

September 10, 2012

Central banks on the move

1/ The ECB launched its new bond-buying program on Thursday, called “Outright Monetary Transactions”, or OMT. The details of this plan were in-line with our expectations (August 22nd Macro Skinny). Key features include: (i) the ECB is prepared to buy whatever it takes to bring periphery yields down¹. This will finally allow the sharp decline in ECB rates since 2008 to be felt in the periphery. (ii) Crucially, these purchases won’t subordinate private sector investors, as has been the case in the old bond purchases program. (iii) Lastly, ECB lending terms to periphery banks were loosened as well – a wider range of low-credit collateral can now be pledged for ECB bank lending² (in soon-to-come LTRO3).

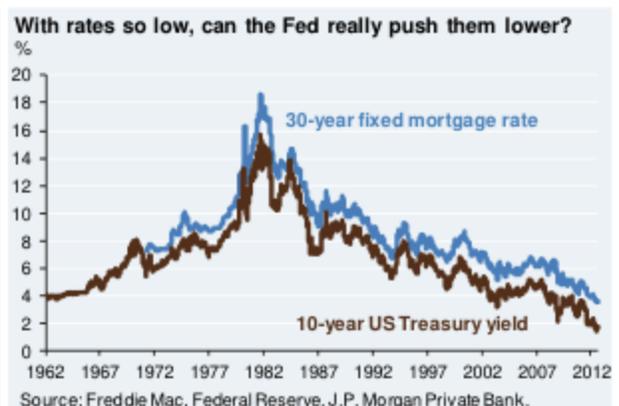
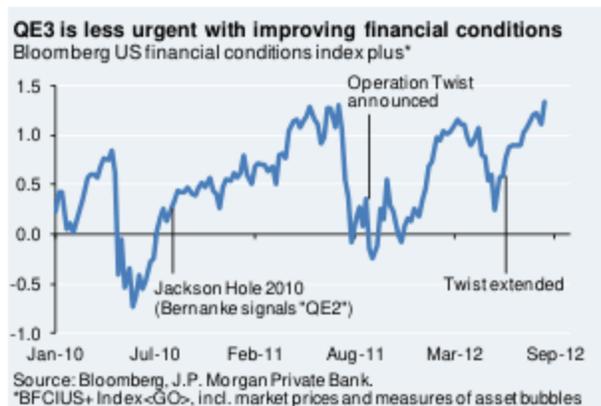
2/ When Spain and Italy will officially apply for help is less critical at this stage³. **What’s more important is the fact that the ECB is now presenting itself as a true “buyer of last resort”.** The reason why periphery yields blew up in the first place was because foreign investors were rushing to sell periphery government bonds, which no one was willing to buy. By committing to keep these yields relatively low, the ECB is effectively agreeing to buy back whatever bonds are left with foreign investors. As for all the other periphery assets foreign investors have been selling (stocks, real estate, etc.), these are already being dealt with using ECB lending⁴ (the LTROs).

3/ European assets still incorporate a high probability of a breakup risk. **We think the heavy discount embedded in these assets should gradually decline in the coming quarters, even if one accounts for an extended recession into the first half of next year.** The euro is a unique animal: it is currently benefiting from a fall in the risk premium like most other European assets, but longer term, ECB balance sheet expansion will be far more aggressive and permanent in nature, which should be a negative for the Euro once the ‘relief rally’ is over. Unlike the Fed, where quantitative easing will be reversed in due course, the ECB balance sheet will only be able to contract when the periphery pays back its loans to the ECB. Until then, true sterilization is impracticable.

4/ Turning to the US, fewer jobs were added in August than we or markets anticipated⁵, and while the unemployment rate fell from 8.3% to 8.1% it did so for the wrong reasons⁶. The weakness is largely attributable to the manufacturing sector—a reflection of the European and Chinese slowdowns⁷. Bernanke will use these data to galvanize support for another round of asset purchases, as early as this month. We’ve been of the view that the Fed will adopt a wait-and-see approach on the basis that an easing program is already in place (extension of Operation Twist), activity is bottoming out, and financial conditions have improved greatly (see charts below). **But there’s a good chance we’ll be wrong here: Bernanke has no patience to wait**

for more signs of stabilization in the labor market; he may well choose to move in September.

5/ Whether we get it in September or not, QE3 will probably matter more for financial markets than for the real economy. After all, Treasury and mortgage yields are already at or near their all-time lows. The bet the Fed is having is that more easing in financial conditions will help bring forward economic growth. **Whether this effort will be successful or not, one thing is clear – Fed policy is consistent with financial markets normalizing well before trend growth recovers back to 3%. By the time the US economy emerges into a new brave cycle, markets will have reflected it already.**



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- [1] High sovereign bond yields in the periphery increase bank funding costs. As a result, periphery banks must charge higher interest rates on loans to customers to retain an adequate profit margin. These high interest rates, in turn, decrease business investment and are stifling for economic growth. For example, as of July, interest rates on one-year loans to nonfinancial corporations were 3.1% in Germany and 5.3% in Spain. Large sovereign yield spreads within the euro zone also reflect exchange rate risk (interest rate parity).
- [2] The minimum credit rating applied to sovereign debt held by banks was suspended. Greek debt is the exception - it was excluded from the credit rating suspension (it is not accepted as per the ECB decision on July 20th, 2012). In addition, the sovereign must either be in an EU-IMF program or an EFSF/ESM program that satisfies OTM conditionality.
- [3] Encouragingly, the conditionality for OMT appears to be lighter than initially anticipated. Last week's meeting between Merkel and Rajoy suggests that a formal request for a program (termed Enhanced Conditions Credit Line) is brewing, although it clearly won't happen before the German constitutional court rules on the validity of ESM—the 'European IMF'. Crucially, Draghi stated that ESM need not buy periphery bonds in primary markets for the ECB's OMT to start. All the ECB needs to see is that the possibility exists.
- [4] Foreigners have been selling these assets in exchange for cash deposits, which were then transferred abroad. Foreigners have also been selling direct ownership of bank debt - repos, bank bonds, interbank lending. Both of these outflows—deposits and wholesale funding—have been managed with the ECB's unlimited funding to periphery banks.
- [5] The 103k rise in private sector jobs and 96k nonfarm jobs were lower than consensus expectations of 142k and 130k, respectively. The report also included downward revisions to prior months and was especially disappointing in light of yesterday's ADP private sector employment report and the ISM non-manufacturing survey. The ADP employment report showed private sector job gains of 203k in August, much stronger than consensus expectations of 140k. The ISM non-manufacturing index rose from 52.6 in July to 53.7 in August (Consensus: 52.5). Particularly encouraging was the 4.5 point gain in the employment index (to 53.8).

[6] The unemployment rate is defined as the number of unemployed actively seeking employment as a percentage of the labor force. An unemployed person who stops actively seeking employment is no longer counted as part of the labor force and thus is no longer included in the unemployment rate calculation. For this reason, the unemployment rate can fall for the “wrong” reason, as opposed to the “right” of an unemployed person becoming employed. If the participation rate (share of the population participating in the labor force) had stayed at the July rate of 63.7% in August instead of declining to 63.5%, the unemployment rate would have actually increased to 8.4% instead of declining 0.2pp to 8.1%.

[7] Service-providing jobs remained stable and the weakness in the headline payroll number was largely concentrated in manufacturing jobs, which is known to be highly correlated with the global manufacturing cycle. Comments from the Beige Book prepared for the September FOMC meeting support the pullback in demand from Europe, too. In particular, the Chicago Fed reported that “Exports to Canada and Mexico continued to increase, but exporters noted a decline in demand from Europe and China.” This observation is quite important because the confidence boost from the recent ECB policy shift should help stabilizing the global manufacturing cycle in the coming months and the US labor market along with it.

Acronyms:

ADP – Automatic Data Processing
BLS – Bureau of Labor Statistics
ECB – European Central Bank
EFSF – European Financial Stability Facility
ESM – European Stability Mechanism
FOMC – Federal Open Market Committee
IMF – International Monetary Fund
ISM – Institute for Supply Management
LTROs – Long-Term Refinancing Operations
OMT- Outright Monetary Transactions
QE – Quantitative Easing
SMP – Securities Markets Program

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