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

MACROCOSM

Nein! Well, Maybe

Tuesday, May 29, 2012

Lorcan Roche Kelly

Germany is softening its stance to keep its place at the head of Europe's table.

Nearly four years into the euro crisis, and two constants have emerged.

- Nothing happens quickly.
- Germany will always say no to anything that would take pressure off the hardest hit euro area members (see "QE Nein" November 23, 2011).

While the decision-making speed is unlikely to increase -- every decision still has to go through a committee of 17 euro area states or 27 European Union states -- Germany's reflexively negative stance is starting to soften.

- The changing euro area political landscape means that Germany is becoming increasingly isolated, and it will have to compromise to maintain its lead role.
- The election of François Hollande as French president changes the tone of the most important relationship in the euro area -- the Franco-German axis (see "On the French and Greek Elections" May 7, 2012).
- Hollande -- a committed European integrationist -- needs Germany to soften its insistence on so-called austerity. He was elected promising a growth compact for the euro area, and has already won some concessions on project bonds and an enlarged European Investment Bank at the informal European Union summit last week.
- Hollande needs to cement his power base at home in the French parliamentary elections on June 17 (see "What's Greek for 'Groundhog Day'?" May 15, 2012). If he is successful -- and polling suggests he will be -- then his hand in negotiating with Germany will be further strengthened.

A strengthened Hollande will be a threat to Germany getting everything its own way. But Germany also has to deal with an emboldened Prime Minister Mario Monti in Italy.

- Monti took the unusual step last week of calling for a meeting of the leaders of Spain, Italy, France and Germany in Rome on June 22 -- after the Greek and French elections.

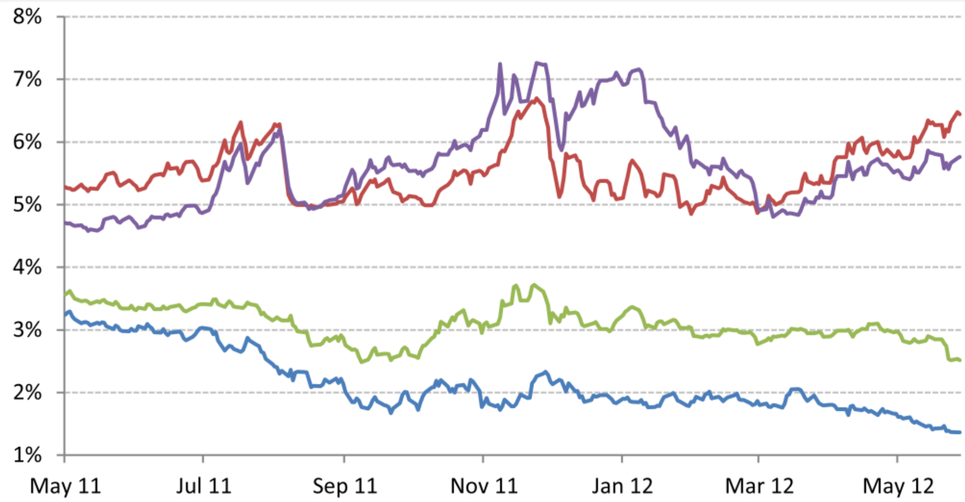
Update to strategic view

EUROPE MACRO, EUROPE BONDS: Germany's political position is becoming more isolated. It has become used to dictating its will to struggling peripheral nations. But the election of Hollande in France and clever politicking from Monti in Italy now means Germany is only one of four core powers, and the one whose ideas are in the minority. "Nein!" has not become "Ja!" yet, but a kinder and gentler Germany is taking a strong move towards "doch" -- which is German for "on the other hand." With the threat of Greek exit receding at the same time, we should start to see recovery in peripheral sovereign debt, and a back-up in bunds.

[Strategy Dashboard home]

- Monti has openly talked about bringing Germany around to acting in Europe's "common good."
- Though Spain and Italy are in some sense part of the periphery, rather than the core of Europe -- as their far higher bond yields make obvious (please see the chart below) -- together with France and Germany they make up the "big four" of euro area economies. Indeed, Merkel and former French President Nicolas Sarkozy explicitly invited Italy and Spain into the core (see "Two-Tier Europe is Born" August 17, 2011) -- and ever since then Italy and Spain have been undertaking the reforms to get them there.

10-year government bond yield: Germany France Italy Spain



Source: Bloomberg

- Now, nearly a year later -- and with Merkel the one leader of the big four still standing -- Spain and Italy have answered the call to the core. But they want the integration to be on their terms, not on Germany's. It seems that Monti is out-maneuvering Merkel.
- So for Germany to maintain its place at the head of the table for any negotiations, it will be forced to compromise on some of its long-held convictions. This does not mean Eurobonds will become a reality in the near term, but it does make them much more likely in the coming 12 to 18 months.
- But support for the European project is still strong in Germany, as a poll published by the Pew Research Center Global Attitudes Project shows. According to the poll, Germans are the strongest supporters among countries polled of both European economic integration and the European Union.

That said, over the coming weeks Germany may also lose some of its reasons to say "nein" even on its own terms, as certain events move in favor of its long-held positions.

- The fiscal compact demanded by Germany is moving through national parliaments now (view ratification progress here).

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]

- It is worth keeping a close eye on the results in Thursday's referendum in Ireland. A no vote in Ireland is unlikely, with polls showing strong support for the treaty. But the large percentage of "don't knows" could still swing it either way.
- While an Irish rejection of the treaty would not derail the process -- no country has a veto over this treaty -- it would likely make ratification in other member states more difficult.
- The Greek election in June may not produce a radicalized government that wants to abrogate the bail-out deal, and thus implicitly threaten Greece's membership in the euro currency. Polls indicate that this stabilizing result is increasingly likely, with the pro-bailout New Democracy party pulling ahead of the anti-bailout SYRIZA.

At the same time, the influence of Germany's monomaniacal anti-inflation bias is on the wane both at home and at the European Central Bank.

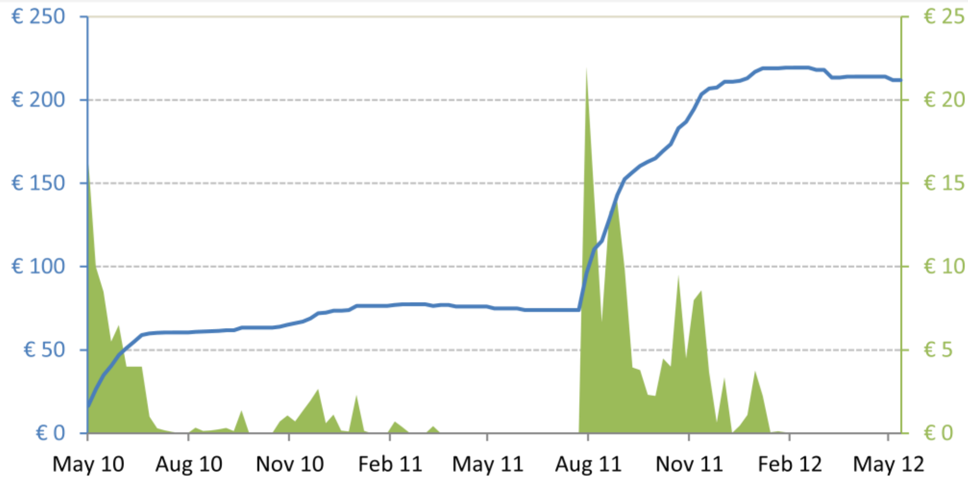
- Recent wage deals in Germany have included hikes far ahead of inflation. The largest industrial union in Germany secured a 12-month pay increase of 4.3% last weekend. This, the largest increase since 1992, follows a 24-month 6.3% wage increase for public sector workers agreed in March.
- That these wage increases have been agreed when inflation in Germany is actually falling shows that, whatever the stereotypes suggest, Germany is willing to try to attempt potentially inflationary stimulus programs to create some domestic demand to make up for the loss of many of its euro area customers.

But not only are we seeing Germany willing to risk some inflation, we are also seeing a less hawkish ECB.

- The appointment of Mario Draghi as President -- coupled with the resignation of superhawks Axel Weber from the Bundesbank and Jurgen Stark from the ECB Governing Council in 2011 -- points to reduced Bundesbank influence at the ECB.
- Draghi has already shown himself to be decisive and imaginative when it is needed (see "On the ECB Monetary Policy Decisions" December 8, 2011 and "Europe's Wall of Liquidity" December 21, 2011).
- The only direct sovereign bond support mechanism -- introduced by Draghi's predecessor, Jean-Claude Trichet -- is the Securities Markets Programme (SMP). It has been notable throughout the recent phase of the crisis for its complete inactivity -- it has purchased no sovereign debt in three months (please see the chart on the following page).
- With overnight deposits at the ECB consistently well over €700 billion, there would be no problem in sterilizing an expansion of the SMP. So it must be either that the ECB has decided that the SMP is an ineffective weapon, or one that they wish to deploy only in an emergency far more dire than the current turbulence.

- The next ECB meeting is on June 6. While do not expect a rate cut, Germany's new softer attitude and reduced influence could lead to other easing actions. We will watch Draghi's comments at the press conference to see if there is any hint of new -- or renewed -- ECB responses to the crisis.

Securities Markets Programme — **Cumulative holdings** ■ **Weekly buys**
EUR billions



Source: Bloomberg

With reform efforts -- not austerity, but *reform* -- still moving forward in Italy and Spain, the risk of Greek euro exit reduced, and a "yes" vote for the fiscal compact coming from Ireland, and now Germany taking a kinder and gentler stance, debt market dynamics in Europe should be due for a change. We should start to see a recovery in peripheral debt, and the bund coming off the new highs it attains on a daily basis now.

Bottom line

Germany's political position is becoming more isolated. It has become used to dictating its will to struggling peripheral nations. But the election of Hollande in France and clever politicking from Monti in Italy now means Germany is only one of four core powers, and the one whose ideas are in the minority. "Nein!" has not become "ja!" yet, but a kinder and gentler Germany is taking a strong move towards "doch…" -- which is German for "on the other hand." With the threat of Greek exit receding at the same time, we should start to see recovery in peripheral sovereign debt, and a back-up in bunds.