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Good News on Europe Now, But Then What?

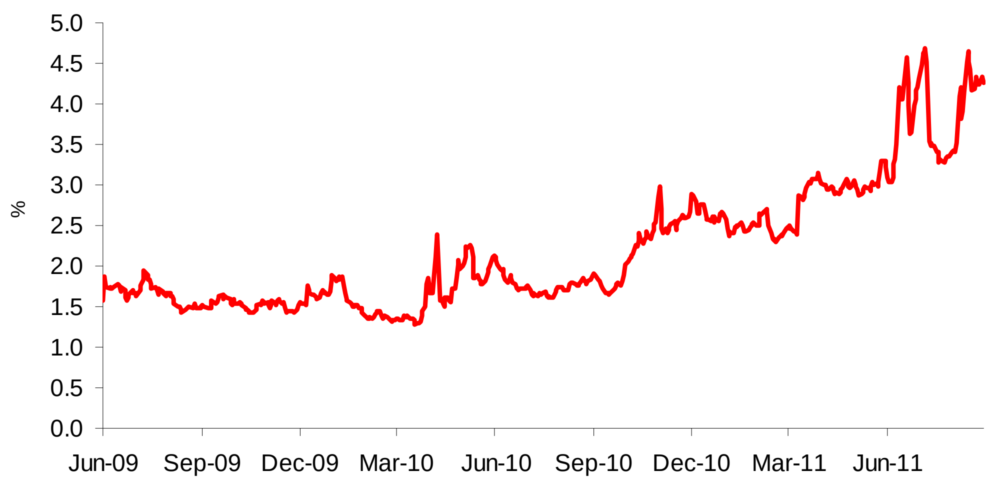
Last weekend's IMF-related meetings in Washington created a coordinated buy-the-rumor buzz that Europe, after Germany's Thursday parliamentary vote, will begin talking about levering up to tackle its debt problem.

- We're skeptical that Europe will use leverage with its existing institutions or move fast enough to solve the contagion problem pushing Europe into recession. The ECB has the power to help (e.g. buy Italian bonds in size), but shows no sign of using it. For other European institutions, there are large legal and political obstacles to investing in sovereign bonds or in banks. We don't think structural reform efforts alone, even if they became energetic in Italy and Spain, would be enough to restore confidence.

- We expect several minor positive European developments in coming days, explaining this week's market strength. However, we don't think these developments will be enough to change the outlook for European recession and long-lasting debt problems.

- The prospect of positive news concentrated at the weekend IMF meeting was enough to launch a rally. European equities gained roughly 3% on Monday and 5% on Tuesday, with banks leading the way. The euribor-OIS spread has narrowed slightly to 82 basis points from 89 on September 22. Italy's two-year yield has fallen to 4.26% from a recent intraday high of 4.8% on September 13.

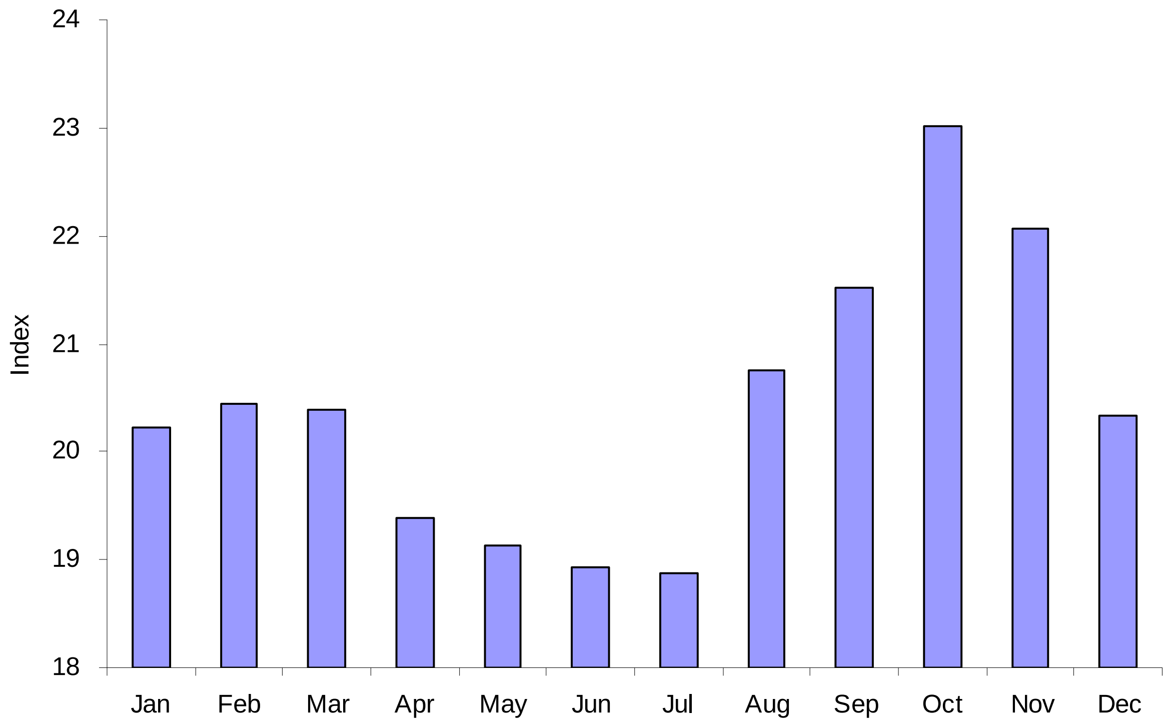
Italy's 2 Year Yields (last obs. September 27, 2011)



Source: Bloomberg; Encima Global

- However, from a U.S. equity market standpoint, October (average VIX since 1990 at 23) is usually more volatile than August (20.8) and September (21.5). That's a high bar for October this year – the August 2011 average VIX was 35, rising to 38 on September 27. With U.S. fiscal and monetary policy getting worse and Europe still not moving to lower the bond yields in Italy and Spain or unfreeze bank-related credit markets, we expect high volatility to continue and equities to be under pressure. We emphasize the possibility of forceful new growth policies in the U.S. or Europe, but think the current policy direction is still toward recession and weaker earnings.

VIX Monthly Average (data from 1990-2011)



Source: Wall Street Journal; Encima Global

Some Good European News Coming…

- Germany will likely approve the expansion of the EFSF (European Financial Stability Facility) on September 29, setting the stage for approvals in other countries.

- Once the German vote is over, we expect several leveraging plans to be floated. If they are not from the ECB, we don't think they will work.

- On October 3, Greece will probably win approval from the EU for the final 8 billion euro tranche in its existing austerity program, allowing it to muddle through for several more weeks. The money comes from the IMF and EFSF and will pay government suppliers and creditors. The disbursement is contingent on Greece increasing the VAT tax and passing a property tax. We don't think Greece will try to collect much actual revenue, but Greece's agreement to sign them into law allows the IMF to forecast adequate cash flow for Greece next year, a requirement for IMF disbursements. This arrangement should allow Europe to kick the can down the road toward year-end. Greece's government will get enough new money to make it worth delaying the inevitable debt restructuring. From a longer-term standpoint, however, Greece is replacing defaultable bonds with non-defaultable IMF debt, creating a more iron-clad debt service burden on subsequent Greek governments.

- We expect a 25 basis point ECB rate cut at the October 6 meeting.

… But Major Obstacles Remain

- We don't think the EFSF will be able to lever up without a German constitutional amendment (which could not be achieved). The head of the constitutional court explained in September 26 comments to the Frankfurter Allgemeine that "There is little leeway left for giving up core powers to the EU." This supports his court's early September ruling limiting EFSF powers (see discussion in our September Cautions piece on September 7.)

- Even if the EFSF could lever up, there hasn't been agreement on what it would do – whether inject capital into banks (a black hole in our view unless Italian and Spanish bond yields fall); or buy Italian and Spanish bonds. But without the authority to issue eurobonds or heavy bond buying by the ECB, an EFSF bond buying effort might not work – it would be like Treasury rather than the Fed buying MBS in late 2008 using appropriated funds rather than unlimited central bank funds as actually occurred.

- We're not sure critical mass can be achieved for Greece's voluntary debt restructuring. With Greece's fiscal and economic outlook deteriorating rapidly, the July 21 agreement on haircuts to private sector debt are increasingly controversial (because taxpayers take the remaining burden.)

- We don't think Greece will be able to get another program after the final disbursement on the existing program in early October. We think it will run out of cash by December, forcing not only the debt restructuring issue (which is difficult) but the fiscal collapse issue as well (fiscal deficit still running well over 8%.)

- The IMF is still pushing for big increases in equity capital for European banks, undercutting their equity prices. Separately, the Basel Committee is pushing forward with its requirement for a capital surcharge for too-big-to-fail banks. These are pro-cyclical regulatory concepts, meaning it makes the growth outlook worse when the outlook is weak. We think relief from arbitrary and escalating regulatory capital requirements would help address the widening freeze in short-term credit markets, but regulators are still moving in the other direction.