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MV Capital Management Weekly Market Flash

Continent at the Crossroads

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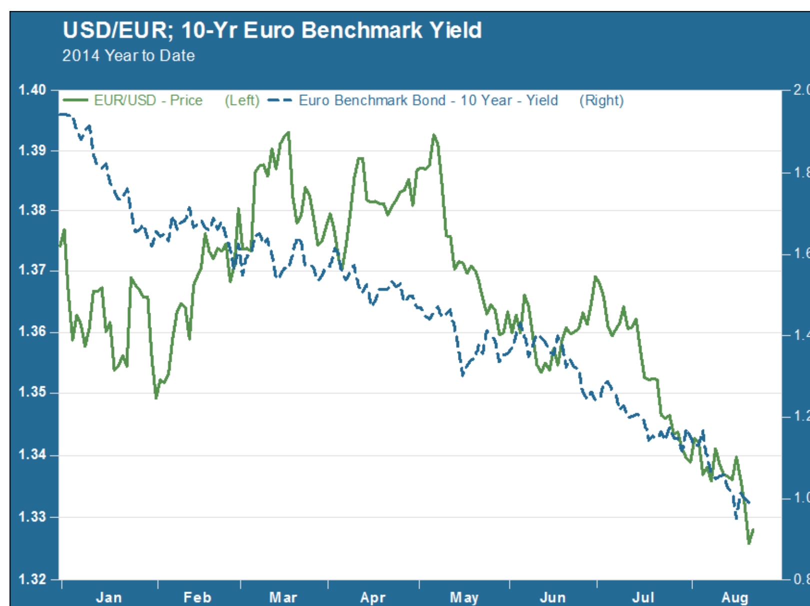
European Central Bank Chairman Mario Draghi is spending a few days this week in the pleasant late-summer climes of Jackson Hole, Wyoming, site of the annual central bank symposium hosted by the Kansas City Fed. Chances are, he won't be spending too much time savoring the many recreational delights of this Rocky Mountains resort as he tries to present a strong, consistent and reassuring message to the world about Europe's financial and economic prospects. Those prospects look anything but promising these days. Talk of a "lost decade" brings to mind the specter of Japan: stagnant growth, waning competitiveness and mounting debt. Draghi has done a masterful job to date in projecting confidence: his "whatever it takes" pronouncement in 2012 was arguably the most important three-word utterance by a Roman since "veni, vidi, vici". But words and confidence alone may not suffice in navigating the current rough waters.

Bond Market Surrealism

All those problems would logically make the Eurozone a riskier bet for investors than the more stable U.S. After all, our economy has regained and surpassed its pre-2008 size, while Europe's economy remains smaller than it was before Lehman Brothers collapsed. Yet a remarkable thing has been happening in Europe's bond markets: yields have plummeted to common currency-era lows. As the chart below shows, the benchmark 10-year Eurozone yield has fallen below 1% in recent days, even as the Euro has also continued a sharp downward trend.



Source: MVF Research, FactSet

We have noted in other commentaries that low bond yields in other developed economic regions like the Eurozone and Japan have been a driving factor in keeping U.S. yields down. The 10-year Treasury yield currently sits around 2.4%. That is much lower than most market observers expected at the beginning of this year, but it's

fairly attractive when compared to the sub-1% levels elsewhere. Riskier assets normally trade at a positive spread to the risk-free rate, but in the Wonderland that is today's credit markets that seemingly impregnable financial axiom stands on its head. And the Euro's decline adds the variable of lower purchasing power to the mix. All this raises the question: why are Eurozone rates so low, and who is crazy enough to be buying?

Mario and the Banks

Much of the answer to that question has to do with the policy measures Draghi and the ECB have focused on up to now. The centerpiece of this policy is the ungainly acronym TLTRO, for "targeted long term refinancing operations". Basically, these are series of ultra-cheap loans provided by the ECB to European banks, for the purpose of encouraging banks make their own loans, in turn, to European businesses.

But in reality, not much in the way of TLTRO funds have found their way into commercial lending markets. Rather, the banks have used the cheap loans to invest in European sovereign debt. Why is the Spanish 10-year benchmark yield virtually the same as the U.S. Treasury yield? Because Spanish banks have loaded up their balance sheets with Spanish government debt, locking in as pure profit the difference between the cheap TLTRO paper they borrow and the sovereign yields they purchase.

Time for QE, Euro Style?

This practice directly challenges the original logic of the TLTRO program. If European sovereign yields are unsustainable from a fundamental valuation perspective, and if most of this paper is concentrated on the balance sheets of European banks, a painful unwinding could follow. The betting among investors currently is that the ECB will take pre-emptive actions to forestall this outcome by implementing its own version of quantitative easing – buying bonds in the open market in the manner of the U.S. Fed, the Bank of England and the Bank of Japan.

A massive QE effort – and there is no guarantee that even Super Mario could jawbone this policy through the EU bureaucracy – would likely add to downward pressure on yields, at least in the near term. But the policy may not work. First, as already noted, rates are already low, and much lower than justified by the fundamentals. There may not be much tangible benefit to squeeze out of whatever additional bond buying can accomplish.

Second, European businesses do not rely on the bond market for their financing anywhere nearly as much as U.S. corporations do. QE has been a boon to U.S. enterprises, enabling them to raise money through bond issues at extremely low rates. In Europe, businesses borrow more from banks than from the bond market – and as we noted above, the banks have not been enthusiastic lenders since 2008.

There are fears in some corners that if European asset markets falter the contagion could spread elsewhere. That is possible, but in our opinion a more likely outcome in the near term would be the continued relative appeal of other markets, including the U.S. and perhaps the recently surging emerging markets. Investors need only look to Japan – the Nikkei 225 is still less than 40% of its peak value 25 years ago – to see what a prolonged freeze can do to portfolios. Mario Draghi, arguably more than anyone else at Jackson Hole, has his work cut out for him.

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