Weekend Developments and Their Significance Going Forward

There have been several important developments over the weekend and is likely to support the euro at the start of the week after falling for the past four consecutive weeks and recording a 7-week low before the weekend. However, we continue to expect corrective gains in the euro will be short-lived and subject to headline risks. We still believe that the $1.29 year-end target for the euro is reasonable.

There are two important developments in Europe.

The first are reports that Germany and France have agreed to fast track a new agreement on what Merkel has called a "stability union" that is said to be able to be in place in a period that may be measured in weeks rather than months or years that are often required for treaty changes.

The second is news that Belgium's political class has finally figured a way forward. The political stalemate has left it without a proper government more the past year and a half. The agreement on the 2012-2014 budgets is an important achievement and a new government may be in place in a week or so.

There was another important press report, first in an Italian newspaper, but duplicated by the media outlets. It essentially claims that the IMF may be preparing a 400-600 bln euro package for Italy if the situation deteriorates further. This would essentially be enough to keep Italy out of the capital markets for the near 12-18 months and allow the new government's austerity measures to re-win the markets' confidence. The report does not appear sourced.

II

The reports suggesting a Berlin-Paris agreement to expedite tighter fiscal rules is consistent with recent comments from Merkel and Sarkozy and appears consistent with the EU proposals last week about a European bond (outlined options) tied to greater fiscal discipline.

Germany is pressing hard for tougher budget rules. It needs what the French budget minister Pecresse has called a "complete commitment" to cutting debt levels and increase budget convergence (toward balanced budgets). It requires real sanctions, tighter than the ones Germany and France wiggled out of a decade ago. This is nothing less than a new dimension to the governance of the euro zone.

Many critics have argued that such a course will require tedious, laborious and protracted negotiations among seventeen countries and the investors were becoming increasingly impatient. However, the German-French initiative that is expected now to be formally put forward at the December 9 EU Summit, will advocate a different but not unprecedented approach.

European countries scrapped passport controls by a series of bilateral agreements. The Schengen Agreement was initially--for a dozen years--outside, but parallel to the EU structures. In 1997, the Amsterdam Treaty integrated it into the EU. This is the general procedural model that Germany and

France appears to be proposing. Such parallel structures can serve the political structure the way scaffolding works in construction.

What would this look like in practice? Italy's new technocrat government may offer the best glimpse right now. The ECB and EU have already sent auditors, according to press reports, to check on Italy's state accounts this month. The IMF is to send a team of experts under special surveillance agreement struck at the recent G20 meeting with then-Prime Minister Berlusconi.

Although the Monti government has sufficient support to pass a vote of confidence, the political parties are not represented in the cabinet. The cabinet needs to demonstrate its resolve to quickly adopt greater austerity than the Berlusconi government. To this end the cabinet will likely approve the new measures ahead of the December 9 EU Summit. The measures may include a wealth tax in the form of a new tax on property worth more than a million euros, pension reform, some labor reforms and efforts to liberalize infrastructure projects.

III

Press reports that the IMF is preparing a 400-600 bln euro aid package for Italy (at 4-5% yield) seems wide of the mark. The IMF simply does not have the resources.

In fact, a year ago the IMF members agreed to double quotas from $375 bln to $750 bln. Press reports suggest that only 17 of the 187 members have taken the necessary domestic measures to authorize the increased quota.

The vast majority of the IMF's members, including those with among the largest quotas, like the US, China and Germany, have not begun the process of implementing the agreed upon plan to increase the IMF's resources.

Under the new Precautionary and Liquidity facility the IMF unveiled last week, it appears Italy could secure 30-40 bln euros over the next six months. This is not a very convincing amount and barely covers the expected bond and bill issuance remaining this year. Italy has roughly 440 bln euros of bills and bonds maturing next year.

Schemes to leverage the IMF, which the proposal seems to assume, quickly run into political and technical difficulties. Leverage is not risk-free and it is not clear who bears the cost of the risk. It is not clear that leveraging the IMF would be acceptable to a sufficient number of members (quotas) to avoid a rejection.

Many observers outside Europe believe that the key deficiency is the lack of will not resources. In addition, by undermining the credibility of the sovereign CDS market (by giving private investors a 50% haircut--and more--in Greece without it being a credit event); guarantees in case of default or other similar schemes encounter very skeptical investors.

Some European officials, including then-ECB President Trichet, at first balked about allowing the IMF a role in the resolution of the European debt crisis. The IMF has come to play an important role, providing roughly a third of the funds for the aid programs to euro zone countries. Even if this analysis is correct and the IMF cannot really afford to lend Italy 400-600 bln euros, it does seem that it will continue to play an integral role in Europe. It remains the lender of last resort to sovereigns.

IV

There was an important political breakthrough in Belgium over the weekend. It will allow a government finally. It has not really had one since the elections in the middle of last year. The agreement was predicated on a budget breakthrough.

As seems frequently the case in economic and political developments, the outcome was over-determined. Clearly there are purely domestic political reasons why Belgium wants a government. The market may have also played a role as it drove up Belgian yields in absolute terms and relative to Germany.

S&P decision before the weekend to downgrade Belgium's credit rating one notch to AA for the first time in thirteen years, was likely more embarrassing than substantive. Among the reasons the rating agency cited was the absence of policy consensus. It does little to dilute the general perception that the rating agencies remain largely behind the curve of events.

Belgium's 2012 budget will boost planned savings by 11.3 bln euros. It projects next year's budget deficit will be just below 3% (2.8%) and will deliver a balanced budget in 2015. The risks to the euro zone growth in general appear on the downside and this in turn risks deficit projections. In any event, the take away here is that end of Belgium's political paralysis comes in the nick of time for it to demonstrate its resolve to stay within the core, despite its high debt/GDP levels.

V

There was also news outside of the Europe that will influence the markets at the start of the new week. The US reported strong Black Friday retail sales. Press reports indicate that ShopperTrack found the largest year-over-year increase (6.6%) since before the crisis.

This provides additional hint that Q3 momentum has carried into Q4. The downward revision to Q3 GDP from 2.5% to 2.0% was largely a result of less inventory accumulation, which is more positive for Q4 GDP. The Black Friday sales will likely kick off a series of relatively favorable US economic reports, capped by the employment report (the early consensus is for about 145k private sector job growth), auto sales and the ISM.

Traders need to be careful here. Counter-intuitively, the dollar has often retreated in the face of favorable economic data. The key is the high correlation of risk assets. The correlation between the euro and the S&P 500 remains near record levels, for example, and a host of similar correlations among risk assets is high.

The US data will again stand in stark contrast to euro zone data. Euro zone economic data is poor and the manufacturing PMI will likely confirm the flash reading. Recall that the flash composite PMI was below 50 for the third consecutive month.

The recent FOMC minutes showed that officials spent much more time discussion how to make its communication more effective than ways to expand its balance sheet. The ECB on the other hand is likely to ease policy when it meets on December 8. It will not only cut the key interest rate 25 bp, to completely unwind the rate hikes delivered in April and July. The ECB will also likely provide longer term financing operations, which some have suggested could be of 2-3 years in duration. In addition, the ECB may further relax its collateral rules.

Italian and French bond auctions may be of extra importance given last week's developments, where both Italy and Spain had to pay more than Greece to raise 6 month money and the Germany auction failed brilliantly to draw sufficient demand to cover the intended supply.

UK's Chancellor of the Exchequer delivers his Autumn Statement. While there may be some surprises, much of the details appear to have been leaked. A GBP20 bln program to assist small and medium sized business appears to be a center piece. More telling will be the slashing of the 2.5% forecast for next year's GDP. The market is at half that and that itself may be optimistic. Slower growth has knock-on effects on the deficit, which in turn impacts the supply of gilts. An extension of the BOE's gilt purchases may be offset by increased supply.

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