

Three little PIGS

This little piggy went to Merkel, this little piggy stayed in Rome This little piggy had a huge beef, this little piggy just loaned And this little piggy was a naughty little piggy And went "oui oui oui" all the way home…

We think it is reasonable to ask whether the EUR500 billion European Stability Mechanism (ESM) is just a house of straw that the latest EU summit failed to upgrade to a house of sticks, let alone bricks? Is it too weak, even if it was merged with the European Financial Stability Facility (EFSF) and fully funded (which it isn't)? As EU and ECB officials get ready for the mass summer holiday getaway thinking that the eurozone is fixed, we believe that little has changed. To us it appears wishful thinking to believe that the big bad market wolf will not return before September. After all, this happened last year when the market sell-off forced many to come back early as the second Greek crisis blew up. The question of whether this latest summit will be 20th time lucky is moot. The ESM pot of money is still too small to scupper the market wolf when it comes back looking for more. Para phrasing David Cameron, if you are going to bring a bazooka, make sure it is a big bazooka!

The latest EU summit ended on a positive note as EU leaders struck yet another minute-to-midnight deal to allow the eurozone rescue funds to buy Italian and Spanish government bonds without channelling the money through their respective governments. The euro immediately rose 2% on the news and Spanish yields fell 0.7% from the critical 7% and Italian yields simultaneously fell below the 6% level. However, we've been here before and it is too early for officials to claim the eurozone has moved to the relative comfort of a house of sticks. These rates are not sustainable for any government in the long term. Despite all the headlines, summits and red carpets we are starting to see the resistance from Germany with Angela Merkel keen to restore her image from the media already writing her epitaph. Her assertion that an EU-wide Banking Supervisor (to administer the funding) will take a year to set up is simply too far away for markets to tolerate. Moreover, the conditions stipulated are inconsistent and do not create EU accord. We understand that whilst Spanish bailout money will rank the same as existing creditors, the same will not apply for holders of Italian debt. Therefore, an inevitable buying program of Italian debt will result in existing holders being subordinated behind the ESM. This is hard to reconcile with the political agenda of greater commonality and throws a bucket of cold water over the terms being retrospectively rolled out to Ireland and Portugal; who were getting quite excited on the summit sidelines. In short, it simply doesn't stack up to a credible plan and thus we see little progress from this time last week. Already the Netherlands is opposing the bond-buying program and Finland will most likely veto the plan outright. The Euro is weakening again with Spanish and Italian yields starting to rise. This suggests that there is a feeling that the plan is unravelling and the realisation that we are still very far away from the security of a eurozone built of bricks.

The analogy of the Three Little Pigs is a faintly humorous take on events, but the bond markets are no laughing matter. They are the ultimate barometer of sentiment and sovereign credibility. They demand constant monitoring in these volatile times and a scrutiny of the political manoeuvrings which have been exasperating in their ability to disappoint. The week ahead will provide much anticipated data for global industrial production and economic activity as well as the important employment data from the US on Friday. Whilst we expect some improvement in recent macroeconomic indicators, we suspect that those officials jetting off to Cyprus (a 5th eurozone bailout candidate) may be just a little premature in thinking the eurozone crisis is over.

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