

CREDIT CRISIS IN EUROPE:

How the Stability
of an Entire Region
is Teetering on the
Edge of a Major Collapse

By Brian Whitmer, Editor
The European Financial Forecast

Credit Crisis in Europe: **How the Stability of an Entire Region is Teetering on the Edge of a Major Collapse**

By Brian Whitmer, Editor of *The European Financial Forecast*

Introduction

EWI's *European Financial Forecast* Editor Brian Whitmer has been anticipating and tracking the credit contagion across Greece, Ireland, Spain, Portugal and other European nations. Whitmer's subscribers were first alerted to the still-developing crisis back in December 2009, when he warned that a set of troubling events across Europe were signaling the entire continent was on edge. But as Europe enjoyed a partial recovery along with the rest of the world, the mainstream media lost focus. Whitmer did not. He continued to warn that the mid-2010 scare in Europe was only a small sign of what's still to come. Recent developments suggest that the markets have finally caught up to Whitmer's forecast. These recent excerpts from *The European Financial Forecast* provide the context for what's happening in Europe now.

Contents

1. *A Modern-Day Greek Tragedy Takes Center Stage* (February 26, 2010) 3
2. *Well, It Was a Recovery* (May 28, 2010) 5
3. *Panic Now and Avoid the Rush* (July 30, 2010) 6
4. *Hip, Hip HoorAAy* (October 1, 2010) 7
5. *Spotlight Ireland: A Country About Out of Luck* (November 5, 2010) 8

About the Author

Brian Whitmer is editor of *The European Financial Forecast* for Elliott Wave International and also contributes to the European stock section of *Global Market Perspective*. Along with Elliott wave analysis, he uses sociometrics, the science of history and social prediction, to forecast financial markets and cultural trends in Europe. After graduating from the University of Maryland, he received his MBA from Georgia Southern University. Since joining Elliott Wave International in 2009, Brian has spoken at numerous European conferences and institutional gatherings, including Institutional Investor's European Pensions Symposium and the Zurich chapter of the Market Technicians Association.





The **European Financial Forecast**

Edited by Brian Whitmer

From *The European Financial Forecast* published February 26, 2010

A Modern-Day Greek Tragedy Takes Center Stage

The panic attack that enveloped Greece in early February should serve to caution anyone who has yet to move into the safe assets recommended in *Conquer the Crash*. In contrast to the slow start of wave **c**, today's downturn comes with the memory of the financial crisis still firmly lodged. As a result, the decline should get rolling more quickly.

Notice below that the Greek FT-ASE index is leading Europe lower. In a mere three months, Primary wave ③ has almost fully retraced the entire 2009 rally. Like Dubai's debt problem, the Greek tragedy appears to be contained for now, but social mood across Europe is again declining at Primary degree. Greece's woes aren't over and neither are its neighbors', meaning that more surprises are sure to come. The critical difference between now and the start of wave **c** in 2007 is that governments are all but out of ammunition to fight another crisis. At some point, markets will force an unconditional surrender. Be prepared. The sheer pace at which panic jumped from Athens into the eurozone signals how rapidly fear can spread during a downturn of this magnitude.



The "Flawed Euro" Concept Takes a Giant Leap Forward

For years, Elliott Wave International stood virtually alone in our belief that the euro's creation represented merely an optimistic extreme brought on by decades of rising stock prices. It's nice to see that mainstream bankers, economists and politicians are finally taking notice, too. Strategists at Société Générale recently used the word "inevitable" to describe an eventual euro collapse. Remember that France is a core founding member of the euro, so the definitive proclamation from one of the country's oldest and largest banks speaks to the extent that euro-skepticism has now penetrated the very core of the continent.

Learn more about the latest issue of *The European Financial Forecast*: www.elliottwave.com/wave/latestEFF

To return to Club EWI for more free resources, go to: www.elliottwave.com/clublibrary

© 2010 Elliott Wave International

The British, on the other hand, have never shied away from criticizing the European currency, but the recent crisis has turned their usual cynicism into full-blown abhorrence. “The Greece episode has made it painfully clear how flawed the euro project was from the very beginning,” says the director of Open Europe, a UK think-tank. At a recent conference, British Tory party leader, David Cameron, called the European currency a “straitjacket,” promising that Britain will “never join the euro,” if he is elected. In the United States, former euro cheerleaders have quickly switched sides as well. Six months before the currency’s all-time high, a prominent American economist called the euro “as important a global currency as the dollar.” His latest op-ed, “The Making of a Euromess,” typifies the about-face we’ve seen in recent weeks. “The fundamental problem was hubris,” he now writes, “the arrogant belief that Europe could make a single currency work despite strong reasons to believe that it wasn’t ready.”

For our part, the January 2010 *European Financial Forecast* identified the start of a major decline in the euro, and the trend continues. Reports of an imminent eurozone breakup are probably still premature, but Cycle wave c down in stocks should continue to benefit currencies that are perceived as safest. Short term, dollar-denominated treasury bills provide the level of safety that we advocate.

Market Psychology

The financial media’s ability to find a silver lining in the Greek debt crisis provides another subtle indication that the bear market’s work is far from over. We described previously that the euro has gathered a new throng of detractors, but as far as we can tell, media reports on the European Union itself are glowing. On the same day that EU leaders promised to safeguard eurozone stability with “determined and coordinated action,” news reports cheered the show of solidarity. The story here says that the Greek crisis may actually be an opportunity for EU nations to come together—sort of like bickering siblings who put aside their differences when a family member becomes ill. Here’s how the Financial Times tells it:

Rescue Plan Points to Closer Economic Links

The German-led efforts to rescue Greece ... are the most dramatic of several recent signs that the 27-nation bloc may be on the threshold of a new surge towards closer economic integration.

Others include a willingness to use new instruments set up under the EU’s Lisbon treaty to pursue more synchronized economic policies, and the imminent publication of a report ... on how to energize the bloc’s single market.

Indeed, at EU headquarters in Brussels, it was business as usual. “The trend is always to reinforce European union, not to weaken it,” said European Commission president, Jose Barroso, who spoke to reporters outside an EU summit on February 5. “The crisis has opened a window of opportunity for EU leaders to push for fiscal integration and coordination,” added an analyst with RBS European Economics.

That may be true, for now, because a massive stock market rally has only just recently ended. It still seems plausible, then, that EU nations can come together to bail out a suffering member. But the crisis will not stop in Athens, and the unified front established by Europe’s leaders will undoubtedly deteriorate along with the market. Our December 2009 Special Report, “The Coming European Tinderbox,” illustrated how precisely European unity follows the dominant trend in stocks. The nascent downturn has apparently already gripped a large swath of the public. A February poll in the German newspaper, *Bild am Sonntag*, found that two-thirds of Germans adamantly oppose any EU country providing assistance to Greece. Even more telling, a majority of Germans, or 53%, want Greece *to be expelled from the euro* if necessary. One way or another, EU leaders, too, will give in to this growing public anger. The cohesion that has been on display up to now will not last.

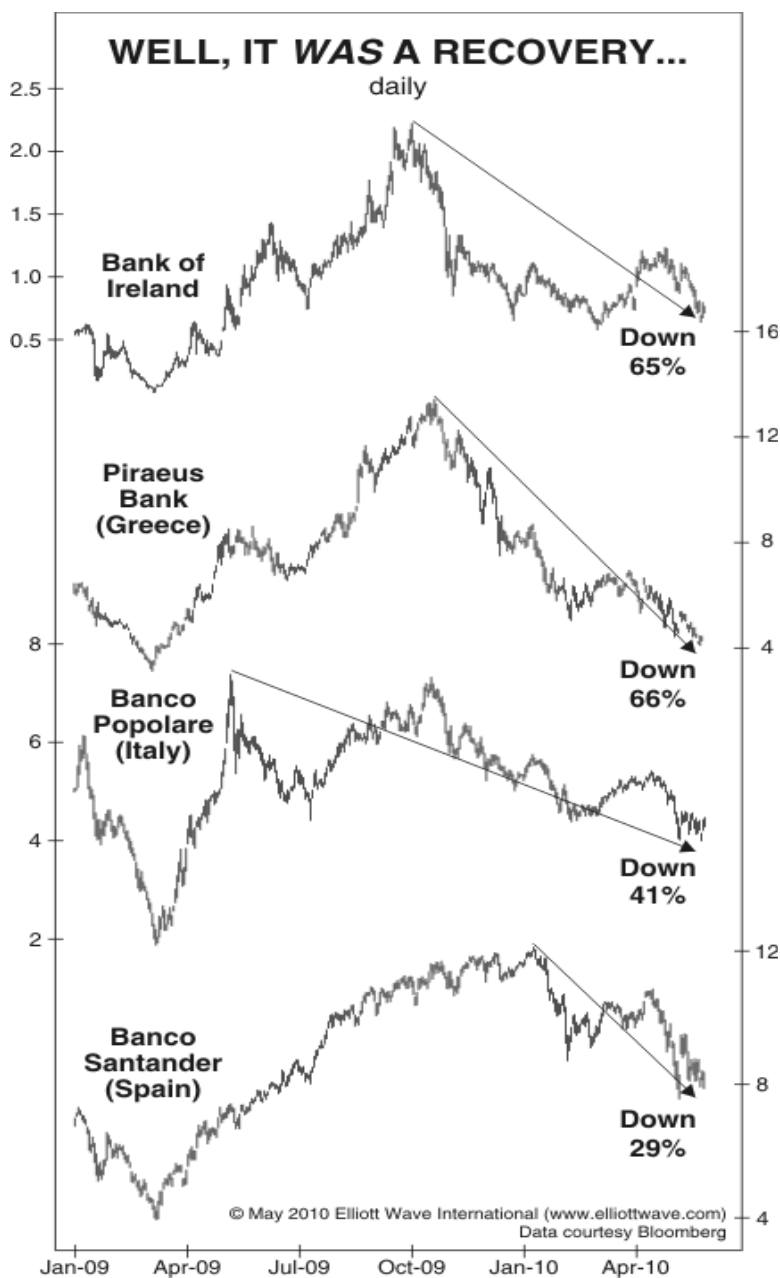
Learn more about the latest issue of *The European Financial Forecast*: www.elliottwave.com/wave/latestEFF

To return to Club EWI for more free resources, go to: www.elliottwave.com/clublibrary

© 2010 Elliott Wave International

From *The European Financial Forecast* published May 28, 2010

When a fresh pile of bad debts forced the UK Treasury to inject another £39 billion into state-owned banking groups, RBS and Lloyds, the December 2009 *European Financial Forecast* stated, “[I]f this is what a ‘recovering’ banking sector looks like, the coming third wave should be a sight to see.” Since then, there’s been a merciless pounding. The four banks shown here are some of the oldest and most venerable in their respective regions. The Bank of Ireland, for example, is the second-largest Irish banking group, originally established by royal charter in 1783. Piraeus Bank is one of Greece’s four largest banks, founded nearly 100 years ago. Banco Popolare formed from the merger of two banking giants with 150 years of history. And Santander is one of the world’s largest banking groups by market capitalization. The big declines in the stock prices of these age-old financial institutions have more or less foreshadowed the bear-market rip current that is now dragging entire countries out to sea.



The critically important difference since the financial sector last made front-page news is that, today, a renewed bear market is only just beginning, not ending. To understand why this situation represents an escalation of the financial crisis, recall the sequence by which the last crisis spread as stocks reached their Cycle wave **b** peak in 2007. Then, as today, problems first emerged on the periphery, as only the most marginal and highly leveraged lenders initially gave way to the deflationary downturn. Only after many months of decline did debt problems arrive at the world’s largest commercial and investment banks.

Today, the crisis has *begun* with the big banks and, as we’ve shown over the past several months, it has seeped into the most marginal sovereign nations. It won’t stop there. Just as almost no one foresaw the disintegration of venerable financial institutions like Bear Stearns or Lehman Brothers in early 2008, most still balk at the idea of a major sovereign nation defaulting. “Italy is not in the same situation as Greece,” says European Central Bank president Jean-Claude Trichet. “Spain is not Greece,” claims the UK Guardian. “The U.K. is no Greece,” declares a May headline in the Telegraph. The ugly truth is that the only thing separating these countries from Greece is the fragile confidence that they are, indeed, distinct. That confidence will erode as markets descend.

Learn more about the latest issue of *The European Financial Forecast*: www.elliottwave.com/wave/latestEFF

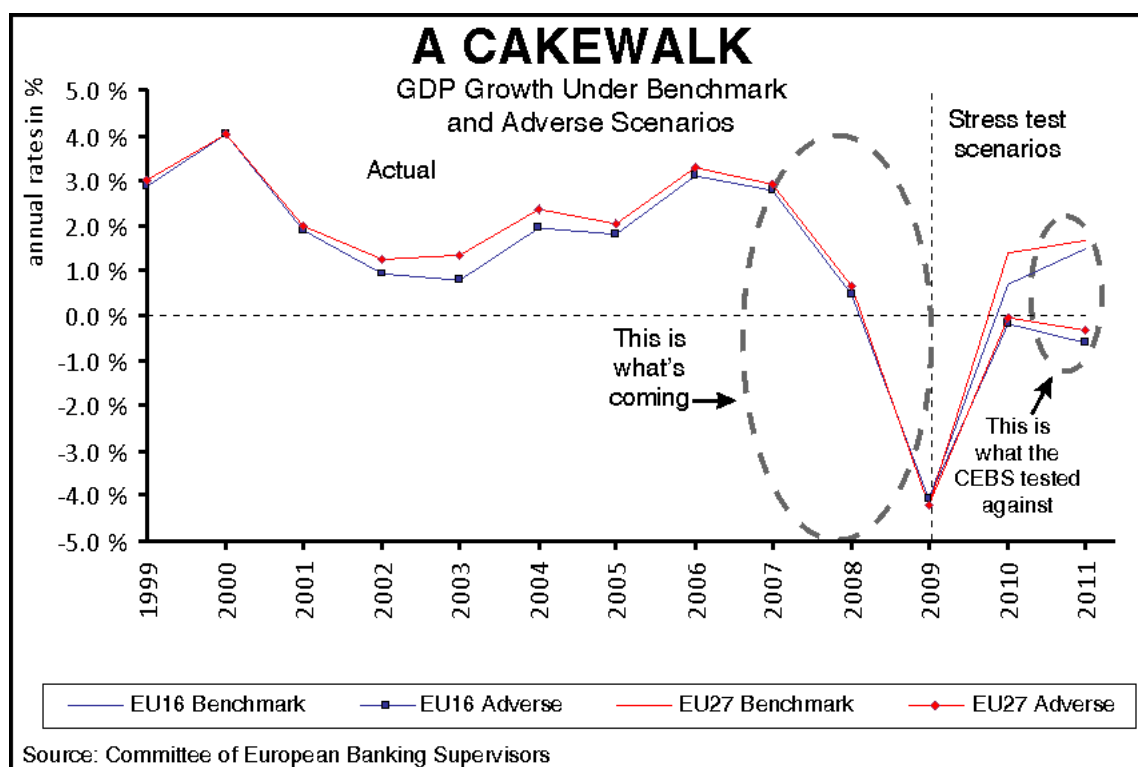
To return to Club EWI for more free resources, go to: www.elliottwave.com/clublibrary

© 2010 Elliott Wave International

From *The European Financial Forecast* published July 30, 2010

Panic Now and Avoid the Rush

The market's collective sigh of relief is also reflected in authorities' stress testing of 91 European banks. In case you missed last Friday's results, their message is clear: relax. The Committee of European Banking Supervisors (CEBS) gave passing grades to nearly every bank on its list. The group, for example, passed both Irish banks and all four UK banks that it evaluated. The CEBS gave clean bills of health to all four Portuguese banks, all five Italian banks, and five out of six Greek banks that it analyzed. And don't lose any sleep over the four banks we showed on page two of the June 2010 *European Financial Forecast* either. Even with share prices that sit 29%-66% beneath their 2009 countertrend highs, the CEBS says that the Bank of Ireland, Piraeus Bank, Banco Popolare, and Banco Santander are all in good shape. In fact, just seven of the 91 banks failed to make the grade. Five were in Spain, one in Greece, and one, Germany's Hypo Real Estate, is entirely owned by the German government anyway. Everyone else – 84 institutions in all – are supposed to be strong enough to withstand another economic shock.



It's not so much the stellar results that expose the optimism of a Primary degree rally, but rather the Banking Committee's stress tests themselves. They are notable primarily because they failed to test for any real stress in the first place. As the chart shows, the Committee's "adverse scenario" regarding economic performance assumed a mere 3% deviation from the European Commission's GDP forecast. Another test looked at banks' resilience to a sovereign-risk shock, yet the analysis merely used conditions similar to those of May 2010. In other words, just like the UK budget office, the CEBS is utilizing a woefully diluted version of the economic deterioration that is about to grip the continent.

Learn more about the latest issue of *The European Financial Forecast*: www.elliottwave.com/wave/latestEFF

To return to Club EWI for more free resources, go to: www.elliottwave.com/clublibrary

© 2010 Elliott Wave International

From *The European Financial Forecast* published October 1, 2010

Hip, Hip HoorAAy

In other signs of complacency, successful bond auctions have allayed investors' concerns over Europe's near-term solvency. Last month, the Irish National Treasury Management Agency sold all of its intended €1.5 billion of government bonds, while Portugal raised €750 million in 4- and 10-year notes amid "strong investor interest." Spain, Greece and Hungary also successfully sold shorter-term debt. Authorities breathed a sigh of relief and quickly informed the press: "Confidence is slowly and steadily returning in Greek debt" said Petros Christodoulou of the Greek Public Debt Management Agency. "[T]here is no question of any imminent danger to the Irish sovereign," said Ireland's finance minister Brian Lenihan. Don't listen to these cheerleaders. Europe's sovereign debt crisis is much closer to a beginning than to an end.

A number of reporters have questioned the timing of the credit rating agencies, which slapped triple-A ratings on the €440 billion European Financial Stability Facility (EFSF) mere days before last month's bond auctions. Recall that the eurozone governments established the EFSF after the May 2010 flash crash in order to stabilize the region's bond markets in the case of future "market disruptions." We'll let others attend to conspiracy theories. For our purposes, the structure of the EFSF alone showcases the continent's ill-preparedness for the next crisis.

For one thing, the ratings agencies have bestowed AAA status on an emergency facility that, at present, has exactly zero euros to combat an emergency. The plan, in fact, is to have the Facility itself borrow the money it needs, when it needs it. Here's how Standard and Poor's primary credit analyst Moritz Kraemer justified the Facility's AAA rating in his September 20 report: "It is our opinion that the eurozone governments are strongly and publicly committed to EFSF.... If a eurozone member receives approval for EFSF funding, EFSF would issue bonds in the capital markets and on-lend the proceeds to the sovereign borrower after deducting an amount to serve as a fungible reserve." In other words, much like the IOUs they will issue, the Facility at this point is merely a €440 billion pool of promises.

On top of that, Ambrose Evans-Pritchard of the UK Telegraph points out this curious fact: Half of the Facility's guarantors are not even rated AAA themselves. In fact, just three AAA-rated commitments – those from Germany, France, and the Netherlands – are primarily supporting the Facility. According to S&P, the two scenarios that could endanger the Facility's rating are: (1) if any of the three AAA-rated countries were to be downgraded and (2) *if they wavered in their support for the fund*.

Make no mistake, support for the fund won't just waver, it will collapse during the next Primary degree decline. You can literally bet on it. Five months ago, when the bailout package sailed through, the June 2010 *European Financial Forecast* described the public attitude that will accompany the next significant bottom: "[C]ountries will laugh at the notion of neighborly assistance, and bailouts will cease altogether." Germany's €120 billion promise makes up the Facility's largest commitment by far, yet the German Constitutional Court has yet to even rule whether the EFSF is legal. For months, a group of politicians and university professors have pressed the Court to rule on whether open-ended bailouts violate the Maastricht Treaty's "no-bailout" clause. (They do.) The Court has refused to intervene up to now, but this will change as social mood falls, damages mount, and German taxpayers are again called in to help.

The situation has that unmistakable rotten odor that wafted throughout the subprime mortgage business back in 2007. Then, the ratings agencies gave their AAA blessing to reams of mortgage-backed securities under the idea that pooling enough individual bad debts somehow reduced the group's risk overall. Today, the agencies seem content to make the same mistake all over again, this time with Europe's bailout facility. For instance, during a conference call following its ratings' release, Standard and Poor's supported its AAA rating, saying that it looked at the EFSF's ability to withstand the combined rescues of *just three countries* (Portugal, Ireland and Greece). The fact is, though, that like subprime and prime home mortgages in 2007, the fates of European sovereigns are far too connected to be cherry-picked in this way. The coming downleg will now do to sovereign debt what the 2007-09 decline did to mortgage bonds, and history will repeat on a much larger scale.

Learn more about the latest issue of *The European Financial Forecast*: www.elliottwave.com/wave/latestEFF

To return to Club EWI for more free resources, go to: www.elliottwave.com/clublibrary

© 2010 Elliott Wave International

From *The European Financial Forecast* published November 5, 2010

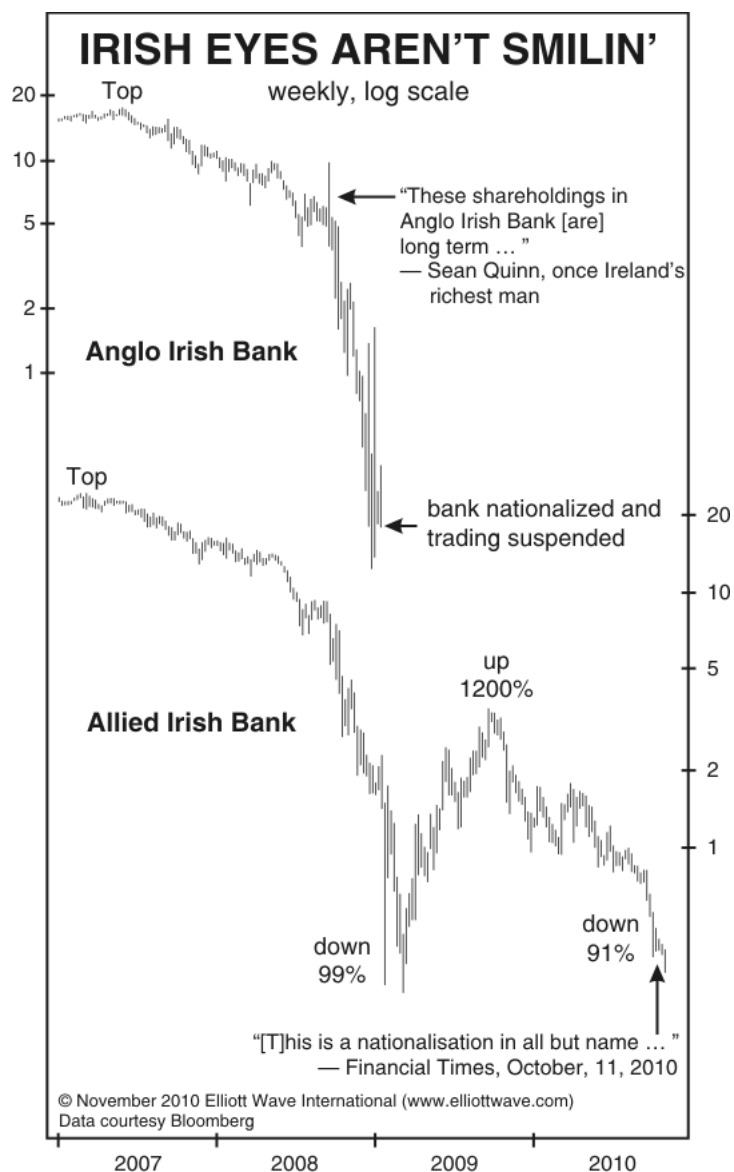
Spotlight Ireland: A Country About Out of Luck

Ireland appears to be deflation's latest target, as bank bailouts grow costlier by the day, and insurance premiums to protect against Irish default continue to set records. Portugal isn't far behind, and Greece looks to be facing another debt restructuring of its own. But despite these warning signs, investor optimism in October pushed back up to levels that have attended previous tops, and the market's riskiest bets have become all the rage. Investors are out and about playing in the sunshine – just in time for the strongest part of the hurricane.

Shown here on the lower line is the bear market's latest target, Allied Irish Bank. AIB shares fell 28% last month after recording a 31% loss in September. Since early June, when most European averages began to rally, AIB shares have lost nearly 60%. BBC News reports on one of AIB's largest shareholders, the Church of Ireland, which has watched its investments fall by more than €17 million lately. You might think investors would be inclined to cut their losses, but here's how a Church representative expresses the buy-and-hold mentality that is a death knell during a large-degree bear market (emphasis added): "These investments are ... *held for the long term*. It's expected that, over time, the value of investments should recover."

We have no faith in that proclamation. Recall that the same invest-for-the-long-term sentiment crossed up even the wealthiest investors during the last financial crisis. In July 2008, when Anglo Irish shares were down nearly 70% from their 2007 peak (see top line on chart), Irish billionaire Sean Quinn plowed another €490 million into the ailing bank, increasing his family's stake by 15%. Said Quinn at the time, "The family regards these shareholdings in Anglo Irish Bank as long-term holdings with significant opportunity for capital growth." Five months later, the Irish government effectively nationalized Anglo Irish, and the London and Dublin stock exchanges suspended trading of the bank's shares.

Our point is this: Nimble traders may certainly want to exploit these opportunities, but EFF's more important objective is to help our private and institutional subscribers *avoid* these current and looming time bombs long before they blow up. Remember the so-called stress tests that banking regulators conducted earlier this year? Even as the Committee of European Banking Supervisors found Allied Irish to be "adequately capitalized," EFF argued that the tests were a joke. "[M]any of the banks that passed [July's] stress test will collapse in the coming years," said the August 2010 issue. Last month, the Irish government announced it would inject another €3.7 billion into AIB, putting its stake at nearly 90%. Right now, it seems especially prudent to follow the safe-banking advice recommended in *Conquer the Crash*.



Learn more about the latest issue of *The European Financial Forecast*: www.elliottwave.com/wave/latestEFF

To return to Club EWI for more free resources, go to: www.elliottwave.com/clublibrary

© 2010 Elliott Wave International



Get the Latest on European Markets from EWI's monthly *European Financial Forecast*

What's next for Europe? Brian Whitmer, editor of EWI's *European Financial Forecast*, gives you ***unconventional, yet accessible, analysis of European markets*** in every monthly issue. Whitmer's insight will help you read in between the lines of the latest news headlines, and his technical analysis will show the trends in investor psychology driving the region's major markets. The combination of technical analysis and unique socio-economic observation makes *The European Financial Forecast* a must-read publication for anyone with money at stake in Europe.

You'll get detailed, chart-filled analysis of Europe's FTSE, DAX, CAC40, Eurostoxx and more with each issue — in addition to insightful, forward-thinking commentary about what these trends mean for Europe's future and your investments there.

Learn more about the latest issue here:

www.elliottwave.com/wave/LatestEFF

Learn more about the latest issue of *The European Financial Forecast*: www.elliottwave.com/wave/latestEFF

To return to Club EWI for more free resources, go to: www.elliottwave.com/clublibrary

© 2010 Elliott Wave International