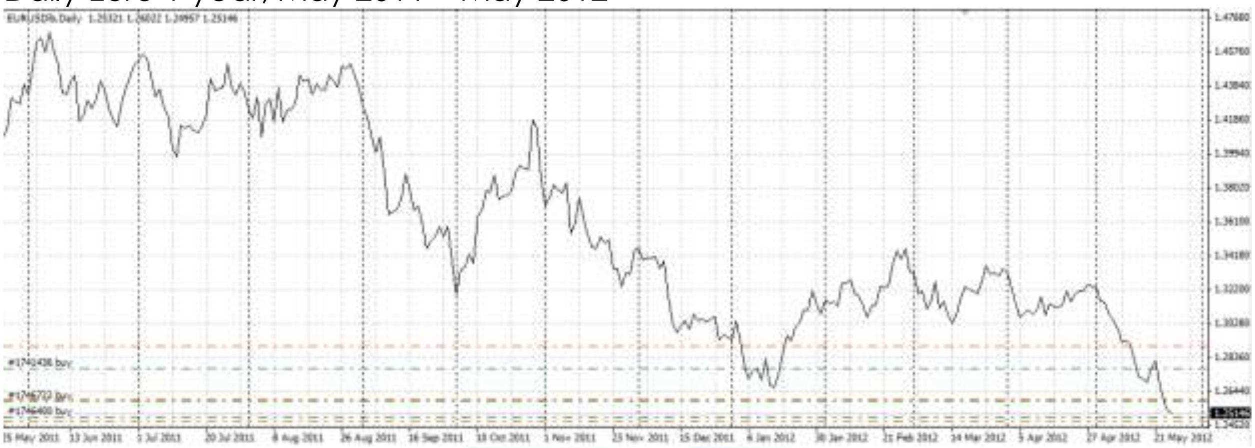
Euro Hedging Analysis: Option protection

Daily Euro 1 year, May 2011 – May 2012



During the past year, we have seen EUR/USD climb down from 1.48 highs to it's current 1.25 – during which time there were periods of volatility such as the 1300 pip drop from August 2011 – Oct 2011, and subsequent 900 pip recovery in October 2011.

A long put was purchased at a strike of 1.20 EUR/USD 100,000 expiry August 1, 2012 when EUR/USD was 1.3230 (April 2012).

Forex Vanilla Option											
EURUSD	1,2000		01-avg-2012	Long Put	100.000	0,0056	0,0107	1.070	510 USD	510	91,07 %

As of today (5/26/2012) it has a market value of $1,070 with a profit of $510, or 91% of the original price. The purchase price to cover 100k EUR/USD at those levels was $560.

It had a profit of 76% - it had a profit of $430, as of 5/23/2012 (see below):

Forex Vanilla Option											
EURUSD	1,2000		01-avg-2012	Long Put	100.000	0,0056	0,0098	980	420 USD	420	75,00 %
EURUSD	1,2000	01-avg-2012	01-avg-2012	Bought Put	100.000	0,0056	0,0098	980	420 USD	420	75,00 %

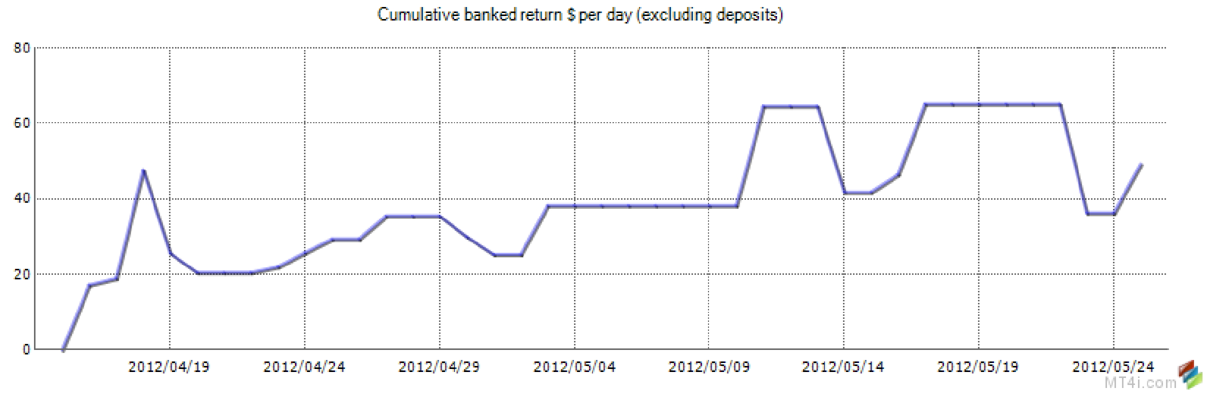
As EUR/USD is going down, the price is exponentially increasing, as is the case with out-of-the money options.

Since last year, EUR/USD has been as high as 1.4868 and as low as now, 1.2555 – a 23% fluctuation. Option protection could provide 2 sided market protection (as EUR/USD didn't go straight down).

This option is an example, properly structured options ladders could achieve a much greater degree of protection in both directions. For example, this is only 1 long put. We could have purchased an option ladder of multiple long puts at differing strikes, such as 1.20, 1.22, 1.24, 1.25, 1.26, 1.2650.

TCCO Strategy 40 day analysis

Since 4/16/2012 EES has been executing the TCCO strategy on a live account using low leverage, at PFG. NOTE: This strategy has been traded on many other live accounts, this is a recent sample created intentionally for the purposes of post trade analysis for future implementation.



Returns

Total return:	0.04%				
Banked return:	0.15%				
Per day:	-	Per active day:	0.01%	Arithmetic mean:	0.01%
Per week:	0.02%				
Per month:	0.10%				

Banked profits per day/week/month/trade

	Winning	Losing	Win/loss%	Best	Worst	Best seq	Worst seq
Days:	12	6		28.64	-28.87	47.64	-28.87
Weeks:	5	1		26.30	-15.88	65.15	-15.88
Months:	2	0		30.00	19.27	49.27	0.00
Closed trades:	81	99		89.24	-80.91	99.22	-102.19

Daily trade statistics

Days where no trades took place are excluded.

Day	Trades	Gross profit	Gross loss	Net profit	% change	Profit factor
4/16/2012	19	44.9	-27.61	17.29	0.06	1.63
4/17/2012	7	54.19	-52.48	1.71	0.01	1.03
4/18/2012	12	123.81	-95.17	28.64	0.11	1.3
4/19/2012	13	23.45	-45.44	-21.99	-0.08	0.52
4/20/2012	3	14.63	-19.74	-5.11	-0.02	0.74
4/23/2012	3	5.93	-4.42	1.51	0.01	1.34
4/24/2012	9	40.63	-36.9	3.73	0.01	1.1
4/25/2012	21	60.93	-57.33	3.6	0.01	1.06
4/27/2012	3	19.12	-13.01	6.11	0.02	1.47
4/30/2012	3	6.2	-11.69	-5.49	-0.02	0.53
5/1/2012	33	267.41	-272.12	-4.71	-0.02	0.98
5/3/2012	12	91.87	-78.89	12.98	0.05	1.16
5/11/2012	9	125.27	-98.97	26.3	0.1	1.27
5/14/2012	9	34.73	-57.49	-22.76	-0.08	0.6
5/16/2012	12	122.5	-117.81	4.69	0.02	1.04
5/17/2012	6	176.55	-157.9	18.65	0.07	1.12

Pairs traded statistics

Symbol	Trades	Gross profit	Gross loss	Net profit	Profit factor
AUDCAD	15	58.56	-68.24	-9.68	0.86
AUDCHF	8	54.77	-69.4	-14.63	0.79
AUDJPY	10	23.09	-100.18	-77.09	0.23
AUDNZD	11	32.17	-14.8	17.37	2.17
AUDUSD	12	54.02	-19.91	34.11	2.71
CADCHF	6	11.33	-28.68	-17.35	0.4
CADJPY	8	30.16	-46.36	-16.2	0.65
CHFJPY	7	63.57	-81.84	-18.27	0.78
EURAUD	12	181.49	-113.48	68.01	1.6
EURCAD	10	120.12	-85.31	34.81	1.41
EURCHF	7	0	-6.94	-6.94	0
EURGBP	13	207.41	-63.01	144.4	3.29
EURJPY	8	174.52	-39.22	135.3	4.45
EURNZD	7	145.99	-39.59	106.4	3.69
EURUSD	7	17.15	-40.24	-23.09	0.43
GBPAUD	2	0	-29.98	-29.98	0
GBPCAD	2	26.09	-56.17	-30.08	0.46
GBPCHF	2	37.12	0	37.12	0
GBPJPY	4	5.41	-76.28	-70.87	0.07
GBPNZD	2	0	-121.03	-121.03	0
GBPUSD	2	14.38	-4.06	10.32	3.54
NZDCAD	5	4.95	-55.28	-50.33	0.09
NZDJPY	3	11.76	-94.53	-82.77	0.12
NZDUSD	2	0.48	-12.75	-12.27	0.04
USDCAD	6	33.27	-33.1	0.17	1.01
USDCHF	5	10.61	-9.5	1.11	1.12
USDJPY	4	42.31	-1.58	40.73	26.78

Return analysis

Leverage used is about 4:1 – by increasing to 40:1 which would be reasonable, returns could average 1% per month. Leverage is calculated based on total position value divided by equity, so we calculate 4:1 based on the fact that if we have 100,000 in positions we have 25,000 account equity, regardless of the number of positions on the account (in the case of this trading session, we had entered many small positions but never totaling more than 100k aggregate position value).

Leverage	Capital	Month profit	Year profit	% Profit	p-fee	m-fee	total fee	Annual fees
4	€ 27,000.00	€ 27.00	€ 324.00	€ 0.00	€ 5.40	€ 45.00	€ 50.40	€ 604.80
40	€ 27,000.00	€ 270.00	€ 3,240.00	€ 0.01	€ 54.00	€ 45.00	€ 99.00	€ 1,188.00
40	€ 100,000.00	€ 1,000.00	€ 12,000.00	€ 0.01	€ 200.00	€ 166.67	€ 366.67	€ 4,400.00
40	€ 2,000,000.00	€ 20,000.00	€ 240,000.00	€ 0.01	€ 4,000.00	€ 3,333.33	€ 7,333.33	€ 88,000.00

The above table extrapolates scenarios using 40:1 leverage with 100k and 2m capital base. With 2 million Euros being managed, in 1 year the clients would have received a profit of 8% after fees, or €152,000. During that same year it would have generated €88,000 in fees for the management company.

The floating drawdown in percentage terms would never have exceeded 2.6% at any given moment. In this month example, all trades were closed at the end of the month, but there may be situations where a floating drawdown occurs from month to month, during extreme market events such as the Earthquake in Japan.

Extrapolation of the volume of 696,000, on a 2m account, is 417m monthly and 5 billion annually. We may receive additional commissions from this volume, but will not count on it. However with volume figures like that we can negotiate better spreads from our counterparty and possibly additional benefits.

The €88,000 in annual fees would be enough to run the operation. Of course, we can expect trading capital to grow as we establish our track record.

NOTE: This analysis has been done on a worst case scenario basis. For example, the 2.6% drawdown based on the leverage is the largest. The drawdown is usually much lower. Also it's possible that in a month, we earn 2% instead of 1%. Also we may receive some additional commissions with larger volume created from the banks. So these numbers are a reasonable, conservative estimate.

Forget about Angela Merkel – Let's hope for a German Housing Bubble

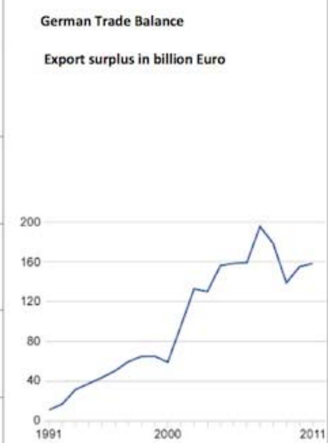
07/05/2012 By Frank Hoffer 32 Comments

This crisis has been good for Germany. Unemployment is at its lowest level since unification, real wages are going up after a decade of stagnation, up to now exports are booming, tax revenues are plentiful, and hence a public deficit of just 1% – well below the Maastricht

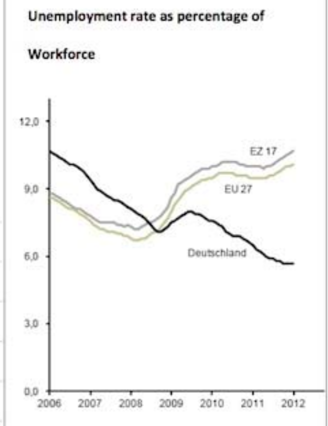
criteria – was possible without any major spending cuts. Thanks to the crisis in the Mediterranean member states the Euro exchange rate is staying low despite Germany's massive export surplus. Emerging sectoral labour shortages are mitigated through growing (high skilled) immigration from Spain, Greece, Portugal and Eastern Europe. Low interest rates of the ECB deliver negative real interest rates for Germany, which is good for investment. Money from other European countries is flooding into the country stabilizing the balance sheets of the German banking system and pushing up real estate prices that had been depressed for decades.

Percentage change of real wages in Germany to previous year	
2008	0.5
2009	-0.4
2010	1.5
2011	1.1

Source: Statistisches Bundesamt 2012[3]



Source: Statistisches Bundesamt 2012



Source: Monatsbericht März 2012 Bundesagentur für Arbeit

Source: https://www.destatis.de/DE/ZahlenFakten/GesamtwirtschaftUmwelt/VerdiensteArbeitskosten/RealloehneNettoverdienste/Tabellen/Reallohnindex.html?nn=50680

Were it not for the turmoil in so many neighbouring European countries for Germans the question would simply be "crisis – what crisis?" Not only does the economic situation defy any crisis talk, also politically Germany has never, since the times of Bismarck, been simultaneously that powerful and respected in Europe. However Ms Merkel seems to lack the wisdom of the greatest conservative chancellor in German history, and some of her ministers and advisers are affected by the Wilhelminian disease of overconfidence and arrogance that proved so fatal for Germany a century ago. Instead of balancing the different interests in Europe – masterly done by Bismarck – Ms Merkel pursues a strategy of German dominance:

"We do not merely want to survive this crisis. Germany shall re-emerge from it stronger and better equipped for the future."

And the German Chancellor actually means what she says. Priority is not given to solve a European crisis, but to strengthen German dominance in Europe. That is why both Helmut Schmidt the conservative social democrat, and Helmut Kohl, the social democratic Conservative, who governed Germany for a quarter of a century, spoke out publicly against Germany's current European policy. Integrating Germany into Europe, replacing fear and dominance by partnership, cross-border cooperation, and sometimes even friendship are achievements no German could have dreamt off after the allied forces opened the gates of Auschwitz, Buchenwald and Bergen-Belsen. Ms Merkel seems at least to underestimate the fragility of these outstanding achievements of post-war German foreign policy.

Economists critical of German policy apparently think that the insistence of Pan-European austerity results from intellectual convictions such as the hawkish anti-inflationary legacy of the *Bundesbank*, the commitment to Ordo-Liberalisms, or a general lack in Germany of Keynesian understanding of the macro-economic dimensions of the crisis. However neither Nobel Laureates such as Paul Krugman and Joseph Stiglitz, nor Martin Wolf – the *Financial Times*' most influential commentator, nor Christine Lagarde, as French Minister of Finance, succeeded in 'enlightening' German decision-makers and convincing them to change course. Why is this the case? Aren't the flaws of the austerity strategy obvious? Maybe not.

By and large the German government advocates policies that have been pursued by the World Bank, the IMF, and the neoclassical mainstream for decades, that have been the gist of structural adjustment programmes, and the advice to deficit countries during the Latin American and the Asian crises. The only difference is that the crisis is closer to home this time. Now the IMF in its recent World Economic Outlook warns that too rapid fiscal adjustment can become self-defeating and there is growing concern in deficit countries that regaining competitiveness through slashing wages and public expenditure is costly and likely to result in a deflationary race to the bottom instead of a recovery. In the past they were not that concerned about deep recessions, high unemployment and misery in deficit countries as long as debts were serviced. Structural adjustment imposed on many countries in the eighties and nineties was bad for the suffering countries, but not for creditors. This might also be the case now. Surplus countries might prefer brutal distributional fights in deficit countries to burden sharing and debt forgiveness. Ironically putting the adjustment burden solely on the deficit countries not only drives the interest rates on their sovereign debts up to unsustainable levels but also pushes German bond rates to historical low levels: allowing the German Government to borrow at negative real interest rates.

It might not be the lack of understanding that stops the German government supporting expansionary policies for a European recovery, but that it doesn't see its benefits for its more narrowly-defined national interests.

As blunt economic and political Machiavellism this might even be a successful strategy, though there are serious doubts about its sustainability. A further contraction of neighbouring European countries will of course reduce German export opportunities to depressed economies, but this might be compensated by the disappearance of competitors and – thanks to a low exchange rate – a stronger performance outside the Eurozone. Or in other words, if Italians buy fewer cars, but Fiat goes bankrupt VW might even benefit and as long as the crisis keeps the Euro down, the German export machine is the biggest beneficiary. Indeed for the time being the German policy works for Germany. But it will isolate Germany politically; it will mobilize anti-German sentiments throughout Europe and, sooner or later create European alliances to cut the political influence of Ms Merkel and Germany down to size.

As the public mood, the media, the business elite, and the academic mainstream in Germany are firmly behind the austerity agenda it is unlikely that the German hard-line approach will be replaced by a policy that is willing to give priority to European partnership and soidarity. The remaining hope hence rests on a Hegelian “*List der Vernunft*” (cunning of reason) that ensures actors unintentionally do what’s historically necessary. Avoiding a long, painful, and ultimately unsustainable deflationary adjustment process in European deficit countries requires a rapid increase of internal demand and higher prices in Germany in order to rebalance the Eurozone. Obviously the best ways to achieve this would be wage increases above productivity growth, and a public investment programme to improve the poor German education system and support the greening of the economy. Unfortunately there are few signs that Germany is willing to pursue such a policy. Though it is encouraging that the trade unions are finally having some success in putting an end to wage moderation, but so far this is too little, too late.

The second best alternative to a deliberate and democratically determined expansionary growth policy is a debt-based consumption and investment boom fuelled by a housing bubble. The good news is that there is a bubble in the making. Historically low interest rates, fear of the inflationary effect of ECB policies and foreign capital inflow seeing German real estate as a safe haven pushed house prices up by 5% last year and even more rapid price hikes are reported in the big cities. Construction is picking up and becoming an important engine of growth. The wealth illusion created through asset inflation will hopefully create a rapid credit expansion and increased consumption spending. A tighter labour market will help the German trade unions to make real wage gains. Inflation will rise faster in Germany; imports will rise, as well as the ability of Germans to spend their money on holidays on the shores of the Mediterranean. Hoping for a big German housing bubble to save Europe does not sound like a sustainable solution. But postponing a crisis means – for the time being – avoiding a breakdown of Europe.

However, will the prudent Germans follow the careless Spaniards, the lazy Greeks and the free-drinking Irish in believing in ever-rising house prices? Of course they will. During a bubble that’s what rational people do, as not buying is as stupid as selling too late.

But will German politicians not – in the light of the bitter experience in Spain, the UK or the US – take precautionary measures? Probably not, as rising housing prices are wonderful for everybody and very popular as long as they continue to go up. Politicians, bankers, and the usual experts will tell people that they shouldn’t worry. “A housing bubble is, for the time being and in the light of - by international comparison – still low German housing prices an unnecessary concern.” Professor Sinn one of the best-known German economists told the public in April 2012. Standard & Poor’s, well known for its failure to detect the subprime mortgage crisis, again sees no reason to worry: “However, we believe that the modest recovery in house prices is based on a healthy foundation of demand exceeding supply rather than on speculation, and on low interest rates.”

As in the US, the UK or Spain there might be a big mess when the music stops, but for the time being let us hope for a big party. Given the political and economic nationalism in Berlin, the alternative is the mess without the party.

Safe as houses? Rising prices fuel German 'bubble' angst

Tue May 8, 2012 8:45am EDT

* German property prices buoyant, central bank on alert

* Investors lured by German "safe haven" status

* German prices and yields still below EU average

By Peter Dinkloh

FRANKFURT, May 8 (Reuters) - Einar Skjerven wants to spend 71 million euros ($93 million) on apartments in Berlin for German and Austrian clients, but decided to hold off after prices surged in a city long famed for its cheap, abundant housing.

House prices elsewhere in Germany have also accelerated after years of stagnation, prompting fears in some quarters of a real estate 'bubble' in a country deeply sensitive about any sign of inflation. Germany's central bank, the Bundesbank, has said it will monitor prices "very closely".

Others take a more sanguine view, arguing that conservative German banking rules and demographic factors will prevent the kind of boom and bust cycle that has ravaged Ireland and Spain.

"Particularly in the second half of last year some houseowners had crazy ideas about the value of their property," said Skjerven, the 46-year-old head of Berlin-based Industrifinans Real Estate.

"We have given it a year longer than originally expected to invest our clients' money," said Skjerven, whose company bought no apartments in Berlin in the second half of 2011.

Residential property prices in German cities rose 5.5 percent last year, after 2.5 percent in 2010 - hardly a 'bubble' compared to the double digit increases seen in parts of Europe before the 2008-09 global credit crunch but quite heady by German standards.

Prices of newly built flats jumped more than 10 percent in Berlin, Frankfurt and Duesseldorf in 2011, DZ Bank economist Thorsten Lange said. By comparison, house prices in Spain were down nearly 20 percent at the end of 2011 from their pre-crash peak and in Ireland they had almost halved.

Given the continued uncertainty over the fate of the euro zone and choppy equity prices, German real estate has seemed a safe and attractive option for investors, not least for affluent Greeks and Italians anxious to shield their hard-earned savings

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from economic crisis at home.

"Right now we see money fleeing from other assets into real estate," said DekaBank chief economist Ulrich Kater. "That led to the first movements of prices and those movements can take on a life of their own."

Echoing that concern, Steffen Sebastian, head of the Institute for Real Estate Finance at Regensburg University, said: "Prices are moving into an area where they do not make sense any longer. We see the beginning of a bubble."

STRONG DEMAND

The value of houses and flats traded is set to reach a five-year high of more than 6 billion euros ($7.8 billion) this year, said Jones Lang Lasalle, which provides real estate services.

Underpinning demand is Germany's strong recovery from the global crisis. Its economy grew by 3 percent last year and economists see it expanding by a further 0.9 percent in 2012, avoiding the recession engulfing the euro zone periphery.

German unemployment has dipped below 7 percent to its lowest level since reunification more than two decades ago.

In a sign of booming property demand, the state courthouse in Frankfurt, Germany's financial centre, moved to a larger auction room to accommodate 30 percent more people than usual attending forced sales of houses and flats, one official said.

The Bundesbank's vigilance is understandable. House price bubbles are more harmful than those in other asset classes - it was sub-prime mortgages in the United States that triggered the biggest global financial crisis since the Great Depression - and even in Germany - with its relatively low owner occupancy rate - far more people are invested in housing than in, say, stocks.

Germans have a visceral aversion to rising prices, rooted in the hyper-inflation of the early 1920s under the Weimar Republic that wiped out the savings of a generation.

Germans are also less keen than other people to own houses: Only 46 percent own the property they live in, the lowest rate in the European Union. The quality of flats for rent is high and tenants are well protected against rent increases and evictions.

Germany's last real estate bubble in the early 1990s demolished parts of Germany's construction industry and led builders such as Hochtief and Bilfinger Berger to drastically shrink their residential construction business and move into such areas as building services.

But there is a fundamental difference in today's situation.

The earlier boom was driven by tax breaks - now scrapped - that encouraged investment in eastern German property after reunification. The boom proved short-lived and prices have been mostly stagnant or falling for much of the past two decades.

Today there is real demand for housing because the number of households is still rising as more people live on their own, even though Germany's population has been shrinking since 2003.

"Right now we have a split market: people move from rural areas into cities where they find jobs and universities," said Franz Eilers, economist at the association of mortgage banks.

"In the countryside prices are stagnating and in the cities they are rising."

Given demographic projections in a fast-ageing society, investors realise this bottleneck will not last forever.

"People definitely want to have earned their returns before 2020," said Konstantin Luettger from CBRE, an adviser to institutional and other large-scale investors in residential real estate, referring to the declining population.

CONSERVATIVE LENDING

Germany's population, the largest in the European Union, is expected to fall to 79 million by 2025 from 82 million now and to as low as 70 million in 2050, according to official figures. Offsetting that, at least in the shorter term, is an expected increase in the number of households due to social changes.

Eloed Takats from the Bank for International Settlements, the central bank trusted with overseeing international financial stability and one of the few institutions to warn of a housing bubble, estimates that house prices will fall "substantially" over the next 40 years.

The BIS also said housing price bubbles "were generally associated with credit booms".

Easy credit, however, is hard to come by in Germany where banks are quite strict in their lending practices.

It is common in Germany to buy a property with at least 20 percent equity, the Cologne Institute for Economic Research said, which restricts the number of people buying houses as well as the overall value of loans outstanding.

Equally important is the fact that banks base secondary loans to houseowners not on the market value of the property, as in the United States, which can further inflate prices. They are based on the collateral value, a value that can be generated even in adverse economic circumstances, said Michael Voigtlaender from the Cologne Institute.

"Fortunately banks don't finance very aggressively in Germany," said DekaBank's Kater. "More debt and easier credit would be the prerequisite for a bubble."

In a recent study of house price gains in Germany, Unicredit Bank economist Alexander Koch presented an "Overheating Barometer", an index of five real estate market indicators measuring market excesses on a zero to five scale, with five signalling the highest alert. Germany scored just one, below France and in line with Britain and Italy.

Investors' expectations themselves run counter to a bubble in Germany, as many do not expect to benefit from rising prices, but are seeking a reliable place to keep their money.

"I don't care so much about rising prices, it's the fact that the downside is limited," said Joe Valente, who helps manage $1.3 trillion for JP Morgan from London.

The Global Property Guide, a website for investors in residential property, shows central apartments in the main German cities are the cheapest among Europe's five largest economies.

But even these comparatively low prices only allow rental yields of 3.7 percent, roughly in the middle range of eurozone countries. That reduces the scope for further house price increases because they would further reduce yields.

BulwienGesa, a real estate agent cited by the German central bank, forecast price increases will slow this year and DZ Bank sees prices growing at 2 percent, just below the ECB's projected inflation rate of above 2 percent.

Einar Skjerven said he was ready to buy again in Berlin.

"We have to get some houseowners' expectations down to realistic pricing, but it's working and we are therefore back in investment mode." ($1 = 0.7603 euros) (Editing by Gareth Jones and Giles Elgood)

May 25, 2012, 11:26 AM

More Economists React: What if Greece Exits Euro Zone?

Article | Comments (25)

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By Laura Clarke and Katie Martin

The prospect of Greece leaving the euro is the only thing anyone is talking about in the markets at the moment. It even has its own nickname: Grexit.

While the world holds its breath for the next Greek elections or major policy announcement, speculation of an exit runs rife.

It is important to emphasize that nothing is certain here; Greece may or may not leave, and there's a huge range of potential policy responses. So, making allowances for some guesswork, from U.S. political upheaval to a knock-on effect for Mexican bonds, here's a rundown of the latest on some economists' and analysts' views on what could happen next. (See previous insights here.)

MORGAN STANLEY: The bank echoes calls for a sufficient firewall to prevent a spillover into other peripheral markets in the event of a Greek exit, also saying the structure of this firewall will determine the medium-term direction of the euro. "The firewall is unlikely to receive much in the way of additional fiscal support, as local budgets of most European Monetary Union members are stretched, suggesting the European Central Bank will play a vital role in strengthening the firewall. However, the more the ECB gets involved in helping to create a sufficient firewall, the weaker the euro. A Greek exit will also create bearish economic second-round effects, which will be felt by core countries via weakening export dynamics too," Morgan Stanley analysts say.

CREDIT SUISSE: The bank believes the Grexit probability for the next year to be lower than the broad 50:50 market consensus, and that political drivers will decide.
"We would expect the contagion from implied FX risk to be considerable. In the absence of bold policy moves…it's likely that financial turbulence would lead to a further, or complete, breakdown of the euro."
The bank believes the most promising response is economic, fiscal and political union. "At its most extreme, it could mean a rapid (and effective) move towards the issuance of Eurobond…[and] a shift towards a pan-euro bank regulation and resolution regime, where the costs of future bank rescues are potentially borne by the euro area as a whole. A softer version of this would be to give the European Stability Mechanism powers to recapitalize banks directly…[but] it's not clear that the political will is there," it says.
Other potential policy responses–but less promising in Credit Suisse's view–would be ECB tools, involving renewed, and possibly aggressive Securities Markets Program buying of Spanish and Italian government debt.
Alternatively, the ECB could be more aggressive.

“This would have to be a formal quantitative-easing program that bought euro-area sovereign debt on a similar scale to that seen in the U.S. or U.K. Although that would likely mean the ECB buying a broad basket of euro-area sovereigns (not just the periphery), it would have a greater chance of stabilizing capital flows as it would imply a greater mutualization of sovereign risk, albeit on the ECB’s balance sheet,” says the bank.

FITCH: The ratings firm warned that Spanish and Italian insurance companies were especially at risk from a Greek exit, as a result of their large holdings of sovereign debt from peripheral nations. It noted that insurers typically carry large inventory of their home-nation sovereign debt and as such are extremely vulnerable to the repercussions of sovereign downgrades. Under the conditions of an orderly Greek exit, contagion would probably be limited to Italy and Spain. If it were disorderly, the effects would be much more widely felt, Fitch added.

CAPITAL ECONOMICS: “Leaving the euro zone could indeed be the only way for these countries to avoid a sustained and damaging period of deflation [and] an exit and devaluation would result in a significant and lasting boost to a departing country’s competitiveness, potentially kick-starting an economic recovery.”
The repercussions if Italy and Spain left would be immense, causing another deep recession. But for Greece, and possibly for the rest of the currency bloc, the advantage of regaining full control of monetary and fiscal policy is likely to outweigh the costs. “After a partial breakup, euro-zone policy makers may feel less need to set an example for weaker countries that have left, perhaps prompting looser monetary and fiscal policy. It may eventually result in all the existing euro-zone economies staging stronger and more balanced growth than if the euro zone remained intact.”

DEUTSCHE BANK: Amid all the concern about Greece leaving the euro altogether, Deutsche Bank suggests another path: introducing a parallel currency, which it nicknames the “Geuro,” to run alongside the remaining common currency. Leaving the euro altogether would cause economic, political and social chaos, the bank says, whereas a parallel currency would give the authorities “the power to stabilize the exchange rate of the Geuro…so as to keep the door open to a future return.”
Rather than a clear-cut and fully voluntary process, Deutsche Bank thinks that a Greek exit would emerge as the unwanted conclusion of a series of micro-decisions on the austerity package, bank recapitalization and the role of the European Central Bank.
In the long run, Greece could be better off out of the euro area, but the change to another currency regime would be extremely painful for the country in the nearer term, with a contraction in the economy and in disposable income worse than was seen in Russia and Argentina. Containing the damage from a euro exit would require swift action and a capacity for policy coordination that has seldom been seen since the beginning of the crisis.

J.P. MORGAN: There’s now a 50% chance of Greece leaving, up from 20% before the country’s politicians failed to produce a coalition government. Regional unemployment could be higher than “anything seen in the past half-century.” In terms of policy responses “the euro-system’s direct exposure appears manageable in the context of large revaluation gains but if losses exceed the readily available buffer, euro-zone sovereigns may be called upon to make immediate capital injections.”
Among the paths it lays out from here, the “chaos scenario” for JP Morgan goes as follows: “outright victory by the Radical Left or significant influence in a coalition and declaration of a debt moratorium, which the ECB/International Monetary Fund/European Union troika would respond to by ending the financing program and denying Greece access to ECB borrowing. If Greece then introduced the drachma, EUR/USD would probably decline to 1.10 due to widespread capital flight from the region. If instead the government backtracked and re-engaged the troika given that 80% of the electorate favors retaining the euro, the currency would stabilize around 1.20.”
A Greek departure is likely to be disruptive and disorderly, pushing the euro to around $1.15-1.10 against the dollar and causing a 2% drop in euro-zone gross domestic product.
Even if the systemic shock of a Greek exit is avoided, the region looks set to be in recession through year-end, says the bank. Elevated levels of stress are “likely to erode growth momentum for a while…the key issue is not the survival of the euro area, but what sort of euro area survives. Germany wants one where prosperity is broadly based across the region, rather than one where the region is dependent on large, ongoing fiscal transfers from the North to the South.”

MITSUBISHI UFJ SECURITIES: “The timing of a Greek exit from the EMU…will depend crucially on the extent to which Berlin can tolerate the squandering of further German taxpayer funds in the mission of securing safe loss-free exodus of Greek funds in the meantime. The subjective view here is that exit will be earlier rather than later,” says the investment bank.

It also suggests wider consequences of a Grexit such as a potential political quake in Berlin and Washington, “The exit will have profound consequences for the future of EMU, the future of political stability in Germany and for the future of Obama-ism and Bernanke-ism in the U.S…[it] will be the beginning of the end for the Maastricht Union. Most likely the route to a new reformed union will pass through other exits, most prominently of Spain.”

The bank adds that a Greek exit could attract U.S. swing voters towards Republican presidential nominee Mitt Romney and be used as a political tool against President Barack Obama and his commitment of U.S. funds to the crisis in the area.

CITIGROUP: “There are many scenarios for a Greek exit; almost all of them are likely to be euro negative for an extended period,” says the bank that coined the now-ubiquitous “Grexit.” If the process is managed, which the U.S. bank deems unlikely, expect a short, sharp selloff in the euro, with a subsequent rally up to $1.45 or higher. If Greece just dumps the austerity program and walks, the risk of contagion rises, and “the euro could begin to rally, but so much damage will have been done by then that it would begin its rally from a much lower level and probably not be anywhere close to the current level at the end of the year.”

If the stronger countries were to break away, some see euro gains ahead, but Citi reckons that “this can take a very long time and is probably well beyond an investible horizon.” All in all, the outlook for the common currency is “not very promising…unless policy makers surprise with decisiveness.”

Citi sees three possible scenarios for an exit; a managed departure with a firewall implemented to prevent contagion (which would push the euro to $1.20), a scenario where such a firewall is insufficient to prevent a euro-zone break-up or risk aversion (heralding a drop to $1.13) and a disorderly worst-case exit with excessive volatility in other markets. The latter scenario sees Citigroup forecasting that the euro could fall as low as $1.01.

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One London-based analyst said the government's handling of Bankia had undermined confidence in whether the figure announced would cover losses. "Whatever they say, people are going to think it's not enough," said the analyst, who spoke on condition of anonymity. "The process has been going on for so long."

Spain is nationalizing the bank, which holds some 10 percent of the country's total deposits, after it was unable to handle heavy losses from a 2008 property crash.

The government insists that Bankia's woes do not reflect the wider financial system in Spain.

Spain will have to go to the markets to raise debt to put into Bankia at a time when its borrowing costs are high.

Spanish banks, flush with cheap liquidity from the Central Bank in the first part of the year, increased their holdings of domestic government debt in April while foreign investors have cut their holdings.

CATALAN WOES

Catalan leader Mas's comment helped to drive the euro currency to a 22-month low. Spain's country risk, as measured by the spread between German and Spanish bonds jumped to 495 basis points from around 460.

Treasury Minister Cristobal Montoro has pledged to come up with a way to back regional debt by July. On Friday, Deputy Prime Minister Soraya Saenz de Santamaria said the central government was still looking at options.

"These are complicated mechanisms that must be analyzed," Saenz de Santamaria said at a weekly news conference.

The government was implementing measures to make it faster and cheaper for people to start up small businesses as Spain tries to meet European demands to make its economy more competitive, she said.

The regions have 36 billion euros of debt maturing this year and have been priced out of international bond markets. Catalonia's debt rating has been cut by S&P credit rating agency to one notch above junk.

Mas said Catalonia's options for refinancing were central government bonds or debt guarantees, high-priced short-term bank debt or the limited market for selling patriot bonds to Catalonian residents.

ADDITIONAL SPENDING

While struggling to put a precise number on a banking sector clean-up, Spain has also revised up its 2011 deficit figure several times as additional spending from regional and local governments has come to light.

The conservative government of Prime Minister Mariano Rajoy plans more than 45 billion euros in savings this year to try to bring the deficit down to 5.3 percent of GDP, a mission many say is impossible.

Spain has gone through four different stages of rescues of its banks, none of which has completely convinced investors that the clean-up has been deep enough.

Now it may end up creating one nationalized bank out of its failed lenders, including Bankia, if the state cannot find buyers for state-rescued banks like mid-sized Catalunya Caixa.

Two sources close to the situation said that the FROB bank restructuring fund, which has taken over several banks to resell them, was considering delaying the auction of Catalunya Caixa and smaller savings bank Banco de Valencia.

Under pressure from the European Union, the government has hired independent auditors to produce a report on the financial system. International institutions such as the European Central Bank and International Monetary Fund will scrutinize the audit to give it credibility.

Bankia shares have fallen 34 percent since its former Chairman Rodrigo Rato stepped down on May 7, in a prelude to the state intervention in the bank. The shares were suspended pending the announcement later on Friday.

Remember Ireland, Iceland, and Hungary also. More to come.