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Strategy Review

The ECB Joins “Club Fed” (through the Backdoor)

Despite its constant protestations that it would not embark on a program of Quantitative Easing, this week the ECB has in effect started doing exactly that (well, almost exactly) in an attempt to keep the European debt crisis from spiraling out of control. The official name of the program is the Long Term Refinancing Operation (LTRO) and its official purpose is to relieve liquidity (short term funding) constraints for European banks. Officially, the ECB is definitely NOT monetizing sovereign debt, but in practice (in our view) the LTRO is a backdoor way to accomplish exactly that goal. When trying to figure out the true intentions of a central bank, the golden rule is *“Don’t listen to what they say - just watch what they do”.* So in that spirit, let’s ignore anything the ECB has said and instead take a look at what they are actually doing.

The LTRO provides unprecedented 3 year loans from the ECB to European banks at a rate of 1% (currently) with the banks being required to post collateral rated ‘A’ or higher. Effectively, this allows the banks to do one of three things:

1. Buy higher yielding sovereign debt (for example, Italy at 6-7%) and post it to the ECB in exchange for euros at 1%. This is known in the industry as a “carry trade”. The bank earns the spread (or the “carry”) between the sovereign bond and what it pays the ECB, in this case, 5-6%.

2. They can use the cheap 3 year loans from the ECB to replace their own financing, a substantial amount of which is coming due over the course of 2012, including a very large slug (over €200bn) due to be refinanced in the first quarter of 2012.

3. They can take the cheap financing from the ECB and lend it out to consumers and businesses in the real economy.

From our standpoint, it seemed likely that the banks would be very keen to take advantage of the facility mostly to do actions 1 and 2. As it turns out, that has been the case. Markets had anticipated that banks might pony up for €250bn or so of LTRO financing this week, but instead close to 600 banks took down almost twice that amount (€490bn) – and we’re not done. The ECB are going to do another LTRO operation in February. We believe this has the potential to be a very big deal as it effectively introduces quantitative easing with the potential to be as big, or bigger, than the QE2 program introduced by the Fed in 2010. Even more importantly, the program has the potential to meaningfully reduce the chances of a systemic banking collapse in Europe (which could then domino around the world). The LTRO could potentially act as the catalyst for both of the following:

1. As banks borrow from the ECB to buy higher yielding sovereign debt in order to earn the carry, increased demand for this debt lowers sovereign yields and improves deficits as these countries refinance. Declining yields also improves the mark to market value of sovereign debt already on bank balance sheets, improving capital ratios and allowing banks to either put on still more carry trades or at the very least, deleverage less. Finally the profits earned from the carry trade also help improve capital ratios at the banks.

2. Banks can also use the cheap funding from the ECB to pay off existing debt, much of which in Europe is currently trading at a large discount. Extinguishing this debt using the LTRO (which will also often have the added benefit of a longer term) could also make a material contribution to improving the capital ratios of the banks. Access to 3 year funding also removes near term funding risk for European banks as we move into 2012.

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To be sure, we still have many problems to deal with, not least of which is the actual solvency of increasingly large European sovereign nations. It is still likely that ramping austerity programs in Europe will cause at least a minor European recession (if not more) next year and recent downbeat earnings outlooks from large global companies such as Oracle certainly need to be considered. But, if we don't have to immediately worry about a systemic collapse in the banking system caused by a large European bank, then the risk to reward of equities overall certainly starts to look much more compelling.

For our capital appreciation accounts we have maintained a relatively conservative allocation to equities through the current quarter and, for those clients who are option eligible, we have rolled our portfolio protection out to March, 2012. That said, we have started to modestly increase our equity allocation based on a reduced concern over systemic banking risk as outlined above. Needless to say, everything could change tomorrow, but for now at least, we see Europe finally taking meaningful action to help reduce risk (note that it wasn't the politicians who finally took the action). At a bare minimum, that is a much nicer frame of mind to enter the holiday season with.

With that in mind, we here at Cumberland offer our best wishes for health and happiness to you and your family.

John Wilson
Chief Investment Officer
December 23, 2011

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