

**From:** US GIO <[REDACTED]>

**To:** Undisclosed recipients;;

**Subject:** Macro Skinny: Draghi sets the floor for Europe

**Date:** Wed, 22 Aug 2012 20:46:40 +0000

**Inline-Images:** image001.jpg; image002.png; image003.png; image004.png; image005.png

---

Macro Skinny

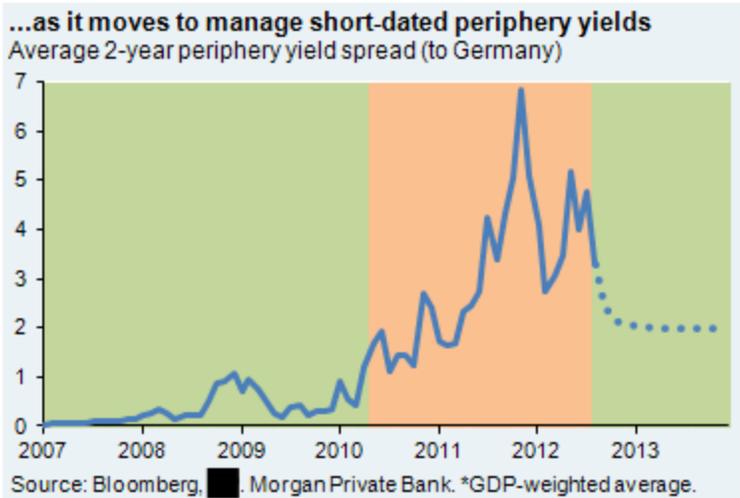
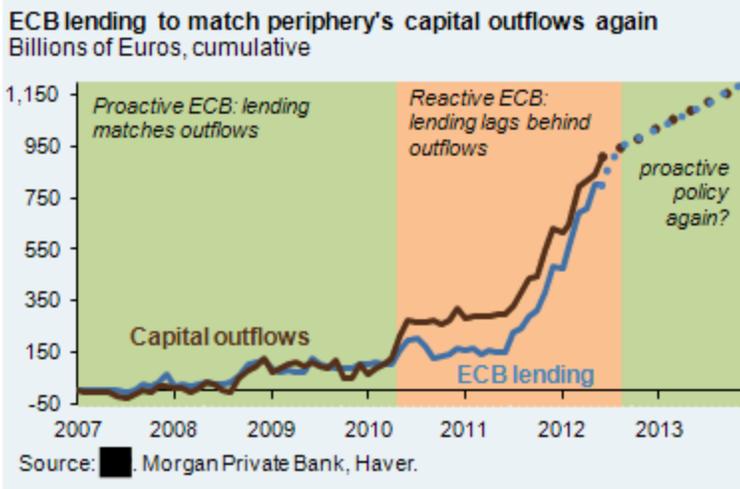
J.P.Morgan

## Draghi sets the floor for Europe

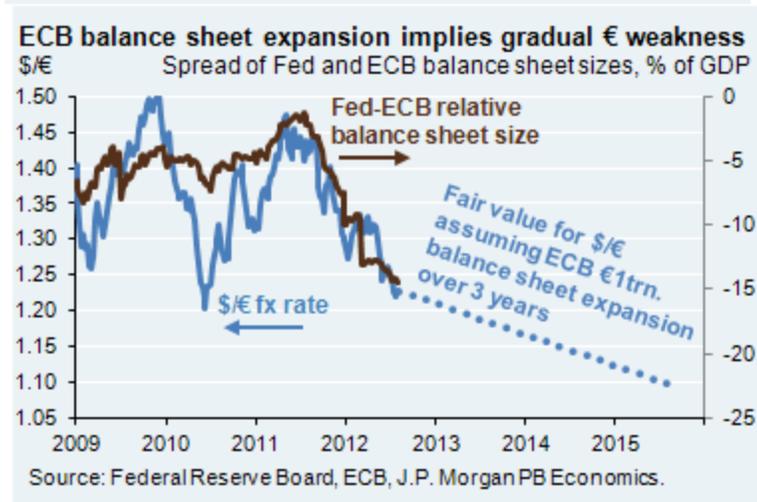
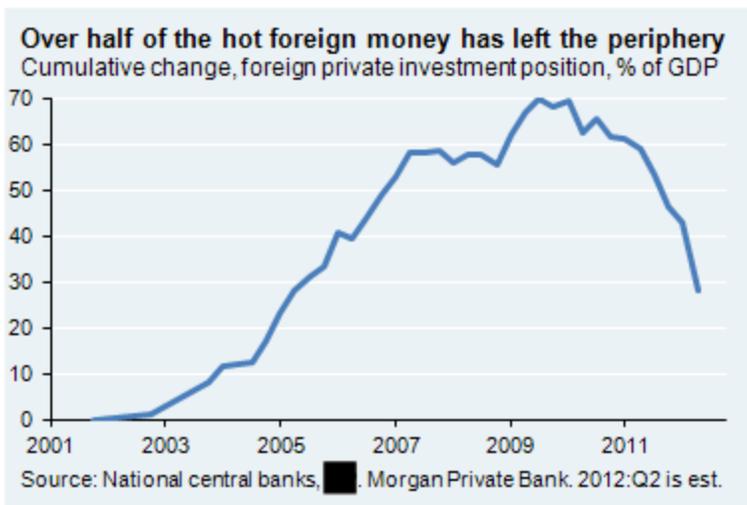
**The European QE1 is officially here.** Mario Draghi's latest speech should be seen as a genuine commitment to stave off EMU break-up risks. His argument: higher yields in the periphery prevent the ECB from easing monetary policy efficiently. As such, the ECB is likely to buy as many periphery bonds as needed to keep yields low<sup>1</sup>. This language is truly exceptional, and it is comparable to how the Fed and the Bank of England justified their first round of quantitative easing (QE1) back in 2009<sup>2</sup>. It is essentially the European QE1, which is much stronger than SMP - the old bond buying program.

**The German resistance has collapsed.** With the exception of Jens Weidmann—the president of the German central bank—the rest of the German political and monetary leadership has given a thumbs up to Draghi<sup>3</sup>. The Germans did, however, deny rumors that the ECB is willing to go as far as capping yields for the periphery<sup>4</sup>. But what Otto von Bismarck<sup>5</sup> once said, applies today as well: “never believe anything in politics until it has been officially denied”. After all, former ECB president Jean-Claude Trichet denied that the ECB was discussing bond purchases just four days before SMP was officially announced in 2010. Bottom line: Europe has learned that there is no other practical solution than ECB money printing.

**Managing periphery yields = proactive ECB policy.** As a reminder, the mess in the periphery started when foreign investors (mostly Germans) asked for their investment money back. And since the periphery was broke (it spent this foreign capital long ago), it could only buy back these assets by borrowing excessively from the ECB<sup>6</sup>. As the left chart shows, up until early 2010, the ECB lent enough money to buy back the assets foreigners were liquidating. But since early 2010, the ECB became less proactive and lending fell short of foreign capital outflows, which is why periphery spreads widened (right chart). This is why a commitment to keep spreads tight by buying sovereign bonds in the secondary market is essentially a commitment to backstop the remaining outflow of foreign capital. This measure of ‘sovereign lending’ should be complementary to existing ‘bank lending’ activity (another LTRO with looser collateral policy is likely over the coming months).



**European assets should feel better, but not the Euro.** It's encouraging to see that more than half of the foreign money has already left the periphery (left chart below), so 'only' one trillion Euros of outflows are left to finance. The precise timing of when the ECB will actually launch its new interest rate targeting regime is unknown<sup>7</sup> and it is quite possible that we could have a mini-bump in spreads before it happens. But one thing is clear - the discount embedded in European assets will likely be lower 12-month from now, even if it won't fall in a straight line. To be sure – the debt problem won't be solved anytime soon. But by shifting periphery debt away from the hostile hands of foreign investors to the friendlier hands of the ECB, the case for hiding behind 'cash mountains' is disappearing, even if Europe remains in recession territory for another year. As for the currency, Draghi just told us that "shorting the Euro" makes a lot more sense than "shorting Europe" (right chart).



Michael Vaknin  
Chief Economist, J.P. Morgan Private Bank

[1] Draghi argued first that “exceptionally high risk premia in bond prices hinders the effective working of monetary policy”. Then he went on to say that “the ECB may undertake operations of a size adequate to reach its objective.”

[2] As a reminder, back in 2009 the Fed and the Bank of England were faced with similar circumstances—elevated yields on US mortgage securities and UK government bonds, respectively. Both central banks argued that higher yields were obstructing the effective transmission of monetary policy and both followed up with successful asset purchase programs.

[3] Importantly, Draghi was backed by Merkel, Finance Minister Schauble and Asmussen—the second German member in the ECB governing council.

[4] Der Spiegel said the ECB is considering capping periphery yields, but the German Finance Ministry commented it is “not aware of any such plans”, and the ECB said it is “misleading to report on decisions, which have not yet been taken”.

[5] Otto von Bismarck was the Prussian Prime Minister and the Founder and Chancellor of the German Empire, 1815-1898.

[6] This situation is very different from past EM debt crises, where the IMF was reluctant to lend the necessary amount of dollars to allow the full outflow of foreign capital. These crises eventually resulted in massive currency devaluations.

[7] Spain and Italy still need to officially sign a Memorandum of Understanding before ECB policy could be activated. It is very unlikely to happen before mid-September.

Acronyms:

ECB – European Central Bank

EM – Emerging Market

EMU – European Monetary Union

Fed – Federal Reserve

IMF – International Monetary Fund

QE – Quantitative Easing

SMP – Securities Markets Program

*IRS Circular 230 Disclosure: JPMorgan Chase & Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with JPMorgan Chase & Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties. Note that J.P. Morgan is not a licensed insurance provider.*

*The material contained herein is intended as a general market commentary. Opinions expressed herein are those of Michael Vaknin and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The above summary/prices/quotes/statistics have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness, any yield referenced is indicative and subject to change. Past performance is not a guarantee of future results. References to the performance or character of our portfolios generally refer to our Balanced Model Portfolios constructed by J.P. Morgan. It is a proxy for client performance and may not represent actual transactions or investments in client accounts. The model portfolio can be implemented across brokerage or managed accounts depending on the unique objectives of each client and is serviced through distinct legal entities licensed for specific activities. Bank, trust and investment management services are provided by JP Morgan Chase Bank, N.A. and its affiliates. Securities are offered through J.P. Morgan Securities LLC (JPMS), Member NYSE, FINRA and SIPC, and its affiliates globally as local legislation permits. Securities products purchased or sold through JPMS are not insured by the Federal Deposit Insurance Corporation ("FDIC"); are not deposits or other obligations of its bank or thrift affiliates and are not guaranteed by its bank or thrift affiliates; and are subject to investment risks, including possible loss of the principal invested. Not all investment ideas referenced are suitable for all investors. Speak with your J.P. Morgan Representative concerning your personal situation. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Private Investments may engage in leveraging and other speculative practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuations to investors and may involve complex tax structures and delays in distributing important tax information. Typically such investment ideas can only be offered to suitable investors through a confidential offering memorandum which fully describes all terms, conditions, and risks. This material is distributed with the understanding that J.P. Morgan is not rendering accounting, legal or tax advice. You should consult with your independent advisors concerning such matters.*

*In the United Kingdom, this material is approved by J.P. Morgan International Bank Limited (JPMIB) with the registered office located at 25 Bank Street, Canary Wharf, London E14 5JP, registered in England No. 03838766 and is authorised and regulated by the Financial Services Authority. In addition, this material may be distributed by: JPMorgan Chase Bank, N.A. (JPMCB) Paris branch, which is regulated by the French banking authorities Autorité de Contrôle Prudentiel and Autorité des Marchés Financiers; J.P. Morgan (Suisse) SA, regulated by the Swiss Financial Market Supervisory Authority; JPMCB Bahrain branch, licensed as a conventional wholesale bank by the Central Bank of Bahrain (for professional clients only); JPMCB Dubai branch, regulated by the Dubai Financial Services Authority.*

*In Hong Kong, this material is distributed by JPMorgan Chase Bank, N.A. (JPMCB) Hong Kong branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as private equity and hedge funds) in which case it is distributed by J.P. Morgan Securities (Asia Pacific) Limited (JPMSAPL). Both JPMCB Hong Kong branch and JPMSAPL are regulated by the Hong Kong Monetary Authority.*

*In Singapore, this material is distributed by JPMCB Singapore branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as a private equity and hedge funds) in which case it is distributed by J.P. Morgan (S.E.A.) Limited (JPMSEAL). Both JPMCB Singapore branch and JPMSEAL are regulated by the Monetary Authority of Singapore.*

*This message has been prepared by personnel in the (Sales and Trading Departments) of one or more affiliates of J.P. Morgan Chase & Co. and is not the product of J.P. Morgan's Research Department. It is not a research report and is not intended as such. This material is for the general information of our clients and is a "solicitation" only as that term is used within CFTC Rule 1.71 (a)(9)(v) and 23.605(a)(9)(v) promulgated under the U.S. Commodity Exchange Act.*

*Each recipient of this presentation, and each agent thereof, may disclose to any person, without limitation, the US income and franchise tax treatment and tax structure of the transactions described herein and may disclose all materials of any kind (including opinions or other tax analyses) provided to each recipient insofar as the materials relate to a US income or franchise tax strategy provided to such recipient by JPMorgan Chase & Co. and its subsidiaries. Should you have any questions regarding the information contained in this material or about J.P. Morgan products and services, please contact your J.P. Morgan private banking representative. Additional information is available upon request. "J.P. Morgan" is the marketing name for JPMorgan Chase & Co. and its subsidiaries and affiliates worldwide. This material may not be reproduced or circulated without J.P. Morgan's authority. © 2012 JPMorgan Chase & Co. All rights reserved.*

*This email is confidential and subject to important disclaimers and conditions including on offers for the purchase or sale of securities, accuracy and completeness of information, viruses, confidentiality, legal privilege, and legal entity disclaimers, available at [REDACTED]*