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

MACROCOSM

Europe's Wall of Liquidity

Wednesday, December 21, 2011

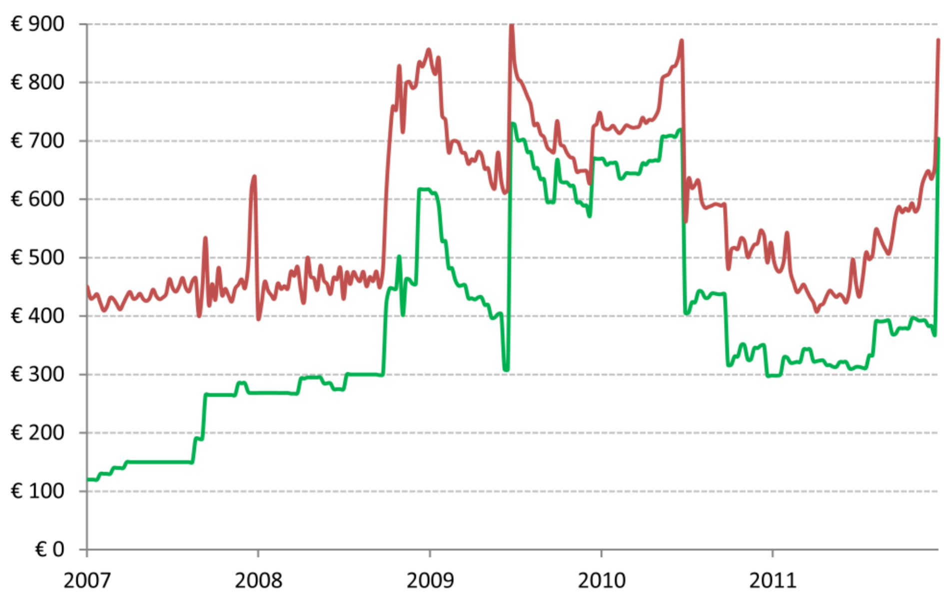
Lorcan Roche Kelly and Donald Luskin

The risk of a Lehman-like banking failure for Europe is essentially off the table now.

This morning's much anticipated [3-year Longer-Term Refinancing Operation] (LTRO) by the European Central Bank came in at €489 billion, [far ahead of expectations]. Allowing for other liquidity operations that were rolling over -- or that were rolled into the new 3-year operation -- the net new liquidity added is €210 billion. Expectations had been for only about €20 billion.

- The total ECB liquidity outstanding from MROs and LTROs now stands at €871 billion, the highest since mid-2010's debt crisis, and very nearly equaling the €896 billion seen in mid-2009 at the height of the post-Lehman global banking crisis (please see the chart below).

Total ECB euro refinancing operations **Longer-term euro operations**
EUR billions outstanding



Source: Bloomberg, TrendMacro calculations

Update to strategic view

ECB, EUROPE FINANCIAL STOCKS, US FED: Uptake in today's ECB 3-year LTRO beat market expectations, and once again shows how far the ECB will go to maintain stability in the euro area banking system. A Lehman-like crisis is now essentially ruled out. We will see over the coming weeks where this new liquidity goes -- whether it funds a lucrative sovereign debt carry trade, or is just used to roll over bank debt. We expect both, with the latter being an urgent necessity. Today's US dollar auction ups the Fed's passive QE operation to $83 billion.

[Strategy Dashboard home]

There was also a 14-day US dollar liquidity operation which came in at $33 billion. This is well up from last week's operation at $5 billion. It stands in addition to the $50 billion in 3-month dollar liquidity that was auctioned earlier this month. The cumulative $83 billion will go into excess reserves on the Fed's balance sheet, continuing to operate as a passive but nevertheless very real form of quantitative easing.

- Initial market reaction to this surprisingly large wall of liquidity provided by the ECB was an up-move in risk-on assets worldwide. But that was only a brief spurt -- the mood has been moderately risk-off ever since. How are we to interpret the market's ambivalence?
- As with all attempts by institutions like the ECB, to support markets in stress, the support is welcome, but at the same time its very existence is disturbing evidence of the stress they are designed to ameliorate. In this case, the surprisingly large uptake of term liquidity by the banks goes a long way toward relieving the major rollover risks they face early next year -- yet it rubs our nose in the ugly fact that these risks exist.
- With regard to the euro in particular, we are not disturbed to see it weaker against the dollar in the wake of the liquidity auction. While the weakening took place at the same time as a general risk-off move, it could quite sensibly be the market taking the view that the ECB's operation is tantamount to quantitative easing -- which would be a very good thing.
- Judging by market chatter, there seems to be a sense that today's new liquidity won't be used by banks to buy sovereign debt. Possibly -- though the wildly successful auctions this week and last of Spanish notes and bills would indicate that *someone* has a new interest in Europe's sovereign debt since the LTRO program was announced. The availability of limitless ECB liquidity to fund debt purchases by banks would seem to create an irresistible carry trade for banks eager to earn some new capital, rather than raise it.
- But the big question for the market now is: where is this liquidity really going to go? Surely it's not all going to go to carry trades. The banks face debt rollovers of €550 billion in 2012, which has to be a top priority for them. But if nothing else, even if much of the new liquidity just ends up back on the ECB's balance sheet in the form of deposits by the banks, hoarded against a rainy day, that should be seen by the market as a tremendously good thing: it essentially rules out a funding crisis in 2012.
- Today's liquidity operation is just the beginning. In our view, it could have even been bigger, and the next one coming up in February probably will be.
- The collateral available for the operation was expanded by ECB President Mario Draghi at the last ECB meeting (see "On the ECB Monetary Policy Decisions" December 8, 2011), but banking sources tell us that much of the new collateral rules -- especially those relating to repo-ing single credit claims -- have not been finalized to the satisfaction of the banks, so they were unwilling to commit to a 1-year minimum lock-in without full clarity on margin requirements.

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

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

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

[About us]

- Italian banks were given a government guarantee of their debt as part of the reform package decreed by new prime minister Mario Monti earlier this month. According to reports, this option was adopted by banks in time to allow them to create collateral that would grant them access to today's LTRO -- indeed, it is being reported that Italy's banks took up almost a quarter of the new liquidity. By next February's operation they should be able to take even more.

Overall, we view today's LTRO operation as a positive development. It once again shows that the ECB will do whatever it takes to maintain the stability of the euro area banking system. The risk of a Lehman-like funding/solvency crisis in the euro area was already negligible before today. Now it has to be off the table entirely.

Bottom line

Uptake in today's ECB 3-year LTRO beat market expectations, and once again shows how far the ECB will go to maintain stability in the euro area banking system. A Lehman-like crisis is now essentially ruled out. We will see over the coming weeks where this new liquidity goes -- whether it funds a lucrative sovereign debt carry trade, or is just used to roll over bank debt. We expect both, with the latter being an urgent necessity. Today's US dollar auction ups the Fed's passive QE operation to $83 billion.