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

TRENDMACRO LIVE!

On the ECB Rate and Bond Buy Decisions

Thursday, August 4, 2011
Donald Luskin (Lorcan Roche Kelly is on vacation)

Trichet fiddles while Rome burns, and world markets take the heat.

The European Central Bank decided today to leave interest rates unchanged, announced that it is creating a new program of 6-month long-term refinancing operations (LTRO), and president Jean Claude Trichet made it clear in remarks that that it would resume buying sovereign bonds through its Securities Market Programme virtually immediately. So far, all this has done nothing to ease financial tensions in besieged Europe.

We believe the ongoing siege of European markets, focusing now on Italy's and Spain's sovereign debt, is the main event driving the drop in US stocks now (see "Europe, Living on the Edge" August 1, 2011). The concluded US debt ceiling drama and risks of a double-dip, which have been getting all the headlines, are side-shows at this point (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011).

- As Trichet talked about ECB bond market intervention today, the spread between 10-year Italian and German government bonds narrowed slightly. But it quickly widened out again to new highs.
- The euro LIBOR/OIS spread -- which indicates the stress level in the interbank funding market -- is also at new highs (please see the chart below). It is nowhere near the horrific levels seen during

Source: Bloomberg, TrendMacro calculations

Update to strategic view

ECB, EUROPE MACRO, EUROPE BONDS: No ECB rate hike -- but there should have been a rate cut, as deflation appears in the Euro area. A new LTRO program to ease funding stress, but only a casual and reluctant commitment to new bond purchases. For Europe, where there's a will there's a way -- the problems *can* be solved, and the authorities know how to do so. But at the moment, the new EFSF is a will without a way, and the stodgy ECB is a way without a will.

US STOCKS, GOLD: The crisis in Europe is center stage for US stocks -- the concluded debt ceiling deal and the chatter about a double-dip are irrelevancies at this point. Gold making new all-time highs signals that we are *not* on the brink of a deflationary crisis like we faced in 2008 -- but rather we face new rounds of reliquefication by world authorities. This tells us we are in a serious correction -- one much deeper than we expected -- but nothing more.

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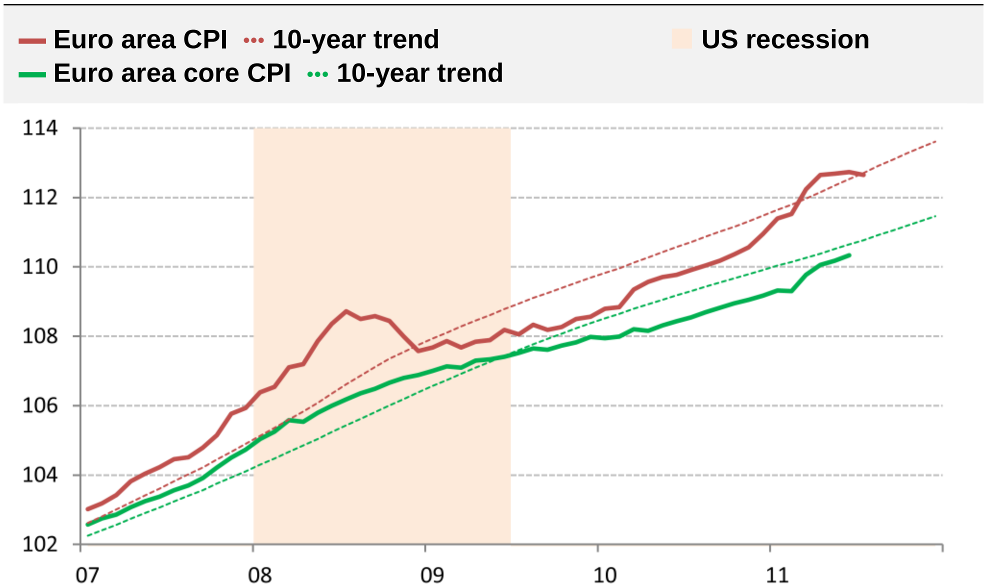
the world banking crisis in 2007 to 2009, but it is wider than it has been at any point during Europe's sovereign debt crisis beginning in early 2010.

- As we have pointed out, the new powered-up version of the European Financial Stability Facility -- announced two weeks ago specifically to deal with crises like Italy's (see "Whatever It Takes" July 22, 2011) -- is unable to act until it is ratified by the 17 nations in the Euro area. The new EFSF clearly demonstrates Europe's will -- but until ratification it is a will without a way.
- The ECB has a way to intervene immediately through the Securities Market Programme -- but after 18 weeks of inactivity while European debt markets have visibly worsened, it is clearly a way without a will. So far markets are giving little credence to Trichet's remarks today about further purchases. And no wonder -- those remarks were casual, almost jocular, as though intervention were an unimportant matter to be taken as unseriously by the markets as it is apparently being taken in the ECB itself.
- The ECB reserves its seriousness for inflation. This seriousness has led already to two rate hikes this year, which we think have had disastrous effects on peripheral economies such as Italy's and Spain's, and has thus contributed mightily to the present crisis (see "EUicide" April 7, 2011).
- As he did last month (see "On Europe's July Rate Decisions" July 7, 2011), Trichet speaks now of "monitoring very closely" -- not "strong vigilance" -- when it comes to inflation. This means there won't be a rate hike at next month's meeting. All to the good, but hardly enough -- *there should be a rate cut*.
- Inflation in the Euro area in July was *deflation* at an 0.8% annual rate, marking the third month in a row of inflation below 1% (please see the chart below). It is *deflation*, not inflation, that Trichet should be "monitoring very closely."



Source: Eurostat, TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

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

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

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552-3629
jclinton@trendmacro.com

[About us]

- For all our concern with incipient deflation in Europe, gold at new all-time highs is seeing something very different -- and very much more encouraging. In 2008 when the world fell into deflation, the gold price collapsed along with everything else. Gold's strength now would appear to be looking through the ECB's blockheadedness, anticipating that this nevertheless ends with massive reflationary reliquefication. We've called this "plan B-plus for gold," and the fact that it is playing out as expected is about the only positive on the board right now (see "Plan B-Plus for Gold" July 14, 2011).

Bottom line

No ECB rate hike -- but there should have been a rate cut, as deflation appears in the Euro area. A new LTRO program to ease funding stress, but only a casual and reluctant commitment to new bond purchases. For Europe, where there's a will there's a way -- the problems can be solved, and the authorities know how to do so. But at the moment, the new EFSF is a will without a way, and the stodgy ECB is a way without a will. The crisis in Europe is center stage for US stocks -- the concluded debt ceiling deal and the chatter about a double-dip are irrelevancies at this point. Gold making new all-time highs signals that we are not on the brink of a deflationary crisis like we faced in 2008 -- but rather we face new rounds of reliquefication by world authorities. This tells us we are in a serious correction -- one much deeper than we expected -- but nothing more.