DrobnyGlobalMonitor

July 19, 2011

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Biases:

EQUITIES:
BONDS:
FX:
EMG: Bullish Asian EMG FX; Bearish Asian EMG interest rates;

Current Exposure:

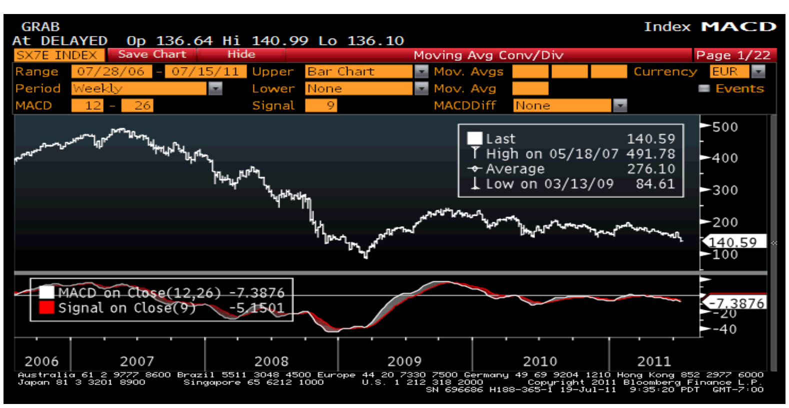
EQUITIES: ****Short DAX (July 19);***
BONDS: ****Formerly Pay 2yr SGD Swap;***
Short CDA 10yr vs long Aussie 10yr (Apr 20);
Pay KRW 2yr Swap (Jan 13);
FX:

Euro Turbulence, the ECB and the DAX

****Please note latest changes to biases and/or exposure***

There seems increased hope that the Euro area policy makers will come to a 'solution' on Thursday. The hope may not be seen in bank shares which, despite their bounce today, have lost more than 25% of their value since March and are down 70% from their peaks (below). Nor is there hope in BTP yields or Spanish bond yields, which under almost any muddling through scenario for the Euro area look pretty juicy.

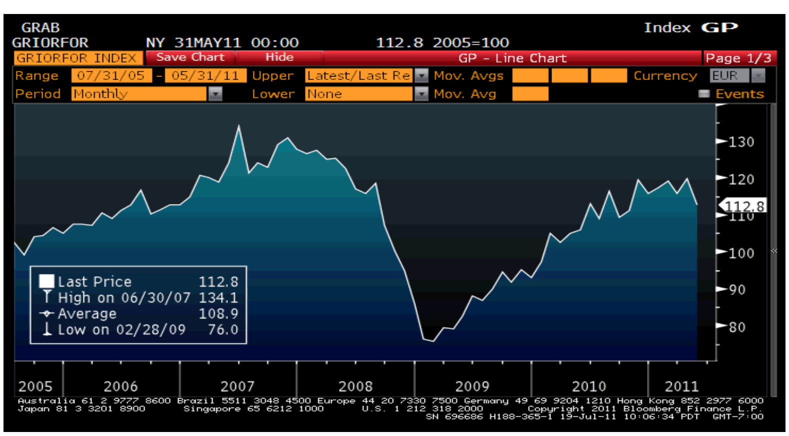
Of course, these two sets of instruments are closely related. As is now widely recognized, things in Europe seem a good deal darker with Italy now in play. Given the size of that market, a further rise in Italian yields rise adds materially to systemic risks. There are probably too many BTPs in the portfolios of banks and other financials.



Instead, hope is in the DAX, which is one of the few equity markets up at all this year (below). It is down just 5% since March, and only about 15% from the twin highs reached in early 2000 and again in late 2007.

There are, of course, very good reasons to own German shares. The dividend/Bund yield spread is high, though that has apparently been the case throughout much of the last decade. Moreover, this spread would likely get much higher in a financial crisis, making this 'indicator' of questionable value in abnormal times.

Another positive is the German economy, which has been booming. But, the PMI declined sharply last month and the latest manufacturing orders data showed a sizeable drop in foreign orders (below). That doesn't sound so good for the export oriented DAX. And, a slowing of export growth shouldn't come as much of a surprise given the stresses occurring in some of Germany's important trading partners. At the very least this data suggests stabilization in German growth, if not a more worrying type of slowdown led by a softening in export growth.



Yet another reason to want to own or hide in the DAX is that, if things were to go badly wrong in the Euro area, at least they are denominated in Deutschmarks. One SG argues that you want to own things that can eventually be priced in DEM's. That, of course, holds for Bunds in this crisis.

But, not so much for German shares. An actual breakup of the Euro area, and resulting revaluation of a new DEM, would serve to restore competitiveness of peripheral Europe at the expense of Germany. It would be good for, say, the IBEX, but not the DAX. The underperforming equity markets would likely become outperformers. And, a continuation of the status quo in the Euro area, as austerity maintains a hold on the peripheral countries and starts to engulf Italy sounds fine for Bunds but not so much for the DAX.

All this suggests, in principal, a relative value summer trade in the Euro area of buying, say, BTP's and using some of the carry to buy puts on the DAX. If the policy makers come up with a solution to the mounting problems, then BTP's offer good potential for quick gains. And, if the policy makers don't resolve things sufficiently, then rising fears of systemic trouble in the Euro area should eventually start to weigh on the DAX. The potential downside is substantial.

And, given the whippy price action recently, the opportunity is to take advantage of the big equity rally today and buy some DAX puts through, say, mid October. They could pay out huge if the policy makers don't come up with a big solution here.

One final point; and it is important. One hope is that the ECB will come to the rescue and provide liquidity in the event the banking system gets very stressed. The idea that they may relax their collateral rules to assist in getting some resolution of the Greek dilemma passed has also added to this hope.

But, that sounds unrealistic. Changes in collateral rules and other tinkering with ECB policy should have no effect on the actual thrust of monetary policy, short term interest rates and general liquidity provision. That is, they can insulate monetary policy and short term interest rates from any effects that changes in repo policy might have. The ECB mandate is clear, unitary and unequivocal. Unlike the FED's dual mandate.

When the ECB was created, the big issue was whether they would behave like the BUBA with a unitary mandate, or more like the Bank of Italy (!). One was steadfast, the other a serial devaluer. Germany insisted, and France agreed, that they behave like the BUBA with a unitary mandate of keeping inflation below 2%.

Thus, the ECB cannot take pre-emptive action to avoid a financial crisis. Its up to the national governments, the fiscal authorities, the finance ministries to solve these problems. Not the ECB.

They can stop tightening and hope that helps. But, their mandate suggests they can't ease in an attempt to forestall a crisis. They never have before in their history. All they've done is react afterwards.

In fact, the ECB (and BUBA) history shows the Euro central bank to be rather daring and provocative in periods of financial stress. The BUBA hiked in the summer of 1992 when stress on the periphery of the ERM was enormous. The ECB did the same in late 2000, when equity markets were already headed downwards and the global economy was starting to follow suit. And, if you remember, the ECB did the same thing in the summer of 2008!

So, maybe today we have a friendlier ECB which will hold back from tightening in the current environment. But, to expect them to suddenly become pre-emptive to ease a liquidity crisis, before the economies start to give in earnest, goes against their mandate…and history.

If this is wrong, by the way, then this would be a game changer for the Euro area as a whole. In such circumstances, the right R/V trade is to balance a short DAX position with short long dated Bunds rather than long BTPs. But, that's an event that would represent such a colossal change that there will be plenty to react to all the repercussions.

For now, the high probability bet is that the ECB may tinker with collateral rules but will remain true to their mandate and remain reactive with liquidity in a crisis. And, pro-active on rates in a rebound. In current circumstances, that leaves the DAX looking very exposed if things go wrong through the summer and into the autumn.

That's it for the **DGM** for a while. Pls make sure you get a good break at some point this summer and refresh. And, try to get away from the screens for a while!

Andres Drobny

Past reports can be accessed at www.drobnyreports.com