



The USD has moved higher and could surge if it looks like US rates will need to go above 5%. And, several of the peripheral Europeans look very exposed should this occur. They outperformed core Europe when the USD came down hard in 2004 due to the search for extra yield. Well, Jimmy Leitner has found another currency vulnerable to a USD recovery.....and it's one that he knows very well! - Andres Drobny

Icelandic Krona Danger

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Friends,

At the Drobny Conference 3 years ago, I recommended buying Icelandic indexed linked housing bonds, funded in part domestically and in part in USD's (see, '2003 Conference Review, **DGM**, April 4, 2003). The trade worked pretty well.

Now things look very different. The bonds have already come down hard and look exposed to further trouble in this relatively illiquid market. But, it's the Krona where the real danger lies. It has appreciated substantially against the USD and Euro since 2001 and is exposed to a drying up of inflows from abroad. This is a currency very threatened by an unwind of the 'carry trade'. I am now playing it from the short side.

The problem stems from two main sources. First, Iceland is now running a C/A deficit of close to 15% of GDP. That isn't necessarily a problem.....as long as you can fund it.

But, working against this are Icelandic pension funds and local investors who have been increasingly investing their growing net assets abroad. Last year they invested 15% of GDP abroad. This flow will continue in 2006 and should actually increase.

Moreover, during the rush into Iceland in 2003-2005, the banks tapped international credit markets aggressively. Last year the 3 major Icelandic banks, with a market share of 80%, issued \$20bn internationally. Compare that with a GDP of \$15bn!

That's on top of large issuance in 2003 and 2004. As a result, foreign debt has increased dramatically. It amounts to around 250% of GDP, having increased five-fold since 2000.

The banks have almost saturated the international markets. If they are not able to issue at similar terms to the past, **and in vast amounts**, there is nothing to feed the local credit



bubble. That should lead to a big correction in the currency (and the equity market – up roughly 6.5 times since the low of 2002 - and real estate market – doubled in 4yrs).

All this is increasingly understood. There was an article in the *London Times* yesterday, warning that Iceland is ‘the most vulnerable country in Europe to an asset price collapse after its credit expanded 45% last year.’ Credit Sights, Barclay’s Capital, JP Morgan, Dresdner and Deutsche Bank have all come out with a critical assessment of the Icelandic banks and their creditworthiness. Barclay’s in their newest report, along with Credit Sights, calls for a downgrade of the banks.

And, last week we saw the first selling of interest rate swaps, which probably means that some of the overseas owners of ISK denominated (‘EuroCod’ or ‘Glacial’) bonds are selling. More ominous, ISK40bn of these bonds mature in August, and ISK20bn in September and October, for a total of ISK60bn this year. ISK100bn matures in 2007.

Why hasn’t the currency dropped yet? It’s the illusion of liquidity. Foreign prop desks are sitting on more than \$1bn in short term ISK positions, possibly \$2bn. And, bear in mind that the minimum commitment from the 3 ISK market makers is only \$1.5mn. This portends a nasty mismatch.

With short rates around 10%, the prop guys are earning nice carry. But, in the event of a USD rally, they will start to feel some pain. And, once they do and start to reduce positions, where do they go? The market makers won’t have to take the other side in size. And, no one outside of Iceland really has any natural ISK business, so there are won’t be natural buyers out there.

This looks like an accident waiting to happen. And, it’s happened before! In 2000-2001, the ISK dropped about 50% in 16 months when liquidity dried up very suddenly and the large long positions took a long time to close out. Everybody was caught on the same side of the trade. Just like now.

So, because of the high negative carry cost, I have been basically using the spot market to trade the ISK from the short side. At this point, I am short against the USD, seeing more USD upside. But, I intend to switch to the Euro when I think the USD has peaked out.

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