Did Mrs Merkel really offer material concessions at the recent EU Summit on the 28/29th June. Hollande, Monti and Rajoy had big grins on their faces and the press and a number of analysts certainly believe that she did. In addition, she faced a stormy meeting at the Bundestag last Friday, particularly with a number (especially in her own party) accusing her of doing an "180 degree U turn". However, Germany, last Friday, passed the necessary legislation in respect of (a) the fiscal compact and (b) establishing the ESM, by comfortably more than the 2/3rds majority needed, as was planned. On a closer assessment however, I'm not sure whether Frau Merkel's "concessions" were that important and, in addition, I believe she has pushed the EZ further further down the road of fiscal, banking and ultimately political union, the ultimate policy objective of Germany/Mrs Merkel. Finally, Mrs Merkel has not increased Germany's financial commitment to the EZ and/or conceded to mutualising debt ie Euro bonds or an EZ wide deposit guarantee scheme.

The key "concessions" were that Germany agreed that (a) Spanish banks would be recapitalised directly, without the funds being provided to the state, thereby reducing the Spanish debt to GDP by around 10 percentage points, (b) that the funds provided by the EZ rescue vehicles to Spain would not rank ahead of private sector creditors and (c) that (meeting an Italian requirement) the ESM could intervene in debt markets if applicable. I had discussed the possibility/likelihood of (a) and (b) in a note on the 27th June. The establishment of ECB as the banking supervisor (powers and scope of responsibilities to be negotiated) by the year end, is the major precondition to any country (Spain) being granted direct aid for its banks - sounds like a great incentive for Spain to push for its implementation as soon as possible. Also will be the case for Italy, which may well isolate France - very interesting, me thinks.

Personally, I believe, quite strongly, that Mrs M went into the meeting prepared to concede on points (a) and (b) above and, as a result, the view that she was forced to offer a number of "concessions" is misplaced.

The recapitalisation of Spanish banks will be subject to "strict conditions" Mrs Merkel repeated last Friday, though no details were provided. In addition, if bail out funds were provided to Spain, rather than, as is now the case, directly to the banks, Spanish debt to GDP would increase to around 90% by the end of this year, forcing Spain to request a fully fledged bail out sooner than otherwise - clearly in no ones interest. Avoiding the thorny issue of subordination reduces interest rates for Spain and allows the country to survive for a while longer, without the need for assistance, though will need a bailout programme in due course.

The Italian PM, Mr Monti gained a "concession" in that the ESM will be able to buy peripheral
country bonds ie Italian bonds, thereby reducing interest rates, though he failed in his demand that measures be put in place that would automatically trigger a bailout, if yields rose above certain (unsustainable) levels. However, once again, Mrs Merkel has insisted on "strict conditionality" - indeed at her press conference, I heard her say that such action would require the consent of EVERY EZ member ie Germany, Austria, Finland and Holland, who are certainly not going to give the farm away. This seems to differ from the view that a bailout would come with a lighter set of conditions, as expressed by Monti and supported by Mr Rompuy - by the way, denied by Germany, Holland and Finland - whose views I would tend to believe, rather than Mr Monti's and/or Mr Rompuy. Indeed, the Dutch were even more strident than the Germans on this issue. They stated "It is absolutely clear that all the decisions taken last night were under the explicit understanding that the conditionality would remain unchanged". Does not seem like a free pass to me. Basically, it means that any country accessing the bailout funds will be subject to full-scale monitoring by the EU/ECB. By the way, Mr Monti hinted that Italy may want to tap the bailout funds. He stated "Italy doesn't plan to activate the mechanism for now, but I don't exclude anything in the future".

Creating a new system of European banking supervision (importantly through the ECB, rather than the EU) is a step towards banking union, leading to fiscal and political union. As it is the ECB, fudges and fixes (so common in the EU) will be far more difficult. Once again, Mrs Merkel has achieved the concept of adherence to rules and movement away from the bureaucratic, incompetent,..........EU.

The real winner following the Summit was Ireland. EZ leaders agreed to "examine the situation of the Irish financial sector with a view of further improving the sustainability of the well-performing adjustment programme". Essentially, Ireland will be able to exclude a significant part of its E64bn of debt incurred to bail out its banks, from its national debt (the loans will be provided directly to the banks, as is the case for Spain) and, as a result, Irish debt to GDP will decline from the expected 120% next year to around 90%, possibly even lower. Furthermore, Ireland will be able to access the international capital markets once again imminently, most likely through the issue of short dated bills initially, followed by longer term bonds. Irish sovereign bond yields are collapsing, following Fridays deal - excellent news. Importantly, the EZ can claim its first success in Ireland. I suspect a number will be looking at buying bombed out Irish property, boys and girls - prices are down between 50% to 60% from their peak levels.

The bottom line was that Mrs Merkel realised that markets were unlikely to provide further time to the politicians and that she had to come up with something, or there really would have been "blood on the streets". Yields on Italian and Spanish debt would have risen to unsustainable levels, without some kind of deal, necessitating bailouts. However, far more importantly, she has forced the relevant EZ countries to accept that they will be subject to further and stricter rules (whatever they may say) and, indeed, has pressed forward the German/Mrs Merkel policy for a banking, fiscal and, ultimately political union within the EZ.
After all, the imposition of a EZ wide banking supervisor takes away sovereign control of a country's financial institutions - a key step ahead of fiscal and political union. Clearly, Mrs Merkel has also achieved progress on her key goals, by forcing rules (to be determined), which will instill further disciple on a number of EZ countries and I for one am convinced that history will (ultimately) see this as a (major) win for Mrs Merkel. I beginning to like this woman more and more. The other real winner last Friday was Mr Draghi at the ECB.

Numerous analysts and the press remain highly sceptical. I can understand that, given the EZ's history. However, I take Friday's moves far more positively. One of the most important and immediate issues remains the firepower available to the ESM. The EFSF and the ESM simply do not have sufficient financial resources to meet expected demands. At present, no one has suggested that its firepower will be increased - certainly not the Germans, in particular, given their unexpected Constitutional Court issues that they are facing at this moment. However, in due course, the ESM will either have to be granted a banking licence, or it will have to be able to issue bonds which will be bought by the ECB, thereby increasing its firepower materially - there is no other alternative - the figures do not add up otherwise. I am convinced that the Germans understand this, but remain coy on the subject, given the pending Constitutional Court issues, in particular.

I have been cynical/sceptical for some time now, but I really do believe that we have an initial basis to progress to some form of resolution. Its not going to be a straight line, but the move towards EZ fiscal, banking and political union remains unbroken. The thorny issue of the UK will come up pretty soon, given the UK's large banking sector, in particular - these negotiations are going to be difficult to say the least, as the current administration will find it near impossible to concede to the EU. However, France will remain the biggest problem, but I really cannot see what alternative (other than ultimately agreeing to fiscal union) that they have. However, I will never underestimate the dangers inherent in French political decisions and/or the ability of the French to take to the streets.

I had previously suggested that it was dangerous to be short the equity markets. Personally, I was also nibbling away at equities, as you know. However, I added significantly to my equity positions on Friday and will continue to do so.

I also believe that yields on 10 year French and German bonds will continue to rise - for example, from a low of around 1.17% (10 year German bunds) at the beginning of June, to 1.58% on Friday - all in a month !!!!! has been a great short so far. French 10 year yields have also risen, to 2.70% at present.

The Euro, well its popped up, but I remain of the view that it will weaken. Next week, the ECB is likely to deliver an interest rate cut (need to consider impact on short French/German 10 year bonds) of at least 25 bps (50bps is certainly a possibility) and quite possibly a cut in their deposit rate from the current 25bps to zero - in an attempt to stop banks depositing funds
with them and to lend instead.

The other issue is inflation. Whilst inflation is declining at present, allowing the ECB to act to cut its benchmark interest rate, I believe that ultimately inflation in the EZ will have to rise to reduce the real value of existing debt - however, that's for another day.

US second Q earnings season is coming up fast and there are some negative indications. However, I am bullish, certainly far more so on Europe, following Friday's announcement.

Kiron Sarkar

30th June 2012