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

MACROCOSM

Correction, Not Crisis

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Lorcan Roche Kelly

Politics and policy have paused Europe's rally -- but this is not a return to the bad old days.

Since our October call right at the bottom of the previous correction (see "Calm Breaks Out in Europe" October 31, 2012), calm has indeed broken out in the euro area. Spanish and Italian bonds have rallied strongly while French bonds have languished, Spanish and Italian stocks have pushed toward new 12-month highs, the STOXX euro area bank index rallied as much as another 26%, and the euro currency has strengthened significantly.

But now we are in a sharp correction, amidst headwinds that appear to put our period calm at risk.

- **Politics:** Italian election uncertainty and alleged bribery scandal in Spain
- **Monetary policy:** The start of the unwind of the ECB's 3-year LTRO, and a strengthening of the euro currency

Global investors have become trained during the crisis years to look for existential risk in such apparently damning evidence. But there is less to each than meets the eye.

The Italian election on February 24 and 25 (see "On Monti's Resignation" December 10, 2012) is certain to lead to a hung parliament -- no party large enough to win an overall majority. A coalition between Pier Luigi Bersani's center left and Prime Minister Mario Monti's centrists is still the most likely outcome. Silvio Berlusconi's electoral list is running between 25 and 30% in polls, but with only three weeks left to the election and no chance of him convincing Monti or Bersani to form a government under his leadership, he is very unlikely to be victorious. Any government including Monti will be viewed positively by markets, as he is the candidate most likely to maintain reform -- the Monti agenda -- in Italy.

- Over the weekend, Berlusconi promised to not only abolish the property tax introduced by Monti's government, but also to refund payments made in 2012. Monti, for his part, called Berlusconi a "snake charmer" in response to the proposal. Like all elections, the next few weeks in Italy will be high on rhetoric -- with increased anxiety for markets if Berlusconi continues to improve in polling. Markets remember well that Berlusconi's antics in 2011 were at the

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS, ECB, FX: Political scandal in Spain, gains by Berlusconi in Italy and an apparently tighter ECB have triggered a correction in European peripheral stocks and bonds, and a much stronger euro. We think this is only a correction, and a buyable dip for both peripheral debt and equities. Political uncertainty will resolve in a matter of weeks, with the most likely outcomes benign for markets. The ECB is not in fact tightening -- the small reduction in outstanding LTRO balances is a voluntary choice by Europe's banks reflecting their confidence, not central bank policy. And the ECB's OMT safety net rules out the existential risks of the past three years.

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center of that year's crisis in peripheral debt (see "Rome Makes Athens Look Good" November 10, 2011).

In Spain, the government of Prime Minister Mariano Rajoy has come under pressure due to bribery allegations involving Rajoy's People's Party. While a bribery scandal as broad as the one alleged in the Spanish media would lead to resignations in the US, in Spain it is unlikely to force Rajoy out of office. There will be a judicial investigation -- if it is deemed necessary -- which may eventually find against Rajoy. But this process will be very drawn out -- there already is a bribery investigation ongoing against Rajoy's People's Party that began in 2009 and has still not delivered any findings. For his part, Rajoy is strongly denying any wrongdoing.

- Also in Rajoy's favor is the lack of a credible alternative. Polling over the weekend showed his personal approval among Spanish voters at an abysmal 23%, but the Spanish socialist opposition leader, Alfredo Rubalcaba fared even worse.

A totally separate development in Spain that is moving markets at the moment is the lifting of the short-selling ban. Spanish stocks have come under pressure, with the IBEX 35 index giving up all of its January gains. But, with volumes twice their usual level on Friday -- the first trading day after the lifting of the ban was announced -- some of this move is probably just a rebalancing as investors take advantage of the return to normalcy.

Turning to monetary policy, the ECB's failure to cut rates in January (see "On the January ECB Policy Decision" January 10, 2013), despite indications to the contrary given at the December meeting (see "On the December ECB Policy Decision" December 6, 2012) -- and then the repayment of a net €140 billion LTRO on Wednesday -- has led to a view in the market that the ECB, already the tightest major central bank, is getting tighter.

- Even though the ECB balance sheet -- which will be officially updated tomorrow -- will show a reduction in liquidity provided to banks of €140 billion, this does not mean that the ECB's monetary policy stance is any tighter than it was (see "On The First LTRO Payback" January 25, 2013). The LTRO's were -- and continuing operations still are -- demand-led operations, in which banks determine how much liquidity they need. That they have chosen to relinquish a small portion of that liquidity is their own choice -- and evidence of their confidence -- and not an indication of ECB policy change.
- That said, the euro currency has risen in the past week to levels not seen since before the announcement of the 3-year LTROs in December 2011. The perception of a tighter ECB is trumping the reality at the moment.
- The next ECB monetary policy meeting is on Thursday, and while it is a certainty that there will be no change in interest rates announced (again, see "On the January ECB Policy Decision"), any comments from Draghi -- however unlikely -- on either the current

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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
617 600 6969
lorcan@trendmacro.com

[About us]

strength of the euro currency or relative weakness of peripheral debt will be significant for the next move in markets.

So is the present back-up in peripheral yields and tumble in stocks just the correction one would expect following a rally of the power we've seen over the last several months?

- For peripheral bonds, we think that no matter how badly things play out in Spain -- and it is our base case that the outcome will be relatively benign -- the ECB's new OMT facility (Outright Monetary Transactions, in which the ECB has the stand-by ability to buy sovereign debt) is there to keep things under control. The equilibrium still is that if peripheral debt sells off enough, the ECB will step in to control the market.
- This means that there is a floor -- albeit an untested one -- to any sell-off. So any correction has a downside limit that did not exist during previous periods of euro area uncertainty. We reiterate our call on peripheral sovereign debt as a total return play.
- In stocks, present anxiety is likely to continue until the Italian elections in three weeks, but we think that will put an end to it. The risks now are an order of magnitude smaller than the existential crises the peripheral economies have faced over the last three years.
- With a foreseeable end to the uncertainty, and the ECB ruling out the worst case in debt, we see a short period ahead in which to buy dips in the larger peripheral economies where structural economic reforms have created new long-term growth potential.

Bottom line

Political scandal in Spain, gains by Berlusconi in Italy and an apparently tighter ECB have triggered a correction in European peripheral stocks and bonds, and a much stronger euro. We think this is only a correction, and a buyable dip for both peripheral debt and equities. Political uncertainty will resolve in a matter of weeks, with the most likely outcomes benign for markets. The ECB is not in fact tightening -- the small reduction in outstanding LTRO balances is a voluntary choice by Europe's banks reflecting their confidence, not central bank policy. And the ECB's OMT safety net rules out the existential risks of the past three years.