

The Death of the Euro

RMB Special Report – Updated!

Fall / Winter 2011

Greek Tragedy

- ✓ *Greek debt is simply too big to pay off* – the question is not whether Greece will default on its obligations, but when. Last year’s \$160 billion bailout wasn’t enough and another \$100 billion this year won’t be either. Greece owes too much and has to pay too much to borrow. Bailouts simply kick the can down the road.
- ✓ *Greek bonds have priced in a 95% probability of default* – two-year Greek notes yield an incredible 45% (as we write this), which is 44.5 percentage points more than German debt of the same maturity. As we write this, ten-year Greek bonds yield 18%, which is 15 percentage points more than their German counterparts. The market is telling us it expects a default.
- ✓ *Greek rates are too high to refinance* – the big problem for Greece is refinancing. It needs to borrow money to pay off debt that is coming due now. Borrowing at current rates (see above) just digs a bigger hole.
- ✓ *Enforced austerity robs revenue and damages economic output* – the very austerity demanded by borrowers damages the Greek economy, drains future revenues to make future bond payments and is self defeating.
- ✓ *Contagion* – a Greek default by itself would cause big banking disruptions. Should it spread to Ireland, Portugal, Spain and Italy, it could make Lehman’s demise look like a walk in the park.

Requiem for a Dream

It was a noble experiment. A confederation of nations with a history of making war comes together in peace to create a monetary union and share a common currency. All constraints to trade within the union would disappear. Populations and goods would cross borders and the result would be prosperity for everyone. And it seemed to work...until now!

Unfortunately, the founders of the euro failed to take into account politics, geography and Europe’s history of nationalism. They failed to predict that differences in culture and language would keep the European economy fragmented and unequal despite a common currency and open borders. Ask a Texan his nationality and he will inevitably say, “American.” Ask a Californian hers and she’ll say the same. But ask a German or Frenchman and the odds are good he or she will say “German” or “French,” not “European.”

Americans move all over the 50 states in search of work. And while Europeans can theoretically do the same, differences in language, culture and skill-sets make this kind of economic flexibility rare in practice. The problem with the European Union and the euro is simple: Greeks and Portuguese won’t move to Germany or France to capitalize

on the booming sectors of the European economy and, more importantly, the Germans and French don't want them to.

Before the euro, the weaker nations of Southern Europe would do what weaker nations always do: lower interest rates and weaken their currencies. This would accomplish two things: (1) make their debt cheaper in real terms, and (2) increase exports, boosting their domestic economies while providing more cash flow for debt service. But, Portugal, Ireland, Italy, Greece, and Spain (the PIIGS) can't do this anymore because they are not in control of their currencies. The European Central Bank (ECB) is.



The ECB is controlled by the two strongest members of the euro-zone: France and Germany. France and Germany do not want a weaker euro because unlike their southern neighbors, their economies are strong. They want to avoid the inflation their southern neighbors want and need.

France and Germany and, to a lesser extent, Britain and the US have another problem: the money-center banks headquartered in these “strong” nations loaned billions of dollars to the PIIGS. A default by any one of them could cause cascading defaults by the others. The banks would have to write down these loans, ruining their capital base and causing even more defaults. It would be Lehman Brothers all over again – only this time on a global scale.

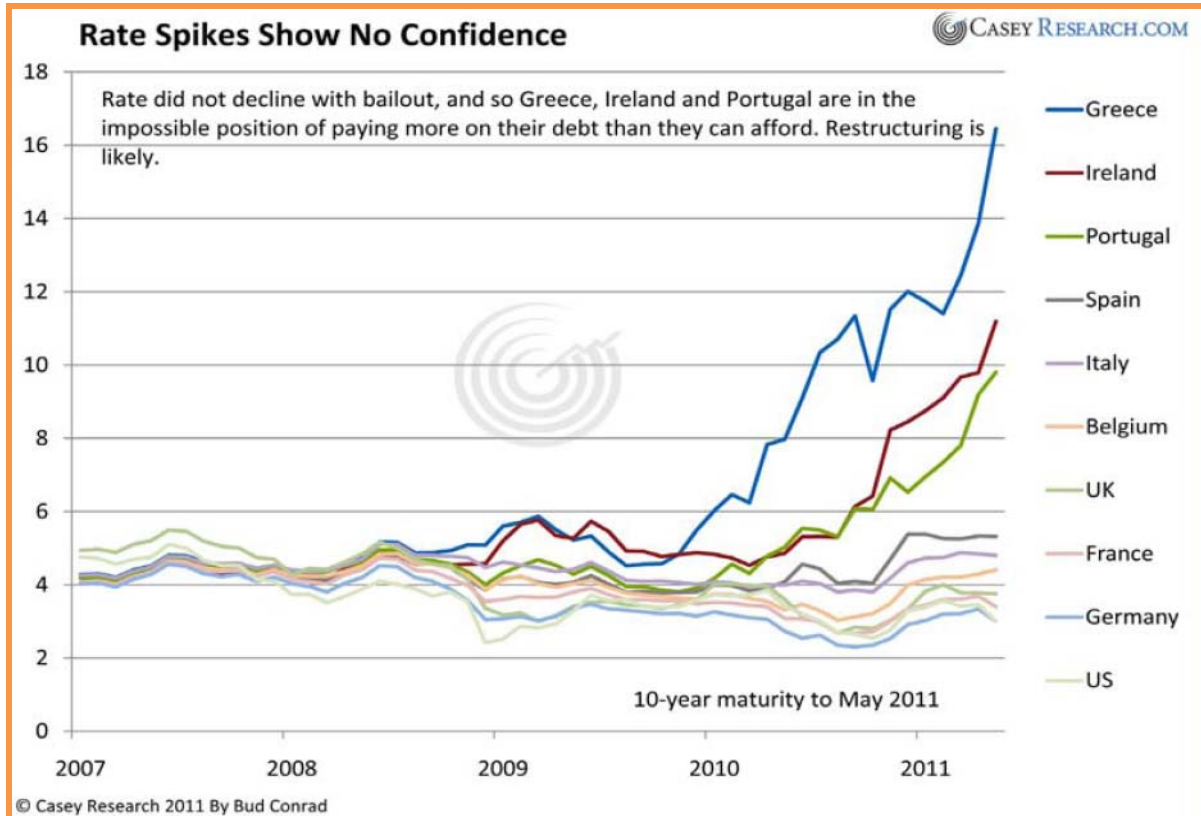
This “contagion” may have already begun. As we write this, Greek bonds (bunds) currently yield 18%, – a full 15 full percentage points more than German bunds – to account for default risk. Greek 2-year notes currently yield 45 percent, an incredible 44.5 percentage points more! Portugal’s yield over German bunds has exploded as well. This is what keeps bankers up at night.

The Problem (As Always) Is Debt

Greece’s debt is expected to explode to 158% of GDP in 2011. This is just one of the reasons why **S&P downgraded Greek debt to its lowest possible rating, CCC/Negative** – a rating far worse than even economic basket-case, Belarus. But Greece is not Belarus. If it defaults, the grand experiment called the “euro” could come crashing down.

Can't happen, you say? A similar scenario already has. Loads of American homeowners – many who can afford the payments – decided to walk away from their

mortgages and “wipe the slate clean.” US home prices crashed as a result. We can debate the morality of this, but defaulting homeowners made a rational, self-serving determination that the quick pain of default was better than years of servitude paying for an asset that may never return its original capital.



Unlike many American strategic defaulters, Greece can't afford the payments on its notes. Virtually no one is making the argument that Greek debt can be paid off. Central banks talk about the Greek problem being “managed” or “rescheduled”, but these are just different terms for the inevitable. One strategic default in a hard-hit American neighborhood often leads to others. Similarly, a default by Greece could lead to defaults by other weak euro-zone nations. After all, no one wants to be the last rat off a sinking ship. (Chart above courtesy of Casey Research www.caseyresearch.com)










Why wouldn't Greece choose the quick pain of default over decades of indebtedness and slow death by economy-killing austerity? Austerity is clearly not working. Greek unemployment soared to 15.9% in the first quarter, up substantially from the 11.7% rate reported in the first three months of 2010.

No Way Out

So what is the solution? Unfortunately there are really only three solutions to overwhelming debt: **1) Grow fast enough to service the debt, 2) Default and stick your**

creditors with the bill, or 3) Devalue the currency the debt is denominated in, thereby reducing its “real” burden. The US is struggling with its debt burden by using a combination of solutions #1 and #3. Europe could do the same, but the price would be a weaker euro and higher inflation. Germany, France and the ECB are dead-set against the latter but ultimately, may have no choice.

Worst of the Worst
 After Monday’s downgrade, Greece is now the lowest-rated sovereign debt covered by S&P.

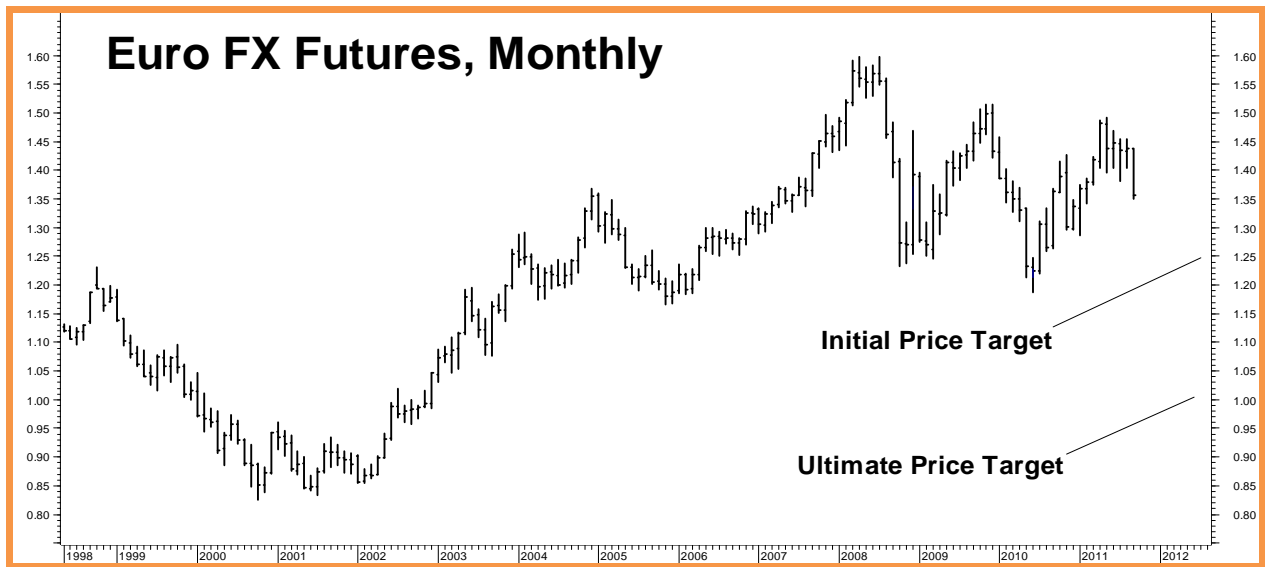
COUNTRY	S&P RATING/ OUTLOOK
 Greece	CCC/Negative
 Jamaica	B-/Stable
 Ecuador	B-/Stable
 Pakistan	B-/Stable
 Grenada	B-/Stable
 Fiji	B-/Positive
 Belarus	B/Watch Neg
 Argentina	B/Stable
 Belize	B/Stable
 Ghana	B/Stable

Note: Some countries are unrated.
 Source: Standard & Poor’s

Enforced austerity takes the economic growth option off the table. That leaves only one other option: default. **A default by Greece (inevitable, we believe) will probably lead to strategic defaults by other weak euro-zone members and send the euro tumbling anyway.**

In fact, all the potential solutions involve a weaker euro at some point in their respective lifecycles, including the least contemplated of all: Greece and other weaker European states dump the euro, default on their debts and reinstate their original currencies. The euro ceases to exist and comes back

as a stronger, northern European currency (an “über-euro”). Meanwhile, the current iteration of the euro gets trashed.



The ECB has already tried to manage this by raising interest rates, which generated periods of euro strength – none of which lasted long. **China is buying European debt to manage the decline in the euro. We expect this to generate even more periods of strength which we view as selling opportunities.**

Ultimately, we believe the long-term direction of the euro will be lower. The euro was “born” buying \$1.18. There has been a lot of talk about the “death of the dollar” but the way we see it, the euro is far sicker and will be the first to meet its demise. Our 5-month downside target for the common currency is \$1.25, then \$1.18 and ultimately \$1.00 (“parity”).

It’s not like the euro hasn’t been down before. It may be hard to believe, but the common currency fell hard shortly after its introduction in the late 1990s, crumbling to 82.5 cents to the dollar during the dot.com crash. (*See chart Euro FX Futures, Monthly*) What do the early 2000s have in common with today? Artificially-low interest rates and a bursting liquidity bubble caused by “irrational exuberance” and exploding debt.

Why We Prefer CME Euro Options to ETFs & ETNs

- 1) *CME euro FX options are a direct play on the underlying currency. Euro ETFs and ETNs may not be –* for example, Market Vectors Double Short Euro ETN (symbol DRR) is a non-interest paying debt security pegged to a euro-based index. Because it is a debt obligation, it is subject to the solvency of its issuer.
- 2) *CME euro FX options have critical cost advantages* – enabling traders to make bets on the direction of the common currency for much less than ETFs and ETNs.
- 3) *CME euro FX options combine big leverage with fixed risk* – the trade suggested in this report costs \$1,250 (plus transaction costs) with the potential to make \$5,000 should the euro decline 9% by March 9, 2012. Given the same % move, a double-short ETF or ETN would yield just \$225.

Today’s debt problems are not only worse, they are global. If 2008 taught us anything, it was how interconnected the global financial system is. We doubt a small economy like Greece could take down a currency in 2000. Today it is not only possible, but in our opinion, highly likely.

What to Do Now

So how do we play it? We could commit a lot of capital to the over-the-counter currency market or ETFs and make our bearish bets that way. *Or* we could take a relatively small amount of capital and make a series of infrequent low-cost, fixed risk, long-term leveraged bets on the euro itself – dramatically reducing our capital exposure while increasing our staying power in the event the euro’s trip southward takes longer than we expect.

Rather than buying a slow moving, capital-intensive inverse currency ETF, **we suggest making a direct play on the euro itself by using Eurocurrency options traded on the CME.** The euro FX options traded in the CME in Chicago represent the most liquid, exchange-traded, foreign currency option market on the planet, making them as easy-to-trade as most stocks. And unlike options created by certain cash dealers, ours

are protected from counterparty risk by the Exchange Clearing Corporation, insuring the integrity of every trade. **This makes them the perfect tool for an anti-euro bet.**

Each CME euro option covers €25,000. A CME euro option quoted at .0100 (one cent) would be worth \$1,250.00. (Multiply the contract size of €25,000 times 1 cent and you get \$1,250.) Euro options are quoted in hundredths of a cent, making each point or (tick) worth \$12.50.

→ Suggested Action – bearish euro: consider placing an order to buy March 2012 \$1.30 euro puts while simultaneously selling an equal number of March 2012 \$1.25 euro puts for a net cost of 100 points (\$1,250) or less, looking for the euro to decline to chart support at \$1.30 prior to option expiration on March 9, 2012.

Your maximum risk, if filled at the price suggested above, is \$1,250 plus transaction costs. Your net profit potential is \$5,000 per spread.

Considering doing this trade in multiples of 2 if possible. Once filled, consider placing a second open order to exit half your position at double what you originally paid, taking your initial risk off the table in the process.

Set It and Forget It!

The trade suggested above is a professional trading strategy known as “bear put spread.” When we buy the bear put spread suggested in this report we are paying money for the right, but not the obligation, to be short the euro at a price of \$1.30 and simultaneously receiving money for the obligation to be long the euro at \$1.25. We use the money we receive for our obligation to be long at \$1.25 to partially offset the money we’ve paid to be short at \$1.30. This reduces both the cost of the trade and our “out of pocket” risk.

We can make the 500 point (5 cents) difference between our right to sell the euro at \$1.30 and our obligation to buy it back at \$1.25, but no more. Multiply 5 cents times the €25,000 contract size and get a gross profit potential of \$6,250 per spread. Subtract the \$1,250 cost of the trade to get a net profit potential of \$5,000.

The phrase “net cost of 100 points or less” tells the broker on the trading floor that we want to do *BOTH* legs of this trade simultaneously and we want to spend no more than a net of \$1,250 for the *entire position*.



One of the nicest things about this strategy is its low cost and limited risk. All we can lose, even if we are dead wrong and the euro manages to shake off its recent Greece-inspired malaise, is the \$1,250 (plus transaction costs) we pay for our spreads. This gives us the ability to weather any temporary price swings. **We can “set it and forget it” and get on with our lives.** By taking this insider’s approach to foreign currencies we get both big potential and peace of mind.

We chose the strike prices of our bear spreads based on the price action of the euro itself. The market negated the euro’s first quarter uptrend in early May. The break below near-term support at \$1.38 could take prices as low as \$1.25 in the next few months.

The March options we suggest using in our bear spreads do not expire until March 9, 2012 – giving us plenty of time to be right. Prices may have changed by the time you read this, so you may need to adjust the trade slightly.

A good broker familiar with option spreads should be able to help you. If you do not have one, the brokers at **RMB Group** know this strategy inside and out and can help you design a position suited to whatever market conditions exist. **Our intermediate-term target is \$1.25, but our long-term downside target is parity.** With the euro trading at \$1.37, that means there should be plenty of downside opportunities as the Greek tragedy engulfing the Eurozone plays out.

Editors’ Note: If you are a trading customer, expect a follow-up to this report when and if the euro reaches our \$1.25 objective. We believe this could be just the beginning of a sustained downside move and may want to reposition ourselves on the short side.

Getting Started

You cannot trade the foreign currency options in this report in your stock account. You need a separate commodity account. The members of the **RMB Group** have been helping their customers trade foreign currency futures and options since 1984. Call them toll-free at **800-345-7026** or **312-373-4970** direct. They'll send you everything you need to get started. Or visit their website at www.rmbgroup.com. Tell the **RMB Group** you read this report and receive the *RMB Short Course in FX Futures and Options*, a \$14.99 value, plus a month of trading publications and do-it-now *RMB Currency Trader Alerts* absolutely free.

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- ✓ *We Actually Call You* with trade entry and exit recommendations. You don't have to learn a new website or a new way to place orders.
- ✓ *Our Specialty Is* "set it and forget it," fixed-risk plays so you can finally declare independence from your computer.
- ✓ *We Are Not* an online broker or your father's stockbroker, but we are definitely "old school" when it comes to customer care and support.

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