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TRENDMACRO LIVE!

On the Europe Summit

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A 50% Greek default -- and the only contagion is a celebration in global stock markets.

Stocks are rallying hard this morning -- with Euro area financials the big winners -- following last night's conclusion to a marathon European summit. Our call in early September to buy European banks has been vindicated (see "CHooF!" September 6, 2011), even as they now face a 50% writedown on their Greek sovereign holdings.

And our predictions for the summit (see "Six Days to What?" October 17 2011, and "Agree to Agree… on Wednesday" October 24,) have been right on the money. We had highlighted three areas where action was needed, and major progress has been made on all three.

Decisive action on Greece:

- There will be a 50% writedown on privately held Greek debt. This writedown will be on the *nominal value* of the debt -- rather than the 21% *net present value* writedown announced in July (see "Whatever It Takes" July 22, 2011) -- so is a comparatively much larger writedown.
- Pause for a moment and reflect on just how remarkable this is. Mere months ago, the prospect of a 21% present value writedown was seen as courting catastrophic contagion risk. Now a far larger *nominal* writedown has been announced, and it's seen as a stabilizing outcome. As we've been saying it would for many months, the Euro area has succeeded in immunizing itself from Greek default (see "Greece: Suicide, Not Murder" June 7, 2011).
- There will be a sovereignty cost for Greece, with the "Troika" -- EU/IMF/ECB -- establishing a monitoring capacity on the ground to ensure Greece maintains its commitments to the program.
- The aim of the Greek program is the have Greek debt at 120% of GDP by 2020.

Maximizing effectiveness of anti-contagion strategies:

- The matter of leverage for the European Financial Stability Facility (EFSF) has been generally settled -- to raise its effective capacity to around €1 trillion.

Update to strategic view

EUROPE MACRO, EUROPE FINANCIAL STOCKS: The marathon Euro summit has managed to produce a Greek default that has restored confidence. Rather than leading to contagion, it has led to a rally in global stock markets. Much more important, the summit started to make concrete moves to address the fundamental structural problem of the Euro area. Only when the monetary union is accompanied by a proper fiscal union can we put Europe's debt crisis into the pages of history.

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- The EFSF will be leveraged in two ways. The first is through credit enhancements for sovereigns issuing new debt. Investors will be offered the option to purchase EFSF backed risk insurance when they buy sovereign debt.
- The second is through the use of a special purpose vehicle (SPV) which will combine with other institutions and investors -- including possibly the IMF and China -- to extend loans for bank recapitalization and for the purchase of bonds in both the primary and secondary market.
- The €1 trillion figure can only be a best guess as to the resulting scope of these strategies, as their deployment will be on a case by case basis.

Bank recapitalization:

- Banks will mark their sovereign debt holdings to market value as of month-end September 2011. They will have until June 2012 to make up any shortfall in tier one capital below 9%.
- The hierarchy of capital sources will be as we outlined previously (again, see "Six Days to What?") -- first private markets, then governments, and finally the EFSF as the investor of last resort.
- The European Banking Association (EBA) last night released initial estimates of the capital shortfall at €106.5 billion, very much in line with our expectations.

All these actions place a very large band-aid over the current phase of the Euro area financial crisis. While this is enough for the market at the moment, it does not address the fundamental structural problem at the heart of the Euro area -- a monetary union without a fiscal union (see "Two-Tier Europe is Born" August 17, 2011).

The summit did make commitments to address this structural problem, with its communiqué stating, "We will strengthen the economic union to make it commensurate with the monetary union." There is a summit planned for March of 2012 to address these structural issues, with -- always risky -- treaty changes possible to ensure integration.

For investors, the outcome of yesterday's summit comes as a relief, with the Greek default proving to be the catalyst we said it would be. However, the Euro area will not be able to stay ahead of the curve until it addresses its fundamental structural problems. It is the moves to address those structural problems that will prove to be the lasting legacy from this summit.

Bottom line

The marathon Euro summit has managed to produce a Greek default that has restored confidence. Rather than leading to contagion, it has led to a rally in global stock markets. Much more important, the summit started to

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