

Walking on tightropes



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10 November 2011

Walking on tightropes

- A series of profit warnings in Europe is giving a fair sense of what we can expect from banking, as we look at the global economic picture and the European sovereign crisis, there's also a shift back to US-UK economic growth in Europe is leading to a more positive outlook.
- European and Asian banks are looking more like a long-term investment, but only one that's been significantly more than they were just a few years ago, but the risk also justifies the price.
- However, don't forget global economic challenges, the fact that significant events in coming months, given the difficulties in agreeing to and implementing relevant policies, and in the absence of real tradeable derivatives, the challenge lies.
- US and Asian equity markets should flow the way back down, but focus on banking, as a way back, starting to move back to invest that absolute risk.
- Recalling the way of the bank curve against the wider economic picture in global economic case, with alternative ways and options, it's also a way to hedge against the risk of a fall and profits from a short-term US and Europe.
- What advice for the Global bond strategies? The lower yielding bond yields are likely to continue, US and Europe should see significant recovery from the US and Europe.
- German Pfandbrief are trading at all-time highs in Europe, as the German Pfandbrief is a substitute for the agency or mortgage bond.
- The advice: China moves to change reserves on margin interest in the amount of a 100% rise in the Reserve Requirement Ratio. This move - and more - increases global asset rebalancing.
- Other US central banks are looking better, from Europe is looking about the possibility of increasing monetary policy, or there is an increase in the rate of inflation, a "volatility shock" may be needed to get the market on. The focus is on the US and Europe.

Summary

Country	Market	Rating	Yield	Duration	Volatility
US	10Y Treasury	AAA	4.5%	10Y	Low
US	30Y Treasury	AAA	6.5%	30Y	Low
US	10Y Corporate	BBB	5.5%	10Y	Low
US	30Y Corporate	BBB	7.5%	30Y	Low
US	10Y Municipal	AAA	4.0%	10Y	Low
US	30Y Municipal	AAA	5.5%	30Y	Low
US	10Y CDO	BBB	5.0%	10Y	Low
US	30Y CDO	BBB	7.0%	30Y	Low
US	10Y CDO	BBB	5.0%	10Y	Low
US	30Y CDO	BBB	7.0%	30Y	Low
US	10Y CDO	BBB	5.0%	10Y	Low
US	30Y CDO	BBB	7.0%	30Y	Low
US	10Y CDO	BBB	5.0%	10Y	Low
US	30Y CDO	BBB	7.0%	30Y	Low

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BOND BUYING – CAN IT DO ANY GOOD?

Example: Buying of (BTPs) Italy since 7 August 2011
 10-year BTP yield (Italy government), %



➔ Almost 6% outstanding of BTPs SPGBs owned by ESCB

SO WHY DID THE BUYING NOT WORK FOR BTPS ?

- More buying \longrightarrow price goes up
- More buying \rightarrow nature of product changes \rightarrow price falls

Why would the nature of the product change?

1) Supplier feared to have less incentive to maintain product quality

\rightarrow **moral hazard**

2) The new buyer is large and powerful

\rightarrow **subordination** (fear that the authorities risk using muscle at a later date)

3) Price is above perceived fair value; easy substitutes

\rightarrow **crowding out**

Subordination: governments affirm pari passu, but they

1) introduce PSI on Greece 2) plan for ESM 3) are accompanied by IMF (de facto senior)

THE NEWSFLOW TERRIFIES POTENTIAL BUYERS

crowding out

IMF warns US of global debt 'shock'

Posted on 30. Jun, 2011 |

public power

Jul 06 2011

'Selective Default' Need Not Derail Greek Rescue

uncertainty

Sep 19 2011

ECB's Weidmann Says EFSF Doesn't Necessarily Need AAA Rating

subordination

5 Oct 2011 – IMF offers support to **Italy, Spain**. by Associated ... Borges also said the IMF could give the two countries **precautionary credit lines**. He said "we ...

moral hazard

October 21, 2011

again delays economic reform package

NO NEED FOR ECON 101 TO FIGURE LATEST ESCB BUYING WOULDN'T WORK

- After the experience with GGBs, IRISH and PGBs, there was no need to figure out that bond buying would not be the panacea.
- ➔ So how did governments manage to still persuade the ECB to embark on yet more purchases of government debt?

Maybe...

- ✦ Some wanted to a bit more time, again, before facing up to the hard decisions

And longer term

- ✦ Inability to face up to the painful political decisions, and drop in living standards, from more durable solutions
- ✦ Institutional momentum; “the institutions are there, let’s use them”
- ✦ Belief that public interventions can fix the problems

OTHER BUYING PROGRAMMES CAN WORK, DO WORK

Eurosystem's Covered Bond Purchase Programme in 2009 worked a charm



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THE IMPACT OF
THE EUROSYSTEM'S
COVERED BOND
PURCHASE
PROGRAMME
ON THE PRIMARY
AND SECONDARY
MARKETS

Chart 5 Covered bond swap spreads

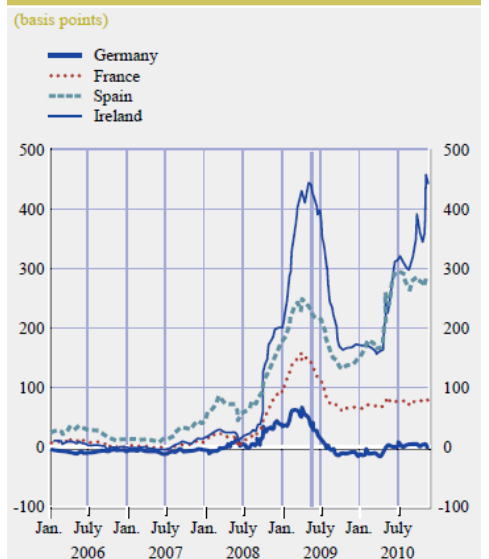
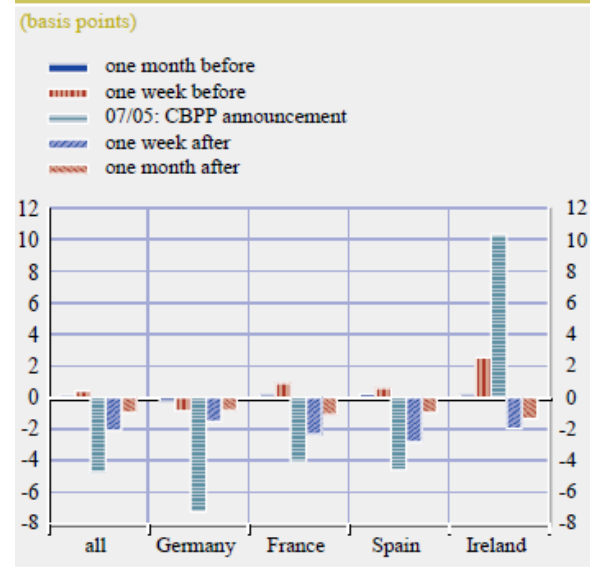


Chart 6 Average daily changes of covered bond swap spreads around the CBPP announcement



This suggests that, along the lines of the rational expectations hypothesis, the introduction of the programme alone had a significant and full impact on prices, while the purchases were only seen as the execution of the previously announced commitment.

$$dy_{1,t} = \beta_1 \cdot dy_{2,t} + \beta_2 \cdot (y_{1,t-1} - \beta_0 - \beta_1 \cdot y_{2,t-1}) + \varepsilon_t$$

WHAT HELPS MAKE FOR A SUCCESSFUL BUY PROGRAMME?

- Underlying fundamentals of issuer seen as remaining sound
- Credit quality of the purchased securities does not undergo deterioration
(risks of moral hazard not dominant)
- Buying addresses liquidity injection (Fed, BoE) or liquidity, less solvency
- Accompanied by other coherent policies (macro, regulatory...)

And in addition...

✱ Securities held for long periods, or to maturity

✱ Purchases large relative to new issuance

(in case ESCB's CBBP, the €60bn programme was small vs outstandings → no subordination)

✱ Purchased amount fixed in advance, for fixed time frame

The 2009 CBBP led to a large increase in supply, making the supply / demand price moves more difficult to interpret

WALKING ON TIGHTROPES

- Possible exits from the sovereign crises:

- 1. Austerity**

- 2. Inflation / QE**

- 3. Forms of default**

And less likely...

- 4. Fiscal transfers**, from the spendthrift to the big spenders

- 5. Unexpectedly strong growth**

Bond buying per se is not on the list, though could be part of Quantum Easing

The West will remain in crisis as long as trajectories for public finances are seen as out of control, against a backdrop of steadily worsening demographics, heightened competition & change, and greater structural difficulties in making the needed adjustments.

→ Ever stronger risk of permanent stagnation / decline for Europe, like Japan, without strong leadership, and taking upfront pain for much longer term gain.

→ The path of least painful adjustments probably involves walking several ropes : austerity, “Quantum QE”, forms of default, fiscal transfers ...

The art would be in getting the vision, leadership, coordination and implementation right.

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