

August 24, 2011

Trichet at Jackson Hole: Huge Profit Available For Europe

Any resolve ECB President Jean-Claude Trichet takes away from his Jackson Hole participation could be more important than Fed Chairman Ben Bernanke's comments. We think the ECB should buy periphery bonds in much larger quantities.

- This morning's German IFO data fell sharply to 108.7 in August from 112.9 in July. This might add pressure on Mr. Trichet to fix the contagion problem sweeping Europe's bond yields and bank stocks. Deutsche Bank stock fell hard yesterday in an up market, adding to the pressure on the ECB to act. The OIS spread for Europe's interbank market has recently widened to the most since the 2008-2009 crisis.

Euribor – OIS swap spread (last obs. August 24, 2011)

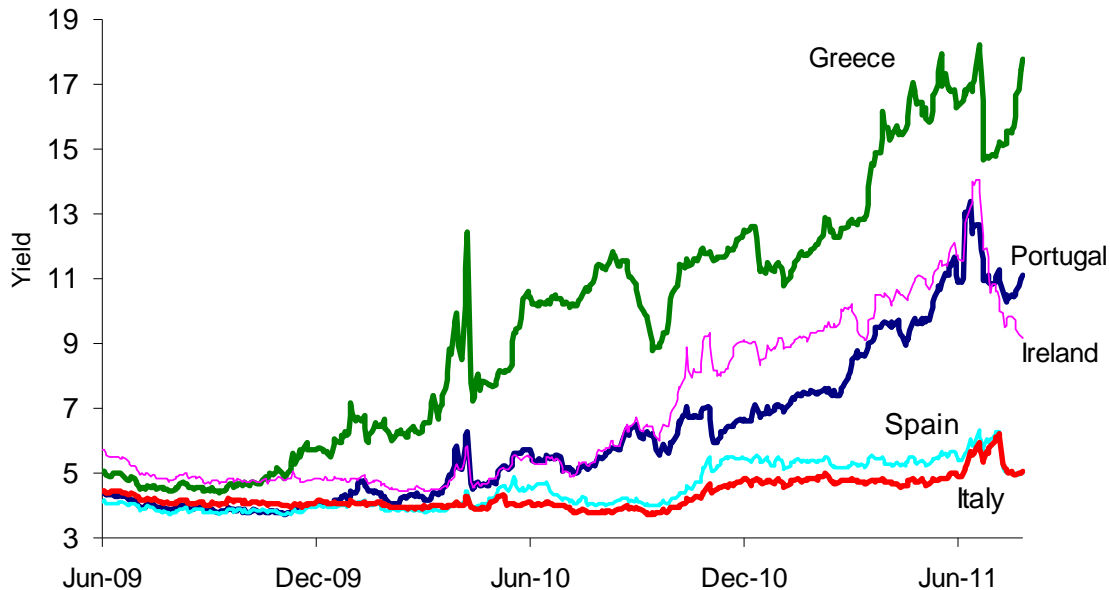


Source: Bloomberg; Encima Global

- One version of the bearish argument boils down to this assertion: Europe faces \$3 trillion in losses if you assume a 50% haircut on periphery sovereigns; this would wipe out bank capital. Our view is that only the Greek and possibly Portuguese sovereigns should take haircuts. The other countries have lower debt-to-GDP ratios, smaller fiscal deficits, more growth potential, and are too big to fail and too big to be restructured.
- **To hold the euro together (as guaranteed by Germany, France and the ECB), the sovereign bonds of Italy, Spain and others have to be protected -- if not through**

euro-zone bond issuance, then through ECB interventions combined with growth-oriented structural reforms and large subsequent purchases by the EFSF perhaps with co-investment from China.

Selected 10 year European Bond Yields (last obs. August 24, 2011)



Source: Bloomberg; Encima Global

- The ECB has unlimited resources yet has only bought about \$150 billion in euro-zone bonds. Like the tiny \$100B Japanese currency intervention fund announced last night, the ECB's bond buying is too small to fix the problem.
- **Bernanke bought \$1.45 trillion in MBS and agencies in 2008-2009, fixing a major market problem** -- wide spreads for a critical too-big-to-fail financial instrument. It came with practically no risk -- the Fed bought conventional MBS guaranteed by Fannie and Freddie which, though kept carefully off-budget, are part of the U.S. government. **The dollar strengthened.** And **the Fed earned a gigantic profit** – the Fed reported roughly \$80B bottom line profit in 2010 and will report \$90B or more in FY11 including profit from Treasury bonds, holding the fiscal deficit down to merely \$1.3 trillion.
- **Trichet could buy ten times his current holdings without weakening the euro. It would reverse the contagion sinking Europe's economy, lower borrowing costs for the periphery, lower deficit projections and allow investment to restart. And it would be profitable:** The ECB has unlimited 1.5% resources to buy Italian and Spanish bonds that are yielding over 5%. A \$1 trillion purchase might generate \$35 billion in annual interest and another \$15 billion or more in appreciation. The ECB has downside trading protection from Europe's national central banks.

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