February 27, 2012

Wallace's Daily Policy Debrief

Today:

1) **Focusing on Size of Next LTRO Misses the Point-Tom Gallagher**
2) **Congress and Candidates Talk Fiscal Policy – Kim Wallace**
3) **Policy Calendar and Weekly Central Bank Report**

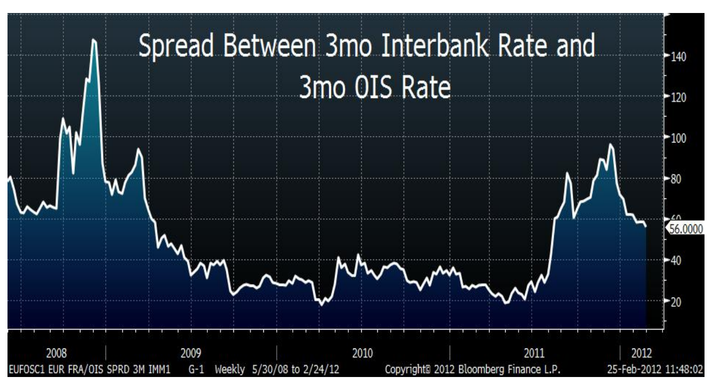
Focusing on Size of Next LTRO Misses the Point

The size of this week's Long Term Repo Operation by the ECB is less important than the adequacy of the Eurozone's macro policy mix, which doesn't look very supportive of growth.

The second of two three-year LTROs announced by the ECB at its December meeting will be held this Wednesday. The first one, held in late December, came in at €489 billion. That was at the high end of expectations, and risk assets initially sold off, presumably on the notion that a high level of bank participation was a sign of how bad the problem was in the European banking sector.

Sentiment shifted quickly of course, and the LTRO is now regarded as the most recent policy move to save civilization as we know it. As a result, markets may respond well to another large take-up on this week's LTRO.

A review of the impact of the first LTRO helps us make the case why the size of the second is not that important. **The most important effect was to reduce substantially the risk of a European banking crisis due to illiquidity.** This chart is a useful measure of perceived European banking sector risk. It has come down significantly since the peak of the crisis in late 2011, back to pre-Lehman levels, but much higher than for most of 2009 and 2010.



To be clear, this is an important effect. The rest of the world can take a European recession, but a European banking crisis is another matter. **But there doesn't seem to have been much of a lift to growth, at least not yet.** There is little evidence that banks are using the 3-year loans to increase their own lending; instead required

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

reserves (a proxy for new lending) at the ECB have actually declined somewhat over the last two months. There has been a notable drop in the yields on key sovereign debt securities (Italy and Spain), possibly because banks haven't had to sell their holdings as much as if there had been no generous LTRO funding option.

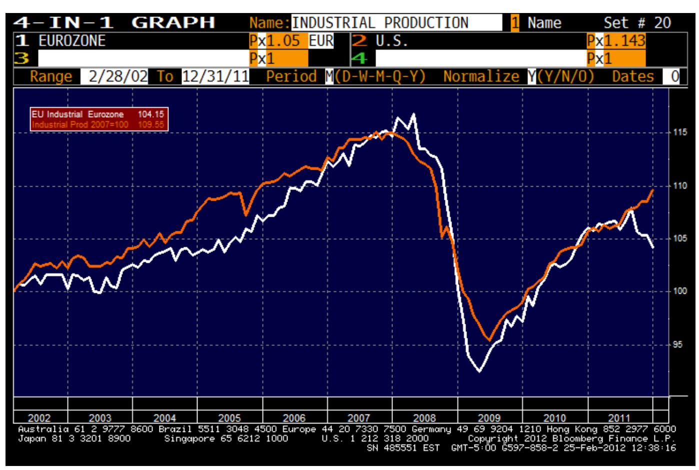
To be sure, there are stimulative effects of the LTROs. Most banks can't get 3-year funding rates at 1%, so there are lowering borrowing costs, and the level of total reserves held by the banking system is higher. **But in a deleveraging environment, the level of interest rates and the quantity of reserves are not the binding constraints on growth.**

The ECB's balance sheet expansion won't have the same impact as the Fed's expansion through QE. In the latter, the Fed is taking on safe assets from the private sector, encouraging private investors to take on more risk. The ECB's balance sheet is expanding due to bank loans through the LTROs – beyond reducing systemic banking sector risk, these don't have the same risk-taking effect as QE. Put another way, if the Fed had expanded its balance sheet through bank liquidity loans instead of bond purchases, it wouldn't have had the same impact on risk assets and the broader economy. In short, we don't see the LTROs as a substitute for easing.

The size of the next LTRO won't tell us much – it will tell us the amount of loans that banks want at these terms. It will tell us how much is needed to produce a well liquefied banking sector. But it won't be a metric on how stimulative ECB policy is going to be. Bank illiquidity was a problem threatening to produce a crisis, and that has been addressed more than adequately; bank liquidity however is not the real constraint on European growth.

On that score, the ECB appears to be ready to sit back after its LTRO has completed. Officials have indicated it doesn't want to make LTROs routine (that doesn't rule out more later of course), they don't appear to want to cut rates below the current 1%, and they are a long ways from quantitative easing. Granted, data from the Eurozone, while recessionary, have been mixed, suggesting the current recession may be shallow. But in terms of a path for GDP growth, the headwinds of fiscal austerity, private sector deleveraging, and bank recapitalization appear quite strong.

The chart on the right was run on the Thompson Reuters Alpha Now blog and points to the diverging trends in industrial production in the Eurozne and the US. It should be pointed out that the data are only through December. **Still, it's ironic that the Fed is the central bank that stands ready to do more, and the ECB is the one exercising more restraint.** - *Tom Gallagher*



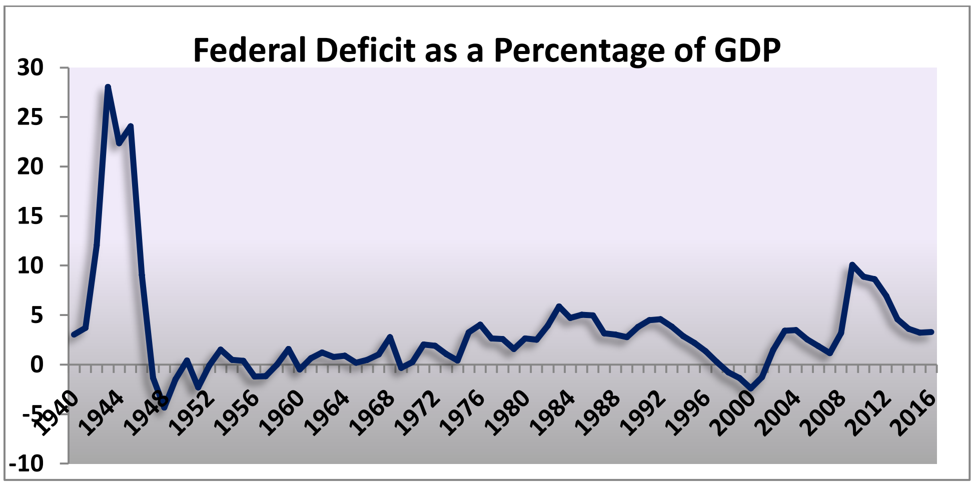
Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

Congress and Candidates Create More Fiscal Air Time

Partisans in Congress and presidential candidates this week will generate plenty of headlines practicing economic and fiscal politics, while the calendar provides more economic indicators important to discerning near-term path. The following picture frames the fiscal debate which will be bathed in electoral politics and might also touch on policy imperative to balance necessary fiscal rebalancing with near-term fiscal drag concerns. Highlights for the week:

- Seven Fed speakers focused on monetary policy, economic outlook and banking sector developments- nothing new.
- Congress holds hearings on housing, tax reform, budget priorities, and monetary policy. None of these hearings set to result in policy or even headlines that would create any volatility.
- GOP primaries in AZ and MI on Tuesday. Santorum has an average advantage of 3 points, down from 6+ points two weeks ago. The latest pro-Romney trend to narrow the gap began two weeks ago and accelerated at the Feb 22 debate in Mesa, AZ. Santorum experiencing similar peak/valley pattern that Perry, Cain, and Gingrich suffered earlier in the primary season.



-Kim Wallace

Policy Calendar Highlights

Monday

- EU Foreign Affairs Council discusses Syria crisis, Brussels
- European Economic Advisory Group launches its annual "Report on the European Economy", Berlin
- GER parliament special session re second GRK assistance package
- US pending home sales

Tuesday

- Senate Banking Committee hearing on housing
- AZ and MI GOP primaries

Wednesday
- House Financial Services Committee semi-annual Humphrey Hawkins hearing
- House Agriculture Committee hearing on CFTC 2012 agenda
- Senate Budget Committee hearing on healthcare spending

Thursday
- Senate Banking Committee semi-annual Humphrey Hawkins hearing
- Senate Foreign Relations hearing on SYR
- Senate Budget Committee hearing on tax reform

Weekend
- G20 leaders' summit in Mexico
- RUS presidential election on Sunday

Central Bank Meetings This Week

Monday, February 27

Israel
- Current bank rate: 2.50% (0.50% real rate)
- Last policy change: 1/23/2012 (-25bps)

Tuesday, February 28

Hungary
- Current bank rate: 7.00% (1.50% real rate)
- Last policy change: 12/20/2011 (+50bps)

Wednesday, February 29

Bulgaria
- Current fixed rate: 0.18% (-2.12% real rate)
- Last policy change: n/a

Thursday, March 1

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

Russia

- Current refinancing rate: 8.00% (3.80% real rate)
- Last policy change: 12/27/2011 (-25bps)

Philippines

- Current overnight rate: 4.25% (0.35% real rate)
- Last policy change: 1/19/2012 (-25bps)

Other Central Bank Events This Week

- **Wednesday** - ECB 3yr LTRO
- **Wednesday-Thursday** – Bernanke Semi-annual monetary policy testimony to the House and Senate Banking committees

Summary of Last Week's Meetings

Country/Region	**Key Rate**	**Other Actions**
Colombia	+25bps to 5.25%	
Namibia	Unchanged at 6.00%	
Belarus	- 500bps to 38.00%	

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

LEGAL DISCLAIMER

Renaissance Macro Research, LLC has entered into a partnership for the distribution of the Macro Policy Report. The Scowcroft Group is paid on a contractual basis. The analyst(s) principally responsible for the preparation of this research report certify that the views expressed in this research report accurately reflect his/her (their) personal views about the subject security (ies) or issuer(s) and that his/her (their) compensation was not, is not, or will not be directly or indirectly related to the specific recommendations or views contained in this research report, as such please read the following disclosures carefully.

Renaissance Macro Research/Rafferty Capital Markets, LLC pays various outside sources for research material regarding investments and securities that such outside sources distribute to their own customers. Renaissance Macro Research/ Rafferty Capital Markets, LLC makes the research material available to its clients. Any recommendation, opinion or advice regarding securities or markets contained in such material does not reflect the views of Renaissance Macro Research/ Rafferty Capital Markets, LLC and Renaissance Macro Research/ Rafferty Capital Markets, LLC does not verify any information included in such material. Renaissance Macro Research/ Rafferty Capital Markets, LLC assumes no responsibility for any fact, recommendation, opinion or advice contained in any such research material and expressly disclaims any responsibility for any decisions or for the suitability of any security or transaction based on it.

Specifically, any decisions you may make to buy, sell or hold a security based on such research will be entirely your own and not in any way deemed to be endorsed or influenced by or attributed to Renaissance Macro Research/ Rafferty Capital Markets, LLC. It is understood that, without exception, any order based on such research that is placed with Renaissance Macro Research/ Rafferty Capital Markets, LLC for execution is and will be treated as an unrecommended and unsolicited order. Further, Renaissance Macro Research/ Rafferty Capital Markets, LLC assumes no responsibility for the accuracy, completeness or timeliness of any such research or for updating such research, which is subject to change without notice at any time Renaissance Macro Research/ Rafferty Capital Markets, LLC does not provide investment, tax or legal advice. Under no circumstance is the information contained within such third party research to be used or considered as an offer to sell or a solicitation of an offer to buy any particular investment/security.

Rafferty Capital Markets, LLC., Member SIPC, FINRA, (the "Firm") does not perform or seek to perform investment-banking services for these companies in the future. Analysts receive no direct compensation in connection with the firm's investment banking business. All Rafferty Capital Markets, LLC employees, including the analyst(s) responsible for preparing this research report, may be eligible to receive non-product or service specific monetary bonus compensation that is based upon various factors, including total revenues of Rafferty Capital Markets, LLC and its affiliates as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by directors, analysts or employees and may effect transactions in and have long or short positions in the securities (options or warrants with respect thereto) mentioned herein.

Although the statements of fact in this report have been obtained from and are based upon recognized statistical services, issuer reports or communications, or other sources that the firm believes to be reliable, we cannot guarantee their accuracy.

All opinions and estimates included constitute the analyst's judgment as of the date of this report and are subject to change without notice. The firm may effect transactions as agent in the securities mentioned herein.

This report is offered for information purposes only, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such would be prohibited.

Additional information available upon request.