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MACROCOSM

LTROphoria

Monday, February 27, 2012

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3-year LTRO's now a rock star. Wednesday's auction is the difficult second album.

How market perceptions of the European Central Bank's 3-year Longer Term Refinancing Operation (LTRO) have changed! When the program was announced in December, few outside Europe's monetary policy cognoscenti even knew what the acronym "LTRO" stood for. Even fewer agreed with us that it would save the euro area banking system by removing funding risk, and spill over into a new risk-appetite for European sovereign debt (see "On the ECB Monetary Policy Decisions" December 8, 2011). Instead, markets were disappointed that the ECB hadn't strengthened its Securities Markets Programme for direct bond purchases. Now the world eagerly awaits tomorrow's second LTRO auction, feverishly speculating on how big it will be and who will participate (while the SMP has virtually ceased to operate, and no one seems to notice).

When the first 3-year LTRO took place in December, its scale was an upside surprise to markets, and at first was misunderstood to be a measure of the euro area banking system's massive weakness. But this was to miss a major buying opportunity in sovereign debt (see "Europe's Wall of Liquidity" December 21, 2011). As it began to be better understood, it enabled a second buying opportunity, this time in euro area banks (see "On the January ECB Rate Decision" January 12, 2012).

But market opportunities are always driven by surprise. The first 3-year LTRO's success was partly due to many market participants missing the significance of it. For the second LTRO, the results of which will be revealed on Wednesday, there has been a great deal of eager anticipation, and there seems to have been much more front-running. At this point, then, can it be the catalyst for another leg-up in sovereign debt and in euro area bank stocks -- or, for that matter, for risk assets around the world -- that have so far been driven by relief from fear of a blow-up in Europe?

Estimates coming into the first 3-year LTRO were for a net liquidity increase of as little as €20 billion (again, see "Europe's Wall of Liquidity"). The result was €210 billion, over ten times the expectation. For Wednesday's LTRO, expectations are much, much higher, with Reuters' median estimate of the allotment at €492 billion, and forecasts ranging from the disappointing -- tens of billions -- to the fantastically large -- several trillion.

Update to strategic view

EUROPE BONDS, ECB, EUROPE FINANCIAL STOCKS: December's 3-year LTRO was the catalyst for the recovery in euro area sovereign debt and bank stocks. Its effectiveness was due to surprise, a factor missing from this Wednesday's operation. Expectations are high, causing downside risk that was not an issue in December. A sub-€200 billion print would be a disaster, but is highly unlikely. Uptake at the high end of the consensus, above €500 billion, might disappoint briefly versus unrealistic chatter about a trillion-plus print, but would likely energize the next leg up for Europe's banks.

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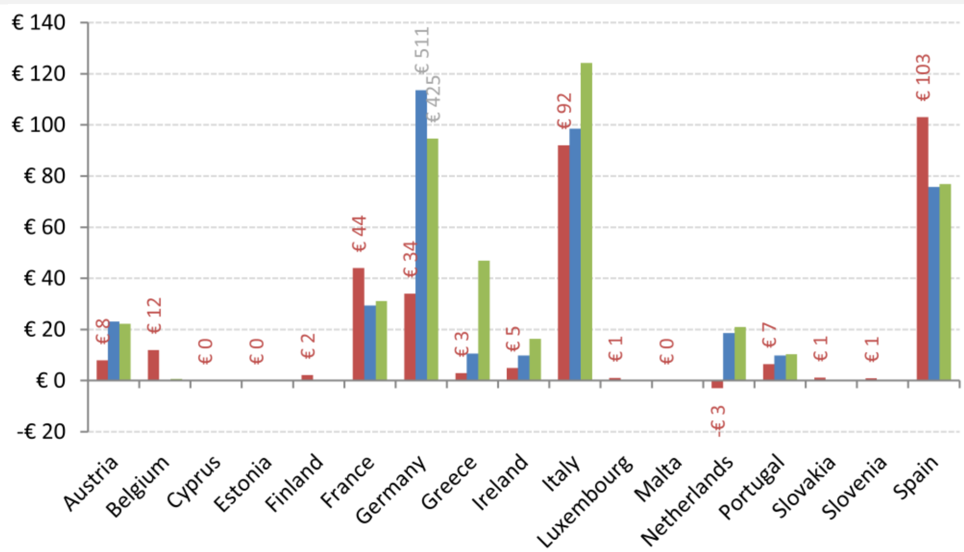
With such excited expectations, the most likely risk is that the size of the LTRO will disappoint. But the sheer range of guesses in the market at the moment is the dominant reality -- nobody knows where the LTRO is going to come in.

- Anything under €200 billion will be a shock -- and a worrisome signal from euro area banks. They are being offered very cheap funding by the ECB. The collateral rules have been relaxed to enable them to make maximum possible use of that funding (see "Le Collateral" January 6, 2011). If they are unwilling to grasp this opportunity -- which is as close as they are ever likely to get to free money -- then that will send a message that the euro area banking system is happy to be no more than a zombie. We do not expect the number to be this low. The increased listing of collateral instruments at the ECB, and seven national central banks taking advantage of the new rules that allow single debt instruments to be used, point to demand well above the €200 billion level.
- €200 billion to €400 billion would be at the lower end of expectations, but would not be a complete disaster. However, beneficial feed-through to the economy would be very limited at these levels. What will be critical would be the distribution across countries of a number this low. If, as was the case in December, the majority of new liquidity goes to Spain and Italy (please see the chart below) then there would probably be enough to preserve reasonable sovereign yields in those critical economies, but feed-through to lending growth -- and M3 growth -- would be limited.

December 2011 LTRO net uptake, by country
Remaining bank bond maturities in 2012 **Bond maturities in 2013**
€ bil German bank bond maturities truncated to fit scale; amounts noted



Source: National Central Banks, Bloomberg, TrendMacro calculations

- €400 billion to €600 billion is the consensus range, and is presumably what the market is positioned for. This is viewed as the

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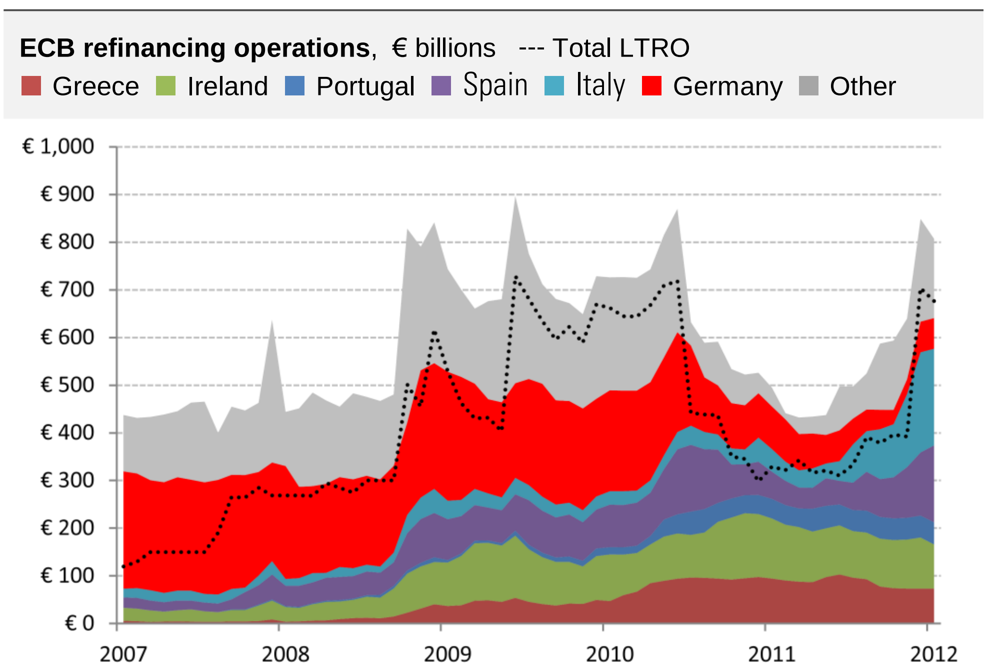
[Goldilocks range](#) -- enough liquidity to sustain sovereign debt and bank lending, and not so much as to stoke inflation fears.

- A number at the high end of the consensus range, or better still above €600 billion, would shock back to life the bank stock rally that has stalled the past two weeks. But expectations are running so high, the first immediate reaction might still be disappointment. A number in the trillions -- which we view as highly unlikely, yet not unheard of in the chatter -- would be a signal to buy any euro risk asset available. Yes, this would stoke inflation fears, and might weaken the euro. A market environment addicted to bad news would seize on this aspect, but in fact it would be part of the bull case: as the disastrous effects of the ECB's tightening regime begun last year have shown, Europe's only inflation problem is that it doesn't have enough of it (see ["EUicide"](#) April 7, 2011).

We don't have any inside information here. Our estimate is as much a guess as all the others. But if you hold a gun to our heads, our guestimate is €560 billion, toward the high end of the consensus range. We base that on noting how much new collateral has been made eligible, and by observing the large volume of bank-issued bonds maturing through 2014, all of which could be refinanced to great advantage with LTRO (please see again the chart on the previous page). And we see a self-fulfilling demand effect of market expectations that may make participation *de rigueur*, when not so long ago it would have been stigmatized.

Whatever 3-year LTRO number is printed on Wednesday, the ECB will be breaking new ground on liquidity provision. Since the start of the crisis, ECB monetary policy lending to banks has not passed €900 billion (please see chart below). Even an uptake at the very low end of expectations would take liquidity provision past the €1 trillion mark, a new all-time high.



Source: National Central Banks, ECB, TrendMacro calculations

The first unknown -- how much the banks will take from the 3-year LTRO -- is the one that is getting the most chatter at the moment. But it is the second unknown -- what the banks will do with the money -- that is really the most important.

- We won't even know the distribution of uptake by country for about a month.
- Media reports do not show any conclusive evidence of how banks intend to use the liquidity. Only about 30 banks have made statements on the subject, according to Société Générale. That's a tiny fraction of the 523 banks that used December's LTRO.
- We have learned from data released today by the ECB that the feed-through to lending growth from the first LTRO has been slow, but significant. The annual growth rate of M3 increased to 2.5% in January, up from 1.5% in December. This is an encouraging reading for euro area growth prospects and, if this trend continues, then the LTRO operations can be viewed as a success in unfreezing the banking sector.
- If M3 growth can be maintained, and funding costs in the interbank market remain low, the euro area economy could be looking at a short shallow recession, rather than the sharp correction that looked likely last November.

Bottom line

December's 3-year LTRO was the catalyst for the recovery in euro area sovereign debt and bank stocks. Its effectiveness was due to surprise, a factor missing from this Wednesday's operation. Expectations are high, causing downside risk that was not an issue in December. A sub-€200 billion print would be a disaster, but is highly unlikely. Uptake at the high end of the consensus, above €500 billion, might disappoint briefly versus unrealistic chatter about a trillion-plus print, but would likely energize the next leg up for Europe's banks.