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MACROCOSM

# Red Letta Day

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**Lorcan Roche Kelly**

**Déjà vu in Italy, time for something new at the ECB.**

Any cobwebs from the long summer of calm in the euro area are sure to be blown away this week as Silvio Berlusconi -- yet again (see, among many, "Rome Makes Athens Look Good" November 10, 2011) -- threatens to pull the plug on Prime Minister Enrico Letta's government in Italy. Letta has called for a vote of confidence in his government in parliament on Wednesday. Also on Wednesday, the ECB meets in Paris for President Mario Draghi's first monetary policy meeting without the invisible hand of the German election constraining his options (see "Bundesblock" June 19, 2013).

- Looking at the Italian political mess first, we can't help have feelings of *déjà vu*.
- Berlusconi-led crises have become an annual event in Italy (see "On Monti's Resignation" December 10, 2012, and again "Rome Makes Athens Look Good").
- Even if there are strong echoes of "the boy who cried wolf" in Berlusconi's actions, this does not mean the market will -- or should -- see through them.
- With spreads between Italian and German 10-year bonds currently under 300 bp, Italian debt is at the low end of its crisis-era range (please see chart below).

**— 10-year spread, Italy minus Germany**


Source: Bloomberg, TrendMacro calculations

**Update to strategic view**

**EUROPE MACRO, EUROPE BONDS, ECB:** Berlusconi has destabilized the Italian government, raising the specter of new elections and a hung parliament. It will be rough on Italian bonds, but they'll be a buy when the political path clears -- which might be sooner than the frantic headlines now suggest. We don't expect significant contagion to other euro peripheral debt, or any durable lift for bunds. Draghi will probably do nothing at this week's ECB policy meeting, but a rate cut is at least a possibility.

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- While a sell-off of some degree is certain within the coming days, it remains to be seen whether it will be a repeat of October 2011 where Italian bond prices crashed, playing a major role in a global bear market (see "Once More unto the Debt Crisis, Dear Friends" September 25, 2013) -- or of December 2012 when there was a mere correction that was quickly recouped.
- At the moment, we see the latter scenario as the most likely. Letta, following his meeting with Italian President Giorgio Napolitano Sunday evening, has decided to seek a vote of confidence in the Italian parliament on Wednesday, hoping to take advantage of dissent among members of Berlusconi's PDL party.
- If he fails in that vote, an early election becomes much more likely -- an election that would be held under Italy's current byzantine electoral law (see "Elezione!" February 14, 2013) which was due to be changed in the coming government term.
- If that happens, it shifts the odds toward a repeat of the October 2011 scenario in which bond prices crashed. Further downgrades of Italian debt -- critical, as a downgrade would increase haircuts on repos of that debt -- would likely follow.
- Either way, Italian debt is going to have a rough patch here. As the week plays out we will find out whether it will quickly become a buy. We think it mostly likely that it will, but remember that we're dealing here with very idiosyncratic political factors.

Turning to the ECB, Draghi once again faces a dilemma, with this morning's Eurostat flash inflation estimate coming in at a lower than expected 1.1%.In a nutshell, he has three options.

- *One, he could do nothing new*. During the summer the ECB introduced its version of forward guidance. At the time we called it -- and still believe it be -- "no guidance guidance" (see "On the July ECB and BOE Policy Decisions" July 4, 2013). But since then the ECB has been at great pains to point out how effective it has been.
- In a speech last week, ECB Executive Board member in charge of market operations Benoît Cœuré put forward strong arguments in favor of the effectiveness of the ECB's forward guidance.
- While there is no denying the reduction in money market interest rates since the introduction of forward guidance, we suspect there may be an element of conformation bias on the ECB's part here. Actions by the US Fed coupled with the benign summer environment could just as easily have been driving factors.
- If, say, the Italian mess or the ongoing US budget uncertainty were to cause money market rates to reverse, we doubt the ECB would be as quick to admit the ineffectiveness of its no guidance guidance.
- *The second option open to Draghi -- and one that seems to be getting some traction at the moment -- is the announcement of another 3-yearr LTRO.*
- With paydown of the original operations continuing apace -- there is now only €657 billion of the original €1018 billion outstanding -- it is hard to see where the demand for a new operation is, unless that

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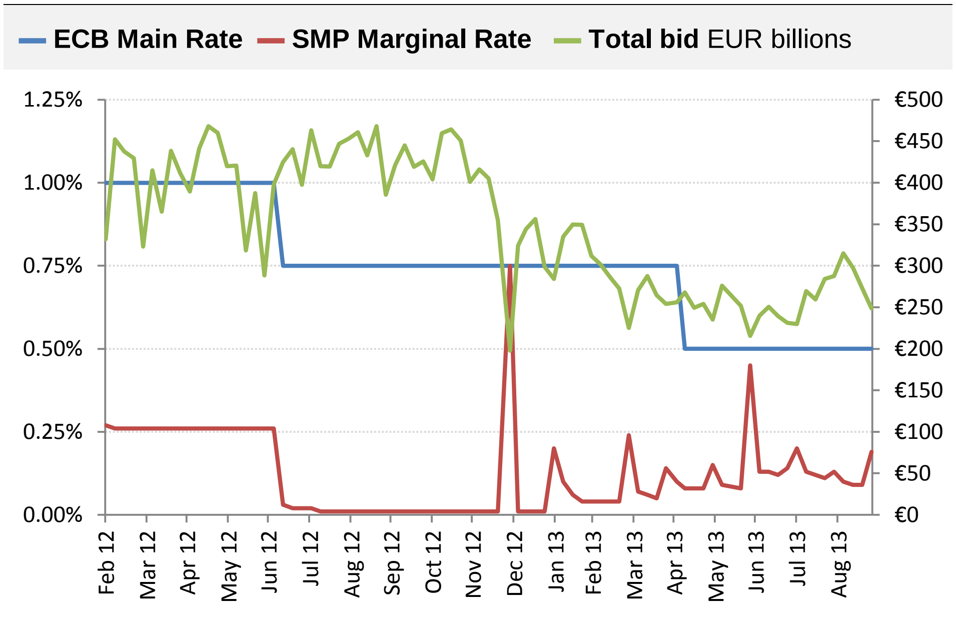
operation was launched with extra sweeteners such as a fixed rate over the full term.

- There is also an argument that once the term of the outstanding LTROs fall under one year, the perception of risks of a liquidity cliff at some weaker banks could hamper their ability to fund themselves in the market.
- We view an announcement of a new LTRO as very unlikely. The ECB plans to do an asset quality review (AQR) of euro area banks in the coming months. If he can avoid it, Draghi would rather wait until after he has the results of that review in hand before deciding on any liquidity-providing measures.
- There is also a chance that if the AQR proves particularly unfavorable for euro area banks, it might itself necessitate a new LTRO, as banks lose access to market funding. An LTRO, for the moment, is a bullet Draghi is better off keeping in the chamber.
- *The third option that Draghi has on Thursday is to cut interest rates.* He has hinted recently that a further rate cut might be in the cards.
- But these hints are nothing new -- in fact they form a central part of the ECB's guidance. The ECB wants the market to believe that it has an easing bias, and hinting at a rate cut is part of that.
- If he were to cut rates, Draghi would have two options. First he could cut *all* rates by the same amount, as is usual. This would have the effect of driving deposit rates negative, which would be uncharted waters for the ECB.
- The other option would be for the ECB to reduce the corridor between the deposit rate and the main refinancing rate, as it did in May (see "On the May ECB Policy Decision" May 2, 2013). This would mean leaving the deposit rate at zero and cutting the main refinancing rate to 0.25%.
- While this would avoid the risks of a negative deposit rate, it would have consequences for another policy of the ECB that is politically very important: the weekly sterilization of its bond purchases under the Securities Market Programme (SMP) purchases.
- Recently, as a consequence of the reduction in liquidity as the LTROs have been paid back, the ECB has had to pay more to get full allotment for its sterilization operation.
- Rates paid at this liquidity-absorbing operation are capped at the ECB main rate. Recently the marginal rate paid has consistently been over the zero ECB deposit rate, and -- more worrying -- is approaching the 0.25% rate that would exist after any rate cut (please see the chart on the following page).
- Technically, there is no reason for the ECB to be concerned if this reverse operation starts to fail regularly. As we recently pointed out, deposits at this operation are themselves eligible for -- and are used as -- collateral at ECB liquidity-providing operations (see "ECB: It Takes Whatever" May 22, 2013).
- But politically, failure to sterilize the already controversial SMP purchases could increase internal opposition to any eventual purchases by Draghi's Outright Monetary Transactions mechanism (see "On the September ECB Policy Decision" September 6, 2012).



Source: ECB, TrendMacro calculations

- If this were to happen, the single most important confidence-giving operation at the ECB would come under threat.
- Rather than risk this, we are sure that should Draghi decide to cut rates, it will include moving deposit rates negative. We further believe that while such a rate cut is not certain at Wednesday's meeting -- our view is that Draghi most likely will do nothing -- the chances of it happening are high enough to inform investors decisions over the coming days.

Together, the political turmoil in Italy and Draghi possibly being forced to back up a dovish stance with risky dovish actions in the form of a rate cut mean that it will be a rough week in Europe. We think this is unlikely to feed through to any great extent to other euro area peripherals. Any rally in the German bund will be a short term effect from the added uncertainty, rather than a structural reversal of durable recent trends.

## Bottom line

Berlusconi has destabilized the Italian government, raising the specter of new elections and a hung parliament. It will be rough on Italian bonds, but they'll be a buy when the political path clears -- which might be sooner than the frantic headlines now suggest. We don't expect significant contagion to other euro peripheral debt, or any durable lift for bunds. Draghi will probably do nothing at this week's ECB policy meeting, but a rate cut is at least a possibility.