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Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

Calm Breaks Out in Europe

Wednesday, October 31, 2012
Lorcan Roche Kelly

Peripheral sovereign debt shifts from speculative opportunity to total return play.

The last three months have changed the game in the euro area. They kicked off with ECB President Mario Draghi's "whatever it takes" speech in London (see "On Draghi in London" July 26, 2012), which he followed up on in subsequent ECB meetings (see "Draghi: Off the Reservation" August 3, 2012 and "On the September ECB Policy Decision" September 6, 2012).

Euro area politicians have been doing their part too, getting the European Stability Mechanism (ESM) up and running, agreeing to a banking union -- although timing is still a little unclear -- and increasing national budget oversight with the fiscal compact. Progress toward stabilization and integration, though agonizingly slow, is being made.

Sentiment has changed markedly. We see it among most of our US clients, for whom Europe has dropped off the list of imminent systemic threats. This change in sentiment is captured in Moody's statement on Spain, when it surprisingly did not downgrade the country.

- *Remarkably, the risk feared most by investors -- Spain needing a bail-out -- is now seen as a credit-enhancing event.*
- Moody's said that Spain's accessing the ESM through a "precautionary credit line" -- and thereby gaining access to the ECB's new Outright Monetary Transaction (OMT) program will materially reduce the risk of Spain losing market access.
- Thus a potential Spanish bailout is a substantively different kind of event than those of Greece, Ireland and Portugal. The Spanish bailout will allow continued market access.
- The ESM in the primary market, and the ECB's OMT in the secondary market, will ensure a cap on Spanish yields. This will serve to both reassure investors, and as Moody's put it, give Spain "the time it needs to stabilise public debt over the next few years" -- while also reducing the risk of burden-sharing among investors.

All very positive. But as we have already warned (see "The August before the Fall?" August 20, 2012), it is not enough to merely save the euro area. There has to be some prospect for growth, too.

Update to strategic view

EUROPE MACRO, EUROPE BONDS, US BONDS: We have long held the out-of-consensus view that the euro area will survive its existential crisis. That view is now playing out in reality, and is becoming increasingly appreciated by investors. The next challenge for the euro area is to find growth, and that will take a great deal of time. Moving from crisis to a growth challenge, peripheral debt is no longer a speculative opportunity, but rather one of total return. Relatively high sovereign yields in large economies like Spain and Italy, backstopped by the ECB and denominated in a conservatively managed currency, are very competitive with US Treasury yields, especially with QE3 launched and a debt ceiling crisis on the horizon. France, conversely, is starting to make less sense as its bonds are still trading like a safe haven -- less necessary with the crisis passed, and less sustainable with an economy starting to look more and more peripheral.

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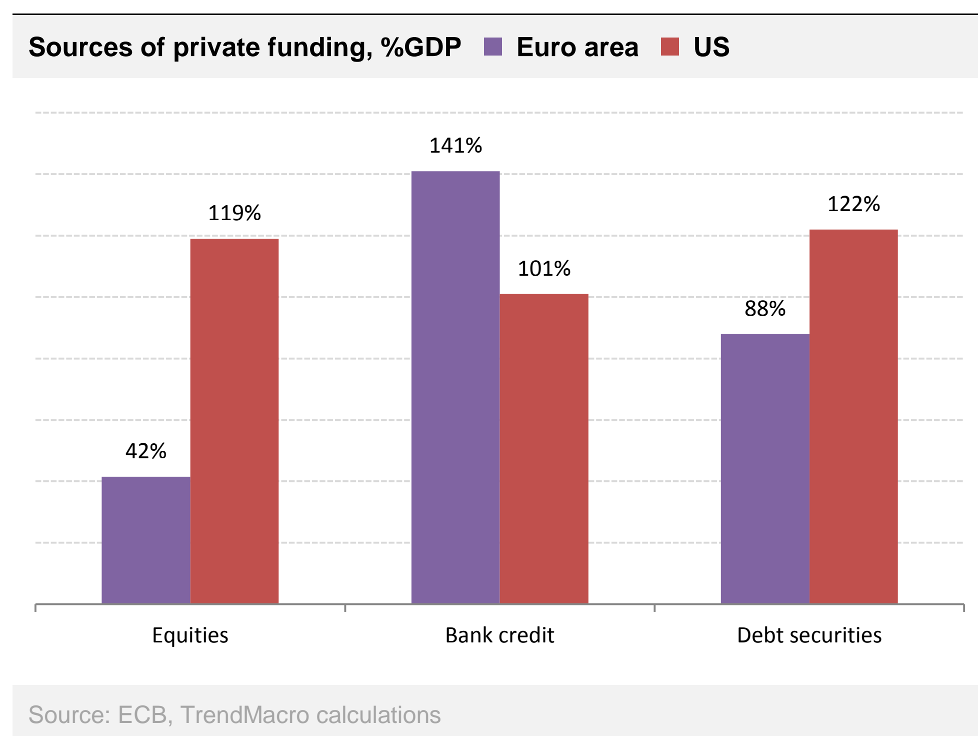
All indicators continue to point towards a long recession. Whether it is unemployment, economic sentiment or investment, nothing is pointing in the right direction for an early recovery. Draghi, in his speech to the Bundestag last week, highlighted the risk of deflation in some economies in the euro area as part of his defense of the OMT program (and, in a brilliant piece of mental gymnastics, managed to argue that the OMT is both anti-deflationary and non-inflationary). He used the past tense when describing those deflation risks. We feel this may have been a little ambitious.

In order to get to the source of the current risks to euro area growth we have to -- unfortunately -- go back to the banks. In the euro area, banking is still by far the most important source of private funding (please see the chart below). With the banking system still in retrenchment mode, it is failing to fulfill its essential financing role for the euro area economy.

Sources of private funding, %GDP ■ **Euro area** ■ **US**



Source: ECB, TrendMacro calculations

Due to the importance of the banking system to the euro area, one of our favorite forward-looking indicators is M3 growth. Despite the ECB's large liquidity injections in the two 3-year LTROs, M3 growth has remained far below trend, with the level practically unchanged since end 2008 (please see chart on the following page).

So far, so deflating. But there remain long-term prospects for recovery in the euro area. They are based on Germany's Agenda 2010 program introduced by Gerhard Schröder's socialist government in 2003 (see "Europe's Supply-Side Revolution" February 17, 2012). That program, with its labor market and social safety net reforms, succeeded in turning the German economy around, rescuing it from its status as "the sick man of Europe." But it did lead to increased unemployment for the first two years,

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
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Donald Luskin
Chicago IL
312 273-6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

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Recommended Reading

A Keynesian Blind Spot
Casey B. Mulligan
New York Times
Economix
October 31, 2012

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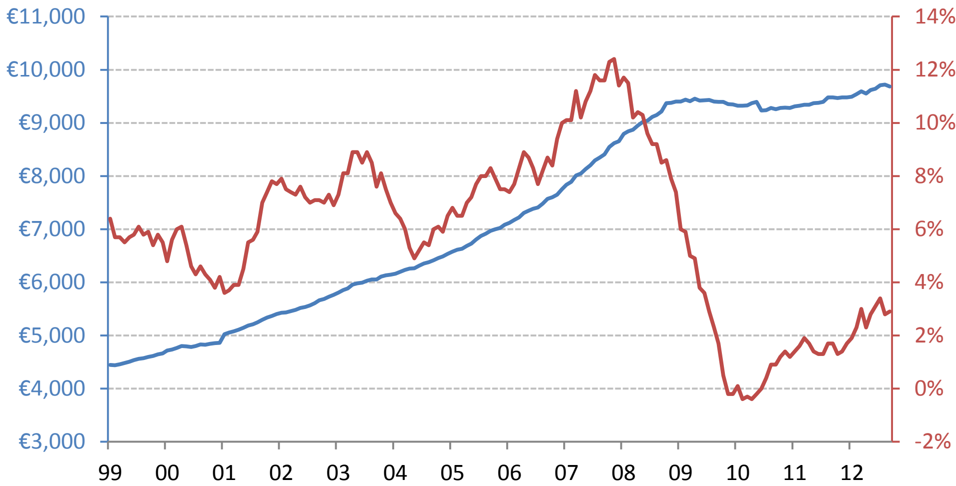
Euro area M3 money supply — Level, billions, SA — YOY growth



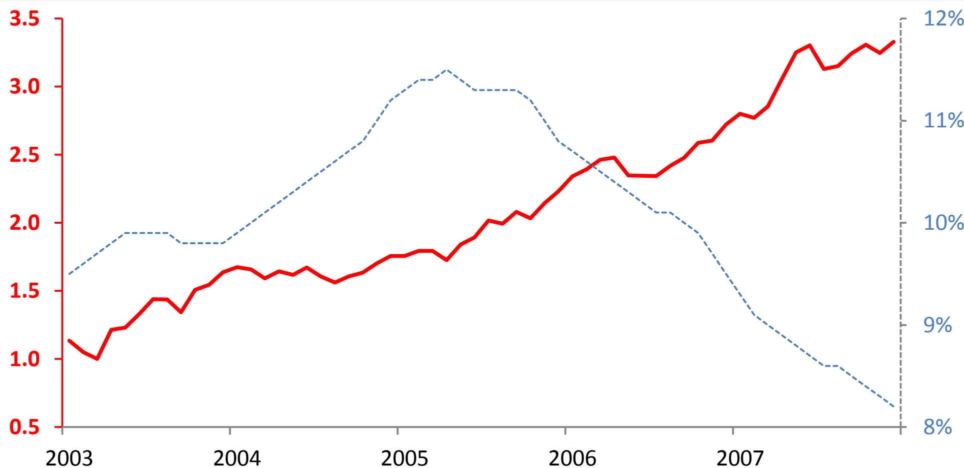
Source: ECB, TrendMacro calculations

as employers took advantage of their new found ability to actually fire some staff (please see chart below).

While the German model is close to ideal from a supply-side perspective, major structural changes do take time to produce results. In Germany it took two years for the first results to begin to show, and that was during a period of sustained global economic growth -- and ultimately Germany emerged as the strongest and most dynamic of all the developed economies. But now, for Spain, Italy and the other peripheral nations following Germany's reform model, turnaround could take much longer than it did for Germany -- they are trying to reform in the face sluggish global growth.

- In Spain, Prime Minister Mariano Rajoy is one year into his term

Germany's "Agenda 2010"
— DAX, indexed to 1 at 2003 bottom ··· Unemployment rate



Source: Bloomberg, Eurostat, TrendMacro calculations

and so far is following the German reform template as closely as is politically possible given the 25% unemployment rate. He has the luxury of probably not facing elections for another three years.

- But in Italy, Prime Minister Mario Monti has a much shorter time-frame for his reform agenda, also based on the German template. Elections are due by April next year, and it is unclear whether Monti will be asked to continue as prime minister after the vote. That said, a bright spot for Italy is the assignment of Silvio Berlusconi to the political dustbin. If -- as is usual in Italian elections -- no party can form a majority after the next election, there is a good chance that Monti will be asked to continue as prime minister. As a senator for life, Monti would not have to face the electorate himself to take the role.
- While Spain and Italy are on the very slow road to recovery, France seems determined to continue to take steps that reduce the chances of growth. It was socialist Schröder that reformed the German labor market. Unfortunately it seems unlikely -- so far -- that socialist President François Hollande is willing, or able, to do the same in France. We have already warned that France is looking less and less like a safe haven (see "Exceptional Measures" August 29, 2012) and recent developments in France are making it look more peripheral than core.
- The Association of French Private Industry, an umbrella group including most of the largest industrial groups in France, published a letter on Sunday highlighting the risks from Hollande's current policies. They called for reductions in corporate and labor taxes to bring the business environment in France more in line with other euro area members. They also called for Hollande to drop his strong opposition to exploiting France's shale gas reserves.

Overall, the euro crisis is in abatement, and absent unlikely political shocks it should remain that way. So peripheral sovereign debt is no longer the speculative play it has been at various crisis points along the way, such as earlier this year when the ECB was engaged in its 3-year LTRO program (see "LTROphoria" February 27, 2012). But from a total return standpoint a stabilized euro area offers real attractions. For example, 10-year Spanish debt offering a 5.5% coupon for the next decade in one of the world's most conservatively managed currencies -- with the ECB's infinite firepower as a credit backstop -- has got to be competitive with low US Treasury yields, especially with limitless QE3 launched and a debt ceiling negotiation coming at year-end.

For France, on the other hand, all the risk is on the downside. The crisis has mostly passed it by due to its position as a "core" nation throughout the crisis (see "Two-Tier Europe is Born" August 17, 2011). But, under Hollande, France is becoming isolated from the true core economies -- Germany, Holland and Finland (see "Bring in the Noise" September 26, 2012) -- and the safe haven premium its bonds have enjoyed will start to unwind.

Bottom line

We have long held the out-of-consensus view that the euro area will survive its existential crisis. That view is now playing out in reality, and is becoming increasingly appreciated by investors. The next challenge for the euro area is to find growth, and that will take a great deal of time. Moving from crisis to a growth challenge, peripheral debt is no longer a speculative opportunity, but rather one of total return. Relatively high sovereign yields in large economies like Spain and Italy, backstopped by the ECB and denominated in a conservatively managed currency, are very competitive with US Treasury yields, especially with QE3 launched and a debt ceiling crisis on the horizon. France, conversely, is starting to make less sense as its bonds are still trading like a safe haven -- less necessary with the crisis passed, and less sustainable with an economy starting to look more and more peripheral.