Trend Macro

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Europe Gropes toward Stress-Tests

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It's a test to see if disunited Europe can establish new rules and play by them.

We continue to be cautiously optimistic about developments in Europe (see "On Today's Drop in Gold" July 1, 2010). We're optimistic because Europe is doing all the right things to draw a safety net under its fragile banking system, generally following the template set in the US's successful rescue last year. But we're cautiously so, because Europe is doing the right things poorly. When the primary objective is to restore confidence, that may not be good enough.

- The Committee of European Banking Supervisors' stress-test will cover 91 banks, representing at least 50% of banking assets in each of the 27 member nations, and overall 65% of European banking assets. We believe that standardized and transparent stress-tests were key to the solution of the US banking crisis in 2009 (see "Geithner Gets a Do-Over" March 24, 2009). In the US, the exact terms of the stress test were revealed *ex ante*, and then bank-by-bank results were revealed *ex post*. CEBS has revealed only very general information about the terms of the test. Results will be revealed at the individual bank level later this month, but the degree of detail is unknown. This is all an improvement on the narrow, aggregated and opaque stress-testing process in Europe last year, but Europe's financial press is right to criticize the authorities for not being more forthcoming.
- Among what little is known about the metrics of the stress-tests is that under the "adverse scenario," the "sovereign risk shock in the EU represents a deterioration of market conditions as compared to the situation observed in early May 2010." Market chatter has interpreted this as signaling that outright sovereign default will not be modeled, because the EU intends under all circumstances to not allow a default to happen. But why not say so explicitly?
- We think the most critical element to the success of the US stress-tests was the pre-commitment of the Treasury to be the recapitalizer of last resort, standing ready to buy equity capital at a known and fixed price (see "The Stress Tests' Hidden Mickey" May 4, 2009). This created predictability about the role of government in any bail-out that may have been necessitated by the tests, and assured investors up and down the capital structure that no one would be wiped out -- even equity holders at the bottom of the

Update to strategic view

US DOLLAR: With semi-opaque stress-tests and no explicit solution for banks that fail, Europe is groping toward the restoration of confidence in the euro, but it's not all the way there. Having broken the treaty rules that define the euro to begin with in rescuing Greece, Europe's challenge is to establish new rules. There's evidence that the rescue of Greece and other PIIGS nations is working, but the euro won't mount a sustained recovery until new rules are established, and that seems to be a long way off.

EUROPEAN BONDS: A notional "federal" Europe is more creditworthy than the US, so assuming that the EFSF can robustly deliver on its rescue promise, PIIGS debt should be seen as implicitly default-free. There is the risk that the market will have to undergo another crisis to reveal the now-unknown terms of rescue, but we think it's a good bet that a rescue will be forthcoming under almost any circumstances.

[Strategy Dashboard home]

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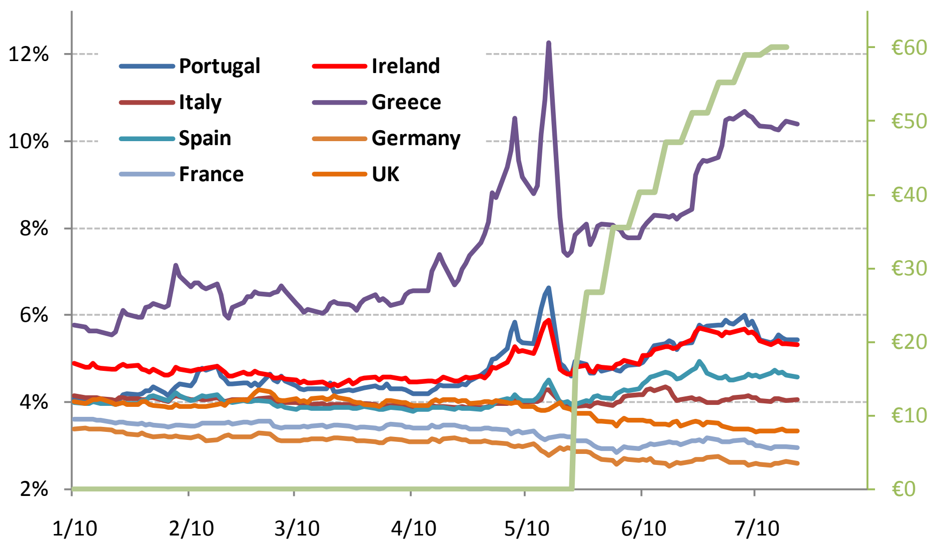
structure knew the limits of potential dilution. That promise allowed for massive public market recapitalization of US banks last year. Today, every stress-tested bank is trading well above the Treasury's fixed price, even ones like Citigroup that underwent the greatest equity dilution. All we have from Europe along these lines is a rumor reported by Market News International (no link available) last Wednesday morning, that "a document prepared ahead of a meeting of European finance ministers" includes a plan under which, coincident with the announcement of the test results, "individual member state governments will make a statement saying they 'stand ready to use back stop mechanisms for recapitalisation' if banks have been deemed in need of such support." Unlike in the 2009 US experience, the "mechanisms" are not pre-defined, but at least it appears they will exist.

As all this has evolved over the last couple weeks, the euro has rallied against the dollar and EU sovereign yields -- the good, the bad and the ugly -- have been stable. These market signals are especially positive considering that the European Central Bank's purchases of distressed sovereign debt have slowed to a trickle -- only a billion last week -- and there have been signals from ECB officials that they will soon stop altogether (please see the chart below).

Most worrisome continues to be the fact that the European Financial Stability Facility -- the massive rescue fund announce March 10 (see "Europe Gets *le TARP*" May 10, 2010) -- remains undefined. It lacks legal authority, with Slovakia still having not voted to make authorization of the EFSF unanimous among the EU16 nations. And there is no clarity as to

ECB sovereign purchases (€ billions) versus Europe 10-year yields



Source: Reuters, ECB. TrendMacro calculations

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Recommended Reading

The Political Economy of the Subprime Mortgage Credit Expansion
Atif R. Mian, Amir Sufi and Francesco Trebbi
Chicago Booth Research Paper No. 10-21
June 9, 2010

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who will be eligible to get bailed out and under what terms. Germany and France remain in conflict about this utterly key point, with Germany agitating for a rigorous regime of creditor hair-cuts and debtor austerity that would threaten to make any "rescue" hardly worthy of the name.

Europe *should* be okay here, at least in the sense that a notional "federal" Europe -- that is, the EU 16 seen as a single fiscal union -- should not be seen as having particularly severe sovereign credit risk. If it *is* at risk, then the US is far more at risk, having both more debt as a fraction of GDP *and* higher deficits. The problem is that there is no federal Europe, and the attempts to improvise attempts to make a disunited Europe nevertheless as creditworthy as a united one reveal almost as much division as cooperation. We really are encouraged by what progress we're seeing, but we remain concerned that "Mr. Market" will eventually have to foment another crisis in order to learn under what circumstances exactly what safety-net will be deployed.

Bottom line

With semi-opaque stress-tests and no explicit solution for banks that fail, Europe is groping toward the restoration of confidence in the euro, but it's not all the way there. Having broken the treaty rules that define the euro to begin with in rescuing Greece, Europe's challenge is to establish new rules. There's evidence that the rescue of Greece and other PIIGS nations is working, but the euro won't mount a sustained recovery until new rules are established, and that seems to be a long way off. A notional "federal" Europe is more creditworthy than the US, so assuming that the EFSF can robustly deliver on its rescue promise, PIIGS debt should be seen as implicitly default-free. There is the risk that the market will have to undergo another crisis to reveal the now-unknown terms of rescue, but we think it's a good bet that a rescue will be forthcoming under almost any circumstances.