Presents

Greek Endgame – EUR/USD Mid Quarter Outlook

Yohay Elam

Introduction

After the Greek deal has been announced, there are a lot of developments awaiting the markets until the end of March. This is a special mid quarter report from Forex Crunch regarding the second part of the first quarter.

The report focuses only on EUR/USD, which has been in range for quite a long time, and the upcoming events will likely make it break.

The main theme covered here is the endgame for Greece, which seems close. The report dives into the Greek deal, the potential pitfalls, critical dates and more. It also touches other European and US themes moving EUR/USD.

The report ends with a list of key events and a long term technical outlook for EUR/USD.

Following some feedback, the next report will be a monthly one for April 2012. The previous two reports were quarterly I'd love to hear your comments at yohay@forexcrunch.com.

Disclaimer

Foreign exchange (forex) trading carries a high level of risk and may not be suitable for all investors. The risk grows as the leverage is higher. Investment objectives, risk appetite and the trader' level of experience should be carefully weighed before entering the forex market. There is always a possibility of losing some or all of your initial investment / deposit, so you should not invest money which is which it can't afford to lose. The high risk that is involved with currency trading must be known to you. Please ask for advice from an independent financial advisor before entering this market. Any comments made on Forex Crunch or on other sites that have received permission to republish the content originating on Forex Crunch reflect the opinions of the individual authors and do not necessarily represent the opinions of any of Forex Crunch's authorized authors. Forex Crunch has not verified the accuracy or basis-in-fact of any claim or statement made by any independent author: Omissions and errors may occur. Any news, analysis, opinion, price quote or any other information contained on Forex Crunch and permitted re-published content should be taken as general market commentary. This is by no means investment advice. Forex Crunch will not accept liability for any damage, loss, including without limitation to, any profit loss, which may either arise directly or indirectly from use of such information.

Copyright

Contents

Greek Deal Failure

The headlines on February 21st were that a second bailout worth 130 billion was secured for Greece. There are too many holes in the deal, and the markets' celebration was rightfully limited.

Some of them are hurdles which are hard to overcome, some will cause a delay and some depend on each other. Greece needs to pay back over €14 billion euros of bond redemptions on March 20th – money it doesn't have. It still has a grace period of 7 days, but even so, too many things have to happen in a very short time. Here are the holes in the deal:

Hopeful Assumptions

The troika report about Greece included a "baseline" projection which seems too optimistic. According to the bailout terms, Greece is expected to hit a debt-to-GDP ratio of 120.5% in 2020. The downside scenario sees a 160% ratio, like now. In addition, it discusses an option for a third bailout for Greece, at a very large scale.

Needless to say, Greece didn't meet expectations so far. It's isn't solely Greece's fault, but also the fault of the EU and the IMF. The recession is deeper, industrial output is lower, unemployment is higher and tax revenue is lower.

The same pattern continued into 2012, as Greece badly missed its tax revenue targets. In addition, Greece raised its deficit expectations immediately after receiving the bailout.

It's hard to believe that European leaders truly believe in the optimistic scenario and think of it as a baseline scenario. Another Greek miss will force another modification of the plan. In the optimistic scenario, it's another delay. In the pessimistic scenario, it will end in letting Greece go.

High PSI Could Trigger Holdout

One of the achievements reached in that long night in Brussels was the larger haircut that private bondholders were forced to pay. They agreed to a nominal haircut of 53.5%. A cut of 21% was first discussed in the July 21 2011 summit. It was then raised to 50% in October. In real terms, it's more than 53.5%, but rather 73-74%.

This "generosity" imposed on bondholders could certainly backfire. Why?

Credit Default Swaps. Some hedge funds insured themselves using CDS against a Greek default. If they can expect to get only 26-27% of the value of the bonds, perhaps they can make more money by losing all 100% on bonds in a full default, and receive more money via the CDS payouts. During the negotiations, the Madrid based Vega hedge fund walked out of negotiations. They are not the only ones that have such an interest.

Greece is passing laws that will require a majority of two thirds, 66% of bondholders to agree to a haircut in order to impose it on all the others. It's called Collective Action Clauses. Nevertheless, with such a high haircut, they might not reach the goal of 66%.

Greek measures that need to be passed

The deal isn't that final. Greece was required to pass harsh cuts prior to the meeting that decided on the bailout. Despite huge protests and 40 burning building in Athens and political dissenters, the parliament approved the measures. Greece was later required to find another 325 million euros of cuts – a very small sum, but it did find it.

The agreement in Brussels requires Greece to pass a supplementary budget worth 3.3 billion euros in cuts and to pass labor reforms in a short time. This is quite hard in the current hostile environment and the tough timetable.

In the meantime, anti-austerity parties are gaining traction in the polls. This impacts the leaders of the mainstream coalition parties behind the deal and their backbench and frontbench members in the parliament.

Constitutional Change is Unconstitutional

One of the demands required form Greece is to amend its constitution to include a prioritization of debt over other things. This joins a stronger role for the troika in determining Greece's policy. In addition to the brutal intervention in Greek sovereignty, there is a legal hurdle: a constitutional change can only be approved when the new parliament ratifies it.

Well, elections are coming in April, so it's all good? Perhaps the new parliament won't be so keen to make this change and will not have and enhanced majority for this.

But actually there are more requirements for a constitutional change, such as an enhanced majority and also a wait period of 5 years between such amendments. The last change was in May 2008, so there's more than a year until a new change can be fully implemented.

There is no strict deadline for the constitution change, but this will be seen as another failure.

ECB Contribution Complicated

The European Central Bank accumulated Greek bonds since May 2010. The ECB bought these bonds at market rates, which were lower than the bonds' face value. It has accumulated quite a lot.

According to the No Bailout Clause in the EU Treaty, the ECB can't take an official haircut on bonds. However, ECB President opened the door to ECB help. In a last moment Steve Jobs style "one more thing" remark, Draghi said that the ECB could distribute profits made on the bonds to Greece. This loophole helps the Hellenic Republic without breaking the rules.

Just before the February 21 agreement, the ECB swapped its bonds for ones that would be immune to a haircut. Its bonds are exempt from the aforementioned Collective Action Clauses. This has its own issues (see the subordination matter later on), but was regarded as a step forward.

Each bank to its own

Well, some of the bonds are not held by the ECB but by the national central banks in the various euro-area countries. The process of distributing the money to Greece involves passing the profits to the governments in these countries that will then pass it to Greece.

Each country has different laws and processes. Part of the Greek bailout deal is based on this money, which will be used to lower Greece's debt burden. It is uncertain if this money will indeed be distributed, and how long it will take.

If we look at the longer term, this preferred status means that private bondholders will not want to lend to Greece in the future and Greece will not return to the markets anytime soon.

The ECB is crowding out the private sector.

EFSF Fund Raising

The European Financial Stability Facility is the mechanism used for the bailouts. It needs to raise around 70 billion euros for the whole bond swap.

The bailout fund has been able to raise money in the markets, and enjoyed the indirect aid of the ECB's LTRO. Yet again, the timetable is bit tight, to say the least.

Another issue with the EFSF money is that it could also be used to recapitalize Greek banks that will suffer from the bond swap. These banks hold their own government's debt.

This puts the bailout and its potential creditors at risk. A recent report by Blackrock has shown that Greek bank recapitalization is larger than estimated. Since then, the estimates became darker, and they rose up to a shortfall of 50 billion euros.

Lending to the EFSF could mean lending to black hole, and not for the first time. This is another hurdle.

IMF Contribution

The managing director of the International Monetary Fund, Christine Lagarde, was also present in the Brussels all-nighter. She didn't commit to any specific contribution of the Washington based fund. She didn't even commit to a date, saying only that this will be discussed in the second week of March.

In previous bailouts, the IMF contributed one third of the money. This time, reports suggest that it will help with only 13 billion euros – 10%. This puts a burden on the euro-zone countries. This isn't the first time that the IMF was reluctant to help Greece.

Typical IMF programs usually include currency devaluation, in addition to reforms and sometimes defaults. Greece cannot devalue its currency, as it is in the euro-zone and the program "ensures" that it stays there. Yet the IMF never felt so comfortable that the currency devaluation component is left out.

The IMF insisted on a future debt-to-GDP ratio of around 120% in 2020. This was crucial in squeezing more out of the private bondholders. The IMF has a preferred status, and it seems eager to protect itself and also cut its losses.

The delay in the decision hints that the preferred IMF contribution is nothing at all.

Parliament Approvals

Apart from the Greek parliament's swift approval of the CAC, labor reforms and budget cuts, also the rich countries need to approve the bailout.

Well, anti-Europe and anti-bailout sentiment is raging throughout the continent. This is especially strong in Finland and the Netherlands. Finland already secured the collateral it wanted from Greece. But there's another Finnish hurdle.

The participation of each country in the bailout is still unknown. It depends also on the contribution of the IMF (see below). Finland refuses to move forward with the approval as long as it doesn't know how much it is required to contribute. Makes sense, no? That's yet another delay.

No Growth Prospects

As aforementioned, more austerity measures and more monitoring are imposed on Greece. This may amount to "financial occupation". The prioritization of debt over anything else serves the bondholders but also backfires.

There are no clauses or prospects for growth. Without seeing the light at the end of the tunnel, Greeks will continue leaving their country, or at least sending their money out of the country.

With no growth, there's more room for missing tax revenue targets, making more cuts to counter that and to pay debt, and more suffering.

What Greece needs is a Marshall Plan for economic recovery, and not only means to reduce the deficit. The program doesn't contain potential investment. The only thing that can help the country in the longer term is measures to enhance competitiveness.

There are faster ways of creating competitiveness, such as currency devaluation. Yet Greece is in the euro-zone. The Greek economy has already fallen off a cliff and it is far away from the euro-zone. In order to recover, it needs a way out.

And if it stays inside the zone, it needs help to grow.

Without growth, the "baseline" projection of Greece reaching a debt-to-GDP ratio of 120.5% in 2020 sound likes a fantasy. Will Europe support a third bailout?

They will probably cut their losses before the implementation of the second bailout program.

The Short Road to Greek Default

After reviewing the holes in the deal, let's see why and then how this can be pushed through.

Why? Because Germany is Pushing for a Default

There is no hard evidence that Europe's No. 1 economy has decided upon a default, but all of its recent actions point to this direction. The endless delays, extra requirements, statements and trial balloons point to this direction.

It all goes down to a lack of trust. The second Greek bailout was discussed in the infamous July 21 summit – a summit which also contained hope for a Greek Marshall Plan. The parties then made progress in the October 26 summit.

Trust was broken when the now former Greek PM Papandreou offered a referendum to approve the deal. Germany and France were furious and threatened to throw Greece out of the euro-zone for the first time in public.

Papandreou was replaced by an ex ECB banker and EU backed Papademos, but trust was never restored. A German draft discussed taking away some sovereignty from Greece. This idea was dismissed, but the Greek leaders were forced to sign a commitment to continue with austerity also after the elections.

German Finance Minister Wolfgang Schäuble was reluctant to throw more money at Greece, saying it is a bottomless pit. It's important to remember that Schäuble is one of the most pro-European politicians in Germany. His boss, Chancellor Angela Merkel, said the she would never force Greece out.

This seems like a "**good cop bad cop**" game that is meant to pass the time.

The notion is backed by public opinion that doesn't want to see more money sent to Greece and also by growing chorus of economists and politicians saying that now is a "better time to default", after banks have been stabilized by the first LTRO. See comments about a second LTRO below.

To be fair, it's not only Germany. French banks have stabilized and can absorb a shock. In addition, the reluctant attitude by the IMF also shows that it is on the same page.

Unconfirmed reports have floated, saying that Wall Street Bankers are planning on a Greek default on March 23rd.

This date sounds logical. Let's see the events.

How? Technical Reason for a Default: Subordination by the ECB

The Greek parliament already approved the law regarding the Collective Action Clauses. The bond swap is expected to start any time. It's a "voluntary" swap, or restructuring, avoiding an official default.

Not so fast. As the ECB has already secured a preferred status, it is **subordinating other bondholders**, giving the ECB all it was promised while trimming the others. Fitch already cut Greece's rating to C following the Greek bailout deal, and will likely announce a default when the bond swap is completed.

It's important to remember that there is no certainty that the bond swap will go through and that 66% of bondholders will volunteer. Assuming the optimistic scenario, this will still likely be labeled a default. Other rating agencies could follow through.

Possible due date for the bond swap: March 10th.

IMF Disapproval

As aforementioned, the IMF is reluctant to provide aid and is certainly taking its time. This delays other moves, such as in Finland. The second week of March is an unclear date.

In the meantime, non-European members are already showing their unhappiness with Europe, and are pushing for more money to the IMF. Canada wants Europe to "boost the firewall" for IMF cash.

The biggest contributor to the IMF is the United States. According to the same unconfirmed reports, the White House is also in the loop for the Greek default and is working to shore US banks and citizens. This means no more IMF money.

The IMF will likely take its time until everything goes wrong and it's clear that it won't help, or provide disapproval.

Potential understanding that the IMF is out: Week beginning on March 12th.

LTRO Will Set Brakes Loose

The ECB has lent around €489 billion to European banks quite cheaply in return for low graded collateral. The cheap money encouraged banks to buy sovereign debt of Spain and Italy (as collateral) and enjoying the arbitrage. In addition, it filled their troubled pockets. The loans are for three years.

The indirect QE was hailed as a success by the ECB itself and also produced the "better time to default" argument by various speakers.

If the first LTRO provided stability, the second one will provide even more. The highest estimates reach 1 trillion euros, double the first operation. Even repeating the same scale of 500 billion or even 300 billion will certainly help banks and will serve as a shock absorber.

The ECB's policy is "full allotment" – meaning every request that meets criteria will be met by freshly printed euro notes.

After the banks get more money, it will be even easier to let go of Greece.

LTRO II is planned for February 29th.

Situation of Greek Banks

Another trigger for a default is the situation of Greek banks. A slow but steady bank run is going on in Greece for a long time. Some money flows out in fear of a default, and other money is withdrawn just for food and bills. The economic situation takes its toll.

Greek banks are heavily exposed to Greek government debt. This puts them in an even more risky situation. With the erosion continuing and a possible delay in EFSF funds, Greek banks could find themselves in deeper trouble.

As soon as rumors get out, people will stand in lines or fight to get their money out of the banks. In order to prevent such a situation, the Greek government could be pre-emptive and announce a bank holiday, together with an announcement of bankruptcy.

March 23rd?

This date sounds makes sense. Greece has to pay back over 14 billion euros of bonds on March 20th. It's important to remember that it has 7 days of grace, meaning it has time until March 27th.

In addition, this sum may be reduced due to the bond swap. If things go wrong prior to this date, leaders will likely seem to work on finding a solution for the rest of the cash, during the grace period.

March 23rd is a Friday, and according to the aforementioned unconfirmed reports, Greece will announced a bankruptcy at the end of the business day, announcing a bank holiday to prevent capital flight and to allow for stabilization.

The weekend will allow for an attempt to calm the public and working on a return to the Greek drachma while markets are closed.

Markets' reaction will likely be relatively muted when such a big event happens over the weekend and not in the middle of the week. The reaction will still be strong, but not as shocking. We've seen it with the historic downgrade of the US credit rating by S&P.

Potential Savior: A Bridge Loan

Leaders seemed to be working hard to prevent a default and to reach a wonderful bailout deal. They will likely show the same efforts in the days before Greece's payback day.

The optimistic scenario is that they will not fake it, but do find a temporary solution and settle for a bridge loan. This idea was already discussed in the past. It will be another kicking of what's left of the can down the road, but this is possible.

The logic for that is that not all the plans for a Greek default ("**grefault**") or a Greek exit of the euro zone ("**grexit**") will be in place. Given the behavior of leaders so far, the chances are low.

Chances are higher for cutting the losses.

European Recession

The European Union now acknowledges that the euro-area will likely contract in Q1 2012 as well as in Q4 2011, making it an official recession. The official scenario is for a "mild recession" that will fade away later in the year, and won't be deep.

France managed to escape contraction in Q4 and will not enter an official recession in any case. Germany contracted in Q4, but seems relatively resilient. The concept of a mild recession was also seen in improving purchasing managers' indicators and in improved German surveys.

Nevertheless, these PMIs turned for the worse once again in February. Germany has a better chance of being pulled down than to pull up the zone.

Even if a Greek default is more contained than earlier thought, it will weigh on the economies of all the euro-zone countries and the euro will follow.

US QE

The Federal Reserve is dovish and tends to act in order to boost the economy, despite signs of improvement. This is the impression from Ben Bernanke's soft tone and the extended pledge to keep interest rates at low levels until late 2014.

On the other hand, the meeting minutes have shown that the FOMC isn't that keen to make a decision on QE3 in March. This is far from certain.

The Fed highlighted Europe as a risk factor. That's hard to argue with. Yet the domestic situation is better, including in the two main fields that the Fed is looking into:

1. **Employment**: The jobs report for January made skeptics work hard to find holes in. The US gained 243K jobs and the unemployment rate fell to 8.3%. Ben Bernanke stated that the recent figures understate the real situation. Since then, the 4 week moving average of jobless claims dropped to 359K as of February 23rd. This implies another drop in the unemployment rate. The improvement could be "blamed" on good weather. If the next Non-

Farm Payrolls report on March 9th will be really good, it will be hard for the Fed to launch QE3 just 4 days afterwards.

2. **Housing**: One of the options for QE3 is buying mortgage based assets in order to support the housing sector, that saw a boom and bust. The situation isn't really good, but not that bad. It seems that single family homes are struggling, while multi-family homes are doing better. Recent housing sector reports have been somewhat encouraging. The arrangement with banks provides a small ray of light for foreclosed homes.

In addition, the Fed faces 2 headwinds for QE:

1. **Rising Oil Prices**: Tensions are rising around Iran's nuclear program, and the sanctions that followed. QE2 pushed commodity prices higher, and this included oil. QE3 will likely have the same effect – of crowding out money from bonds (or MBAs) to commodities and stocks. As the US consumer is reliant and exposed to changes in global oil prices, a rise in oil prices will actually hurt the US economy and will be counterproductive. If prices remain elevated, Bernanke will be reluctant to act.
2. **Political**: The ongoing Republican primaries keep the heat on the activism of the Fed, even though the focus has shifted to social issues. Nevertheless, the question of the price at the pump is gaining traction in the Republican debates. Pushing the price higher during the heated debate isn't the best timing.

US Politics

As discussed in the quarterly report, certainty is the key for the dollar. The level of uncertainty is now lower regarding US politics.

The improvement in the economy certainly supports Obama. In addition, the Republican contest has been more complicated than expected. The candidates have spent more money and words criticizing each other. This also helps Obama.

The mainstream scenario is that Mitt Romney will win the primaries. While he is the most electable candidate, his policies are not too different from Obama's, especially regarding the economy and foreign policy. He might pose a threat to a second term for Obama, but it isn't likely to make a difference for the dollar.

Rick Santorum has surged on the expense of Newt Gingrich. If either of them surprises and defeats Romney, it will be much easier for Obama to win, and the level of certainty will be even higher.

The upcoming weeks are packed with many contests, including the famous "Super Tuesday" on March 6th, which has 10 contests. Nearly half of US states will have the primaries behind them after March 6th, and the picture will be clearer.

Conclusion

The second part of Q1 2012 has a very tight calendar. Up to now, EUR/USD saw relatively limited ranges in 2012, and especially during February.

This could dramatically change now. **All the signs point to one direction of the pair: down**. The dollar has more reasons to rise, and the more importantly, the euro is facing a major event in Greece.

In the long run, it will be better for Greece to be out of the euro-zone, but this will take a very long time – eternity for traders.

Key Events

Here are the key events that are set to impact currencies all over the world, larger than the scope of any individual country. Note February 29th, which is a rare date on the calendar and has a special event.

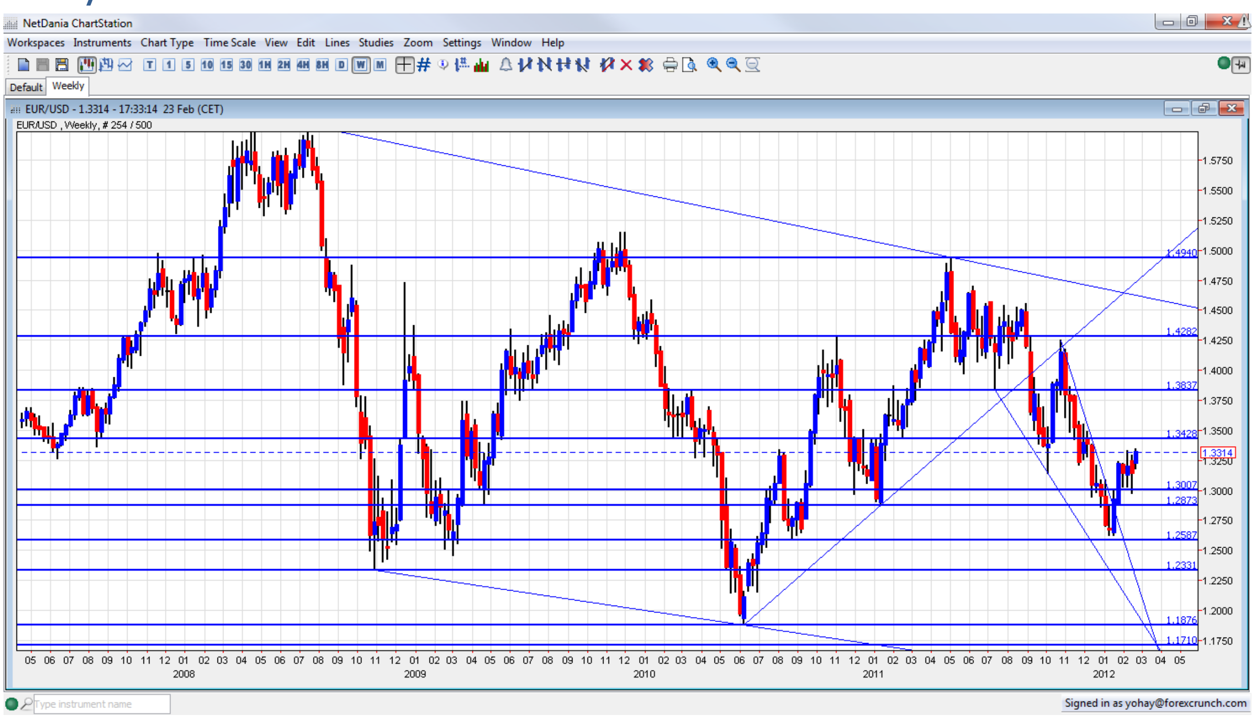
- **February 29th: Second large ECB LTRO Operation**
- February 29th: US GDP, Second release. Big revisions have been seen in previous quarters.
- February 29th: Ben Bernanke Testifies.
- March 1st: Yet another Eurogroup meeting.
- March 6th: US "Super Tuesday" – Primaries in 10 states.
- March 8th: ECB Rate decision before Greek deadline.

- March 9th: US Non-Farm Payrolls, Note the revisions.
- March 10th: Potential date for the bond swap to be completed.
- March 12th onwards: Potential decision or indecision by the IMF regarding Greek aid.
- March 13th US Rate decision – potential QE3.
- March 20th: Critical Greek deadline for debt redemption.
- March 23rd: Potential date for an announcement about Greek bankruptcy.
- March 27th: The last day for Greek bond redemption, including the 7 day grace period.

Sources for this report:

- [Forex Factory Calendar]
- [FX Street] Calendar ([available on Forex Crunch]).

EUR/USD Technical Outlook



[Click here to see the image on the web]

The very wide channel that begins in 2008 is trending down, and the pair is in the middle of it. Uptrend support which accompanied the pair since mid-2010 was also broken to the downside. On the other hand, the pair managed to break out of the short term sharp narrow downtrend.

Lines

The 2011 peak of 1.4940 is a significant line as well on the upside. 1.4282 was the peak of the surge in November 2010

The swing low of 1.3838 seen in mid-2010 was also of important at the beginning of 2010 as a cap and as a separator back in 2008. The 1.3430 was also an important separator and the failure to recapture this line is another bearish sign.

The round number of 1.30 is more of a pivotal and psychological line. 1.2873 was the trough of 2011 during most of the year and its break is important, although needs to be fully confirmed.

1.2587 is important support below after providing support during 2010. The first post crisis bottom at 1.2330 is becoming old, but still worth mentioning.

Below 1.20, the 1.1876 bottom seen in 2010 is a very strong line. The last line is symbolic: 1.17. This the launch price of the euro in 1999.

For more on the euro, see the **EUR/USD Weekly Outlook**.

Additional Notes For Forex Traders

Here are some additional notes for forex trading during this quarter.

High Volatility

Choppy trading was already seen so far in this quarter. Sharper moves are expected now. It is important to note that unknown events can surprise us anytime, also during the most boring hours of the day.

Trade with care! High volatility with high leverage and wide stops can be disastrous to your trading account. When volatility is higher, reduce position sizes and minimize your risk. Don't gamble.

There are still some traders who widen their stop loss points when the trade is open. Having success with such a move can lead to more dangerous actions later on and is only more dangerous. So stop moving your stops!

Choosing a More Predictable Pair

Some pairs follow the rules of technical analysis in a better way, while others are quite unpredictable. This depends a lot on your trading system and on your style and these patterns change all the time. Nevertheless, here is an updated list of the **5 Most Predictable Currency Pairs – Q1 2012**.

Resources

General Articles

- **5 Points on When to Go Pro** – Successful at forex trading and considering of doing it full time? There are a few steps on the way.
- **How to Choose a Forex Broker in 2011** – There are quite a few tools you can use before making this important decision.
- **How About Investing in Forex?** – Foreign exchange doesn't necessarily have to involve active trading, but can be
- **Risk Factor Explained** – A deeper explanation about why the dollar falls on good figures and vice versa and under what conditions this will end.
- **Trading in Range or Catching Breakouts?** – What is your style? And what to look out for.

Recommended Sites:

- **TradingNrg** – For all you need to know about gold, oil and other commodities.
- **BO Crunch** – All you need to know about trading binary options.
- **ForexStreet.Net** – A great forex social site where you can interact with others.
- **Forex Live** – For the fastest updates on the web.

That's it! As I've mentioned at the beginning, I welcome feedback, comments, suggestions, complaints and anything you wish to tell me about this report. Please send any feedback to yohay@forexcrunch.com.

Happy forex trading!