Insights

Crossing the Rubicon

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Mario Draghi has crossed the Rubicon by recently announcing that the European Central Bank (ECB) will start to conduct asset purchases as an additional form of market support. There is no turning back now as this measure by a central bank to stabilize an economy is difficult to reverse once it is implemented. What we can expect going forward from the ECB, regulators and lawmakers, is continued support mechanisms to increase European bank lending capacity by transferring risk from the bank sector to the non-bank sector—similar to what we have observed in the U.S. Transferring risk to the non-bank sector and kick-starting lending to the real economy is specifically what the ECB's purchase program is designed to do. A new fixed income investment dynamic has been set in motion, which we believe will have a significant impact on market performance for many months to come.

Upon the ECB's announcement on October 2 to pursue an asset purchase program for covered bonds and asset backed securities (ABS), the market seemed disappointed that Draghi was not more explicit about the size of the program and did not reemphasize an expansion in the ECB's balance sheet. We believe this is short-sighted and misses the point. The longer-term significance of this action by the ECB is that it expands their tool-kit to support the Eurozone economy by easing financial conditions through the credit channel, rather than just being restricted to providing support through the interest rate channel.

Asset purchases have an effect that extends beyond the expansion of the ECB's balance sheet, weakening the euro and increasing inflation expectations. Purchasing ABS has both the impact of directing credit to the real economy and also transfers risk from the bank sector to the non-bank sector. Since banks are a contingent liability on the sovereign, this transfer helps reduce the linkage between the banks and the sovereign. Thus political leaders and lawmakers may also find incentives to support the ECB's plan.

From an investment perspective, we see this as an opportunity to add uncorrelated risk to portfolios and add alpha. This can be achieved by investors finding opportunities to buy assets in the Eurozone that may benefit from easier credit polices from the ECB versus underweighting investments that might come under pressure due to the Fed ending its own asset purchase program and from expectations for the interest rate policy cycle to shift toward rising rates. Effectively, investors can play one policy cycle against another.

Sequencing of policy support

Investors in European fixed income assets can learn a lot from the sequence of post-crisis support facilities in the U.S. When the U.S. experienced its own banking crisis, the sequence of policy responses were as follows: 1) recapitalization of the banks (TARP)[1];

[1] TARP (Troubled Asset Relief Program): This was a US government sponsored program to purchase or insure troubled assets, such as residential and commercial mortgages, among others, in order to stabilize the financial markets. The size was $700bn and was signed into law on October 3, 2008 by President George Bush.

2) de-levering banks by transferring risk, mainly legacy assets, from the bank sector to the non-bank sector (e.g., TALF, PPIP among many others)[2], which had the effect of creating new lending capacity from the banks; 3) reflation of asset prices (QE1, QE2 and QE3)[3] and re-levering the banks by incentivizing them to make new loans to direct credit to the real economy. Even to this day, despite the fact that the U.S. is past the peak of its crisis, regulators are still making changes to incentivize and support new credit creation, especially as it pertains to residential housing.

Clearly, this is a summary version of the events that occurred in the U.S., nevertheless, we believe Europe may follow this same script, but of course, not exactly. As we know, there are many differences between the U.S. and the European Union; however, we are encouraged by the fact that European governments and the ECB have already taken the critical first step of providing cheap capital to the banks to shore up capital requirements. Furthermore, they are already discussing ways to implement the next two steps, supporting a risk transfer of assets to the non-bank sector (i.e., the investor community) and directing credit to the real economy. This is where we see investment opportunities.

Now that the ECB will become the regulator for Eurozone banks, they can catalyze the risk transfer process from the bank to the non-bank sector. Part of this risk transfer involves European banks selling pools of loans, or ABS, from their balance sheets to the non-bank investment community. Effectively, this makes room on bank balance sheets such that they will have additional lending capacity to support financing of economic activity. Said differently, shifting the risk transfer process directs credit to the real economy, a long-held policy goal of the ECB to support the broad Eurozone economy.

However, the markets have doubts as to how effective the ECB's plan will be. Of course, this should not surprise anyone as there were many doubts as to how this policy would work in the U.S., where, ultimately, we saw that the Fed ultimately succeeded in reflating asset prices, which represented a great investment opportunity. But what should not be overlooked were the many policy and regulatory changes that occurred in the U.S. to create this success. We see European policy support only at the beginning stages of making these changes. Investors should try to be patient during this transition and consider that implementing such a measure will be more difficult for an eighteen member European Union than one United States. We feel that an opportunity will present itself as the ECB's program takes root and the EU governments develop the accompanying supportive legislation.

Leverage: Once the problem, but maybe now the solution

Overleveraging financial assets was the source of the financial crisis, but ironically, leveraging support facilities was the key to the success of the financial market recovery in the U.S. For instance, the U.S. Treasury, through its $700bn TARP facility, initially agreed to provide up to $20bn in capital to TALF, putting the U.S. Treasury first in line to absorb any potential losses from the program. This leveraged U.S. Treasury funds by a 10:1 margin by providing TALF with the capacity to lend up to $200bn.

Additionally, U.S. policy makers launched the PPIP as a plan for the private sector and the government to partner in buying distressed assets during the crisis in order to increase buying power. Structural leverage was created by secured non-recourse debt financing provided by the U.S. Treasury, Federal Deposit Insurance Corp. (FDIC) and the Fed. Equity capital was provided by both the U.S. Treasury and private investors. These were extreme support measures undertaken by the U.S., but one must remember that this was at the height of the financial crisis and these facilities were designed to "unfreeze" what were then frozen asset markets.

Conditions are not as bad currently in Europe than in the U.S. when it implemented its market support programs. Asset markets are actively trading and banks are awash in liquidity. Nevertheless, the success of leveraging these programs is a lesson not lost on the ECB. Already, policy makers in Europe are discussing regulatory changes to make it easier for banks to package and sell pools of loans into the market in the form of ABS. Additionally, the EIB[4] released a whitepaper on October 23 entitled, "Unlocking Lending in Europe", which proposes a plan for the EIB to support the ABS market through mezzanine tranche guarantees across Europe. Effectively, this provides structural leverage to the ECB's ABS purchase program.

It is reassuring that discussions surrounding guarantees of mezzanine tranches of ABS have started and may be presented to the European Council at their December meeting. This is because it increases the ECB's potential buying power for ABS since they have already declared that they will only buy guaranteed tranches of ABS in their purchase program. Banks also benefit from this because bank balance sheet deconsolidation is enhanced by receiving the full capital benefits of issuing ABS if it is able to sell the riskier tranches of the deal. The benefit for the Eurozone

[2] TALF (Term Asset Backed Loan Facility): Announced in November of 2008, this facility was designed to support new lending to households, small businesses and large corporations by providing liquidity to the frozen ABS market. PPIP (Public-Private Investment Program): Announced in March 2009 as a plan to transfer risk of legacy assets from the bank sector to the non-bank investment sector. This program was sponsored by the government and provided structural leverage to the private non-bank sector to buy illiquid and hard to price assets. Purchases were facilitated through the PPIF (Public-Private Investment Facility).

[3] QE refers to quantitative easing.

[4] EIB (European Investment Bank) is the European Union's bank which is owned by and representing the interests of European Union member states.

comes from banks selling existing pools of loans from their balance sheets as a means of creating lending capacity to make new loans and direct credit to the real economy. We expect more details on this plan in the coming months.

Conclusion

Recognizing policy driven investment opportunities in Europe may be a difficult first step because there are many uncertainties, similar to the way it was in the U.S. We believe the ECB may ultimately prevail and reflate asset prices in the process. The market should interpret the ECB asset support plans in the context of sequencing, meaning that we believe their decision to buy ABS and covered bonds is the first of many forms of credit easing and creative ways to support this plan in the days to come. Once the die has been cast for central bank policy to buy assets as a means of support, there will be no turning back.

About the Author

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Jim is a portfolio manager and senior member of the MSIM Global Fixed Income team and a member of the Asset Allocation Committee focusing on macro strategies. He joined Morgan Stanley in 2006 and has 22 years of investment experience. Prior to this role, Jim held the position of global head of interest rates, foreign exchange and emerging markets strategy with Morgan Stanley Research. He authored two interest rate publications, the monthly Global Perspectives and the weekly Interest Rate Strategist. Previously, he was a director at Merrill Lynch where he headed the U.S. interest rate strategy group. Prior to that, Jim held various trading positions. He headed the U.S. options trading desk at Sanwa Bank, was a proprietary trader at Tokai Securities and traded U.S. Treasuries at JP Morgan. Jim received a B.A. in physics from Bowdoin College, a B.S. in aeronautical engineering from the California Institute of Technology and an M.B.A. in finance from New York University, Stern School of Business.

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1050176 Exp. 10/29/2015 8055294_KC_1014 Lit-Link: INSIGHTSGFI 11/14