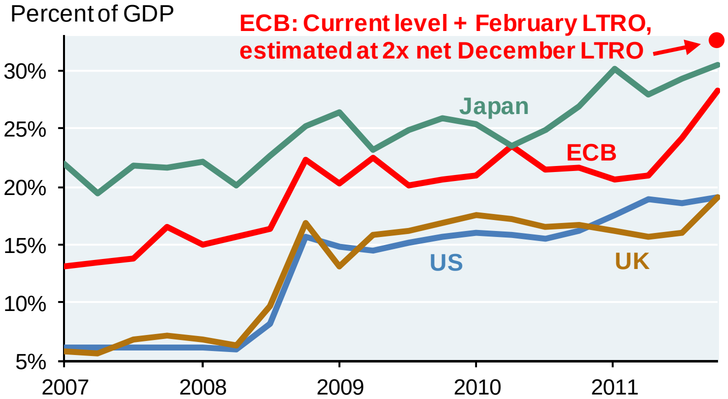
Topics: Germany capitulates, kicks can well into 21st century…or at least into 2013

Das Kapitulation. There has been good news in the US (manufacturing, small business optimism, bank lending to businesses, some housing indicators), and in China (no hard landing yet, with strength in production and retail sales offsetting weakness in exports and capital spending). But the biggest market-moving event so far this year is undeniably the positive aftershock from Germany's capitulation on monetary expansion. The mechanism: the long-term refinancing operations (LTRO) of the ECB, shown in the first chart. I did not foresee this kind of radical policy being put into place so aggressively and so quickly. The ECB is printing money, and lending it to just about any European bank against practically any asset it owns, for three years.

This has positive near-term implications for sovereign and bank financing pressures, the speed of deleveraging, and the EU recession. On the first point, as shown below, the front ends of Spanish and Italian yield curves have collapsed. With demand from national champion banks, and assuming continued ECB purchases of government debt, 2012 Spanish and Italian financing needs do not look as onerous as they did 3 months ago[1]. On the second point, there has been a partial re-opening of core and peripheral bank debt markets. More importantly, a recent Morgan Stanley report estimates that some European banks used the LTROs to prefund 50% to 150% of their 2012 bond maturities assuming markets *don't* reopen. And on the third point, based on this morning's preliminary manufacturing and service sector surveys for January, the ECB's actions may have slowed the severity of the EU recession as well. **The bottom line is that the ECB, directly and indirectly, is giving its governments and its banks the money that the rest of the world has been taking away**. Combine the ECB largesse with the initiatives in Table 1, and you've got a region that appears determined to banish concerns about itself from financial markets this year.

Central bank balance sheets
Percent of GDP

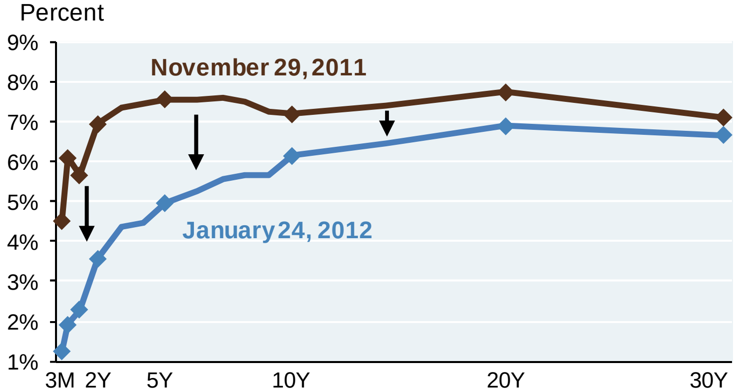


Source: FRB, BEA, ECB, Eurostat, BoE, UK Office for National Statistics, BoJ, Japan Cabinet Office.

Table 1: Crisis management, by any means necessary

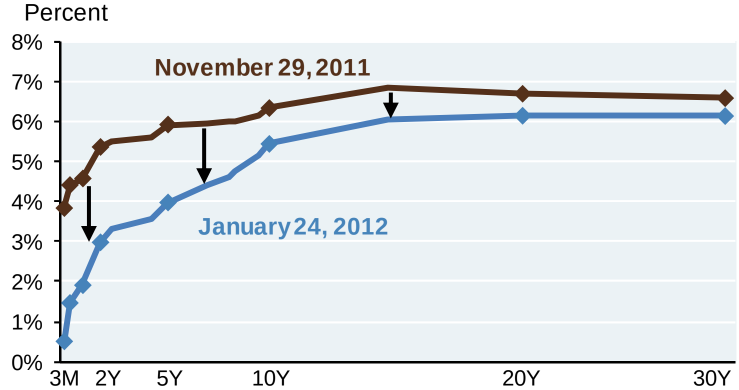
Relaxation of ECB collateral lending rules (e.g., more loans, lower allowed credit ratings on asset backed securities)
Finance ministers Schauble and Baroin push for watered down application of certain Basel III standards
Sanctioning for EU banks to address 115 bn capital shortfall through earnings rather than rights offerings
Dilution of proposed Maastricht 2.0 deficit constraints; Spain pushing for lower deficit target given collapse in growth estimate
Creation of a European rating agency to compete with those unfriendly Anglo-saxon ones
European systemic risk council: EBA stress tests and mark-to-market for sovereign bonds is a 1-time event (not ongoing)
Lower bank reserve requirement ratios, from 2% to 1%

Italy's sovereign yield curve
Percent



Source: Bloomberg.

Spain's sovereign yield curve
Percent



Source: Bloomberg.

It should not be lost on anyone that first prize in the Central Bank balance sheet expansion race is not necessarily one you want to win. After all, Europe is poised to surpass Japan, whose (admittedly belated) Central Bank expansion did not prevent bouts of low growth, asset price deflation and perhaps the world's least attractive equity market returns over the last 10 and 20 years. Germany was reluctant to go down this road in 2011, a view I thought would prevail.

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[1] According to a JP Morgan investment banking research piece ("*Flows and Liquidity Report*", January 20, 2012), Spain and Italy need a combined 225 billion in 2012 to finance deficits and maturing bonds not held locally. Assuming a modest uptake by respective national champion banks, and continued purchases by the ECB of 20-30 billion Euros per month, "engineered" demand for bonds could be sufficient.

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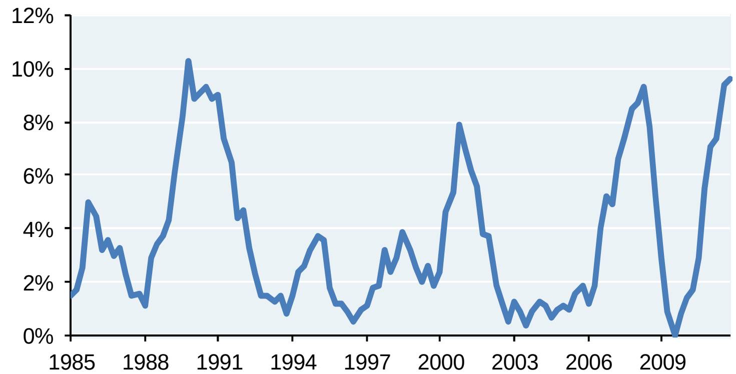
However, it's clearer now that German resignations from the ECB in 2011 (Stark, Weber) were not, as I saw them, a reflection of a battle being waged between Germany and the Periphery. **They were instead a reflection of a battle that Germany had already lost; the resignations were merely signs of the capitulation that followed**. Italian Prime Minister Mario Monti actually went so far last week as to warn about a "powerful backlash" in the periphery against Germany, should Germany not do more to lower credit spreads in Italy. *A chi dai il dito si prende il braccio*…What kind of action is Monti demanding here? Since Germany already surrendered on its insistence for ECB balance sheet control, perhaps he is referring to fiscal transfers through joint and severally guaranteed Eurobonds. Will Germany cave in on this as well? Who knows. I spoke last fall to a former Bundesbank member and professor of economics at Bonn University who organized the petition of 150 German economists in 1998 arguing for a postponement of the Euro, since conditions for monetary union were "most unsuitable" for it. He thought the idea of Eurobonds was absurd, but also thought the same thing about radical ECB balance sheet expansion.

German manufacturers reporting labor shortages

Percent of firms listing labor shortages as a factor limiting production



Source: European Commission.

The positive market reaction is understandable, given the reduction in Armageddon risk, and how cheap (and under-owned) European equities had become. The latest steps give Europe more time to try and sort through all of its structural problems (e.g., why is the level of German manufacturers reporting labor shortages close to the highest on record while unemployment in Spain is 23%?). I am still a considerable skeptic on this front, for reasons we have written about often, and I would be surprised if Italy or Spain grew at all over the next couple of years. I'm also not sure how many obligations Germany and France can really take on, given sovereign debt ratios above 80%. And of course, if the current strategy doesn't work, the EU will simply have made the problem bigger for the ECB and EU banks. Southern Europe needs capital to finance both budget deficits *and* trade deficits. Private sector capital is going to need a reason to come back, and absent a much weaker Euro, downward pressure on wages and prices may be the only way to do it. For a project designed to reduce regional credit risk, growth and unemployment differences, the European Economic and Monetary Union sure has elevated them. As Marx noted in *Das Kapital*, the road to hell is paved with good intentions.

These caveats aside, in a moment of reflection, I may have misread how the crucible of EU market pressures would resolve themselves in early 2012. We positioned for continued concern about sovereign and banking sector problems negatively affecting European equity markets, and instead, ECB operations have alleviated them. The benefits are accruing to the US and Asia, whose equity markets have gone up as much (or more) than European equities so far this year.

With risks related to European sovereigns and banks in partial retreat, we will return to the mundane topic of investments. Next week, a detailed look at opportunistic US commercial real estate investing in the current environment.

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Postscript: As a reminder, the Institute of International Finance is attempting to corral private sector Greek bondholders into a voluntary exchange, with losses ranging from 60%-70% on an NPV basis. Private sector (non-ECB, IMF) bondholders only amount to 40%-50% of overall Greek debt. The entire process is still a concern, as we wrote last week, given the focus on:

- whether the ECB will avoid losses on its Greek bonds and effectively assert preferred creditor status. If so, they will need to exchange their bonds before the restructuring takes place
- whether retroactive collective action clauses will be inserted and used on Greek law bonds, furthering concerns about the risk of extra-legal outcomes in the region
- whether holders of Greek law bonds have standing to litigate outside Greece if CACs are both inserted and used, if they have cause to do so
- how Greece will treat holdout creditors in situations where it gets approval for the CAC from bondholders
- how Greece will treat holdout creditors in situations where it *doesn't* get approval for the CAC from bondholders
- whether a triggering of credit default swap contracts will reflect cash instrument losses. Markets could be concerned if there were a large difference between the price of Greek bonds and the CDS settlement price. This risk is mitigated, given 3.2

billion in net CDS contracts, and 18 billion in international law bonds whose holders will likely resist the use of a CAC, since they are primarily held outside of Greece. As a result, these appear to be plenty of bonds that would be "cheapest to deliver" into the CDS settlement process.

On some days, I wonder whether the EU will just pay the non-participating holdouts as scheduled, so as to avoid all the complexities that could be created by a broader default. On the other hand, that would be quite a bill to foot. Greece's primary fiscal deficit, e.g. before interest, is 3% of GDP. So, even if *all* of its public debt were written off, Greece still has a financing problem that Europe would have to solve.