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October 6, 2011

ECB Does the Minimum; Grimmer News Coming

We think most of the last week's better news on European debt and U.S. growth is over. The world equity rally made sense based on recent U.S. growth data and the hope that the Greece and Dexia crises might be forcing progress on bank funding. However, we note low volume at the market bottom and in the rally, the expectation of high volatility in October, and an **absence of fundamental policy improvements in the U.S. or Europe.**

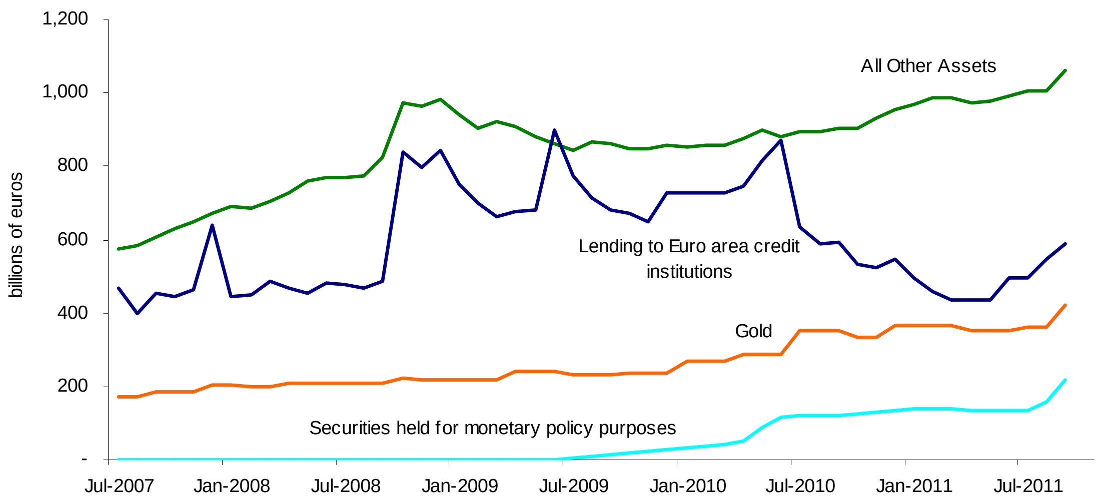
- **There might still be a positive surprise from the establishment or household surveys tomorrow morning.** Both are based on a small set of observations compared to ADP and jobless claims, so there's a wide range of possible outcomes tomorrow that won't give much more insight into future growth. ADP and jobless claims have been better than expected.

- If job or wage growth is stronger-than-expected, we may end up raising our third quarter growth from 2% to 2.5% given recent data on auto sales, construction spending, ISM and ADP, but we don't think the payroll data will improve our 1.5% expectation for the fourth quarter – it's based on the negative July-August inflection point for government policies in the U.S. and Europe.

Regarding Europe, **the ECB did the minimum this morning in softening its liquidity stance**. It is buying 40 billion euros in covered bonds and launching 12-month and 13-month refinancing facilities to lend to banks**. Like the ECB's still-small sovereign bond purchases, we think this is too little to compensate for or fix Europe's weak interbank and covered bond markets.**

- The ECB's 2.3 trillion euro balance sheet shows 220 billion euros in bond purchases of which covered bonds total 59.2 billion euros (will increase by 40 billion euros less maturing principle).

ECB Balance Sheet (last obs. Sept 30, 2011)



Source: ECB; Encima Global

- The euribor-OIS spread has declined 17 bps to 72bp from its recent peak of 89 bps. It's mostly due to an increase in the OIS interest rate, and we don't think this reflects an improvement in the functioning of Europe's interbank markets.)

Euribor – OIS (last obs. October 6, 2011)

Source: Bloomberg; Encima Global

We note a range of reluctant voices as Europe tries to respond to the debt crisis.

- Merkel is holding down expectations. The ECB shows no signs of leading Europe out of the crisis. Banks insist on completing the previously-agreed Greek haircut (which they calculate as a 21% reduction in debt). They warn that further delay or a bigger haircut will infect Italy. (We agree unless parallel steps are taken by the ECB or Germany to make clear that Italy's debt is worth about as much as Germany's.)

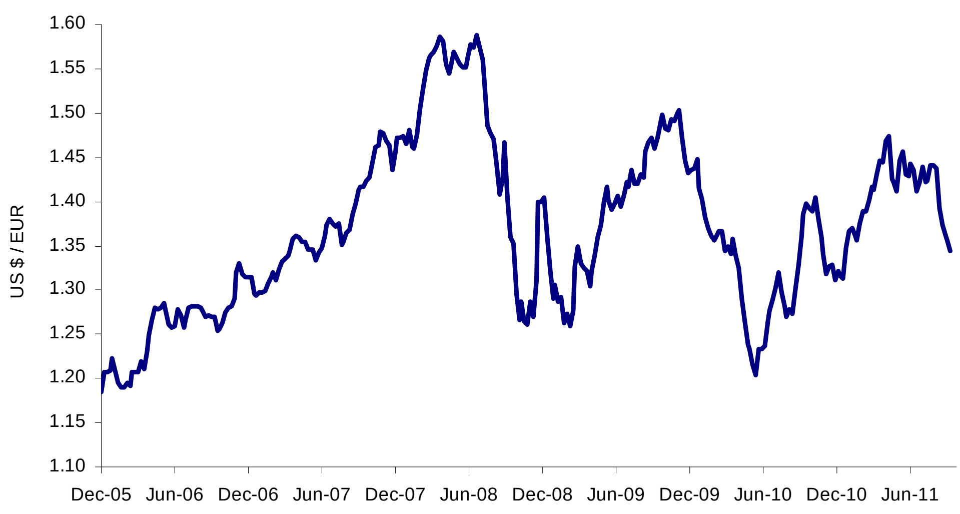
- The result: Italy's sovereign yields have stayed very high...

Italian 10 Year Bond Yield (last obs. October 6, 2011)

Source: Bloomberg; Encima Global

- The euro has weakened against the dollar to 1.34. It was 1.47 in May. It would stronger if the ECB had taken steps to improve the outlook such as a rate cut, bigger purchases of Italian bonds or a more aggressive expansion of bank lending and guarantees.

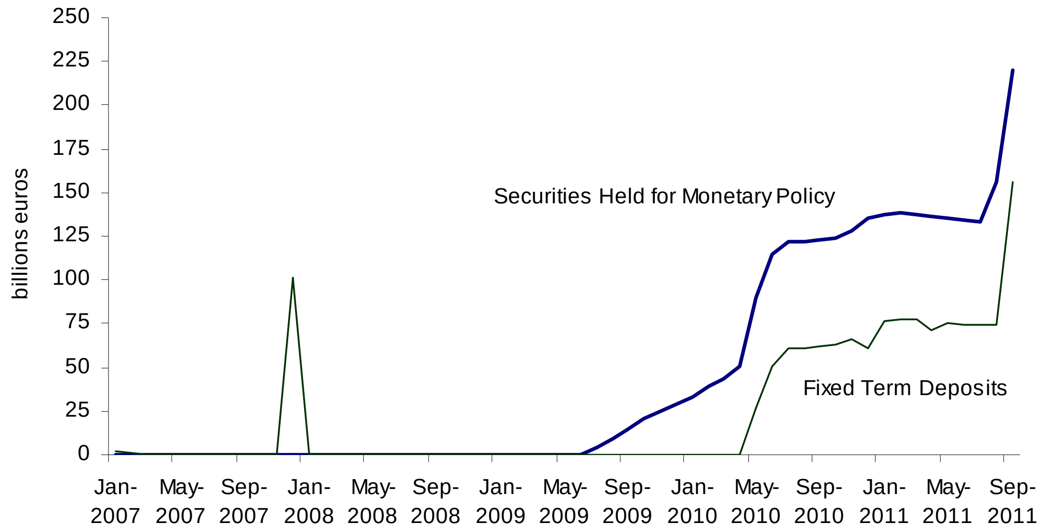
$ / Euro (last obs. October 6, 2011)



Source: Federal Reserve; Encima Global

- The ECB is continuing to sterilize the sovereign and covered bonds it buys for monetary policy purposes. It uses seven-day term deposits to create the expansion in its liabilities, which we think has about the same neutralizing impact as the Fed's 25 basis point payments on excess reserves (though the latter count in monetary base even though they don't increase private sector credit or cause economic stimulus.)

ECB Securities Held for Monetary Policy and Fixed Term Deposits (last obs. Sept 30, 2011)



Source: ECB; Encima Global

The October 9 Merkel-Sarkozy summit will surely be more constructive than the failed one in Paris in August, but we don't think it will help much. Both leaders have weakened politically. They have sharp differences on national guarantees for bank debt -- France can't do much without risking its AAA rating and has more bank problems than Germany. They have different visions for the EFSF -- Germany heads it and provided the lion's share of the resources.

The underlying problems in the outlook loom large:

1) World growth is slowing despite (or due to) massive monetary and fiscal expansion. S&P earnings expectations are too high.
2) The U.S. is frozen into harshly contractionary fiscal and monetary policies through the November 2012 election. This means vital tax and regulatory relief is more than a year away. The next disruptive debt ceiling crisis is fast approaching (scheduled for January 2013, but slow growth and tax receipts could bring it into 2012.) President Obama's press conference this morning heightened the confrontational tone. The anti-bank sentiment has deepened.
3) Germany isn't taking steps to separate Tialy from Greece. We don't think bank recapitalization is a substitute for guaranteeing either Italian debt or a bank's ownership of Italian debt. Merkel's recent comments make clear that any bank recapitalization will be narrow.
4) The decline in GDP and tax receipts in Italy and Greece is accelerating, complicating structural reforms and aid plans.