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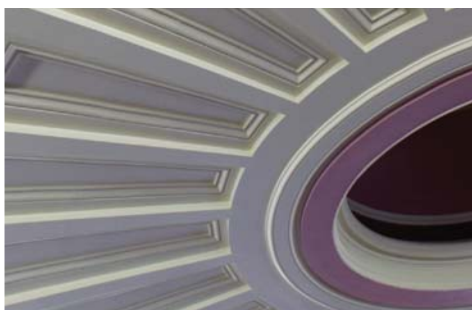

Eurozone Solvency Concerns Abate As ECB Buys More Time

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Although the ECB’s OMT program will not address the structural flaws in the common currency, it should provide European leaders with some time to lay out a roadmap for an eventual fiscal and banking union.

Executive Summary
Standish Global Macro Strategist Tom Higgins examines the recent European Central Bank (ECB) actions aimed at securing the solvency of the eurozone. Tom argues that the recent market rally across sovereign issuers that accompanied the ECB announcement of its new Outright Monetary Transactions (OMT) program appeared justified since the risk of a solvency crisis in Europe has now been lowered. Still, convertibility and default risk remain to an extent. And while he believes the prospects of near-term volatility cannot be ruled out, the primary short-term benefit of this program, he says, has been to shift the spotlight away from the eurozone and to provide European leaders more time to address structural flaws in the common currency and common euro structure.

“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” – ECB President Mario Draghi
July 26, 2012

The ECB’s Latest Response to Eurozone Crisis

In late July, European Central Bank (ECB) President Mario Draghi first raised the prospect that the ECB might buy enough peripheral European debt to bring down yields to the point where they are no longer pricing in any risk of a break-up of the common currency. He argued that eliminating what he dubbed “convertibility risk” fell within the ECB’s mandate since it was hampering the proper functioning of monetary policy within the eurozone.[1] Spanish and Italian government bonds rallied strongly in response, with yields dropping by 100 to 300 basis points across the curve.

The ECB unveiled some details of its so-called Outright Monetary Transactions (OMT) program at its September policy meeting. The central bank said it will purchase short-dated bonds (1-3 year maturities) of countries that request bailouts from the European Financial Stabilization Facility (EFSF) or European Stabilization Mechanism (ESM)

1 Mario Draghi, Global Investment Conference in London, July 26, 2012, p. 2.

and submit to the conditionality associated with such loans. Bond purchases will be unlimited but sterilized, implying that there will be no impact on the money supply. Moreover, the ECB holdings of peripheral debt will be treated *pari passu* to the private sector in any future debt restructuring.

Although the ECB's OMT program will not address the structural flaws in the common currency, it should provide European leaders with some time to lay out a roadmap for an eventual fiscal and banking union. The question is how much lower can peripheral European bond yields go from here? This is of critical importance both for investors in these countries as well as those who have their money in safe haven markets, such as U.S. Treasuries or German Bunds, which have been the primary beneficiaries of capital outflows from peripheral Europe. In the text that follows, we will explore the notion of convertibility risk in the eurozone and try to determine what the fair value of peripheral European government bonds might be in the absence of this risk. We will also discuss the implications for safe-haven markets and global financial markets more broadly.

Overall, based on this analysis, we believe convertibility risk may be adding between 100 and 200 basis points to bond yields across the peripheral European debt markets.

Convertibility versus Default Risk

According to Mr. Draghi, there are at least three components to peripheral European bond yields: liquidity risk, default risk, and convertibility risk.[2] The ECB indirectly addressed liquidity risk earlier this year with the two Long Term Refinancing Operations (LTROs) that injected a half trillion of net liquidity into euro area banks. This money was then partially redeployed by the banks into peripheral sovereign debt markets. While some liquidity premium still persists in the market for peripheral debt, we believe that most of the spread between these bonds and those of core countries such as Germany is explained by default and convertibility risk.

We believe there is little that the ECB can or should do about default risk since it reflects internal factors related to a country's ability to repay its debt. However, Mr. Draghi has argued that it is within the central bank's remit to address any additional convertibility premium that may result from concerns that a country could leave the euro and redenominate its bonds into a weaker currency. The challenge for the ECB is to quantify the convertibility risk premium. We believe it is probably easier to begin with default risk since credit metrics are more readily defined, and then attempt to back into convertibility risk.

There are at least two ways to measure default risk. The first would be using sovereign credit default swaps (CDS), which measure the cost of insuring bonds against default. Yet, the CDS market seems to have the same convertibility risk premium priced into it that we see in the cash bond market. Indeed, Italian 3-year CDS and Italian 3-year government bonds trade at comparable spreads to Germany (see Exhibit 1). In our view, this suggests the market believes that default implies a higher probability of a country dropping out of the euro and reintroducing its home currency.

An alternative way of separating default from convertibility risk may be to look at the yields on euro denominated debt of similarly rated non-euro sovereigns. Theoretically, since they are not members of the euro zone, their bond yields should only reflect default risk. Italy, Spain, Ireland and South Africa are all rated BBB+ by Standard & Poor's, but South Africa trades about 200 basis points tighter to German Bunds. This would suggest that the convertibility premium is considerable and that there is further scope for ECB intervention to have an impact on lowering peripheral European bond yields.

2 *Ibid.*, p. 3.

However, this analysis is far from perfect. For one, it assumes that the ratings agencies' assessment of credit risk is accurate. In our opinion, the yields on peripheral debt appear elevated from where their credit metrics indicate they should be. Therefore, we believe convertibility risk may be adding between 100 and 200 basis points to bond yields across the peripheral European debt markets. The remainder of the yield differential is likely due to default risk in these countries.

From our perspective, the rally seems justified since ECB bond purchases lower the tail risk that rising bond yields in peripheral Europe will result in a solvency crisis in the region.

Exhibit 1 – Sovereign Debt & Credit Default Swap Spreads

Country	S&P Credit Rating	Sovereign Debt Spread to German Bunds	3-year CDS
Poland	A-	100	93
South Africa	BBB+	170	86
Ireland	BBB+	361	417
Italy	BBB+	337	381
Spain	BBB+	398	452
Mexico	BBB	106	67
Hungary	BB+	543	373
Turkey	BB	261	130
Portugal	BB	516	604
Germany	AAA	4	19

Source: Bloomberg as of September 6, 2012.

Implications of ECB Action

The difficulty associated with parsing out convertibility from default risk probably explains why the ECB resisted adopting yield caps for peripheral European debt markets. Yet, the lack of yield caps does not seem to have deterred investors from adding back European risk into their portfolios following the announcement of the OMT program. From our perspective, the rally seems justified since ECB bond purchases lower the tail risk that rising bond yields in peripheral Europe will result in a solvency crisis in the region. This suggests that safe haven markets, such as U.S. Treasuries and German Bunds, may begin to come under some pressure as capital outflows from peripheral Europe begin to abate and potentially reverse. This has also benefited the euro versus the dollar, especially in an environment where the Fed may be considering another round of quantitative easing whereas the ECB has said it will sterilize any intervention.

Yet, questions still remain including whether the recent decline in Spanish and Italian government bond yields will lessen the likelihood that either nation will request a bailout from the EFSF/ESM and be eligible for assistance under the OMT program. Consequently, one cannot rule out further volatility in peripheral European debt markets. In addition, the steps the ECB has taken do little more than buy time for European leaders to address structural flaws in the common currency including the need for a fiscal/banking union, debt mutualization, and common Eurobond issuance. But for now, some of the spotlight will likely shift away from Europe and back onto the United States where the November elections are approaching and there has been little progress on addressing the impending fiscal cliff.

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