Big Fat Sloppy European Tails - 06/01/2011

On 28-May I attended a roundtable discussion in Limassol, Cyprus with Athanasios Orphanides, the governor of the central bank of Cyprus, Don Kohn, the ex-vice chairman of the FRB, Lucas Papdemos, the ex-vice president of the ECB, and Nout Wellink, president of the Dutch Central Bank and chairman of the Basel Committee on Banking Supervision.

There were a few press releases surrounding the conference with links as follows:

http://online.wsj.com/article/BT-CO-20110528-701482.html

http://online.wsj.com/article/BT-CO-20110528-701521.html

I have three key takeaways from the event –

1. The divide between Greek policy makers and Dutch policy makers on issues related to the debt crisis is extremely wide. The Greek position is basically as follows – “we Greeks have austerity fatigue so give us time and money and all we be just fine in a few years”. The Dutch position is as follows – “we have given you a bunch of money and you have not met any of our targets – and while we would love to cut you off, we cannot because we really don’t have a plan in place for dealing with the uncertain knock on effects from your default”.

2. There is a lot of work beginning behind the scenes on how to secure the European financial system in the event of a Greek or other peripheral default, but that work is far from complete. It will take months and probably quarters before northern European politicians are willing to pull the Greek default trigger and have any level of confidence that they can control the situation.

3. The Greeks will eventually default/restructure or exit and all the preparation in place will not be enough to stem a very ugly “EuroPanic” trade.

Importantly, the panic trade is not likely today or this summer – so there is no short term tactical trade. The ECB has rightfully scared many of the politicians into believing that a Greek default would unleash a torrent of financial chaos that would be capable of destroying the European financial system. But the storm lurks and will constantly create a cloud of nervousness. In addition, the potential for political drivers to take us faster into a default scenario is very much alive – the tail events in Europe are big, fat and sloppy!

Of course all of these European shenanigans are occurring while the US economic data looks to be in free fall. Whether it is coming from Japan supply disruptions, Chinese tightening, the natural ebb and flow of an economic recovery or something more sinister like a double-dip remains uncertain – but the reality is that this combination one-two punch of European chaos and US data weakness is enough to drive every govvy bond market bear into hibernation. One can marvel at the 1.5% handles on 5 year notes and think like I do– “there must be some form of better investment for 5 years than 1.5% in a world where the headline CPI is 3.2%” – but that does that logic does not apply short term. Market memory is very myopic, and the wounds of 2 to 3 years are still fresh in many folks’ minds. Our baseline contention on the US data downturn is that this is simply the natural ebb and flow of an economic recovery from the worst downturn since the Great Depression. But on Europe, the market worries are more legitimate and more pressing. I have not spent much time in Europe in the last 6 months, and I certainly have not spent a lot of time with European central bankers. I should do it more often because it would temper my rosy outlook.

Even for a diehard euroskeptic such as myself, watching the events this weekend live, and discussing the issues in person with key players, left me even more skeptical. While the economics of a short term bailout make sense, political forces will soon become too difficult to overcome. The resulting default/restructuring/exit for one or more European nations will be highly unsettling for all markets – and there will of course be global spillovers. My key take away from the weekend is that a negative European scenario is likely to unfold MUCH sooner than most people had anticipated – and it will occur purely for political reasons. It is not imminent – but it is creeping closer – and European policymakers, even with all their theoretical preparation, will NOT have the tools to handle the fallout.

All of that said, and even with the 2% drop in spoos today, I suspect we are still going to push to new risk asset highs for the year over the summer months. Further, HY corporate and mortgage credit will continue to press through cyclical tights. Outright risk asset longs remain the easiest way to play the long term US recovery trade that we still see as very much in place. But the situation in Europe and its knock on effects, create serious concerns that the path to a sustainable US recovery will be VERY VERY bumpy. There is a massive European storm brewing in the distance, it’s not an immediate threat, but it’s going to be very messy when it hits!! Good luck trading.