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European Monetary Policy and its prospective ramifications: Follow-Up

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What a wild and strange week it has been in Cyprus! It has been 8 days since I e-mailed you about what I consider a notable a development in the European Union (EU): the proposed levy/tax on depositor's balances in Cypriot banks. And while there have been many modifications of the initial proposal, at least one thing remains the same: the Cypriot banks are still closed. (ATMs are operational but there is a government imposed daily-withdraw limit of €100.)

Given the competing demands on all of our time, particularly shoveling snow here in Kansas City and nationwide March Madness Bracketology, below is a quick refresher:

Why was this levy being proposed? The tax was designed to raise enough capital to qualify the country to receive bailout funds from the Troika (the combination of the European Central Bank (ECB), the International Monetary Fund (IMF) and the European Commission (EC)).

Why did Cyprus need bail-out funds? Cyprus had loaned a lot of money to the Greek government and Greek corporations – both of which technically defaulted on their obligations a few years ago. When an entity "technically" defaults on its obligations, the creditor "technically" receives less than they were expecting under the initial terms of the loan. (Editorial comment: it has become politically palatable to "technically" default on things these days, as the adverb insinuates imminent full satisfaction of the outstanding obligation, and the non-performance is a function of time and not intent. Not "technically" - that is impossible in this situation.)

How did the banks make it this far if the Greek debt situation got really bad 3-4 years ago? Great question. Solely by virtue of the Cyprus government stepping in to assist through nationalizing one of the largest Cypriot banks and favorably loaning tons of Euros to the others. However, the cost of those funds has been increasing. Just like here in the US, the Cyprus government funds its operations by selling bonds. And the interest rates on those bonds has been increasing faster than the Cypriot economy has been growing. In the world of high-finance, that presents a problem known as "negative arbitrage," or put more simply: unaffordable and unsustainable. So, it was the Cyprus government that reached out the Troika for assistance as they feared expulsion from the EU (a 17-member aggregation of European countries that share a common currency, the Euro, and are subject to the monetary policy of the ECB). The Cyprus president agreed, pending Parliamentary ratification, to subject the country's depositors to the aforementioned tax as condition precedent to receiving bail-out funds. The plan was to raise enough capital (approx €6 billion) to demonstrate a serious commitment to the Troika and have them fund any remaining "gap" on favorable terms.

Isn't this where the last e-mail you sent left off on March 18th? So has anything new happened? Yes and yes. So the Cypriot parliament did not pass the levy legislation, in fact, of the voting members (the ruling party members abstained) absolutely no one voted for it, necessitating a quick revision. And the current revision looks like this:

Depositors with more than €100,000 (approx $129,000) in Cyprus banks will be spared from the levy, though those with larger than €100,000 will be assessed upwards of a 30% levy[1].

In addition, and these are all yet to be 100% finalized:

- Some large banks will be closed and deposits transferred to state-run banks[1];
- Bank bondholders will take losses/write-downs on the money owed to them[1];
- Capital controls will be implemented (measures to keep people from withdrawing money from their bank accounts) [2].

What about the whole Russian involvement and the rumors of a Cyprus being a haven for money-laundering and post-Soviet economic corruption? This is the subject of much debate but less factual evidence. I thought the quote below from NPR's web site did a great job in framing some perspective:

"The financial mess on Cyprus is thus not the product of Russian money, but of parallel failures of European governance and of Greek Cypriot risk-taking. However, Russian (and Russophone) money certainly bulked up the problem, just as foreign funds did in Iceland, Ireland and on Wall Street. The Russians, in other words, added a bunch of zeros to the scale of the crisis, but they did not create it.

Now, Russian oligarchs and companies—many of them effectively national entities, like Gazprom—are facing significant losses on their Cypriot accounts. They are annoyed, as they had figured a Eurozone economy was ultimately insured by the German taxpayer.

They figured wrong. The Troika (a.k.a. the European Commission, European Central Bank, and the International Monetary Fund) negotiated a no-nonsense rescue package with the newly-elected government of the Republic of Cyprus. The Greek Cypriot administration initially tried to tax its population, rather than impose the entirety of the costs on foreigners (and risk them taking their dirty business elsewhere). The parliament in Nicosia, however, gagged on this idea, and the revised "bail-in" now pending will end up hitting the Russians hard.

Moscow has condemned not only the substance of the Troika package, but also the fact that EU institutions had negotiated

the deal with an EU member state without Russian participation. It then demanded a three-way mechanism, of the Troika, Russia and Cyprus. Moscow, in other words, wanted a seat at the table of the European club, of which it is not member, and a seat equal to the entire club."[3]

The Cyprus banks intend to open in 2 days, and under an entirely different set of operating circumstances under which they closed for business just 10 days before, and so we are left to ponder the implications for the world financial markets. I have had this discussion with many clients over the past week and I have to resist the temptation to dismiss this as inconsequential until learning that it is. Not dismissing it however, is not necessarily indicting its impact. So below are 2 items of importance that we are closely monitoring:

The Euro/Dollar exchange rate: Weaker Euros make dollar-denominated products more expensive. More expensive products typically sell fewer units. Mathematically, even the same number of units sold at a higher exchange rate equate to less revenue. In coming quarters (when companies report profitability), this could be a headwind. If this is combined with other headwinds, like the initial effects of sequestration, the elevating costs of the new Affordable Care Act and/or the persistently high unemployment rate, there may be a tendency for disappointments in earnings reports.

The flip-side of this point is that the relative quality of the US currency may continue to attract capital to our country, generally, and to our debt markets, specifically. Attraction of debt market capital keeps borrowing costs low, allowing more of every dollar of revenue to fall to the "bottom-line" (profitability), improving or maintaining the valuation of our stock market.

Confidence and access to capital are the axes on which capital markets pivot: These 2 conditions – one anecdotal and one empirical – tend to be most notable only in their absence. Recent history is littered with the interrelation of the two and the canary in the coal mine is any sign of impediment in the flow of international credit. While our own Federal Reserve Bank and those of Japan and the ECB are doing what they can to keep the world awash in liquidity, once confidence abates, risk enters that is more difficult to mitigate with easy money.

Much has been written about whether dealing with Cyprus as they have will be a specific and unique approach/remedy by the Troika or be replicated should similar situations arise in countries like Spain or Italy. Officials have indicated both at different times and the prospects of overlaying such a strategy on a more systemically important banking system is not inspiring. We will be alert to any evidence of signs of capital flow reduction as the Cyprus bank bail-out proceeds.

In managing a portfolio, it is critical to maintain a balance and a bias. The balance is a function of three primary inputs: need for income, time horizon and intestinal fortitude (otherwise known as a threshold for risk). The bias leans into or away from risk as the expected returns from the assets classes of: stocks,

bonds and alternative assets, dictate. Why we assess situations like Cyprus is simple – if it elevates risk in our portfolios through the consideration of fluidly assessing items like the 2 above, then we modify accordingly. Much like I'm sure you are thinking about the length of this e-mail……it is a long and arduous process! Have a great night and we will continue to keep in touch on this. dc

[1]http://www.reuters.com/article/2013/03/26/eurozone-cyprus-russia-idUSL5N0CH1LG20130326
[2]http://www.nytimes.com/2013/03/26/business/global/bailout-or-no-cypriots-simply-want-their-money.html?pagewanted=all&_r=0
[3]http://www.usnews.com/opinion/blogs/world-report/2013/03/26/a-russo-european-spat-over-cyprus

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