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

MACROCOSM

The Phony Bailout

Friday, October 12, 2012

Lorcan Roche Kelly

The ESM is up and running. The ECB is ready with OMT. So where's the bailout?

Between the German invasion of Poland in September 1939 and May 1940 there was a period that became known as the "phony war," or the *sitzkrieg*. All of the combatants had formally declared war, committing themselves to a long and bloody conflict on the continent. But for that 8-month period all was quiet on the western front. The actual breakout of hostilities was not until the German invasion of France.

While the situation in Europe is thankfully very, very different now -- as the Nobel committee reminded us this morning by awarding the Peace Prize to the EU -- the tradition of making grand declarations and failing to follow through with timely actions is alive and well.

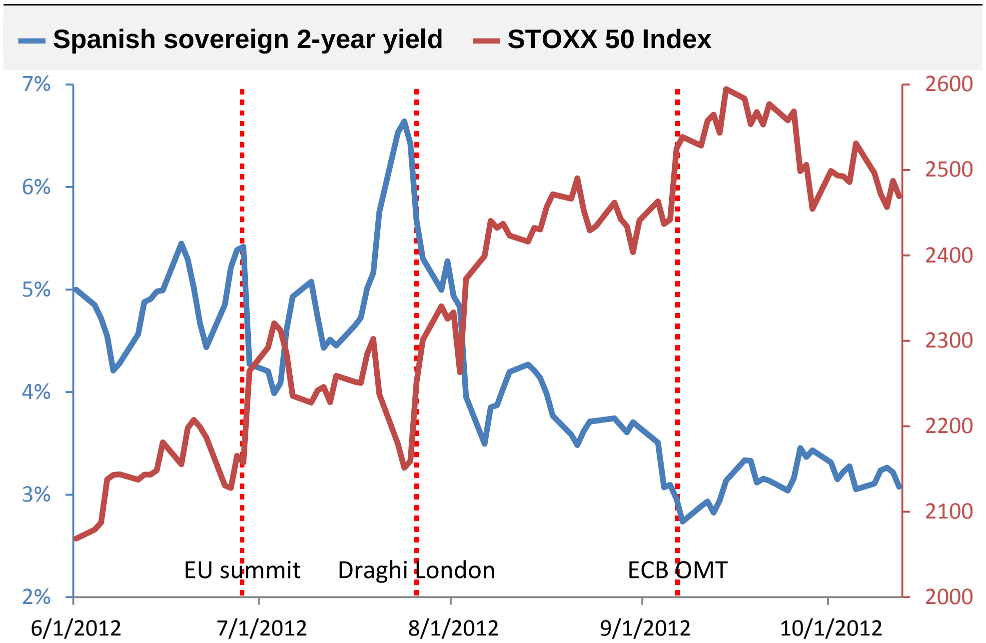
- The June summit agreed to the details of the Spanish bank bailout (see "No Senior Discount for Spain" July 2, 2012), and held out the possibility of direct ESM bank recapitalizations and an improvement to the sustainability of the Irish financial sector.
- The permanent European Stability Mechanism (ESM) -- following a long and difficult birth (see "Europe Beyond Draghi's Promised Land" September 13, 2012) -- is finally up and running. It is ready to meet the funding needs of the already agreed Spanish bank bailout, and those of any other country requiring a bailout.
- Away from conventional politics, ECB President Mario Draghi has been making his own declarations, starting with his speech in London where he famously promised the ECB was ready to do "whatever it takes" within its mandate to preserve the euro (see "On Draghi in London" July 26, 2012).
- He followed up on his promise, announcing a very well received bond buying program -- Outright Monetary Transactions (OMT) -- plus other collateral easing measures (see "On the September ECB Policy Decision" September 6, 2012).

All of these measures have two things in common. The markets have welcomed them (please see the chart on next page) -- and none of them has actually been put to use.

Update to strategic view

EUROPE MACRO, EUROPE BONDS, EUROPE STOCKS: We are still waiting for words to become actions in the euro area. The current "phony bailout" period, with powerful new bailout modalities put in place, but not one of them actually deployed, gives investors a chance to take tactical positions ahead of their use -- the inevitable "outbreak of facilities." We still see peripheral debt ex-Greece as a good buy, and certain core debt as currently over-valued. For equities, the risks are from both euro area and US policy uncertainty.

[Strategy Dashboard home]



Source: Bloomberg, TrendMacro calculations

To be clear, all the new facilities *will* eventually be deployed. But in the interim -- let's call it the "phony bailout" -- we have time to position for a new world after the "breakout of facilities."

- In sovereign debt, we continue to like peripheral bonds (see "Exceptional Measures" August 29, 2012) -- with the clear exception of Greece. While we correctly concentrated on opportunities in Portugal, we see Italy and Spain as also being attractive.
- The great news from Italy this week was the decision from former prime minister Silvio Berlusconi not to contest the spring 2013 election. It now seems more likely that Mario Monti may continue as prime minister after that election, which would take a major political risk off the table (and keep at the helm one of the smartest pro-growth politicians anywhere in the world today).
- Spanish debt has rallied recently, but yields at the short end are still elevated when compared to Italy. OMT intervention -- when it eventually comes -- should tighten that spread. If Spain continues to hesitate on taking a bailout, the yield spread may start to widen. We see an opportunity in buying on any widening, as higher yields for Spanish debt only make a bailout more likely.
- Note how in this regard the world has been turned upside-down by the ECB's new OMT modality. By intervening in markets in such a way as to preserve market access for the sovereign being assisted, now bailouts can be expected to *narrow* spreads, not widen them as in the past (see "On the October ECB Policy Decision" October 4, 2012).
- Of the core ex-Germany, two countries' bonds now stand out as most at risk of a sell-off.

Contact TrendMacro

On the web at trendmacro.com

Follow us on Twitter at twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
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 End of Social Security Self-Financing: What Does It Portend for Social Security's Future?
Charles Blahous
Mercatus Research
October 10, 2012

I Was Right About That Strange Jobs Report
Jack Welch
Wall Street Journal
October 10, 2012

[Reading home]

- France under new President François Hollande is taking some less business-friendly tax decisions that are already weighing on investments by French companies. If French growth turns negative -- and without investment it is hard to see how it could remain positive -- French bonds will come under pressure. We have already argued that this should happen, anyway, given France's diminishing importance as a safe haven for capital flight (again, see "Exceptional Measures").
- Austrian debt has been trading like that of its western neighbor, but the Austrian economy seems to be more at risk of credit excesses. Austrian house prices are up over 27% since mid-2008, by far the largest move of any euro area nation, triple that of Germany. While its current debt-GDP ratio and deficit are favorable, they do not seem to justify yields only basis points above zero at the short end.
- The current push from euro area policy makers to take the next step forward in integration -- reiterated today by European Council President Herman Van Rompuy -- will, if successful, mean that more common debt liability will exist across the euro area. While this is part of a longer term project, it should continue the tightening of spreads across all euro area debt.

In equity space, the biggest drag continues to be policy uncertainty.

- For financials, the ESM position on "legacy issues" has yet to be decided. The statement from the German, Finnish and Netherlands (our proposed collective acronym: DeFiNe) finance ministers last month (see "Bring in the Noise" September 26, 2012) seemed to castrate direct bank recapitalization as a useful feature of the ESM. But comments from Draghi and Van Rompuy since then point to continued negotiations on that issue.
- More broadly, equities in the euro area may start to suffer from uncertainty that is, for once, not European in origin (see "Positioning for the Fiscal Cliff" October 3, 2012). With global growth prospects already looking weak, a major volatility event from the United States would have severe adverse spillovers in Europe. Germany's industrial-heavy DAX index -- which has had a significant rally recently -- would be hit especially hard.

Bottom line

We are still waiting for words to become actions in the euro area. The current "phony bailout" period, with powerful new bailout modalities put in place, but not one of them actually deployed, gives investors a chance to take tactical positions ahead of their use -- the inevitable "outbreak of facilities." We still see peripheral debt ex-Greece as a good buy, and certain core debt as currently over-valued. For equities, the risks are from both euro area and US policy uncertainty.