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

MACROCOSM

Exceptional Measures

Wednesday, August 29, 2012

Lorcan Roche Kelly

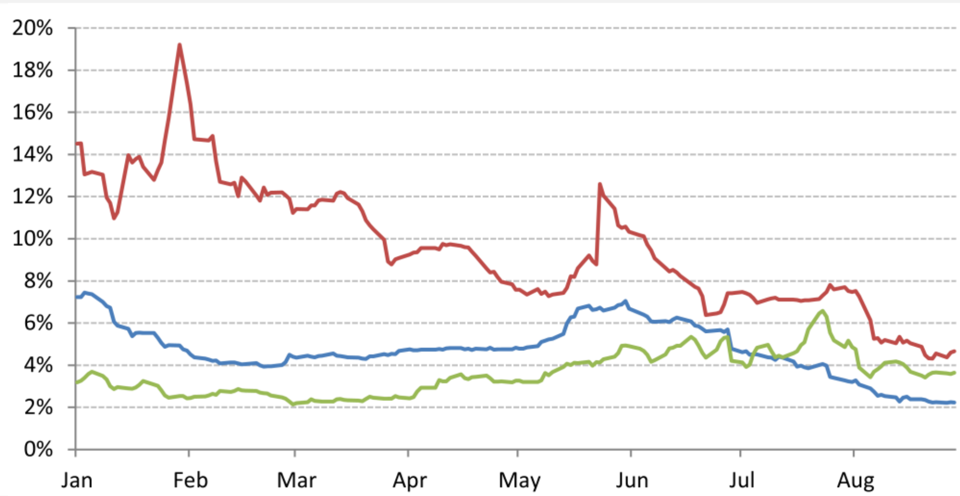
The ECB won't disappoint next week -- and there's still room on the upside.

The information vacuum since ECB President Mario Draghi's last policy press conference (see "Draghi: Off the Reservation" August 3, 2012) has led to speculation on his next announcement that ranges from the exuberant -- yield caps -- to the despondent -- nothing until the German federal court's ESM decision.

The truth will be somewhere between the two extremes. A speech by ECB executive board member Jörg Asmussen on Monday -- unfortunately only available in German -- and today's op-ed by Draghi in the German newspaper *Die Zeit* (which ECB sources tell us is the speech he had planned to give at Jackson Hole, if he hadn't cancelled that engagement) give the strongest hints yet to what the ECB is going to announce.

- The new bond purchase program will be an improvement on the old Securities Markets Programme (SMP), which lacked clear objectives or conditionality.
- The conditionality will not be imposed by the ECB itself, but rather the EFSF and ESM. This will allow the ECB to appear apolitical throughout the process, while reducing the risks that a country

2-year sovereign yield — Portugal — Ireland — Spain



Source: Bloomberg

Update to strategic view

ECB, EUROPE BONDS: The ECB will announce unlimited and unsterilized bond purchases -- subject to EFSF or ESM conditionality -- at the next meeting on September 6. The conditionality requirement redresses the mistakes of last year's SMP intervention, which had the unintended consequence of moving Italy off its reform track. But conditionality does not reduce the momentousness of the decision by the ECB to engage in unsterilized QE. Peripheral sovereign debt -- other than that of Greece, where we think there is still default risk -- should continue to rally, even on top of the considerable gains already made. Conversely, as the recipient of overflow safe haven demand, French sovereigns are the most at risk.

[Strategy Dashboard home]

might abuse the ECB's assistance. In his speech Asmussen said Italy failed to use the time given by the SMP to implement reforms in 2011 (see "Rome Makes Athens Look Good" November 10, 2011).

- The EFSF and ESM will be able to make purchases in the primary market, with the ECB then buying in the secondary market -- but at the short end only.

While these moves may be a disappointment for those who expected the ECB to impose a fixed exchange rate regime on bond yields across the periphery, the power of the program the ECB is going to implement should not be underestimated.

- Any ECB purchases will be straight QE. There is no talk of sterilizing them, and as such, they will be unlimited in size.
- This intervention should silence the arguments that the critics of the EFSF and ESM have rightly raised that those funds are too small for the job at hand. A €500bn fund would not be able to accommodate either Spain or Italy in a full bailout, and certainly not both. However, a fund backed by a central bank willing to make unsterilized purchases can be viewed as limitless.
- The ECB has made clear that it will address the seniority issue -- making sure it does not subordinate existing bond-holders, but rather ranking *pari passu* with them. This has two advantages. First, we will not see a repeat of the seniority debacle following the Spanish bank bailout (see "I Love the Smell of Bailouts in the Morning" June 11, 2012). And second, if Spain or Italy come under EFSF/ESM budget oversight, it is likely that they would be able to maintain access to capital markets -- unlike Portugal, Ireland and Greece where bailouts meant long absences from capital markets.

The greatest benefit from the new ECB policy is the gift of time that it -- and only it -- can give to nations implementing difficult structural reforms (see "Mario Canute" July 25, 2012).

- Both Draghi and Asmussen pointed to the long game for the ECB -- and the euro area -- in which the current crisis solutions can only be made in the context of ever closer European integration.
- If the ECB announced yield caps, or any intervention that reduced the pressure on politicians to continue reform and integration, it would be failing to take full advantage of the crisis.
- However, it also knows that too much pressure may lead to disintegration, so it is going to balance its policies to allow enough pressure to force reform, but also have the relief valve of unsterilized purchases available.
- Draghi said that the ECB mandate may at times require "exceptional measures." Make no mistake, what Draghi is going to announce on Thursday, September 6 will be exceptional.

The ECB is building a permanent safety net for euro area sovereigns. Politically, it may be difficult for some to jump into that net-- the reduction in

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
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]

Recommended Reading

The *Goldkrieg*: Revaluing the Bundesbank's Reserves and the Politics of EMU
Mark Duckenfield
Center for European Studies, Harvard University
September 1998

[Reading home]

fiscal sovereignty that comes with an EFSF/ESM program is unlikely to be an easy pill to swallow. But the goal for the euro area is that eventually all euro area sovereigns -- not just the peripheral nations -- will cede sovereignty to a central agency.

Currently the need for budgetary oversight is understandably stigmatized -- attached to a real or perceived failure of the fiscal policies of the state seeking the bailout. If all countries are to eventually cede fiscal sovereignty to external oversight, then this stigma needs to be removed. German Chancellor Angela Merkel is already pushing for a new treaty to allow Brussels to monitor budgets of all euro area nations. This would remove the stigma -- when *every* nation is stigmatized, then *nobody* will be.

It is hard to see how all this can be anything other than very positive, especially at the short end for peripheral sovereigns. There have already been substantial gains there over the last month, but more gains are likely in store.

- Following the second 3-year LTRO (see "On the Second 3-year LTRO" February 29, 2012) Spanish 2-year yields fell to 2.2% (please see chart on the first page). There is no reason to think that if -- or rather, *when* -- Spain gains access to the unlimited purchasing power of the ECB that these yields would not at least fall back to that level.
- It is interesting that Ireland -- still a program country -- has 2-year yields 140 bp lower than Spain's. We do not see much movement lower here.
- The most immediate opportunity could well be in Portuguese debt. Portugal already meets all the criteria that the ECB might specify as preconditions for action. While it has rallied strongly this year, there still is plenty of room to move further.
- On the other hand, if all this comes to pass then the safe havens among European sovereigns could come under pressure. We think France is especially vulnerable, being not as intrinsically creditworthy as Germany, but nevertheless the lucky recipient of overflow safe haven demand.

Bottom line

The ECB will announce unlimited and unsterilized bond purchases -- subject to EFSF or ESM conditionality -- at the next meeting on September 6. The conditionality requirement redresses the mistakes of last year's SMP intervention, which had the unintended consequence of moving Italy off its reform track. But conditionality does not reduce the momentousness of the decision by the ECB to engage in unsterilized QE. Peripheral sovereign debt -- other than that of Greece, where we think there is still default risk -- should continue to rally, even on top of the considerable gains already made. Conversely, as the recipient of overflow safe haven demand, French sovereigns are the most at risk.