Why The Mario Put is Bullish for Stocks

It’s taken many observers including me longer than it might to comprehend, but ECB chairman Mario Draghi has done something that should be very bullish for U.S. stocks. Floyd Norris noted some of the ramifications in today’s New York Times. The Long Term Repurchase Operation (LTRO) in effect is an extension of credit from the ECB to EU sovereigns.

How can this be, when Mr. Draghi said all along he would not lend directly to governments? Because of the symbiotic relationship that exists between EU governments and their banks. The banks own most of the debt. If the banks can’t afford to roll over maturing bonds governments will default. If governments default banks will go with them. Both are locked together, and we believed that the ECB was holding off from proving needed sustenance while the politicians showed some evidence of imposing fiscal austerity. They (sort of) did at the last summit, and now the ECB has taken a path from which it will be difficult to turn.

Eurozone banks took down 489 billion Euros of three year loans at 1% this week. Whether they choose to buy sovereign debt or not is really not the point. They can, and now whenever the banks appear sufficiently shaky that they won’t be able to finance what their sovereigns need, the ECB can be relied upon to provide it. There will no doubt be more brinkmanship and dire warnings about delaying needed economic reforms in the south, but the problem has always been the absence of a credible punishment to wavering countries. The Maastricht Treaty incorporated enormous fees (1% of a country’s GDP) that were soon shown to be implausible when Germany and France were among the first to breach the 3% deficit/GDP criteria. Forcing a country to default is clearly unacceptable. The Eurozone’s countries are all roped together, and the ECB recognizes that pushing one off the cliff endangers them all. The ECB is the lender of last resort to banks. It has become the lender of last resort to EU governments as well, and Germany as a guarantor of the ECB’s balance sheet is now part of this solution.

This is not necessarily bullish for the Euro, although the tail risk of a disorderly collapse has been removed. But it is assuredly bullish for U.S. equities. By far the single biggest question mark hanging over stocks has been Europe, and now the roped-together have stepped away from the cliff. Equities are attractively priced compared with bonds and have been for some time. This may just be the development that nudges investors off the fence.

Dislocure: Author is long diversified equities equivalent to SPY, and is long EUO