Ibex PE is 8.7 !
- Italian 3y auction at 7.89%

And what about the

- EUR, GLD,...

What are the good "risk trades" here?

Answer is: what probability do you put on PlanA and the path to it

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Plan A: EUxPIG vs. the US

	GDP	annDtoG	totDtoGD		pop	UnEmp
	[\$B]	DP	P		mil	[%]
US	14,526.0	9.0	94.0		312.0	9.0
EUxPIG	10,936.0	3.8	83.4		288.5	10.2
GER	3,286.0	1.0	83.0		82.0	7.0
FRA	2,562.0	5.8	82.0		65.0	9.9
ITL	2,055.0	4.0	118.0		60.0	8.3
ESP	1,409.0	6.5	61.0		46.0	22.6
NLG	780.0	4.2	61.0		16.0	5.8
BEF	467.0	3.9	96.0		11.0	6.7
AUT	377.0	3.6	23.0		8.5	3.9

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Plan A

- Ringfence (...bailout) banks... then drop [PI]G
- IMF gets involved in EasternU, PIG, indirectly in ITL, SPN
- ECB supports Italy and Spain sov.bonds
- ... EUxPIG starts issuing EuroBonds (a *de-facto* fiscal unification)
- ... inflation in DEM austerity in ITL SPN align relative competitiveness

Can we avoid the "*Lehman Moment*"? Probably not

- we need a year, no way we have that
- For Germany to swallow some of the aboves we would need to relook into the abyss

- KEY RISK: once we do, will PlanA still be attainable?
- Here is PlanB

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Plan B



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