Trend Macro

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

MACROCOSM

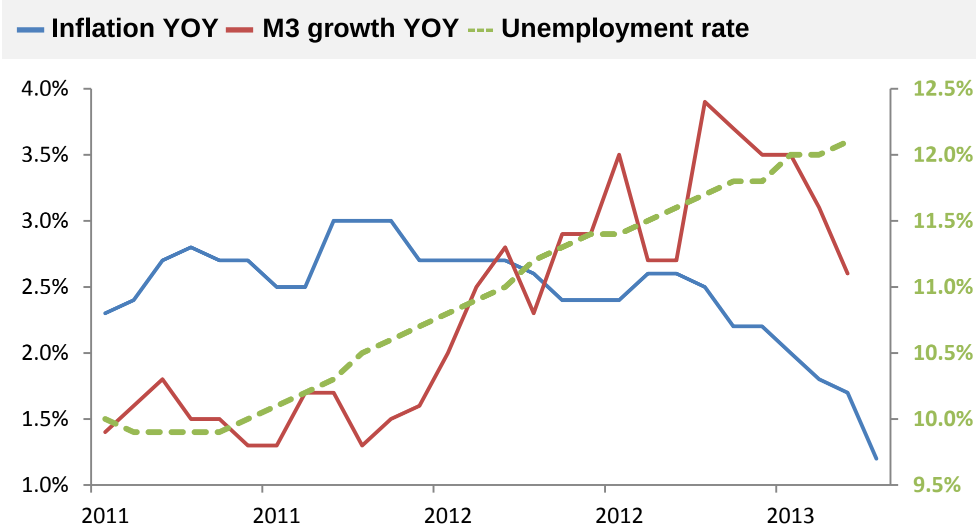
Draghi's Troika of Troubles, Volume 2

Tuesday, April 30, 2013

Lorcan Roche Kelly

Draghi can either cut rates Thursday -- or do something that might actually help.

A month ago we wrote about the three major problems facing ECB chief Mario Draghi -- disinflation, fragmentation and sluggish lending growth (see "Draghi's Troika of Troubles" April 3, 2013). The ECB governing council will meet on Thursday to make its monetary policy decisions in the face of significant disimprovement in recent data on all three fronts -- especially this morning's flash inflation report from Eurostat, showing headline inflation at only 1.2% year-on-year (please see chart below).



Source: ECB, Eurostat, TrendMacro calculations

With this latest data, a cut of 25 basis points of the ECB's main refinancing rate to 0.50% at the Thursday policy meeting now seems likely. Further, it is unlikely that there will be much resistance to such a cut from the Bundesbank, as latest readings show German inflation plunging to 1.1%, from 1.8% in March.

We have been skeptical that the ECB would cut rates this week (see "On The April ECB Policy Meeting" April 4, 2013), and still see it as far from a sure thing -- perhaps the major argument in favor of it being the drumbeat of expectations for it from ECB-watchers. Demand effects aside, at the moment there seems to be little -- other than something symbolic -- that an

Update to strategic view

ECB, EUROPE MACRO, EUROPE BONDS: Terrible inflation data, coupled with weak broad money growth and high unemployment, means we should expect action from the ECB on Thursday. But if that action is only a rate cut, which would be completely ineffectual at addressing the problems the euro are faces, then it is time to start taking profits on peripheral debt. If Draghi uses the bad data to announce or strongly hint at something more substantial, there is nothing stopping peripheral debt continuing its spectacular rally.

[Strategy Dashboard home]

interest rate cut could actually do to reverse any of the problems facing the euro area.

- Fragmentation of the euro area -- that is, primarily, stunted lending growth in the periphery (again, see "Draghi's Troika of Troubles") -- means that the only places a rate cut will get traction are the places that least need the help. In the periphery -- where the monetary policy transmission mechanism is still not working -- a rate cut will have little immediate effect.
- Similarly, unemployment is very unevenly distributed across the euro area, with the states where it is highest the same states that will benefit least from a rate cut.
- This morning's flash inflation report showed that a large component of the inflation miss was due to collapsing energy prices (see "Gold and Commodities: Breaking Bad" April 15, 2013). The only thing that will turn *that* around is global growth -- which will not be spurred by an ECB rate cut at the moment.

Though in his March press conference Draghi assured that the ECB stood "ready to act" if needed (again, see "On The April ECB Policy Meeting"), he has emphasized in recent press conferences the role for other actors, such as the European Investment Bank, national central banks and governments (see "The EIB, Not the ECB" April 12, 2013). We are starting to see movement from those agents.

- The European Investment Bank has in recent days made €200 million credit available to both Portugal and Ireland for the small and medium enterprise (SME) sectors in both countries. That lending will be made available through domestic banks at discounted rates.
- While not directly impactful on credit growth, today's approval of Enrico Letta's new government in Italy -- with Draghi's former Bank of Italy right-hand man Fabrizio Saccomanni as finance minister -- is certainly a positive.
- Spain and Germany yesterday agreed a joint program to increase investment in Spanish firms -- although details of the agreement have yet to emerge.
- It may be that these moves are enough to prompt action from the ECB -- such as increasing collateral eligibility of SME credits, or so-called "structural operations" through the national central banks (again, see "Draghi's Troika of Troubles"). If they were, then that would certainly be much more positive for the euro area than a rate cut.

Without something more substantial than a practically meaningless rate cut, markets should see Thursday's meeting as an excuse to take some profits on their Spain and Italy sovereign bond holdings.

- The rally in peripheral debt -- particularly Spanish and Italian sovereign debt -- has been sustained through the back-to-back crises of the February Italian election and the March Cypriot bailout

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

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

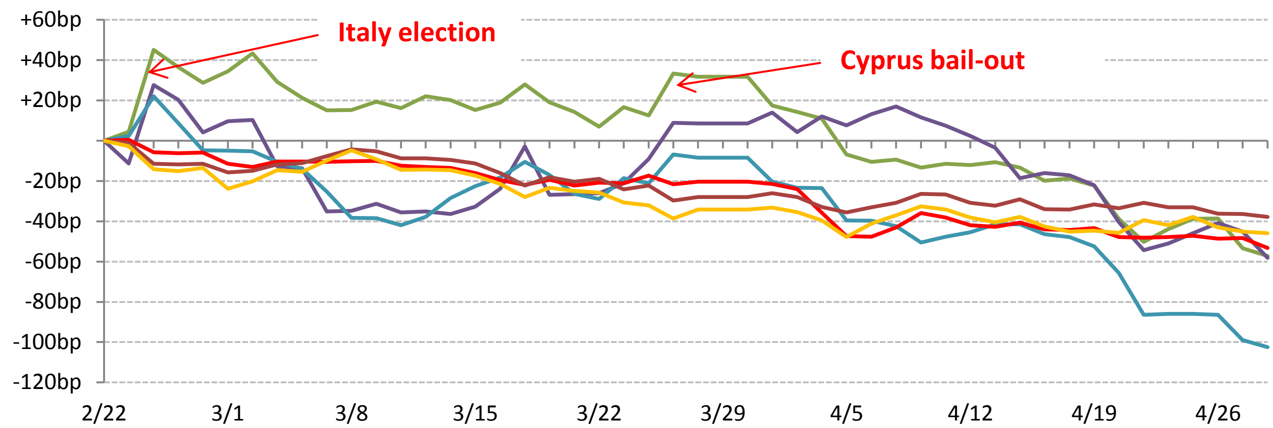
Lorcan Roche Kelly
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

[About us]

(please see chart below), and the absence of substantial action from the ECB should lead to a correction.

10-year yield, change from before Italy election

Italy — Portugal — Spain — France — Germany — UK



Source: Bloomberg, TrendMacro calculations

As usual with the ECB, this Thursday the rate announcement is made 45 minutes before the press conference starts. An announcement of a rate cut is a likely signal that the ECB is going to do nothing more. Conversely, *no* rate cut announcement should *not* necessarily be viewed as a time to sell. The data -- especially the inflation data -- demands a reaction from the ECB. If it -- correctly -- chooses not to use the interest rate tool, then anything else it chooses will have more of the "big bang" properties that can give the ongoing rally new legs. On the other hand, if the ECB does nothing at all, we will have the seen the top in the peripheral debt rally, at least until the ECB finally responds.

Bottom line

Terrible inflation data, coupled with weak broad money growth and high unemployment, means we should expect action from the ECB on Thursday. But if that action is only a rate cut, which would be completely ineffectual at addressing the problems the euro are faces, then it is time to start taking profits on peripheral debt. If Draghi uses the bad data to announce or strongly hint at something more substantial, there is nothing stopping peripheral debt continuing its spectacular rally.