Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

TRENDMACRO LIVE!

On the ECB and BOE February Rate Decisions

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Lorcan Roche Kelly

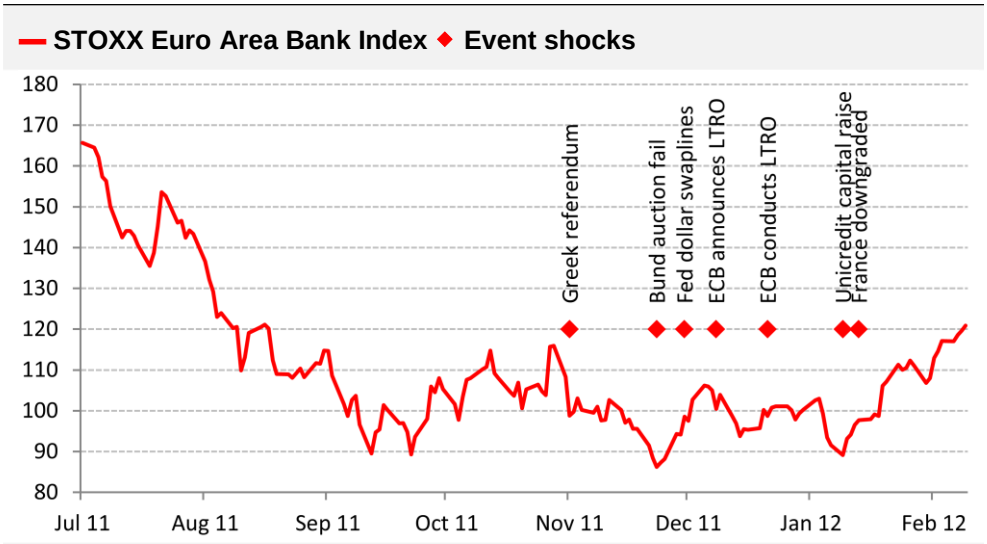
Now it's up to Europe's banks to bet on themselves with a huge LTRO uptake at month-end.

The European Central Bank left its base rate unchanged at 1%, despite market expectations giving a better than 50% chance of a cut. The Bank of England also maintained rates, but announced another £50 billion of quantitative easing.

As central bank announcements go, there was little today to get excited about. The biggest news was the increase of the BOE's QE program to £325 billion. With the United Kingdom's government debt crossing the £1 trillion mark in December, the BOE's QE is the equivalent of the Federal Reserve doing $4.4 trillion.

With the ECB maintaining rates unchanged, we look to President Mario Draghi's press conference to see if he gives any hints as to future monetary policy developments.

- The latest Eurostat inflation flash estimate for the euro area was 2.7% YOY. Draghi blamed energy and commodity prices for inflation remaining above the 2% target at the moment, and said that the economic outlook is subject to downside risks.



Source: Bloomberg, TrendMacro calculations

Update to strategic view

ECB, EUROPE FINANCIAL STOCKS, BOE: The ECB stands pat, betting on a large uptake at the next 3-year LTRO at the end of February to encourage economic recovery. The size of that uptake is at the discretion of the banks, so if the banks are willing to bet on themselves, a large LTRO uptake should sustain Europe's stock market rally. If the uptake comes in low, the banks are not willing to bet on themselves -- then we won't bet on them either. Meanwhile in the UK, the BOE has taken a more activist approach, bringing its QE program to the equivalent of the US Fed doing $4.4 trillion.

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- This implies that Draghi would not be afraid to further reduce interest rates even if inflation remains above target. The ECB's own projections see inflation returning to target in the coming months.
- Draghi said that while the latest lending data shows continuing tightening, the latest figures did not reflect the full effect of the December LTRO (see "Europe's Wall of Liquidity" December 21, 2011) which Draghi said are "still unfolding."
- He blamed the slowdown in lending on funding needs of the banks, capital needs of the banks, and risk aversion. He said that the LTRO has been used so far only to solve the funding needs. We would add that this, in turn, alleviates risk aversion -- as the uncertain funding status of banks was surely a large component of the risk to which investors have been averse.
- Highlighting a theme that we have been articulating for several months, he said that the European Union's new fiscal compact is a "first timid step towards a fiscal union," but that a full fiscal union cannot be in place until the structural rigidities are removed and wage flexibility increases across the euro area (see, among many, "Two-Tier Europe is Born" August 17, 2011).

After the press conference we received some clarification on the new collateral rules (See "Le Collateral" January 6, 2011) introduced by the ECB at the December meeting.

- Only seven of the 17 euro area national central banks (NCB) have felt the necessity to adopt the new more liberal collateral rules:

    - Central Bank of Ireland
    - *Banco de España* (Spain)
    - *Banque de France*
    - *Banca d'Italia*
    - Central Bank of Cyprus
    - *Banco de Portugal*
    - *Oesterreichische Nationalbank* (Austria)

- It is interesting that only these NCBs chose to take advantage of the new rules. This potentially shows which banking systems -- at the national level -- are finding it hardest to access collateral for ECB funding (and which *aren't* -- such as Germany). But the new more liberal rules mean new sources of collateral for these banks, so their funding stresses should now be reduced coming up to the next LTRO.
- The most notable absence from the list is the Bank of Greece, where one would have expected the banks to need all the help they can get. So, either the Greek banks have no collateral problems, or -- more likely -- they have no collateral at all and will have to continue using emergency liquidity assistance (ELA) provided by the Bank of Greece (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011).

Contact TrendMacro

On the web at
trendmacro.com

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Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

All eyes now must turn to the next 3-year LTRO at the end of February. If the banks take advantage of the infinite ECB money available -- we hope to see a number in excess of €500 billion -- then we expect the current stock market recovery in Europe to continue. But if the LTRO uptake comes in below our expectations -- anything below €300 billion -- then that will be a warning sign to investors that the euro area banks would rather continue as zombies than try to grow their way out of the current mess.

To be sure, being the walking dead -- a zombie -- is better than being just dead. But by the end of February we will know if the euro area banks want to achieve true recovery, or merely to repeat the Japanese experience. The ECB has done almost everything in can for the banks. As a result, the STOXX index of euro area banks is up 28.4% since we said it had turned the corner, less than a month ago (please see the chart on the first page, and "On the January ECB Rate Decision" January 12, 2012). Now we expect the banks to keep building on this great start by maximizing their use of the LTRO.

Bottom line

The ECB stands pat, betting on a large uptake at the next 3-year LTRO at the end of February to encourage economic recovery. The size of that uptake is at the discretion of the banks, so if the banks are willing to bet on themselves, a large LTRO uptake should sustain Europe's stock market rally. If the uptake comes in low, the banks are not willing to bet on themselves -- then we won't bet on them either. Meanwhile in the UK, the BOE has taken a more activist approach, bringing its QE program to the equivalent of the US Fed doing $4.4 trillion.