Aitken Advisors

Some observations on the plumbing.

April 11th, 2012

Aitken Advisors

AITKEN ADVISORS

AITKEN ADVISORS

Objectives:

1. In a financed financial system, collateral is money

2. EMU: it's over

AITKEN ADVISORS

1. In a financed financial system, collateral is money

AITKEN ADVISORS

Velocity of collateral:

the number of times a financial instrument received as collateral can be sold, or repledged

Large banks and dealers use and reuse collateral pledged by nonbanks, which helps lubricate the global financial system

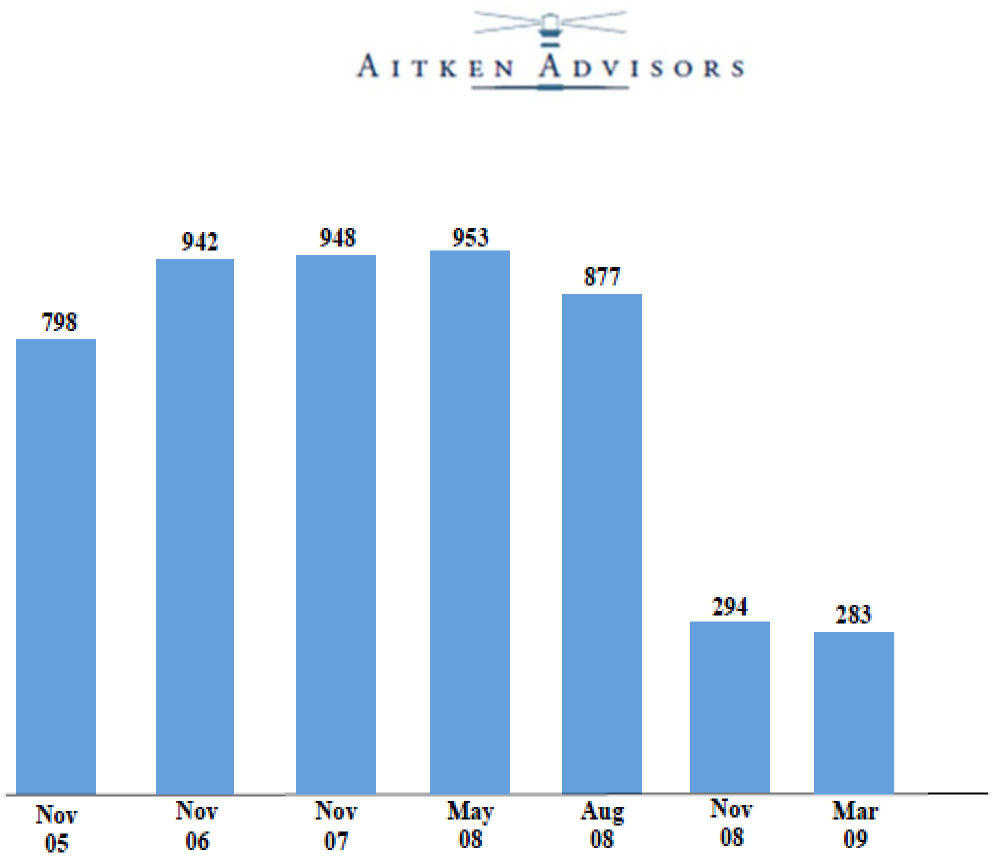


Figure 11: Securities pledged to Morgan Stanley that were available to be repledged to third parties. Data source: Aitken and Singh (2009), from SEC filings. Figure source: Duffie (2010).

Post Lehman, there has been a significant decline in the source of collateral for the large dealers that specialise in intermediating pledgeable collateral

AITKEN ADVISORS

The overall effect may have been a $4-5 trillion reduction in high-grade collateral circulating in the US financial system

AITKEN ADVISORS

This decline in financial lubrication likely has an impact on the conduct of global monetary policy

...but remember ‘subprime is contained?’

Why?

New classical, new Keynesian, DSGE models: the crisis was not supposed to happen.

Indeed, it could *not* happen.

Aitken Advisors

These models rule out extended economic disequilibria by assumption..

AITKEN ADVISORS

....and pay little if any attention to the factors now commonly believed to have both precipitated the crisis and to have contributed to its longevity

Aitken Advisors

Worse, recent regulations aimed at financial stability, focussing on building equity and liquidity buffers, reducing leverage, and segregation of margin will also reduce financial lubrication between banks and nonbanks

Aitken Advisors

From 2011 10-Ks:

'Fair value of financial instruments received as collateral that can be sold, or repledged'

Morgan Stanley: $488 billion, of which $335 billion sold or repledged (69%)

Goldman Sachs: $622 billion, of which $454 billion sold or repledged (73%)

JPMorgan: $742.1 billion, of which '$515.8 billion [69%] was sold or repledged, generally as collateral under repurchase agreements, securities lending agreements or to cover short sales and to collateralize deposits and derivative agreements'

Aitken Advisors

Keynes:

Precautionary demand for cash balances, defined as those being held for fear of not being able to meet future obligations

AITKEN ADVISORS

Lessons from AIG & Lehman:

1) for banks: you will need more collateral than you think

2) for investors: keep that collateral in a segregated account

AITKEN ADVISORS

<u>In a financed financial system, collateral is money</u>.

AITKEN ADVISORS

3. EMU: it's over.

Aitken Advisors

Verdun
22 September, 1984

AITKEN ADVISORS

Schuman Declaration

AITKEN ADVISORS

Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity

Aitken Advisors

The coming together of the nations of Europe requires the elimination of the age-old opposition of France and Germany. Any action taken must in the first place concern these two countries.

AITKEN ADVISORS

The convergence criteria within The Maastricht Treaty were designed to ensure that a Member State’s economy was sufficiently prepared for the adoption of the single currency.

Aitken Advisors

They provided a common baseline indicator of the stability, soundness and sustainability of Member State public finances that reflected economic policy convergence and a resilience to economic shocks..

AITKEN ADVISORS

The signatories gambled was that you could create a monetary union before you created a political union, and by the time the inevitable crisis arrived, you would have the institutional infrastructure to deal with it

AITKEN ADVISORS

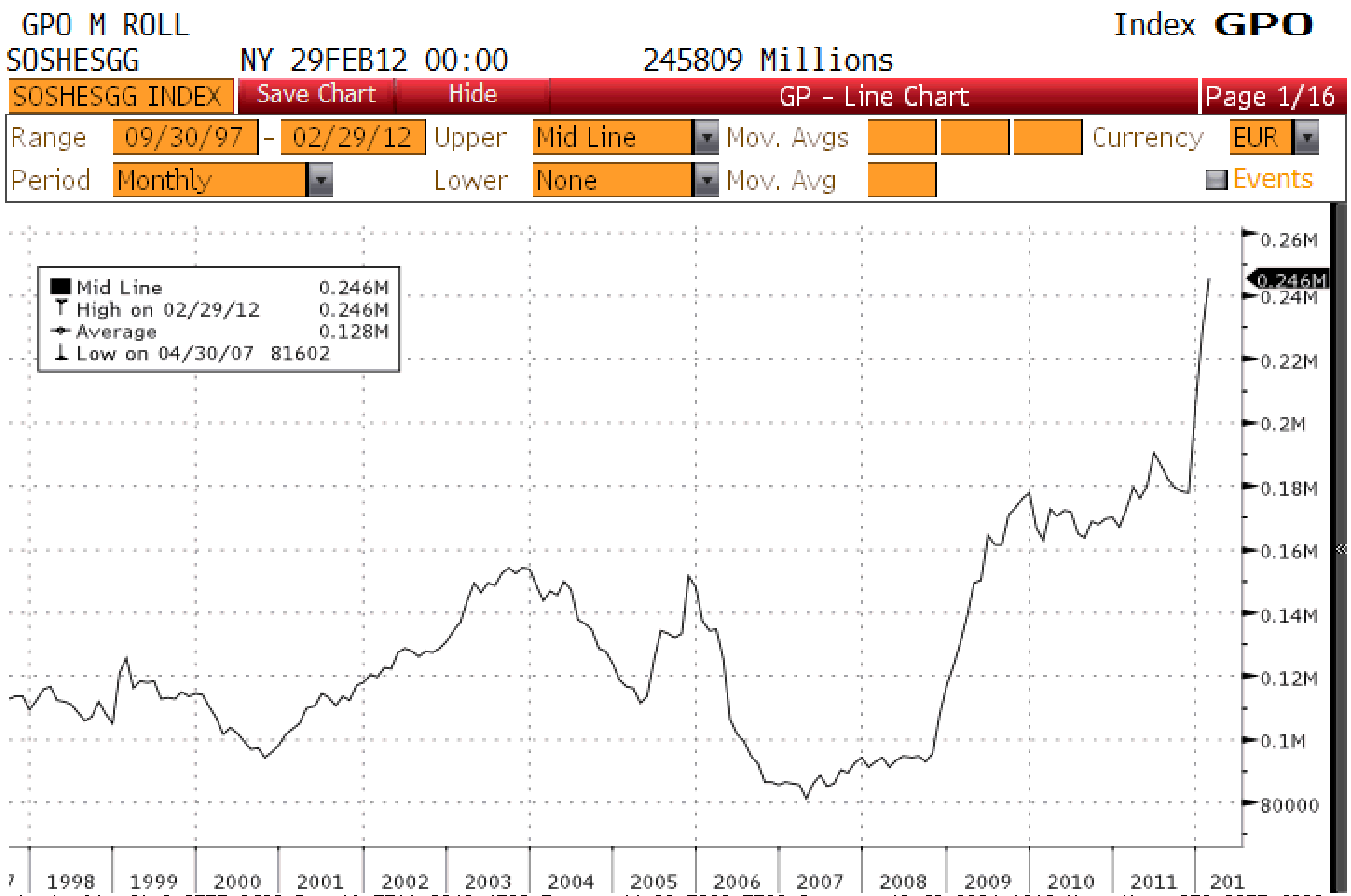
What’s the problem?

A consensus is emerging – better late than never – that the euro zone crisis is also at its root a pure balance-of-payments crisis...

AITKEN ADVISORS

..in which a number of key peripheral countries with current account deficits are struggling to fund themselves at the right price..

....and in which austerity is only just beginning.



GPO M ROLL
Index GPO
SOSHESGG NY 29FEB12 00:00 245809 Millions
SOSHESGG INDEX
Save Chart
Hide
GP - Line Chart
Page 1/16
Range 09/30/97 - 02/29/12
Upper Mid Line
Mov. Avgs
Currency EUR
Period Monthly
Lower None
Mov. Avg
Events
Mid Line 0.246M
High on 02/29/12 0.246M
Average 0.128M
Low on 04/30/07 81602
0.26M
0.246M
0.24M
0.22M
0.2M
0.18M
0.16M
0.14M
0.12M
0.1M
80000
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
201


GP M ROLL
Index GP
SOSHITGG NY 29FEB12 00:00 301642 Millions
SOSHITGG INDEX
Save Chart
Hide
GP - Line Chart
Page 1/6
Range 09/30/97 - 02/29/12
Upper Mid Line
Mov. Avgs
Currency EUR
Period Monthly
Lower None
Mov. Avg
Events
Mid Line 0.302M
High on 02/29/12 0.302M
Average 0.194M
Low on 12/31/00 0.151M
0.302M
0.28M
0.26M
0.24M
0.22M
0.2M
0.18M
0.16M
0.14M
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
201
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2012 Bloomberg Finance L.P.
SN 528572 GMT+1:00 H259-623-1 08-Apr-2012 21:43:38


GP M ROLL
Index GP
SPLBTOBO NY 29FEB12 00:00 169.802 Billions
SPLBTOBO INDEX
Save Chart
Hide
GP - Line Chart
Page 1/6
Range 01/31/99 - 02/29/12
Upper Mid Line
Mov. Avgs
Period Monthly
Lower None
Mov. Avg
Events
Mid Line 169.802
High on 02/29/12 169.802
Average 39.033
Low on 04/30/99 9.977
180
169.802
160
140
120
100
80
60
40
20
0
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
201
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2012 Bloomberg Finance L.P.
SN 528572 GMT+1:00 H259-623-1 08-Apr-2012 21:44:20


GP M ROLL
Index GP
ASSICNTR NY 31MAR12 00:00 270.05 Billions
ASSICNTR INDEX
Save Chart
Hide
GP - Line Chart
Page 1/6
Range 09/30/97 - 03/31/12
Upper Mid Line
Mov. Avgs
Currency EUR
Period Monthly
Lower None
Mov. Avg
Events
Mid Line 270.05
High on 03/31/12 270.05
Average 29.47
Low on 04/30/03 5.65
270.05
250
200
150
100
50
0
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2012 Bloomberg Finance L.P.
SN 528572 GMT+1:00 H259-623-1 08-Apr-2012 21:45:10

Please be careful to distinguish between austerity measures *passed*, and austerity measures *implemented*

AITKEN ADVISORS

Aitken Advisors

How did EMU run out of eligible collateral?

Where did that Euro 14 trillion of eligible collateral go?

Aitken Advisors

Answer: nowhere, and that is the problem


EXP FEB 2015
1.0% Interest
LTRO
Injection
1018.7bn

Aitken Advisors

Genius of Draghi's LTROs?

For the first time in over two years, European banks had liability stability.

AITKEN ADVISORS

Liability stability:

* no rollover risk
* no involuntary deleveraging
* ability to take ECB money and (for example) buy back debt at a discount
* capital constructive rather than capital destructive

Aitken Advisors

Downside?

Correlations increased as MFIs increase exposure to the same credits that got them into such trouble in the first place...

AITKEN ADVISORS

...at a time when austerity is only just beginning.

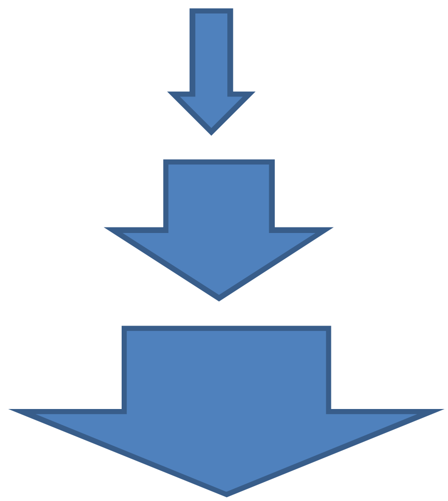
AITKEN ADVISORS

Bigger firewalls?

OR

Creating the right incentives for buy-and-hold credit and fixed income investors to return to peripheral European credits with confidence?

Aitken Advisors



Subordination risk?

What can the ECB do:

* cut rates?
* further loose collateral guidelines?
*(~~trash-talk the euro~~)

..nothing to stop ECB cutting below 1.0%, which would increase the positive carry of the ECB's LTROs

AITKEN ADVISORS

How about loosening collateral guidelines even further?

AITKEN ADVISORS

<u>The looser the collateral guidelines, the bigger the haircut, the less the bang for the ECB's buck</u>.

AITKEN ADVISORS

New collateral guidelines = credit risk absorbed by national central banks

Aitken Advisors

Balkanisation of collateral guidelines across EMU = credit nationalism

AITKEN ADVISORS

What should you do?

Aitken Advisors

If you think, like me, EMU is slowly and occasionally rapidly disintegrating before your eyes then the question you should be asking yourself every day is this:

AITKEN ADVISORS

‘How do I reduce my gross exposure to European credits and European banks to zero?’

In the absence of adequate hedges, the answer is ‘never take the exposure in the first place’.

Aitken Advisors

Thank you for your attention.