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MACROCOSM

No Senior Discount for Spain

Monday, July 2, 2012

Donald Luskin

Europe learns the hard way that markets in the post-Lehman world are still too fragile.

Last week we said Europe's two-day summit would be "the highest stakes summit for some time" (see "For Europe, It's the Politics, Stupid" June 27, 2012). Indeed it was, with much being made in the press about the extent to which Germany compromised its hardline stance -- very much as we predicted last month (see "Nein! Well, Maybe" May 29, 2012).

We will report at deeper granularity later this week as more details become known. We will be particularly interested to see how ECB President Mario Draghi reacts at Thursday's policy meeting, having said conspicuously little at the conclusion of the summit.

For today's very brief report, we will discuss only one summit conclusion -- but it is one with important systemic resonance for world markets, and we believe it largely explains markets' ebullient action on Friday.

- The seemingly trivial -- but, in fact, systemically critical -- issue of the potential subordination of Spanish sovereign debt has been resolved.
- As European Council President Von Rompuy put it in his post-summit statement, "Financial assistance to Spain will be provided without seniority status for the financing provided by the EFSF/ESM."
- When the Spanish bank bailout was announced three weeks ago, we immediately flagged this as a critical issue (see "I Love the Smell of Bailouts in the Morning" June 11, 2012). Spanish yields subsequently running to euro-era highs confirmed our fears.
- The issue at stake is the same one that, we believe with 20/20 hindsight, was the catalyst for last year's intense sell-off in global markets -- when the second Greek bailout was made contingent on hair-cutting private holders of Greek sovereign debt (see "2011: A Lost Year" December 29, 2011).
- In the Spanish bank bailout announced three weeks ago, subordination would be tantamount to hair-cutting all existing holders of Spanish debt.
- Last year's Greek bond loss-taking marked the first time since the fall of Lehman Brothers that senior bondholders were not fully bailed out. Until then, the operating assumption was that *in the*

Update to strategic view

EUROPE MACRO, EUROPE BONDS: Europe's summit relieved Spanish sovereign bondholders of the risk of subordination, and created a mechanism for avoidance of similar crises in future bank bailouts. With the Spanish seniority issue resolved, we have avoided a repeat of last year's systemically risky experiment in haircutting holders of Greek debt.

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post-Lehman world the possibility of cascading default makes even the smallest bond losses too systemically risky.

- Last year, world markets didn't bottom until early October, when Europe demonstrated that it appropriately respected the fragility of the global banking system by quietly rescuing Dexia's depositors and bondholders (see "Europe Fails, US Stocks Flail" October 4, 2011).
- The cost of this policy stance has been moral hazard. Yes, the day must come when the banking system is weaned from it. But self-evidently last year was too early to try -- and judging by the market's reaction to the potential subordination of Spanish sovereign debt, it is still too early.
- In the case of Spain, there were other pernicious dynamics at work.
- The subordination of Spanish sovereign debt would have damaged the solvency of the very banks that the bailout was intended to rescue, by lowering the value of the banks' holdings of sovereign bonds. This would have spilled over into other European banks with holdings of Spanish debt, or of Spanish bank securities. That, in turn, would have spilled over into the world banking system.
- The indecision of the last three weeks made it worse still. It seemed that European authorities were almost deliberately trivializing the issue, even as markets flailed in distress.
- If we learned anything from the trial-and-error process of rescuing the US banks in 2008 and 2009, it was that aid must be decisive, generous, well understood and consistently applied (see "Death by Rescue" November 17, 2008).
- Now those lessons have been learned again, and the matter is put to rest: today, for Spain -- and in the future, for other banking bailouts through the newly agreed mechanism of direct capital injections in the distressed banks themselves (rather than the sovereign agency responsible for the banks).

But neither this, nor any other single element to come out of last week's summit, changes our strategic view. Europe remains in a long-term "managed crisis," in which economic pressure is brought to bear and removed, alternately (see "Unquestionable Success?" March 9, 2012). The aim is to drive 17 separate nations toward a United States of Europe, dominated by Germany and France, which Winston Churchill envisioned 65 years ago. "Managed crisis" is another term for "war." This is, and will be, a long drawn-out war, in which only in retrospect will we ever know which particular battle was the decisive one.

Bottom line

Europe's summit relieved Spanish sovereign bondholders of the risk of subordination, and created a mechanism for avoidance of similar crises in future bank bailouts. With the Spanish seniority issue resolved, we have avoided a repeat of last year's systemically risky experiment in haircutting holders of Greek debt.

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