TrendMacro

Trend Macrolytics, LLC
Donald Luskin,
Chief Investment Officer
Thomas Demas,
Managing Director

MACROCOSM

The Libyan Connection

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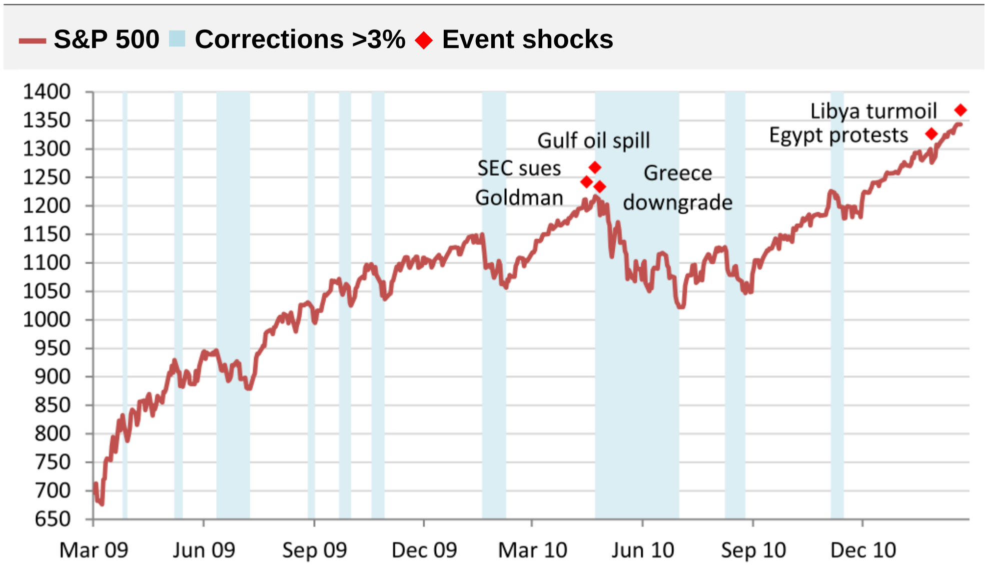
Donald Luskin

The systemic risk from Libya points to Europe and to gold.

After a record 97 days without a 3% correction for US stocks, the turmoil in Libya over the weekend could be enough to finally trigger a pause in the slow-motion melt-up (please see the chart below). But based on what we know now, we don't see why this ought to be anything more. The political instability we are seeing in the Middle East and Africa is typical in the aftermath of a systemic credit crisis. We've seen a more orderly version of it playing out in the US, and so far here it has evolved as a strong economic positive (see "The Pendulum Swings Back" November 2, 2010). We think political instability presents the greatest threat to Europe, where it risks upsetting an already very difficult debt resolution situation. This, in turn, impacts or view on gold and inflation.

First, some thoughts on Libya and its possible economic spillovers, especially with regard to oil.

- Unlike Egypt, Libya's instability is exacerbated by long-simmering tribal fissures that could lead not only to regime change but to fracturing the country into separate nations.



Source: Reuters, TrendMacro calculations

Update to strategic view

US STOCKS: Maybe Libya will be the catalyst for a long-overdue correction, with 97 days having gone by without one. We think it would be nothing more than a correction, and would be looking for re-entry points.

US MACRO: A higher oil price doesn't help, but at this point it shouldn't be enough to derail the recovery.

GOLD, FED FUNDS, US DOLLAR: Libya plays into the already dovish dynamic at play, and raises the likelihood that the Fed will stay too easy for too long. This would normally be dollar-negative, but Libya's impact is disproportionate on troubled Europe, where covert money creation through Emergency Liquidity Assistance is already underway. Now even more should be expected, and the resultant weaker euro should keep the dollar seeming strong. All this plays into the second-best bull case for gold. We maintain our $1500 price target.

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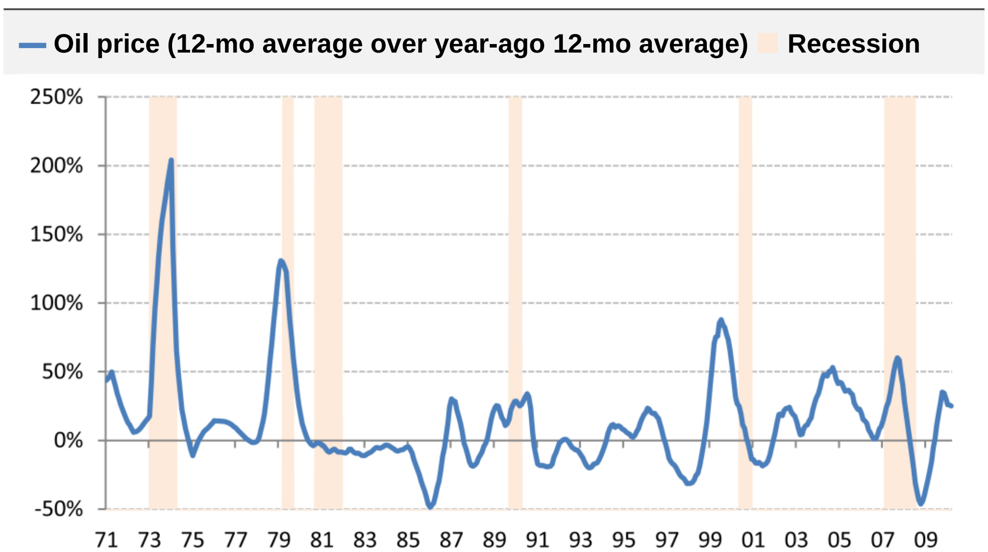
- Also unlike Egypt, Libya is a major oil exporter. There will be a disruption in oil supplies until the dust settles -- but the iron law of survival dictates that when it does, oil will continue to be sold to the rest of the world. Political resolution will necessarily involve dispute about ownership and control of oil resources, which will make a complicated process more difficult, and would extend the duration of an energy disruption.
- Obviously, while this plays out, oil prices will be elevated.
- Will this be enough of a price shock to derail economic recovery? Sure, you can posit some possible oil price that will make it so. In the summer of 2008, $147 oil would have eventually triggered a recession even if there had been no Lehman failure the following month. The price we see today -- already reflecting a considerable instability premium -- is unhelpful, but it doesn't have to be disastrous.
- Evidence suggests that recessions are triggered by the *path* and *volatility* of the oil price, not just the price itself. This reflects the intuition that economies can adapt to any given oil price, provided that it is not a large sudden shock. Based on history in the US, it seems that the oil price is substantively damaging when the 12-month average price is more than 50% above the year-ago 12-month average price. Today's 12-mo average is now $16 away from that (please see the chart below). A less reliable but frequently cited trigger is when the oil price makes a new three-year high (we're now $40 away from that).
- Booming economies at full capacity and operating on thin margins are more vulnerable to oil shocks than ours is today -- operating well below capacity, and on wide margins. *Remember -- our forecast for better growth in 2011, with real GDP in the high 3's, is a conservative one, even if it was very much out of consensus when we first made it last fall* (see "Stock Outlook: Differences Make a Difference" November 10, 2010)*. By historical standards, we should expect twice that or more. If we were predicting that kind of full return to normality, then a small oil shock would be a big game-*



Source: Reuters, NBER, TrendMacro calculations

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

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

[About us]

changer. Given our more modest forecast, we think it is not.

Now let's turn to the impact of Libya on Europe, which is especially vulnerable to disruptions in Libya. It is the destination for most of Libya's oil, so the impact of persistent instability will be more than a matter of price. It will also entail unique supply-chain disruptions that will be costly. This will be very unhelpful, as Europe struggles with crippling debt resolution issues. It will be especially challenging for Italy, Europe's largest debtor, still in recession and deflation, and with extensive business interests in Libya. The result will be to intensify the political instability already simmering in Europe, which will in turn also be unhelpful, and may have systemic implications.

- The EU/IMF bail-outs of Greece and Ireland (and potentially other peripheral countries south as Portugal) depend on the governments of those countries submitting to harsh austerity in order to avoid debt default. So far Greece and Ireland have agreed, but that could change.
- In Ireland, rejection of the EU/IMF bail-out has been a dominant issue in the run-up to this week's election. The long-ruling Fianna Fáel party is sure to lose its majority in the Dáil as a result. The radical opposition party Sinn Féin has been campaigning with the slogan "burn the bondholders" -- referring to the fact that the EU/IMF bail-out effectively underwrites the Irish government's bail-out of all bondholders of all Irish banks. The more moderate Fine Gael party, which is likely to win an absolute majority of seats in this week's elections, says in its manifesto that losses will be imposed "unilaterally for the most junior bondholders."
- This is important because, as we have said all along, the whole point of the EU/IMF bail-out has been not to save peripheral nations, or save the euro, but to protect systemically important but weakly capitalized German and French banks (see "Europe Gropes toward Stress-Tests" July 12, 2010). Ireland's undoing the EU/IMF bail-out raises the specter of catastrophic spillovers to those institutions.
- But it remains to be seen what Fine Gael will really do when in power. The reality is that more than half of Irish bank debt is in Irish hands, so imposing losses could be counterproductive for the national economy. So it makes a better campaign slogan than an actual policy.
- Further, Fine Gael is clear that it respects the systemic implications of what it might do. In the manifesto it says the imposition of losses "could be extended -- as part of a European-wide framework -- for senior debt, focusing on insolvent institutions like Anglo Irish and Irish Nationwide that have no systemic importance." The key phrase is *as part of a European-wide framework* -- which signals the core intention to play cooperatively with the EU, where hair-cuts on senior bondholders are already being discussed as part of a future steady-state outcome.
- Potentially of more concern is the drubbing that German chancellor Angela Merkel's Christian Democratic Union party took in Sunday's elections in the state of Hamburg. Merkel maintains that this was

driven by local, not national, considerations. But if, in fact, it represents a rebellion against her support for the EU/IMF bail-outs of Greece and Ireland, then as more state elections are held over the coming months, there could be real risk to Germany's continued commitment to ongoing rescue.

We think all this has inflationary implications, and plays into the strong rally in gold over the last several weeks, bringing it earlier today to within $25 of all-time highs.

- Gold turned up in late January, before Egypt and long before Libya got onto the radar screen. In fact, it coincided with the January FOMC meeting, when we saw subtle indications that the Fed was gearing up to stay too easy for too long as the economy recovers, thus activating the second-best bull case for gold (see "On the January FOMC" January 26, 2011).
- It continued higher after the announcements of the resignation of Federal Reserve Board Governor Kevin Warsh, the most effective hawkish voice on the FOMC (see "This Hawk has Flown" February 11, 2011) -- and two days earlier of well-known German hawk Axel Weber, who also withdrew of his candidacy to replace Jean-Claude Trichet as the president of the ECB.
- The turmoil in Libya only enhances this view, as surely the major central banks will be even more cautious given the potential risk to spending represented by higher oil prices.
- In late January, just as gold started to turn up, it became known that the Central Bank of Ireland had extended massive Emergency Liquidity Assistance (ELA) to Irish Banks -- €51 billion, which represents almost one quarter of Ireland's GDP, and 34 times the CBI's capital. Under the governing statute, national central banks may provide ELAs unilaterally -- they do not require ECB permission, and they are not ECB obligations. Thus if the €51 billion is not repaid to the CBI, and the CBI were to be bankrupted as a result, it would become a liability of the Irish state, not the ECB or the EU.
- The national central banks provide data on ELAs imprecisely, and with a lag, because they signal serious risks for the banks involved. And the ECB is evasive on the subject. Last December when Trichet was asked about them, he said opaquely, "we have a doctrine covering the emergency liquidity assistance (ELA) and I have nothing to add to it, this is a standing concept."
- Earlier this month when questioned specifically on the CBI's ELA, he was evasive but approving when he said, "The initial decision is not made by ourselves. The central bank concerned makes the initial decision... we are extremely clear that Ireland must apply the plan. …again, our message is: apply the plan!"
- Setting aside the financial stability issues here, or the wisdom of it, in our view this amounts to money creation. In that sense it is a strong positive, because the ECB itself has remained unconscionably tight -- even with its Securities Markets Programme that has acquired €77 billion in peripheral sovereign debt (see "Gold is a Hold" December 20, 2010).

- So even though the first-best bull case for gold is off the table -- one in which the US economy is so persistently sluggish that the Fed is obliged to execute QE3, QE4 and QE*n* (again, see "Gold is a Hold") -- not only is the Fed likely to stay too loose too long, but now the ECB is adding to inflationary pressures, too.

Bottom line

Maybe Libya will be the catalyst for a long-overdue correction, with 97 days having gone by without one. We think it would be nothing more than a correction, and would be looking for re-entry points. A higher oil price doesn't help, but at this point it shouldn't be enough to derail the recovery. Libya plays into the already dovish dynamic at play, and raises the likelihood that the Fed will stay too easy for too long. This would normally be dollar-negative, but Libya's impact is disproportionate on troubled Europe, where covert money creation through Emergency Liquidity Assistance is already underway. Now even more should be expected, and the resultant weaker euro should keep the dollar seeming strong. All this plays into the second-best bull case for gold. We maintain our $1500 price target.