SPECIAL FX

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Drivers in Q3

As we begin the second half of what has already been a challenging year, it may be helpful to consider the potential drivers of the global capital markets. As always, numerous factors have to be juggled. Now however, even though the markets are as complicated as they've ever been, there are two key drivers that stand out: the European debt crisis and the macro-economy. Each needs to be broadly conceived and the nuances understood.

European Debt Crisis

Investors are already familiar with the broad outlines of the European debt crisis and the policy response in terms of support mechanisms and austerity measures being adopted. Investors are now trying to get a handle on the next chapter in the saga. There are several dimensions of the crisis that will likely play out in the coming months.

First, countries in the euro zone, especially those in the periphery, will be either attempting to roll over their debt that is coming due or raising funds to finance this year's deficits. Spain has almost €25 billion of debt maturing in July.

At the start of the year, Spain offered 60 bp more than Germany on 10-year bond. At the start of Q3, the premium stands at 200 bp. In absolute terms, the Spanish yield stands at 4.55%, about 60 bp above where it began the year. Of the countries in the periphery of Europe that have been the focus, (Greece, Ireland, Portugal, and Spain), Spain's yield is the lowest. While the July auction poses event risk, the new supply should be absorbed by the market relatively smoothly.

Greece plans to sell T-bills in July, even though the €110 billion package cobbled together by the EU and IMF in early May is sufficient to meet the country's financial needs for the next two years.

When Greece last sold 13 week bills in early April, it paid an annualized yield of 3.65%. It will be lucky to sell the same bills now for less than 4%. An even larger increase in yields is likely to be necessary for the 26 and 52 week bills. Greece may be required to pay close to 200 bp more to borrow for both of those tenors than what it paid at the last auctions in mid-April; 4.55% and 4.85% respectively. These yields are well above what was assumed in Greece's budget.

The bill sales represent an event risk. Many market participants are convinced that a restructuring of Greek debt is a question of when not if. This may deter interest. However, because a restructuring is unlikely in the next several months, we suspect the bills will be absorbed. Still, a poor auction could see knock-on effects on other markets.

Second, it is not just the sovereigns that need to secure funding. European banks do as well. Given the regulatory uncertainty and the sensitivity to counterparty risk, there may be upward pressure on Euribor.

The stress tests of European banks may complicate the situation further and must be seen as a risk event as well. Some banks will likely need to raise more capital, but it seems that this will have to be addressed by national officials, rather than the EU or ECB.

Many observers are focusing on the Spanish cajas and German landesbank sectors. Spain has a fund (FROB) to assist the restructuring of the cajas, and although the June 30th deadline has passed, reports suggest that FROB funds could be extended.

Germany has a bank rescue fund (Soffin) that still has scope to provide €250 billion of credit guarantees, as well as another €52 billion of capital that can be disbursed. That said, the Landesbank sector may turn to their state sponsors for support as well.

Third, any move on credit ratings will most likely be on the downside, rather than the upside. As is all too often the case, we suspect the rating agencies are behind the curve.

Our proprietary ratings model warns that several peripheral countries are at risk for downgrades. Greece is vulnerable to a downgrade by Fitch (BBB-). We think Fitch and Moody's ratings are too generous for Portugal (Aa2 and AA-), and that all three rating agencies are too optimistic about Spain (A/A2/A).

Outside of the periphery, our models suggest that the U.K.'s metrics would put its rating more in line with Japan (AA/Aa2/AA). Also our work suggests that France may have slipped from conditions that warrant an AAA rating in Q2 10. However, we recognize the odds of a downgrade of either U.K. or France in the coming months to be slim at best.

Fourth, the European Financial Stability Facility (EFSF), which has the potential to raise as much as €440 billion, is now operational. Neither the creation of it, nor the ECB's sovereign bond purchases, has been sufficient to stabilize the bond markets. The cost of insurance in the credit default swaps market for some countries has risen despite the EFSF.

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The risk is that a country will seek to access the facility. However, the stigma attached to it means that it probably won't be used in a preventative manner. Instead drawing on the facility is likely to occur only when a crisis becomes particularly intense. The existence of the facility should reduce the risk of a country leaving the monetary union for at least the next several years. The various costs associated with abandoning the euro, make it a course of action quite high up on the escalation ladder. The EFSF and IMF now extend that ladder by two additional rungs.

Macro Economy

In addition to the European debt crisis, the other key driver is the macro economy. In recent weeks macro economic considerations have gradually eclipsed Europe's debt woes as the key market driver. There are two dimensions here: growth and inflation.

Since the middle of 2009, albeit in an uneven and fragile way, there was an economic recovery, aided by extraordinary monetary and fiscal policy. In recent weeks, economic data from the major industrial countries have generally surprised to the downside.

There are serious and increasing concerns that the economic recovery is not simply losing momentum, but rather may experience a new contraction—the infamous double dip. Fiscal support is either being reduced, promising to be reduced, or past the point of diminishing returns.

Monetary policy also appears to have reached some kind of limit. The Federal Reserve and the Bank of England's balance sheets are not growing. The Swiss National Bank has signaled the end of its QE policies by declaring victory over deflation. The ECB is reluctantly buying sovereign bonds at an average pace of a €1.5 billion a day, while the BOJ continues to buy JGBs in Rinban operations at ¥1.8 trillion (~$20 billion) a month.

Policy rates still remain at emergency low levels. Banks are sitting on large excess reserves, or placing funds on overnight deposit at the ECB, or similar activities through the major countries. Banks are not lending. The demand for credit also appears weak, at least from large businesses and households.

Broad measures of money supply suggest policy is too tight. Money supply, measured by M3 in the euro zone, is contracting on a year-over-year basis. In the U.S. the pace of M2 growth has collapsed from 10% in January 2009 to less than 2% in May 2010, the slowest pace since the mid-1990s.

Average headline CPI is running at 1.4% among the G7. Various measures of inflation expectations seem to suggest that, if anything, expectations have eased a bit. The risks on core inflation seem to generally be on the downside in the coming months.

Indeed, Japan continues to experience outright deflation the pace appears to be slackening a bit. The U.K. by contrast is at the high end of the inflation in the G10. If price pressures do not ease in the U.K. in the coming months, the hawks could move into ascendancy. Capacity constraints and the impact of the nearly 30% decline of sterling on a broad trade-weighted basis in the 2007-2009 period may overshadow some of the more transitory factors.

If these trends persist, talk may increase of the necessity to renew QE measures in the U.S. and U.K., as well as increase QE measures in the euro zone, such as renewed covered bond purchases, or no longer sterilizing the full amount of sovereign bond purchases. Given the near liquidity trap conditions, it is not intuitively clear what more QE would accomplish. While the risk must be recognized, the bar for such policies is sufficiently high and the data is noisy enough to require several months, or at least severe discontinuities in conditions, to warrant action.

The U.S. Treasury market appears to have drawn substantial safe haven flows and more important, it is perceived as such. Many investors, looking at the U.S. debt and deficit levels argue this is a debatable proposition. Under certain scenarios, it can be imagined that there is a capital strike against the U.S. It would result in sharply higher U.S. interest rates and a dramatic decline in the dollar.

While the probability is above zero, it is not very far, especially in the coming months. The dollar's reserve status, the depth and breadth of the U.S. Treasury market, the generally cautious nature of managers of large pools of public or private capital, the absence of compelling alternatives and inertia all favor a general continuity of the current international monetary order.

In recent weeks the market's emphasis on the European debt crisis eased and the macroeconomic concerns grew. This also coincided with a decline in the U.S. dollar, after it had trended broadly higher against the euro and sterling since last November.

Yet it would seem that a slowing from near 3% in the U.S. is one thing, but slowing from the less than 1% pace in Europe is something else. Europe's monetary and fiscal strategies can only be sustained if there is growth. In the near-term the focus on macroeconomic challenges is dollar negative, but the over time, as the implications of a slower global economy filter through the capital markets, the risk-off trade may see flows into the dollar.

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