Market Overview – August 2012

On 10 October 1992 heavyweight boxer and NZ icon David Tua appeared on NZ's version of the "Wheel of Fortune" game show. Asked for a *consonant* he chose "O for awesome" – cleverly changing the English language to fit his immediate need.

On 6 September 2012 head of the European Central Bank (ECB) Mario Draghi announced an unlimited bond purchase program for Europe called the "OMT" (Outright Monetary Transactions). Using David Tua's language the OMT acronym should stand for the "Orsome Monetary Tool". It is potentially a game changer for Europe and Euro stability – but right now it delivers more hope and promise than outright action.

The OMT is a very significant event for Europe and global markets generally in 2012. We have devoted our comment this month to an explanation of the OMT and what this means for markets.

What is the OMT?

The ECB will buy European sovereign bonds which have a term of less than 3 years (i.e. short duration). The key buzzwords with this program are "sterilisation" and "conditionality" which we explain below.

Why do it?

If the ECB buys bonds it pushes the price up and at the same time the bond yield is forced down (bond yields move in the opposite direction to bond prices). This will make life easier for those European countries with high short term borrowing costs – funding becomes cheaper and markets more stable. All OMT bond purchases will be "sterilised".

What is "sterilisation"

If the ECB buys bonds it pays cash to the owner of the bonds (i.e. a European bank) increasing the money supply. Under the quantity theory of money, MV = PT (M = money supply, V = velocity of circulation, P = price level and T = transactions). So if M increases it usually follows that P (inflation) will follow. A market awash with excess liquidity (i.e. the new money) will eventually drive up inflation - Germany would never allow this. "Sterilising" however, means the ECB will use methods to take out of circulation an amount equal to new OMT cash. Typically they could do this by taking more deposits from banks or lending bonds to banks (effectively a secured deposit) - in this way the total money supply does not increase, but the assets and liabilities on the ECB balance sheet do increase.

Don't "sterilised" bond purchases just sound like money go round?

Well yes, if you look at the system as a whole. Overall the European banking system will be swapping bonds issued by a sovereign for an ECB deposit. But there is a point to it - the OMT will drive down short term bond yields for troubled Eurozone countries, reducing their borrowing costs.

What is the "conditionality"?

This is the point in the process where monetary policy intersects with politics. The ECB will not conduct an OMT for a country unless that country first requests action and signs an MOU (Memorandum Of Understanding). No country wants to sign an MOU as this effectively cedes full financial control and budgetary decision making to the European Financial Stability Facility (essentially Germany) and the IMF. Thus stability in bond markets will come at a price – the imposition of austerity and a rigid policy framework. Signing an MOU is an admission of financial failure – your country becomes another Ireland or Greece. It's the sovereign version of a company entering receivership. However receivership is better than liquidation.

Is the OMT "orsome" for European markets?

This is a big positive for sentiment in the short term. European equity markets rallied strongly on the announcement – even though it had been leaked in advance. For the OMT to be positive beyond the short term we will need Spain and Italy to step up and sign the MOU. If they do so then the OMT will effectively cap their short term funding costs – a big plus for their on-going solvency and for general stability across Europe.
The OMT is not *the* silver bullet for markets. Taken in isolation it does not satisfy last months' comment from Draghi that the ECB will "do whatever it takes" to save the Eurozone (it will take more than the OMT). However unlimited ECB capacity to buy bonds of troubled sovereigns is a good step.
Our predictions, based on "new hope" from the OMT, are that for the remainder of 2013 there is a floor under European asset values:

- equity markets across Europe will (on a relative basis) be better behaved
- the Euro will not test new lows against the USD (of 1.20)
- the risk of a country leaving the Eurozone this year has dropped significantly. The one exception is Greece. The OMT creates a very robust firewall – perhaps allowing Germany to now cut Greece loose without imperilling the Euro. We see this as a possibility if the Greeks continue to overpromise and under deliver their austerity program.
- The OMT is not designed to be immediately inflationary – given the ECB sterilisation plan. However we still expect inflation (both in Europe and the US) to return in possibly a 12-24 month horizon.

What about global equity markets?

If we look around the world for the region with the highest potential to cause "market carnage" globally, it is Europe. Before OMT, the potential impact from (and likelihood of) a European meltdown was considerably higher than an unexpectedly deep Chinese or US slowdown. Europe had the greatest potential to cause global carnage.
We see the OMT announcement (and eventual implementation) as a very significant event globally, not just for Europe. In particular we expect:

- the OMT announcement should prove to be a turning point for global equity market sentiment in the near term – equity markets will be "more positive than negative" for the remainder of the year.
- Local factors will decide which regions are winners and losers for the remainder of the year. **We remain positive on German and US equity markets.** This year's continuous **weakness in emerging markets could start to reverse**. We are **unexcited about prospects for equity markets in Australia and Japan.**

Any negatives from the OMT for EU growth?

Along with the OMT announcement the ECB lowered its 2012 and 2013 growth outlook for the Eurozone. The EU now sees a -0.4% contraction for 2012 (previously -0.1%) and +0.5% growth for 2013 (previously +1.0%). Any growth (even +0.5%) in 2013 could prove optimistic. Because it is sterilised the OMT does not in itself kick-start growth or repair damaged balance sheets of financial institutions. The OMT cannot fix the Eurozone in isolation. But it does buy more time for the region to naturally heal itself.

Can there be unexpected consequences?

Politics and economic necessity will determine who signs up for OMT help and when. Spain needs it badly but will not readily accept the harsh MOU conditions. Spain could play brinkmanship and push to the limits – holding out as long as possible trying to negotiate a weakening of MOU terms. This would then mean we need high levels of stress in Spain's funding markets to force it into the OMT - a conflict of political will and economic reality.

This possible scenario would mean the OMT becomes responsible for causing exactly the stress it is designed to avoid!

Does Germany support the OMT?

The ECB board approved OMT with one dissenting vote – Germany's Bundesbank. Bundesbank President Jens Weidmann described the OMT as "tantamount to financing governments by printing banknotes". Germany fears two outcomes from OMT:

1. Governments will not adhere to fiscal conditions essentially meaning the OMT is nothing but a direct (and cheap) financing tool, and
2. Banks will sell poorly rated Government bonds to the ECB (i.e. issued by Greece, Spain, Portugal), reducing the credit quality of the ECB balance sheet. This in essence would mean the ECB becomes a pan-European financing vehicle, backstopped by Germany.

Timing of implementation?

Spain has its 2012 funding requirements broadly under control – so we may not see an MOU request from it in the next few months. (Having said that, Spanish Prime Minister (Mariano Rajoy) requested a bailout for Spanish banks only 2 weeks after explicitly denying one was required).

Italy also needs funding assistance. Its prime minister (Mario Monti) has been calling for the ECB to buy bonds, but given the MOU conditions he is not so keen. Having said that, Monti's term as Prime Minister ends next year and as a technocrat appointed to "save" the country from economic oblivion, he is likely to want to sign Italy up to structural reforms and spending constraints (via the MOU/OMT) before leaving office.

Any negatives for OMT implementation?

As a practical matter there is implementation uncertainty with OMT. It is not clear once an MOU is signed in what circumstances will the ECB spring into action? Accord to President Draghi a range of indicators are relevant such as "yields, spreads, liquidity conditions and volatility" However this doesn't yet give certainty on when he is prepared to push the button and buy bonds.

Summary and outlook

The announcement of the OMT is likely to be a key turning point for Europe and markets globally. The ability of the ECB to buy unrestricted amounts of short term sovereign debt means funding rates of troubled European countries (namely Spain and Italy) can be capped. But implementation brings uncertainty – the first question being whether Spain and/or Italy will ask for assistance and sign up to the MOU terms.

In short this is a big first step towards stabilising European markets, currency and sovereign funding. The ECB's signal of intent is a very significant, but not final, answer to the European debt puzzle.

The graph below says it all about use of the ECB balance sheet through the GFC. Note the huge leaps in balance sheet size through 2007/08 and 2001/11 as the ECB bought bonds of peripheral European countries. Whether the actual market value of these bonds actually reflects the reported balance sheet value is another matter…..