

# European Crisis Averted, For Now.

## ECB and Politicians Avert Near Term Disaster

In our November research piece titled ["Tipping Point, November 22, 2011"](#) we opined that financial markets were being pushed into a corner as interest rates were starting to rise and infect core countries like France and Germany. Stresses were building and it was quickly becoming apparent that something needed to be done. Well the ECB and European Union officials did respond, with several programs and one key piece of communication that lead us to believe a near term crisis has been averted. While these programs do not fully solve all of Europe's problems, it does greatly reduce the near term systematic issues being faced by market participants. Below we outline the programs, the communiqué and a key indicator that we feel our important for the markets moving forward.

### ECB Meeting

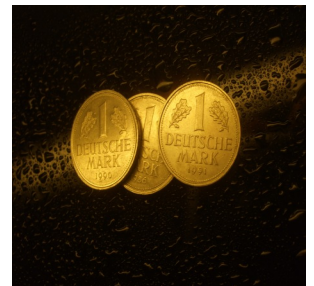
The result of the December 8th European Central Bank (ECB) meeting was critical as the central bank announced various operations that will assist in granting more liquidity into the system and keep borrowing rates low for an extended period of time. First, the ECB governing council introduced a thirty-six month long-term refinancing operation (LTRO) to replace the original twelve month term operation in place currently. An LTRO operation is where a central bank (ECB) lends money to banks at a fixed average rate in return for deposited collateral. It is a form of a carry trade, as banks borrow from the ECB at approximately 1% and use proceeds to buy sovereign debt at many multiples of that. It is also back-door way for the ECB to take on sovereign debt to its balance sheet without having to violate treaties by purchasing debt directly from individual governments. While a similar program had been in effect prior to the meeting, we believe the extended term of the program is of material importance as it gives banks a lengthier period to offload debt to the ECB, build retained earnings and keep interest rates on some sovereigns under control.

The second announcement of importance was the ECB's willingness to relax the rating threshold on asset backed securities (ABS) which it will accept as collateral. This action is fairly self explanatory as it helps create additionally liquidity and demonstrates to markets the central bank's accommodative stance to remedy the situation.

Finally, the ECB reduced the reserve ratio, currently at 2%, down to 1%. This will free up approximately \$100 billion in collateral and hopefully reduce stress in the money markets.

### Merkel and Sarkozy's Agreement

On December 6th, Merkel and Sarkozy announced a new fiscal framework that contained rules which are to become applicable for 26 of the 27 European Union members. While there remains much discussion on exactly how this will play out and which countries finally sign up, the true gem was below the headlines. In an apparent concession to France, Merkel agreed that future private sector bond holders would not be subjected to forced losses but instead oblige themselves to collective *(cont page 2)*



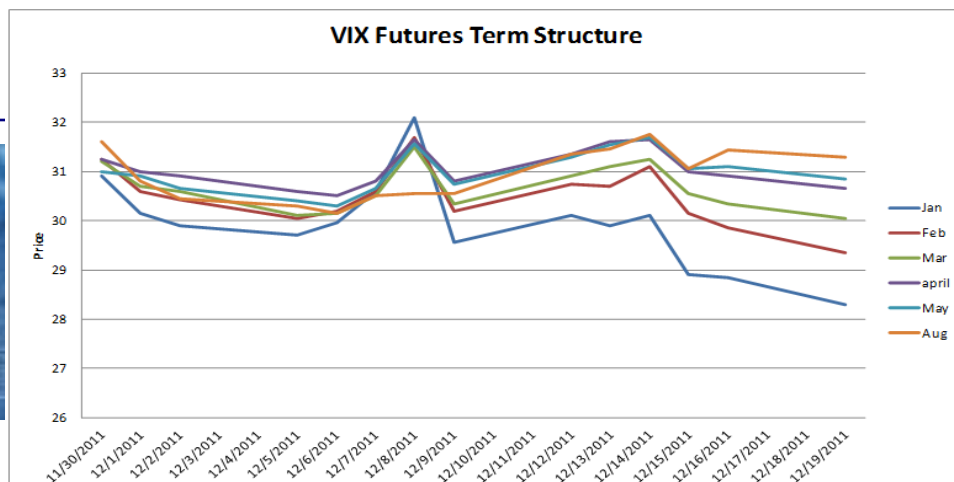
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action clauses (CAC). Collective action clauses lay out ground rules for a potential voluntary rescheduling of private debt if 75% of the bond holders agree. This creates clarity on the playing field as borrowers and lenders are clear on the rules of the road. Merkel's position reversal is important as it signals to investors that "Europe is a safe place to invest" and they will not be incinerated by government policy like what Hank Paulson did to investors of Fannie Mae and Freddie Mac in 2008. Mr. Paulson's actions greatly exacerbated the 2008 financial crisis as it chased capital away from financial institutions that were greatly in need. Finally, collective action clauses are already used in many types of sovereign debt and were successfully utilized to resolve Latin American restructurings in the 1990s.

### Volatility Futures

As we reconciled the above information we also analyzed an interesting development in volatility futures that appeared to confirm our belief that a near term crisis was abating. Volatility futures measure future expectations of volatility and typically falling equity markets correlate with increased volatility. However, following the December 8th ECB meeting volatility futures broke significantly lower in January, February and March contracts (see Chart 1) and continued to trend lower even as equity prices fell last week. This was unusual and while we may have considered a decline in January volatility to be seasonal, we consider the decline in volatility over the bulk of the term structure to be generally positive for the underlying market in the near term.

Chart 1: source CBOE



### Conclusion

As for now, a serious crisis has been averted but this is by no means an all clear for the longer term. While officials have provided a substantial amount of liquidity and greater clarity, they must gain on this positive momentum by establishing initiatives to spur growth and get uncompetitive economies going in the right direction. If they fail to utilize this time wisely the window of opportunity will close and markets will surely revolt again. As for Fourth Quadrant Asset Management, we are cautiously optimistic on 2012 but we will use the opportunity of lower levels of implied volatility and higher equity prices to establish attractive equity hedges for our client accounts.

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