



BLUE WATER

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Further Declines in the Euro Ahead

The Euro closed below \$1.30 last week for the first time since January 11th of this year. The Euro is likely to deteriorate further as the European debt crisis deepens and we would not be shocked to see it fall well below \$1.20 and possibly even reach par with the US Dollar. To put that potential move in perspective, the Euro has not traded below \$1 since the fourth quarter of 2003 and it last traded below \$1.20, briefly, in June 2010.

Why do we suggest the Euro is likely to decline significantly against the USD? The fact that the European debt crisis is deepening increases the probability that the whole Euro experiment implodes and the Euro vanishes. While the probability has increased, it remains unlikely for a number of reasons. First, the Euro is a significant, at roughly 25%, component of global foreign currency reserves. That alone will increase the pressure on Europe to find a solution that does not result in the end of the common currency. Additionally, many in Europe, not just politicians, but businesses and average people as well, have a vested interest in the maintenance of the common currency. However, the longer, deeper, and more fractious the crisis becomes, the greater the probability of such an outcome. As traders, speculators, and investors begin to price this risk into the market, the value of the Euro will decline.

Additionally, the crisis is having an increasingly negative impact on the European economy and banking system. This has already led the ECB to reverse its 50bps of interest rate hikes from earlier this year and it is a safe bet that the policy rate will break to new lows in 2012. It is also evident that the ECB will continue to inject liquidity into the Euro-zone banking system and economy next year. All of this suggests a weaker Euro.

Finally, the two issues above suggest a stronger US Dollar as investors flee to the US currency and US Treasuries. In short, the "risk-off" trade is likely to increase the demand for Dollars and Treasuries, not only strengthening the Dollar, but also keeping the yield on US 10-year Treasuries below 2%. In fact, the 10-year Treasury may fall below 1.75% and remain there for some time.

While all of the above suggests a weaker Euro throughout

most, if not all of 2012, there are outcomes over the next 18-36 months that could result in a stronger Euro. One of the challenges in Europe is that the Euro is too strong for the likes of the Greek, Italian, and Spanish economies and likely too weak relative to the economies of Germany and some of the more fiscally sound northern European nations. If Greece and a number of other weaker nations exit the Euro, the currency is likely to strengthen.

It seems likely that a number of the weakest links in the common currency will abandon the Euro before the crisis concludes. Even if Greece goes through a "hard" default, it is difficult to see the Greek economy becoming competitive again without the ability to devalue its currency. While abandoning the Euro will impose significant hardships on Greece, the alternative would be far more painful. Remaining in the Euro would entail massive wage cuts for Greek workers, likely in the range of 40-50%. It is hard to imagine the Greek people bearing such a burden. The faster Greece and the Euro-zone admit this fact, the better off both will be.

It is hard to imagine the Euro-zone without the continent's third largest economy, Italy. But the nation is also the world's third largest debtor behind the US and Japan. We suspect that Italy will leave the Euro for some period of time, seeking reentry after it has gotten its economic house in order. While more competitive than Greece, Italy has structural rigidities in its labor market that must be addressed if it is to become competitive on the global stage. Portugal too, seems likely to need a break from the common currency before all is said and done. Finally, Ireland seems more likely to survive in the Euro-zone as much of its trouble came from the government's attempt to bailout its overgrown banking industry. Despite its debt issues, the nation remains more competitive than others mentioned above.

All of the above suggests that the Euro is likely to weaken significantly, and possibly dramatically, before undergoing a partial breakup. However, after that occurs, the Euro would be the currency for a smaller, but far more economically sound, common currency zone. While this is not the only possible scenario, we believe it to be the most likely.

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