DO WHAT WE MUST: EUROZONE THEATRICS

 January 3, 2015

In "The Clouds", an ancient Greek comedy by Aristophanes, the philosopher Socrates asks:
"What did you come for?"
Strepsiades replies: "To learn to speak. I am wracked and ruined and dispossessed
By most malignant debts and usury."
Socrates: "How could you fall into debt without knowing it?
Strepsiades: "It was the galloping consumption, a voracious plague.
But teach me the other of your Logics, the nonpaying one.
Whatever your fee is, I swear by the gods I'll pay it."

****

OVERVIEW AND CONCLUSION

In the relatively near future, the European Central Bank probably will declare it will embark on more extensive quantitative easing (money printing) via purchasing Eurozone sovereign debt in secondary marketplaces. Assorted intertwined variables invite dramatic action. First, the ECB's creative measures of the past several months have accomplished little. Think of negative policy interest rates. Marketplace response to the Targeted Longer Term Refinancing Operations (TLTRO) has been uninspiring. The ECB underscores its determination to significantly expand its balance sheet. Nevertheless, its current money printing scheme, which purchases asset-backed securities and covered bonds, thus far appears relatively modest to most audiences.

Moreover, the ECB's fear of insufficient inflation (the deflation spectre) has increased in recent weeks, partly due to the continued bloody tumble in the petroleum complex. In its early December 2014 meeting, it underlined the Eurozone's mediocre economic growth realities and prospects.

Potential for notable social unrest on the European scene exists. Unemployment remains stubbornly elevated. Difficulties, especially in Greece, but potentially elsewhere, recall the European periphery crisis. Greek political troubles erupted again, with a crucial election being held in late January 2015. Greece's leading left-wing opposition party has a significant chance of winning that contest. That party wants to renegotiate and reduce the nation's monstrous debt. Will it continue reforms of the economy and state administration desired by creditors? At times, though less so recently, this leftist group has displayed some hostility to the country's remaining in the Euro FX circle.

****

Despite the Eurozone's noble struggle to create adequate inflation (avoid deflation), its success on that front probably will be limited. Inflation and long term government interest rates in key nations such as Germany probably will not sustain substantial increases even if the ECB races down the path of massive money printing via buying of government debt securities. Keep in mind Japan's history. The United States still falls short of the Federal Reserve's inflation target despite sustained massive easing. Remember as well America's experience after it ceased (or steadily "tapered") quantitative easing rounds; the 10 year United States Treasury note yield declined.

In recent months, the Euro FX has weakened, both against the United States dollar and on an effective exchange rate basis. This currency relationship and bear trend will continue. Nowadays, part of the ECB's inexorable determination to "do what we must" pursuant to its interpretation of its mandate involves a willingness to let the Euro FX slump. In any event, even if massive ECB money printing and currency feebleness manage to achieve an inflation goal (and higher interest rates), they likely will not generate enduring significant Eurozone economic growth.

SETTING THE STAGE

As the curtain rises for 2015 and potential European Central action, and with the ECB's "price stability" goal an inflation rate close to but below two percent, what appears to marketplace watchers?

The ECB provided forecasts for growth and inflation in its 12/4/14 meeting. Real GDP increased a meager .8 percent in 2014. It inches up to 1.0pc in 2015, with 2016's expansion only 1.5pc. These figures represent a notable downward revision from the bank's September 2014 forecast. Moreover, "risks surrounding the economic outlook for the euro area are on the downside". Annual HICP inflation is merely .5 percent for 2014, .7pc in 2015, and 1.3pc in 2016 The ECB likewise revised these inflation figures "significantly downwards" relative to September. In addition, the inflation estimates are based upon information as of mid-November, so they "do not yet incorporate the fall in oil prices over the past few weeks following the cut-off date for the projections". The ECB thus suggests that annual inflation rate projections may march lower given recent further fall in oil prices.

Unemployment in the Euro area was 11.5 percent in October 2014 (Eurostat).

Overall Eurozone debt is rather high, though considerably less than Japan's. According to the International Monetary Fund's October 2014 "Fiscal Monitor" (Statistical Table 7), Euro area general government gross debt as a percent of GDP stood at about 67 percent in 2007. However, it climbs to 96.4pc in 2014 (Japan's 245.1pc), with 2015's 96.1pc little changed from that. It retreats modestly to 88.2pc out in 2019. Compare the United States general government debt level in 2014 of about 106 percent; America achieves only a small drop to around 104.0 pc by 2018 (and 2019).

What about the Euro area general government overall balance as a percent of GDP? The Euro area deficit was -.7 percent in 2007. It peaked at -6.3pc in 2009, falling in 2014 to -2.9pc, with 2015's forecast at -2.5pc. The US general government overall balance is -5.5pc in 2014, with 2015's deficit at -4.3pc in 2015 (Fiscal Monitor, Statistical Table 1).

EUROPEAN CENTRAL BANK: THE PROTAGONIST

In "The Iliad", Homer refers to a speaker "from whose lips the streams of words ran sweeter than honey". (Book One, line 249; Richmond Latimore translation)

****

European Central Bank rhetoric and action has evolved in recent months. The bank undoubtedly would characterize all its talk and behavior, not only as pursuant to its mandate, but also as logical, reasonable, intelligent, prudent, and sensible.

The European Central Bank not long ago (6/5/14) introduced negative interest rates and devised Targeted Longer Term Refinancing Operations (TLTROs). To boost the size of its balance sheet, it recently (9/4/14) embarked on a money printing adventure via authorizing the purchase of asset-backed securities and covered bonds.

But so far it has delayed on the quantitative easing via sovereign bond buying issue. Yet measures once viewed as off-limits may become a new orthodoxy due to allegedly extraordinary circumstances.

Whether such sovereign bond buying (even if in the secondary marketplace) falls within the ECB's mandate is by no means absolutely clear, regardless of what the ECB's leadership says and however liberal its interpretation of its price stability mandate. Wouldn't it in essence be monetary financing? On a related note, the world awaits adjudication on the legality of the summer 2012 introduction of the Outright Monetary Transactions (OMT) scheme, which involved both sterilization (supposedly no money printing) and conditionality.

In any event, the ECB has moved close to unveiling a significant government bond buying program.

On 11/21/14, the ECB President proclaimed: "We will do what we must to raise inflation and inflation expectations as fast as possible, as our price stability mandate requires of us. If on its current trajectory our policy is not effective enough to achieve this, or further risks to the inflation outlook materialize, we would step up the pressure and broaden even more the channels through which we intervene, by altering accordingly the size, pace and composition of our purchases." Would this composition include "sovereign bonds in the secondary market"? Arguably eventually; see the specific reference to them in the Vice President of the ECB's 11/26/14 speech.

Moreover, underscore the ECB President's closing comment during the ECB's 12/4/14 press conference. "Evidently we are convinced that a QE programme which could include sovereign bonds falls within our mandate, or better, is an eligible instrument that we could use in the pursuit of our mandate. Not to pursue our mandate would be illegal."

The ECB's Chief Economist indicated (interview with Boersen-Zeitung; summarized 12/30/14 by Bloomberg) "lower oil prices increasingly risk de-anchoring inflation expectations". "Euro-area inflation will drop below zero 'for a longer period' in 2015 amid a slide in the cost of crude, and the Governing Council 'cannot simply look through' that." Moreover, "the ECB must 'not be paralyzed' by the problems a QE program might create. Sovereign bonds are 'the only kind of asset for which there is a significant market volume'".

Finally, read the just-published interview between the ECB President and Handelsblatt (1/2/15; ECB website). The President states: "we are now ensuring that the risk of deflation you just asked me about does not materialise." He emphasizes "The risks of not fulfilling our mandate of price stability are in any case higher than they were six months ago. Our mandate is symmetric. We have to avoid too high inflation and we have to avoid too low inflation as well."

Although the ECB "cannot breach Article 123 of the Treaty, which forbids monetary financing", "The purchase of government bonds is one of the tools in our toolbox, which we can use to fulfill our mandate." The President claims that its government bond purchase plans do not "come very close" to monetary financing. The interviewer asks how close the ECB is "to buying the next large batch of government securities"? The President declares: "The ECB's Governing Council has instructed the staff and Eurosystem committees to prepare concrete measures.

GREECE, ENCORE

In the 2010 film "Get Him to the Greek" (Nicholas Stoller, director), Aldous Snow wonders: "Doesn't it make sense that we should stay here and possibly have the time of your life?

****

Current Greek politics and speechmaking evoke memories of Greece's fearsome debt crisis and gigantic bailout about two years ago and the associated worries regarding the breakup of the Eurozone and its currency union.

Greece will hold a general election on 1/25/15 because its parliament rejected the ruling party's Presidential nominee. Concern has mounted that an anti-bailout (left-wing) party may win and "put the country on a collision course with international lenders". (Financial Times, 12/30/14). Fears persist that if this left-wing party (Syriza) achieves power, it will reduce dramatically (default on) the nation's debt. Syriza wants to renegotiate two bailouts worth $240 billion Euros (about $290 billion) with the so-called troika of lenders (International Monetary Fund, European Central Bank, European Commission) and to persuade creditors to write off some of the nation's debt. Some also worry that Syriza's victory eventually may result in Greece's leaving the Eurozone (move from the Euro FX), although at present such a departure seems unlikely.

****

Greece has substantially slashed its large central government overall deficit as a percent of GDP over the past several years. According to the International Monetary Fund's Fiscal Monitor, after peaking at -15.6 percent in 2009, it fell to -6.4pc in 2012 and -3.2pc in 2013. The IMF estimates 2014's at -2.7pc, with 2015 at -1.9pc and 2016 at only -.6pc.

However, Greek general government gross debt as a percent of GDP remains awesome (as does unemployment around twenty-five percent). Gross debt increased from 107.2 pc in 2007, at the dawn of the worldwide economic disaster, to 170.3pc in 2011. Though it peaked at 175.1pc in 2013, 2014's 174.2 slips little from that, as does 2015's predicted 171.0pc. The IMF optimistically predicts 135.3pc for 2019. (Fiscal Monitor).

****

Note the closeness in timing between the next ECB monetary policy meeting (1/22/15) and the Greek election. The following ECB meeting, 3/5/15, is not long after the Greek election.

Concerns regarding Greece probably encourage eventual dramatic ECB action on the money printing (government debt buying) front. In his 1/2/15 interview, the ECB President stressed: "A breakup of the euro area? That will not happen."

****

One method to mitigate the pain resulting from an onerous debt burden denominated in Euro FX is to depreciate the Euro FX.

****

The ECB and European politicians also worry about economic weakness and political strife elsewhere in the Eurozone, not just in Greece. The Financial Times (1/2/15, p1) headlines "Merkel [German Chancellor] attacks wave of European rightwing populism and prejudice", with her "warning echoed by presidents of France and Italy". Worries surely also exist regarding left-wing movements in addition to the Greek ones.

THE EURO FX: CURRENT WEAK PERFORMANCE

The song "Love, Life and Money" (written by Julius Dixon and Henry Glover, performed by Johnny Winter and others) declares:
"Money you've made me
Some very fast friends
And just like you made them
You're gonna break them in the end".

****

Recall the famous proclamation by the ECB President during an earlier act of the Eurozone crisis. Aiming at rescuing (rallying) the Euro FX and protecting the Eurozone's integrity, the ECB President thundered: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." (Speech by Mario Draghi, 7/26/12).

The Euro FX rallied against the United States dollar from around the time of that speech. From 7/24/12's bottom at 1.204, it ascended to nearly 1.400 in 2014 (1.397 on 3/13/14, 1.399 on 5/8/14).

Note that the key Spain less Germany 10 year government note spread began a monumental decline from nearly 640 basis points around 7/24/12 to not much over 100 basis points in recent weeks. If the Spain less Germany yield spread widens sharply, perhaps alongside a rise in Greek yields, warns of dangers to the European economic situation.

What about the Greek 10 year government note? Around the time of the Greek debt restructuring in first quarter 2012, yields reached a pinnacle around forty-four percent. In the subsequent new era for the Greek 10 year note instrument, although yields slumped, they rather quickly danced over thirty percent. However, the ten year established a final high at just under thirty percent around the time of the ECB's "whatever it takes" speech. The Greek 10 year note established yield bottoms in June and September 2014 around 5.5pc, rising from that depth as Greece's political and economic challenges recaptured headlines.

****

The ECB of course always will "do what it takes" in pursuit of its mandate. However, as its deflation (too low inflation) and other worries (such as mediocre GDP growth, sustained high unemployment, and the potential consequences of the Greek situation) have increased, the ECB has changed its tune regarding the Euro FX.

In contrast to its July 2012 effort, from around late spring 2014 (note its 6/5/14 policy revelations), it began tolerating (and perhaps indirectly pushing for) Euro FX weakness. In more recent weeks, that guardian probably has encouraged Euro FX depreciation, and it probably will continue to sacrifice the Euro FX for at least the near term. Thus one key element of the ECB's current "do what we must" policy includes Euro FX depreciation, which is the currency policy Greece (and many other Eurozone nations suffering from weak GDP and lofty unemployment) would embrace if it had its own currency. Besides, though history is only a guide, the Eurozone did not break apart when the Euro FX was at lower levels than currently exist.

****

Though important, cross rates such as the Euro FX versus US dollar do not present the full breadth of a currency's strength or weakness. Clairvoyants should concentrate their focus on wider measures for the currency "in general", such as that provided by the Bank for International Settlements.

The BIS offers broad real (CPI based) effective exchange rate ("EER") indices for the Euro area and many other countries. (2010=100; monthly average; 12/15/14 is most recent release, November 2014 the most recent month in the series).

The Euro FX EER rested at 101.6 in March 2014, the highest since April 2011's 101.8. It slumped to 95.6 in October 2014, with November 2014's 95.7 neighboring that level. These autumn 2014 months thus edged under June 2010's 96.3 noteworthy low. Assuming the Euro FX's weakness against the dollar in recent weeks is a rough guide, the current level for the Euro FX EER probably is a bit beneath the October/November 2014 level.

During the European periphery crisis, recall the Euro FX EER's 91.8 in July (and August) 2012. This was a crucial trough reached alongside the ECB's "whatever it takes" speech (7/26/12) and the related Outright Monetary Transactions announcement (8/2/12). These summer 2012 levels represent important support for the Euro FX EER. A ten percent fall from 101.6 (March 2014) is gives 91.4.

Well under today's Euro FX EER lurks October 2000's 82.3 major bottom. A twenty percent fall from 101.6 (March 2014) is gives 81.3. Important peaks include 110.3 in December 2004, slightly surpassed by April 2008's 112.0 (a twenty percent fall from that gives 89.6).

****

On the Euro FX versus the dollar cross relationship, current levels are cutting through the "whatever it takes" bottom around 1.204 of 7/24/12. The Euro FX also is beneath the important lows of late October 2008 (around 1.233; major low in China's Shanghai Composite stock index 10/28/08 at 1665)/early March 2009 (1.246; major bottom in the S+P 500 on 3/6/09 at 667).

As the Euro FX weakens against the dollar, watch its 6/7/10 bottom around 1.188 as well as its 11/15/05 low around 1.164. Well underneath this is the Euro FX's low of .8230 on 10/26/00.

OTHER SCREEN STARS

Greece is an important model, but not the only one, underlining the challenges facing low-quality debt securities (whether sovereign issues or corporate junk bonds) and many emerging/developing stock marketplaces. If sovereign creditworthiness decays substantially, interest rates may climb (and economic growth may be inadequate as well).

In regard to evaluating and plotting trends in emerging stock marketplaces, keep an eye on commodity battlefields. Take the broad Goldman Sachs Commodity Index (GSCI) as a benchmark for commodities "in general". It collapsed, of course propelled by bloody price dives in the petroleum complex, from 6/23/14's interim high around 673 to under 420 recently.

****

The German 10 year government note yield has plunged under the one percent barrier. At around .50 percent, the benchmark Bund has ventured close to Japan's 10 year JGB yield of just over .30pc. Given Japan's extended experience with money printing and deficit financing, why should Europe's effort to escape "too low" inflation (or deflation) be any more successful than Japan's? The continuing decline in German 10 year government note yields over recent months strongly suggests that battles by Eurozone central bankers (and politicians) to insure sufficient inflation (accompanied by other policy objectives such as adequate GDP growth), ultimately will fail, even if they implement new money printing measures.

One sign of the obstacles facing the Eurozone and Japan in their crusades to boost inflation (and generate higher interest rates) is the recent behavior of the UST 10 year government note. However, the UST 10 year note yield under 2.15 percent remains well beneath its 1/2/14 top at 3.05pc. The decline of the United States 10 year Treasury note yield from its January 2014 summit fits a story of subdued international inflation and low global growth. Admittedly the UST's yield flew up from the low under 1.90pc touched 10/15/14. But even since that mid-October 2014 depth, the UST yield has traveled up to only around 2.40pc, never piercing the important resistance around that level. The failure of UST yields to rally may signal future mediocre US (and worldwide) economic growth since yields generally advance during recovery (or hope of one).

After all, shouldn't an actual and persistent recovery (or at least hopes of one) generally be accompanied by increasing interest rates, even allowing for some residual central bank yield repression? Besides, despite several rounds of ardent Federal Reserve money printing, US inflation generally has remained under the Fed's beloved two percent target.

STOCKS: WHATEVER IT TAKES

"Never to be cast away are the gifts of the gods, magnificent,
which they give of their own will, no man could have them for wanting them." Homer, "The Iliad" (Book Three, lines 65-66; Richmond Lattimore translation)

****

A determined effort to engineer and sustain rises in benchmark stock marketplaces has been far more of a Federal Reserve policy than a European Central Bank one. The Fed's behavior suggests it will do "whatever it takes" to keep United States stocks strong. Nevertheless, in recent years, European stock signposts such as the Stoxx Europe 600 Stocks Index (and many national benchmarks) generally have moved in a similar pattern to America's S+P 500. Major trend changes in the S+P 500 and key broad European stock yardsticks probably will continue to occur around the same time.

The bullish odyssey of the S+P 500 from its major low around 667 on 3/9/09, despite many twists and turns, has been majestic. The S+P 500's all-time high to date is 12/29/14's 2094. From its low on 3/9/14 at 155.4, the Stoxx Europe 600 index began a major bull move. It reached about 351.0 on 12/4/14 (under the record of 401.0 on 7/13/07), closing at 341.3 on 1/2/15.

Suppose the ECB engages in significant new quantitative easing via purchasing Eurozone sovereign debt securities. The Federal Reserve's quantitative easing programs, and recent rounds of Japanese ones, have helped to spark and sustain notable equity rallies. Many stock investors surely hope any ECB quantitative easing will generate bull stock moves.

However, that noteworthy ECB money printing move, even if it helps to move European (and American) stocks higher, probably will not do so by much or for very long. Note the weakness in emerging marketplace stocks and commodities over the past several months, the failure of the UST 10 year note to sustain yield increases, and the ongoing rally in the broad real-trade-weighted dollar index ("TWD"). The inability of the S+P 500 to sustain a rally after an announcement of ECB money printing will warn of a significant decline in that and related stock marketplaces.

According to the Federal Reserve (H.10), the Euro area is almost 16.4 percent of the TWD. Compare China's 21.3pc, Canada's 12.7pc, Mexico's 11.9pc, and Japan's 6.9pc. The UK represents about 3.3pc of the TWD, Switzerland about 1.7pc.

Although history need not repeat itself, it should not be forgotten. For various financial marketplaces nowadays, remember the bull move in the TWD as the worldwide economic crisis that emerged in 2007 accelerated. The TWD made a key low at 84.2 in April 2008. By September 2008, it was 88.8. In October 2008, it leaped to 93.8, making a major high in March 2009 at 96.9. Although the S+P 500's major high was 10/11/07 at 1576, its final top was 5/19/08 at 1440, not long after the TWD's April 2008 bottom. The S+P 500 collapsed from 9/19/08's height around 1265; compare the TWD's rapid advance from September 2008 to October 2008 (and rise for several months thereafter).

The broad real TWD established a major bottom in June 2011 around 80.5 (monthly average; H.10; 1/2/15). This autumn (with September 2014's 86.6), it broke above June 2012's 86.2 resistance level. From November 2014's 88.8, the broad real TWD stepped up to 90.8 in December 2014. It thus has moved decisively above September 2008's 88.8 and is marching toward the key 93.8 level of October 2008.

****