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MACROCOSM

The Short of a Lifeline

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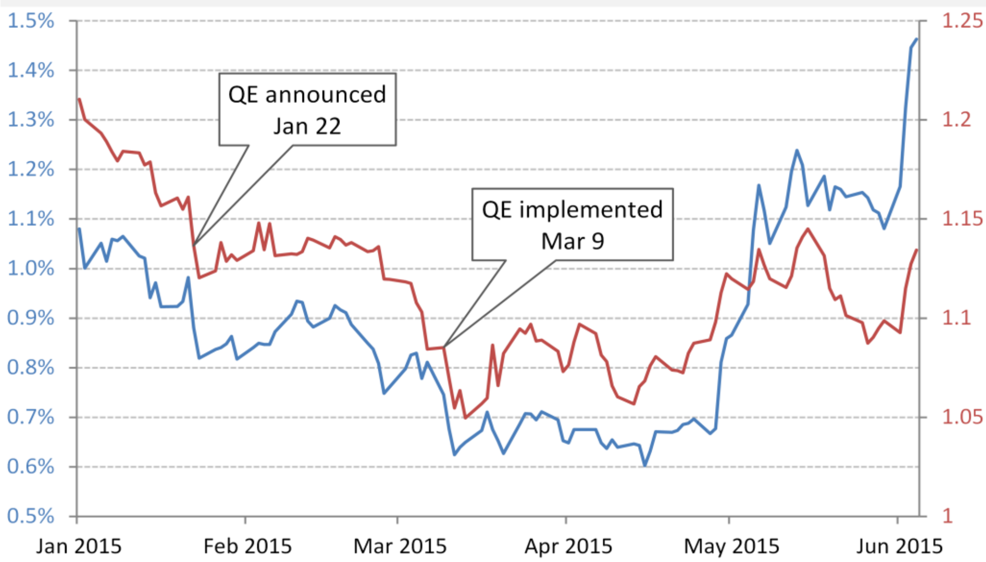
Donald Luskin

The back-up in euro area yields is a good thing -- it's all about QE and improving inflation.

With the latest episode of potential Greek default heading into crunch-time -- with IMF Director Christine Lagarde warning that Greek exit from the euro currency is a "potential," and with US Treasury Secretary Jacob Lew warning of an "accident" that could force Greece out -- should we be worried by the dramatic back-up in euro area bond yields over the past six weeks, taking the German 10-year bund from a yield below 5 bp in mid-April to almost 100 bp earlier this morning? It's not just bunds -- it's all euro area yields, including those of Spain and Italy, large globalized economies that, unlike Greece, really matter. The average yield of 10-year euro area sovereigns, weighted by their ECB capital keys has more than doubled (please see the chart below). *Should we be worried that we're headed back into another euro area sovereign debt crisis like that of mid-2012?*

- *We're at some risk of confirmation bias here, because we predicted this.* No, we never said the bund was "the short of a lifetime." We did say, when the European Central Bank first announced its quantitative easing program of sovereign bond purchases that,

Yield of weighted average of 10-year sovereigns: DE, FR, IT, ES, ND, BE
USD/EUR exchange rate



Source: Bloomberg, TrendMacro calculations

Update to strategic view

EUROPE BONDS, ECB, EUROPE MACRO: We think the sharp back-up in euro area sovereign yields -- which we predicted when ECB QE was announced -- is mostly a healthy sign, reflecting improved inflation expectations. If it were signaling a new euro area debt crisis, we'd see a blow-out in spreads, which in fact have been well contained. We continue to see a live possibility of a Greek default and/or exit from the euro currency, and believe that this would not be a global systemic event.

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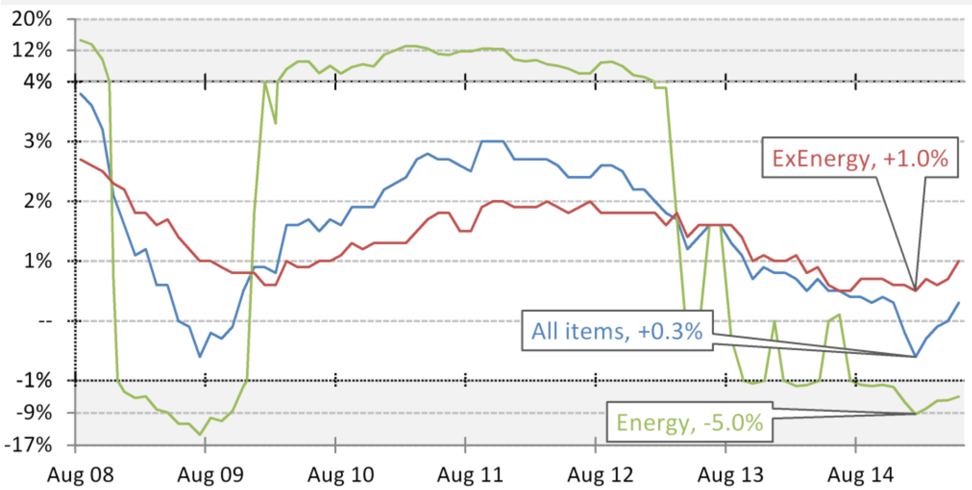
"after an initial knee-jerk reaction and some random turbulence, we would ultimately expect euro area bond yields, priced to perfection, to rise -- as yields did in the US whenever the Fed announced a purchase program. The already weak euro should strengthen" (see "On the January ECB Policy Meeting" January 22, 2015).

- *How could it be otherwise? Central bank asset purchases are intended as a lifeline to improve growth and inflation expectations. If the lifeline succeeds, how could it not, perforce, move long-term yields higher* (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013)?
- So we are strongly inclined to see this back-up in euro area yields as reflecting good news -- and thus good news itself. *Indeed, it has come against the backdrop of euro area year-on-year inflation pulling back from negative territory, where it had been all year, into positive territory* (please see the chart below).
- We've long argued that too-low euro area inflation was largely the result of the collapse in oil prices from their peak a year ago (see "The Deflation Hoax" January 8, 2015). Now, the substantial recovery in oil prices since their global lows in January has moderated that effect. But it's more than that -- euro area inflation ex-energy has substantially improved, as well (please see the chart below). *How could 10-year bond yields not rise with this going on?*

Euro area consumer prices YOY



Source: Eurostat, TrendMacro calculations

- According to ECB President Mario Draghi in the press conference following yesterday's Governing Council meeting, this is all according to plan. Sort of. Or not. Well, here's what Draghi actually said: "Let me say, the recovery is on track, exactly according to our projections. However, we had expected stronger figures, stronger than our projections."
- In the meantime, QE will continue, no matter what. Draghi again: "…we plan to keep our course steady and unchanged, and if anything, if necessary, we'll actually add to that."
- So far we haven't seen a blow-out in spreads between peripheral euro area debt and the bund -- nor between the bund and US

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Treasuries -- both of which would surely have occurred here if we were really staring down the barrel of a new euro area debt crisis.

All that said, we're respectful of the strong possibility that there could be a volatility event in the euro area -- the whole world, for that matter -- if the present Greece crisis ends in default. We have been saying for quite a while that this time around it's very much a live possibility (see "Greece: Failure Is an Option" February 10, 2015).

- But, unlike last time in 2012, we continue to believe that a Greek default -- or even a Greek exit from the euro currency -- would not be a serious systemic blow, and indeed would likely strengthen the euro area's resolve to continue with structural reform (see "From Grexit to Griddance" February 23, 2015).
- With global equity markets having not experienced a serious correction for three years, it's possible that even if a blow-up in Greece doesn't have any lasting meaning, it could nevertheless trigger a short-term panic.
- But as we've talked to investors about this over the year, we've detected a significant swing in consensus expectations about that. Increasingly, investors who had formerly been quite fearful of the prospect of a Greek crisis are coming to agree with us that it would have little substantive impact. Perhaps this is a form of complacency, suggesting that a crisis would foment a large negative reaction in markets, precisely because no one is positioned for it. Another view would be that confident investors are waiting for a Greek crisis to provide a buyable dip -- which, in this atmosphere of confidence, will not in fact materialize.

At this point we don't have a strong view on how the negotiations with Greece will resolve. But we continue to believe that the euro area will not cave in to Greek demands for debt relief. To do so would be to encourage radical political elements in Spain and Italy. Indeed, the best way to suppress those elements might be to let Greece default, leave the euro, and become a failed state (see "From Grexit to Griddance" February 23,

Greek bail-out extension negotiations: game theory payoff matrix
Europe's favored outcomes **Greece's favored outcome**

		Europe	
		Extend	**Don't extend**
Greece	**Comply**	SYRIZA rendered ineffective	Infeasible outome
	Don't comply	Europe caves to populism	Grexit, failed state

Source: TrendMacro calculations

2015).

- Thinking in game-theoretic terms, Grexit could be the euro area's "minimax" solution -- the one that minimizes the maximum risk (please see the table on the previous page).
- Make no mistake about it --- the maximum risk now is that, with recovery restored some degree of complacency among "crisis countries," radical politics will throw the euro area right back into crisis. While the negotiations with Greece have approached their coming climax, regional elections in Spain and in Italy over the last two weeks have driven excited media accounts that reform-minded incumbents are losing their grip in the periphery of the euro area.
- So "the institutions" have no interest in making SYRIZA look good. And this puts the decision in Greece's hands -- it either complies with the requirements of "the institutions" or it doesn't. This puts Greek Prime Minister Alexis Tsipras in an impossible political position -- trapped between the demands of "the institutions" on the one hand and his radical anti-austerity coalition on the other.

Bottom line

We think the sharp back-up in euro area sovereign yields -- which we predicted when ECB QE was announced -- is mostly a healthy sign, reflecting improved inflation expectations. If it were signaling a new euro area debt crisis, we'd see a blow-out in spreads, which in fact have been well contained. We continue to see a live possibility of a Greek default and/or exit from the euro currency, and believe that this would not be a global systemic event.