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MACROCOSM

The August before the Fall?

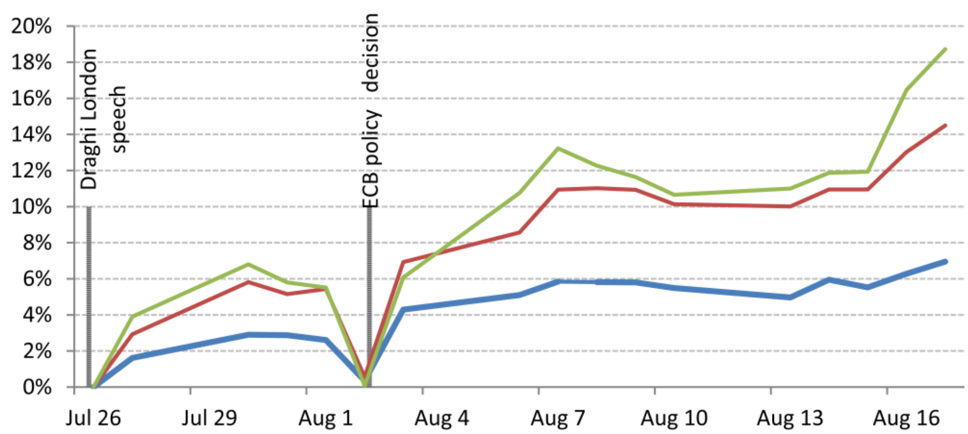
Monday, August 20, 2012

Lorcan Roche Kelly

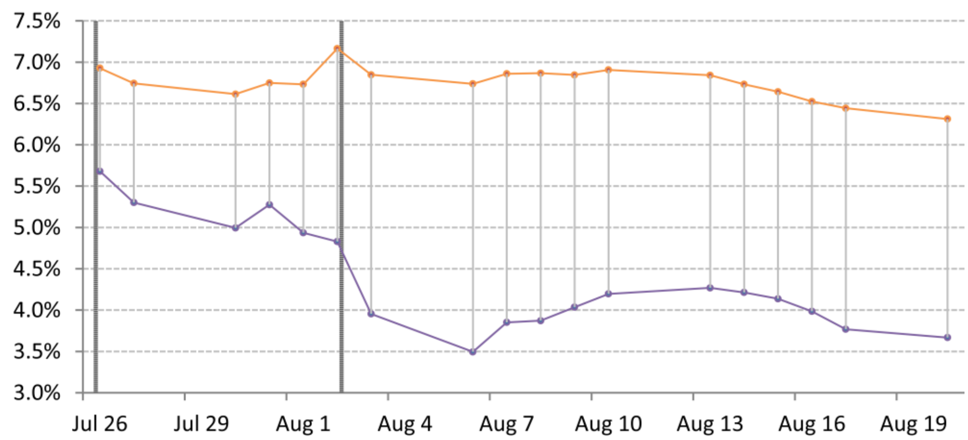
It's Europe's best August since forever. But what happens when the politicians come back?

Since ECB President Mario Draghi's speech in London on July 26 (see "On Draghi in London" July 26, 2012) and the ECB policy decision the following week (see "Draghi: Off the Reservation" August 3, 2012), markets across the euro area have staged significant rallies (please see the charts below).

Stock index return from July 26 — DAX — IBEX — MIB



Spanish sovereign yields ● 2-year ● 10-year



Source: Bloomberg, TrendMacro calculations

Update to strategic view

ECB, EUROPE BONDS, EUROPE STOCKS: In the short to medium term there is little risk to the rally in euro area markets. Beaten-down stock markets -- particularly in Spain and Italy -- are moving higher on the promise of ECB action. We do not expect the ECB to disappoint. The next round of Greek talks will lead to unhelpful rhetoric, but a Greek exit is the only substantive risk, and that is still highly unlikely. But on a longer investment horizon, risks from continued policy uncertainty in the euro area will weigh on investor confidence. Without that confidence the euro area cannot have the one ingredient that will end this crisis -- growth. That's the challenge we expect policy-makers to take up when they return from their August holidays.

[Strategy Dashboard home]

If nothing else, Draghi has given Europe its first calm August since the global financial crisis began. The question now is: can this rally continue, or is it a false start that will be derailed after European policy-makers return from their August vacation?

In the short term, the first thing we need is clarity on what the European Central Bank is actually willing to do.

- Draghi took the revolutionary step of putting unsterilized bond purchases by the ECB on the table, but we still do not know the conditionality the ECB would attach to those purchases. Among the most urgent unanswered questions: will the ECB be willing to act alone, or whether it would only act in concert with the EFSF or the ESM?
- We expect clarity on this in the coming weeks -- certainly before Spain and Italy return to the bond markets after the August break from bond sales.
- While we wait for clarification from the ECB, press speculation about the scope of any action is increasing. Over the weekend the German magazine *Der Speigel* published an article saying that the ECB may use bond purchases to explicitly target yields on sovereign debt, along lines we have suggested. The ECB offered a denial this morning.
- As the charts above clearly show, it is the ECB and only the ECB that has triggered the rally. We strongly believe that the ECB will meet market expectations. However, were it to disappoint, recent gains would be quickly wiped out.

After August, Greece is once again going to rear its ugly head.

- Prime Minister Antonis Samaras is seeking a two-year extension to the latest reform program.
- If the proposal leads to another stand-off between Greece and its euro area lenders, then the rhetoric surrounding that stand-off is likely to destabilize markets.
- It is important to remember that the only real significance of more Greek noise is if it starts to look like it will lead to a Greek euro exit.
- We put the likelihood of such an exit as very, very remote. Support for the euro within Greece is still very strong, and those policy-makers sitting across the table from Greece know well the costs to them of a Greek exit.
- If Greece were to leave, it would likely be the end of the euro. The "irreversibility" of the currency would be broken.
- The very thing that Draghi highlighted in London on July 26 -- he calls it "convertibility risk" -- would come to pass. Investors wouldn't -- and shouldn't -- hold peripheral debt, as they may find themselves paid back in some new currency that would be close to worthless.
- It is the awareness of this risk -- among many others -- that means euro area policy makers, rhetoric aside, will do all they can to keep Greece in the euro.

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Recommended Reading

Why Europe Will Rise Again
Interview with Guy Sorman
Wall Street Journal
August 17, 2012

It's the Circumstances, Stupid
Peggy Noonan
Wall Street Journal
August 17, 2012

Fussbudget: How Paul Ryan captured the G.O.P.
Ryan Lizza
The New Yorker
August 6, 2012

There is a possible roadblock in September that is outside the control of policy-makers -- the German Federal Constitutional Court's decision on the ESM. The court previously ruled in favor of the ESFS (see "On the German Court EFSF Decision" September 7, 2011) -- and we see no reason for a different outcome on this occasion. However, the decision will be watched very closely if Draghi links any ECB action to ESM conditionality.

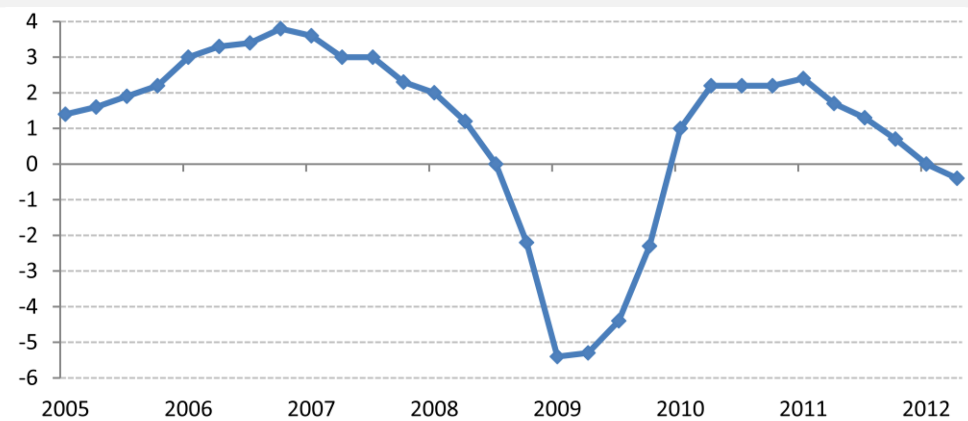
The fall will also bring the next round of euro area summits.

- The October 18-19 summit is due to produce a report on the next stage of euro area integration -- adding a fiscal union to the monetary union. This round of negotiations is likely to be extensive and beset with legal difficulties.
- We do not expect a rapid resolution of the negotiations. Europe is still waiting for the "quantum leap" forward in integration that the ECB called for in June 2010.

While the negotiations over Greece and the way forward for union drag on, confidence is going to continue to be damaged by the uncertainty those negotiations cause. That already has had, and will continue to have, consequences for the real economy.

Euro area real output growth has turned negative for the second time in the crisis era -- and the second time since the euro came into existence -- (please see the chart below).

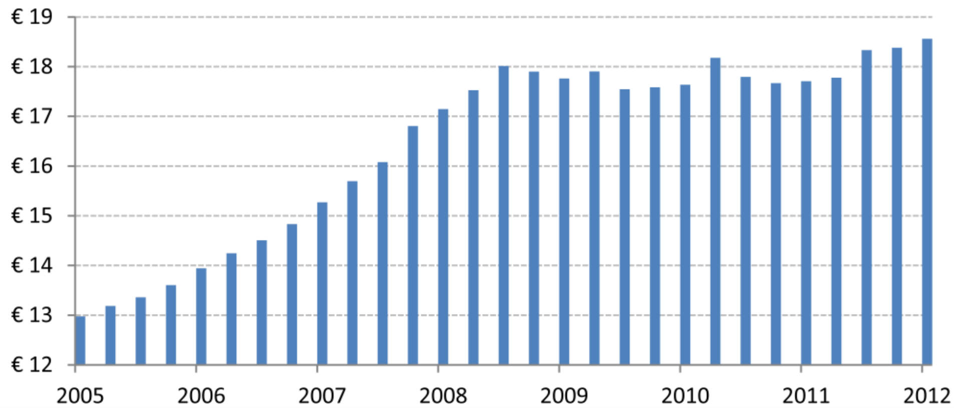
♦ Euro area gross domestic product, real growth YOY



Source: Eurostat, TrendMacro calculations

This is familiar and backward-looking data -- everyone knows the euro area is in recession. But the rally of the last three weeks aside, forward looking macro data looks no more encouraging. For example, while bank lending is at an all-time high, its growth is anemic at best (please see the chart on the following page). In the 42 months up to October 2008, lending increased by €5 trillion. In the 42 months since, it has grown only a tenth of that.

Outstanding loans, EU credit institutions € trillions



Source: ECB, TrendMacro calculations

With the two LTRO operations leaving EA banks flush with cash, sluggish lending growth isn't a question of funding. Rather, it is a reflection of confidence about the future in the hearts and minds of borrowers and lenders. The longer the political crisis lasts -- even if it continues to succeed in muddling through and preventing the disintegration of the euro -- the longer investors will hold off making the kind of commitments (such as borrowing and lending) that lead to growth.

Uncertainty continues to be the euro area's greatest affliction, and ultimately its greatest risk. Unless the ECB and the politicians can turn rhetoric into action on more effective monetary policy and closer integration this fall, that uncertainty will continue to weigh heavily on euro area growth. And with no growth, there is no amount of monetary or political action that can save Europe or the euro.

How do we square the optimistic outlook that markets are taking this month with the bleak growth scenario the euro area faces? The no-growth scenario is premised on a continued lack of policy certainty -- a failing which, given the lethal consequences of a prolonged period of negative growth, is very much on the minds of those empowered to fix it. The coming months are going to be the test of the will of policy-makers to find a path through the challenges facing them.

We believe that they will succeed. The speed at which they act is critical, though. Four more years of muddle-through will not be good enough.

Bottom line

In the short to medium term there is little risk to the rally in euro area markets. Beaten-down stock markets -- particularly in Spain and Italy -- are moving higher on the promise of ECB action. We do not expect the ECB to disappoint. The next round of Greek talks will lead to unhelpful rhetoric, but a Greek exit is the only substantive risk, and that is still highly unlikely. But on a longer investment horizon, risks from continued policy uncertainty in the euro area will weigh on investor confidence. Without that confidence the euro area cannot have the one ingredient that will end this crisis -- growth. That's the challenge we expect policy-makers to take up when they return from their August holidays.