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THOUGHT CONTAGIONS

Europe Gets MAD

Tuesday, November 15, 2011

Donald Luskin

G-Pap opened Pandora's Box -- stocks are amazingly strong facing new risk of euro dissolution.

Our strategic outlook continues to be based on three evolving themes:

- Stocks are extremely cheap in the US, and world-wide.
- A US double-dip recession is unlikely, and if it happens it will be trivial.
- The big risk -- highly unlikely, but potentially catastrophic -- is a global credit hard-stop emanating from Europe's debt crisis.

EUROPE Developments over the last two weeks have increased the risk that something could go terribly wrong in Europe. We warned at last month-end of a speculative attack in Europe, and a correction in stocks (see "Not Crazy, Still Cheap" October 31, 2011). We got them both. It's testimony to how cheap stocks are that the correction has not been more severe, given the severity of the speculative attack -- with Italy's 10-year yield now about 7% -- and the deeply troubling political developments underlying it.

- When former Greek Prime Minister George Panadreou called for a referendum on Greece's bailout, he -- like his mythical Greek forbear -- opened Pandora's Box (see "On the Greek Referendum Surprise" November 1, 2011).
- The evil that escaped from the box, and is now loose in the world, is the idea that a Euro area nation could choose to leave the euro currency. That's a very dangerous thought contagion, and it will be hard to put it back in the box.
- French President Nicholas Sarkozy and German Chancellor Angela Merkel made it harder when, instead of chastising Papandreou for being so reckless, they upped the ante by being even more reckless themselves. They publicly demanded that any referendum on the bail-out include a vote of in-or-out of the euro (see "Papandemonium!" November 3, 2011).
- *Why is this so dangerous?*
- Typically a currency relies on faith in the nation that issues it. But the euro relies on faith in an even more fragile thing -- a political coalition of 17 nations. For that faith to be sustained, it must be utterly unthinkable that any nation might leave the coalition. That's why the treaties that created the euro don't include a single word

Update to strategic view

US STOCKS, US MACRO, EUROPE MACRO, ASIA MACRO: The Greek referendum crisis put in play an open discussion of the possibility that nations could leave the euro, provoking a game of mutually assured destruction among euro members that could spill over into the world economy. In the face of this elevated threat, US stocks and the US economy are remarkably resilient -- because stocks are extremely cheap, and because markets are getting accustomed to Europe's endless crisis. There's no evidence of US recession -- the forward earnings decline has slowed to a trickle, and falling inflation in China means the threat of more tightening is coming off the table.

[Strategy Dashboard home]

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about any member voluntarily or involuntarily leaving -- it's marriage for life, without a pre-nup.

- If Greece can leave the euro, then why can't Germany or France leave also? If that were thought to be even remotely possible, confidence in the euro would collapse.
- As a practical matter, a country -- or multple countries -- leaving the euro would necessitate harsh controls to prevent capital flight to the strongest economies. And it would likely lead to severe devaluations. Together, these would lead to cascading defaults that would ramify through every economy -- and every bank -- in Europe, and spill over to the whole world.
- This means that the euro currency coalition depends on the same strategic logic as the Cold War -- the threat of mutual assured destruction. That logic worked quite well in the Cold War. There were crises and conventional wars, but there was no nuclear war.
- The doctrine of mutual assured destruction relies, in turn, on creating fear in the mind of enemy, by making him believe you would fearlessly retaliate after a first-strike. So amidst the referendum panic two weeks ago we saw stories appear -- seemingly at random, and subsequently denied -- about how Germany and France want to create a "two tier Euro area."
- Then yesterday Merkel's Christian Democratic Union party voted to adopt the policy of endorsing treaty amendments to permit exit from the euro. Such a vote is only symbolic. But we urge you to recognize the extent to which even speaking of such a thing is a radical and dangerous departure from the previous doctrine of the inviolable euro.
- In both cases, the geopolitical objective is crystal clear. It is Germany and France using the present crisis, and the threat of its worsening, to coerce and to hasten econonic and political integration around what would inevitably be Franco-German leadership. This agenda emerged clearly in August, from Merkel's and Sarkozy's bilateral summit (see "Two-Tier Europe is Born" August 17, 2011).
- And it's more than just verbally brandishing the possibility of the euro's dissolution. Through the European Central Bank -- where surely German and French policy preferences dominate -- inaction speaks louder than words. The blow-out in sovereign yields over the last two weeks -- especially in Italy and Spain -- is something the ECB has explicitly permitted to happen, by only intervening minimally with its Securities Markets Programme (see the chart on the following page, and "Rome Makes Athens Look Good" November 10, 2011).
- In a world of mutually assured destruction, confrontations between players are inevitably structured like the game of "chicken." Greece and Italy have both, to large extents, backed down to the Franco-German threat. Both nations in the last week have replaced leaders not to France's and Germany's liking with technocrats much more likely to toe the line of economic and political integration.
- So what are France and Germany waiting for? Isn't it time to take the pressure off by reactivating the ECB's SMP in size -- as in

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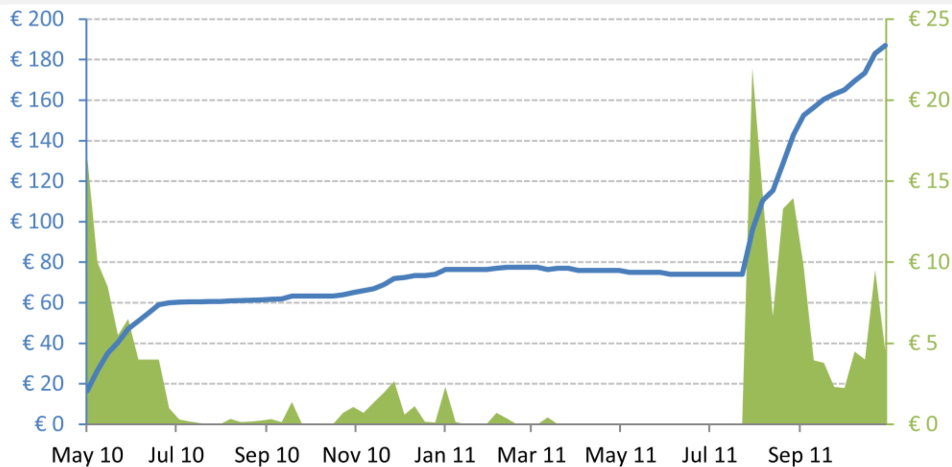
[About us]

ECB Securities Market Programme purchases — Cumulative ■ Weekly
€ billions



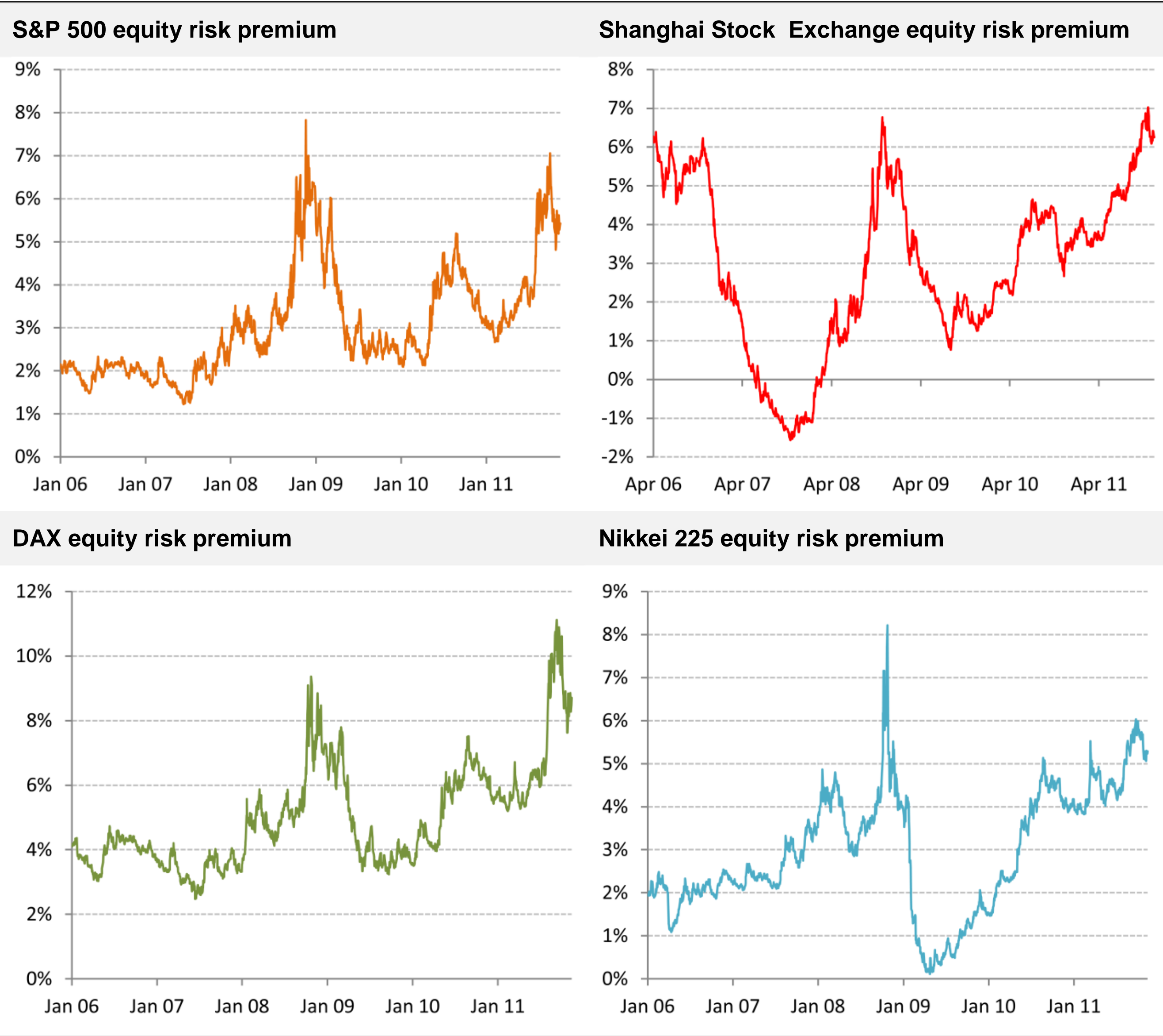
Source: ECB

early August (again, see the chart above) -- bringing Italian and Spanish yields back down to sustainable levels -- and likely bringing other nations' elevated yields along with them?

- Perhaps France and Germany intend to keep the pressure on until new Greek Prime Minister Lucas Papademas and new Italian Prime Minister Mario Monti actually form unity governments capable of delivering the necessary reforms.
- Or perhaps this is where the mutual assured destruction analogy gets complicated. The Cold War confrontation between the US and the USSR was conveniently bilateral. The present confrontation in Europe has an extra player -- *the market*. If the market deems the mere threat of dissolving the euro -- never mind the reality, *just the threat!* -- as cause for an irreversible phase-shift in expectations, then risk aversion will be permanently higher.
- That higher risk aversion means higher bond yields. Most analysis rightly focuses on the deadweight cost of those higher yields for governments desperately trying to control their spending already. Fair enough, but we tend to look at it a little differently. We see the market operating in coalition with forces of economic and political integration. The only way the nations of Europe can reduce the risk of their sovereign debt -- and thus lower their yields -- is to integrate into a single more creditworthy political entity.
- Beyond the immediate bond market pressure, the longer term risks to sustainability of the Euro area are reflected in the latest sluggish growth statistics -- 0.8% annual growth in the third quarter. Imbalances within the Euro area continue, with today's external trade data showing Germany continuing its role as the China of Europe, with a cumulative year-to-date trade surplus of €100 billion.
- These two problems -- lack of growth, and lack of *balanced* growth across the Euro area -- will continue to be the biggest challenges to the overall policy mix for Euro area leaders. These imbalances

cannot be solved in the short to medium term -- so closer integration over the long term will continue to be seen by policy makers as the best -- indeed the only -- solution.

STOCKS While we expected a correction, we're surprised that stocks have held up so well in the face of these developments. Surely one reason is that they came into this epsiode so cheap -- that is, they were already priced for a lot of risk. Around the world, equity risk premia remain near where they were at the bottom in March, 2009 (please see the charts below).



Source: Various, TrendMacro calculations

- More qualitatively, we also sense that investors have come to view the risks in Europe with more equanimity. As Europe's debt crisis has dragged on now for a the better part of two years (see, earliest, "PIIGS, Panic and Jobs" February 5, 2010), markets have begun to

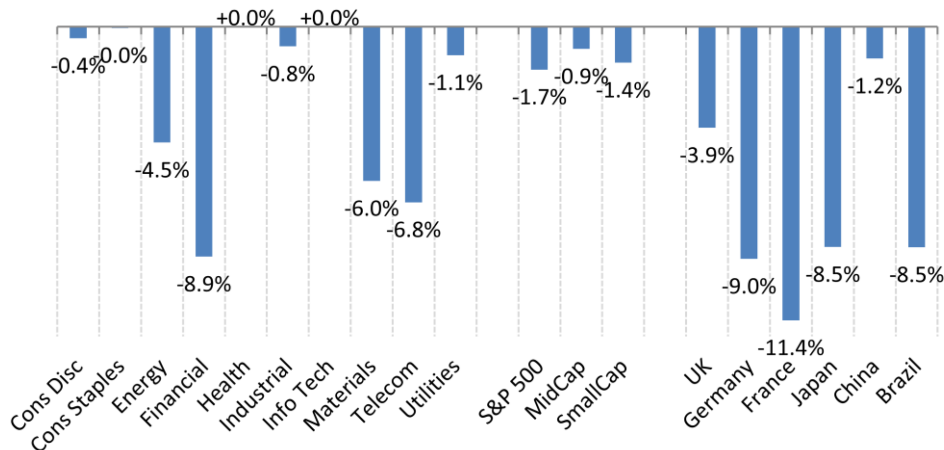
get accustomed to the glacial pace of decision-making, the opacity of communications and the seeming preference for half-measures.

- Perhaps markets have come to grasp the underlying geopolitical logic of the crisis -- the intertwining dynamics that economic and political integration of Europe are a solution to the crisis, and that prolonging and intensifying the crisis is in the interest of those nations most eager to pursue that particular solution.
- Perhaps there is even some relief that the present risks in Europe carry with them something of an offsetting good -- they signal the exit from the global policy of endless unconditional bail-outs and infinite moral hazard, an exit that we predicted a year ago (see "Eyeing an Exit from 'No Exit'" November 18, 2010).
- We've had since mid-July to get used to the fact that Greece would end up in a structured default -- and that private bondholders would take losses (see "Whatever It Takes" July 22, 2011). Such a thing was held to be unthinkably dangeous In the post-Lehman age, in which all risk was deemed to be systemic, and no moral hazard was too costly. Yet defalt has come, and the sun rises each morning.
- Even Merkel and Sarkozy calling Papandreou's bluff on the referendum -- by daring Greece to leave the euro -- however reckless it may have been, was constructive in the sense that it drew a limit to moral hazard. Yes, there is a crisis in Europe in the aftermath, but the sun *is* rising every morning.

THE ECONOMY In the same sense that it seems stocks have gotten used to the unlikely but potentially catastrophic possibility of a systemic blow-up in Europe, so too has the US economy. We have been concerned that we might talk ourselves into recession, based on the sheer fear of what might happen in Europe -- but it looks like we're avoiding that.

- There is simply no conventional macro data that demonstrates the onset of recession (see "On the October Jobs Report" November 4, 2011 and "On Q3 2011 GDP" October 27).
- Our favorite quirky macro indicator -- the UCLA Ceridian Pulse Index, derived from real-time telemetry on diesel fuel loadings, which is highly correlated with industrial production -- rose 1.1% last month, after three months of decline.
- On the negative side, forward earnings continue to fall for the S&P 500, and for stock indices around the world (please see the first chart on the following page).
- But the pace of decline has decelerated, and we are now beginning to even see some up-days for the S&P 500. There are now two S&P 500 sectors posting all-time high forward EPS, at least ever so slightly (health care and information technology).
- Finally, to turn a bit far afield, we note that without getting a lot of fanfare, inflation in China has stopped going up. In fact, it's been going down now for three months (please see the second chart on the following page).
- The yuan has now appreciated against the US dollar more than 8% since resumption of the crawling peg in mid-2010 (see "On RMB

Forward earnings per share, difference from year-to-date high

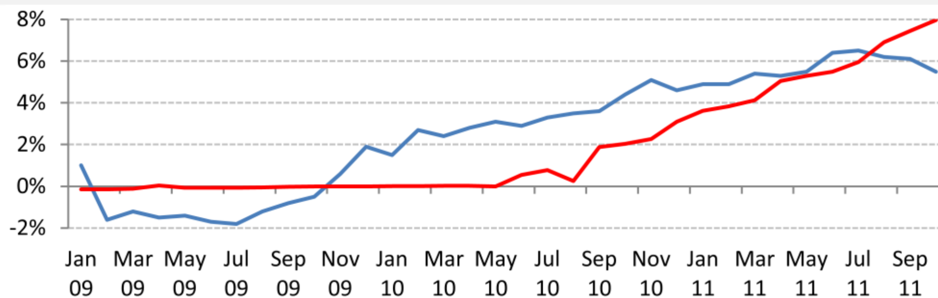


Source: Bloomberg, TrendMacro calculations

Revaluation" June 20, 2010). The fall-off in inflation suggests that this has been successful at halting the importation of US monetary policy -- appropriate *here*, but too accommodative in China -- via the exchange rate.

- Whatever the reason, this sustained fall-off in inflation gives China scope to relent in various non-exchange rate tightening policies, and lowers the risk that a sharp slowdown in China could feed forward into a US recession.

China consumer price index YOY **RMB/USD appreciation**



Source: Bloomberg, TrendMacro calculations

Bottom line

The Greek referendum crisis put in play an open discussion of the possibility that nations could leave the euro, provoking a game of mutually assured destruction among euro members that could spill over into the world economy. In the face of this elevated threat, US stocks and the US economy are remarkably resilient -- because stocks are extremely cheap, and because markets are getting accustomed to Europe's endless crisis. There's no evidence of US recession -- the forward earnings decline has slowed to a trickle, and falling inflation in China means the threat of more tightening is coming off the table.