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

MACROCOSM

EUicide

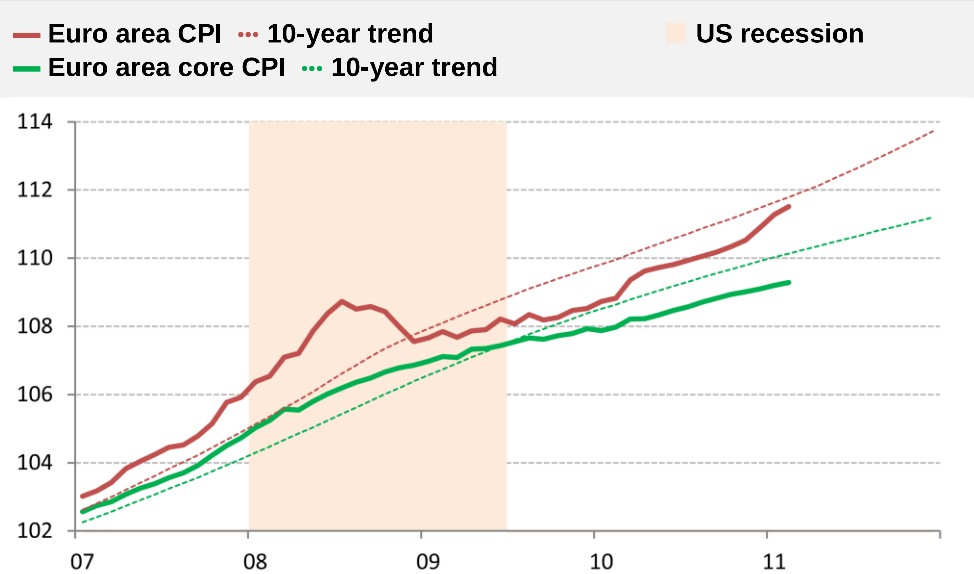
Thursday, April 7, 2011

Donald Luskin

The ECB has pointlessly made Europe's debt burdens heavier, especially for the PIIGS.

We hoped and half-expected that the European Central Bank would find some last minute excuse not to do it. But even Portugal's official request yesterday for a bail-out by the EU's rescue fund wasn't enough. Today the ECB announced a 25 bp hike in its key interest rate to 1.25%, after 23 months at 1%. In our view, unless this is just a one-time gesture to placate conservatives in Germany, it will prove to be a disastrous mistake.

- Even granting the ECB's mandated single-minded obsession with containing inflation, born of Germany's cultural memory of the horrors of the Weimar hyperinflation, this move is unnecessary.
- Yes, Euro Area headline inflation is currently 2.4% year-over-year, above the ECB's informal target of 2.0%. But after a long period of deflation at the worst of the Great Recession, the price level would have to grow at 2.5% over the coming 12 months just to catch up to the long-term trend (please see the chart below).
- Clearly, the present bump in headline inflation is an exogenous shock from the oil price. EA *core* inflation is currently only 1.2% (lower than it was last month). It would have to jump 1.8% to catch



Source: Eurostat, NBER, TrendMacro calculations

Update to strategic view

EUROPEAN BONDS, US DOLLAR: The ECB's rate hike, tellingly juxtaposed with Portugal's plea for a bail-out, sets the stage for more weakness and more crisis in the Euro Area. It undercuts the peripheral economies by aggravating already dangerous mortgage debt overhangs, thus making sovereign debt burdens increasingly unsustainable. We continue to believe that the EC and the ECB will pull every trick to keep the sinking ship afloat, but this raises the risk that it can't be done without significant currency debasement. In this context the Euro's recent strength is inexplicable.

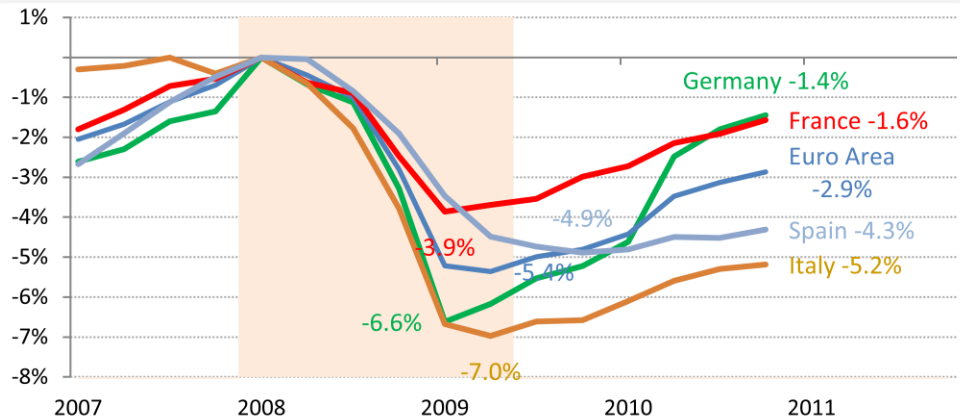
GOLD: While it is folly for the ECB to weaken the Euro Area in an unnecessary crusade against inflation, it makes the Fed's antipodal commitment to reflation all the more obvious. We stand by our price target for gold of $1500, and will reevaluate when we get there.

[Strategy Dashboard home]

up to the long-term trend.

In the name of this completely superfluous inflation-fighting crusade, the ECB is imposing headwinds on the entire European economy -- which on the whole is still pretty much in recession. Germany and France are the best of a bad lot (please see the chart below), but still well below peak real output (compared to the US, which achieved an all-time high in Q4 2010). Spain and Italy, the Euro Area's two next largest economies, are far behind Germany and France -- while peripheral nations like Ireland, Greece and Portugal are complete basket cases.

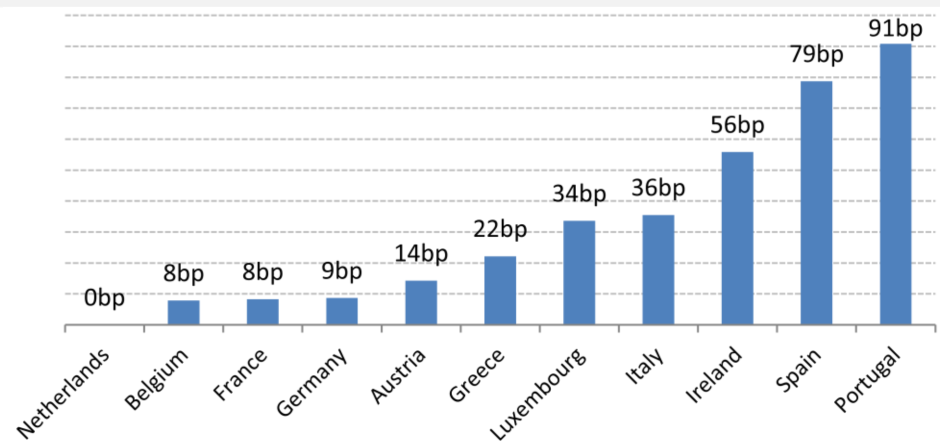
Real GDP versus peak **US recession**



Source: Eurostat, NBER, TrendMacro calculations

Higher ECB rates will be an unsustainably burdensome for peripheral economies struggling with excessive mortgage debt. There the majority of home mortgages are variable with the ECB rate, and even modest hikes will consume household income representing significant fractions of GDP (please see the chart below), probably leading to more foreclosures,

Estimated increase in annual mortgage debt service as percent of GDP, with 1% hike in ECB rate



Source: Lorcan Roche Kelly

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

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

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

[About us]

further drops in home prices, more risk to undercapitalized banks, continued economic stagnation and deepening pressure on sovereign debt.

In the US, many smart people of good will -- including several regional Federal Reserve presidents -- think the Fed should do what the ECB has done. For them, the inflation *rate* is too high, and it doesn't matter that the *price level* is still well below trend. For them, the growth *rate* is back to normal, and it doesn't matter that the *output level* is still well below trend. We don't see it that way -- in our framework, *flows* or *rates* are meaningless outside the context of *levels* or *stocks* or *quantities* (see "Will the World End when QE2 Does?" April 4, 2011). Fully contextualized in that way, both the US and Euro Area economies are still in deflation, and still only in nascent recoveries.

We are positive that Ben Bernanke sees it our way, and that the Fed will act accordingly (see "The Fed is from Venus, The ECB is from Mars" March 9, 2011). Moreover, while the ECB's leadership is culturally anchored to memories of the Weimer hyperinflation, Bernanke is anchored to memories of the 1930s deflation. So for Bernanke, it's easy to wave away the current rise in US inflation as "transitory," as he said at an Atlanta Fed conference this week. Bernanke's approach is not without risk -- deliberately letting the inflation rate run a bit so that the price level can reflate up to trend begs the question of when and how to eventually tighten, and overshoot is always a possibility. In fact, we expect that the Fed *will* overshoot, as we have been saying since the inception of the present leg higher in gold (see "On the January FOMC" January 26, 2011). But in monetary policy the best one can do is to choose which risk one wishes to take. The ECB has made the wrong choice.

Bottom line

The ECB's rate hike, tellingly juxtaposed with Portugal's plea for a bail-out, sets the stage for more weakness and more crisis in the Euro Area. It undercuts the peripheral economies by aggravating already dangerous mortgage debt overhangs, thus making sovereign debt burdens increasingly unsustainable. We continue to believe that the EC and the ECB will pull every trick to keep the sinking ship afloat, but this raises the risk that it can't be done without significant currency debasement. In this context the Euro's recent strength is inexplicable. While it is folly for the ECB to weaken the Euro Area in an unnecessary crusade against inflation, it makes the Fed's antipodal commitment to reflation all the more obvious. We stand by our price target for gold of $1500, and will reevaluate when we get there.