

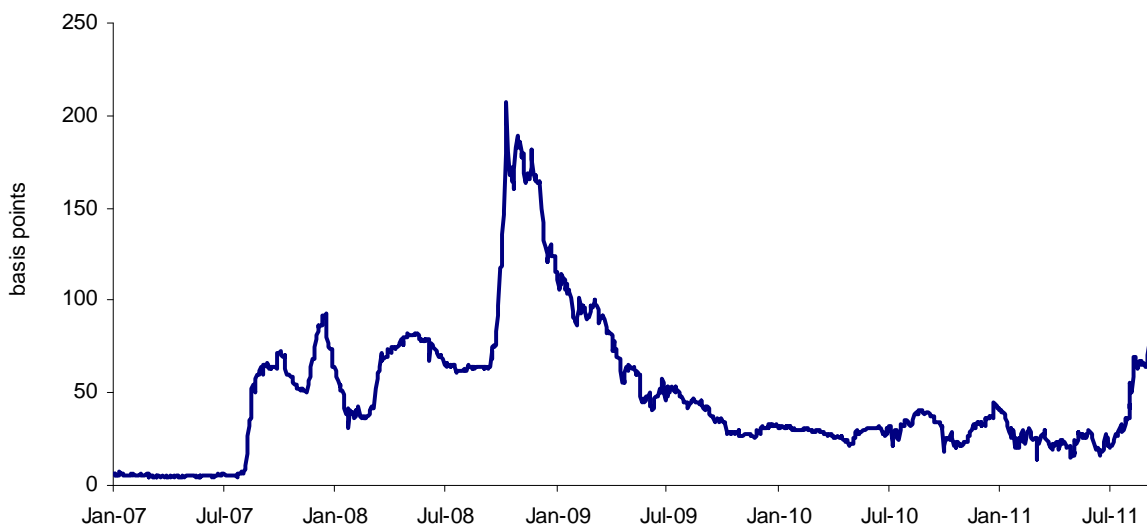
September 9, 2011

Europe Developments Overshadow Obama and Bernanke Speeches

Developments in Europe and on U.S. fiscal and monetary policy continue to deteriorate, reducing the global growth outlook. The weekend's G7 meeting would normally produce something positive amid the gloom. The ministers are experienced and the problems clear enough. We keep looking for calming statements on bank capital requirements (to counteract the view that regulators want banks to lend less and issue more equity). It's not clear the G7 will even put out a communiqué given the divergence of views.

- Speeches yesterday by President Obama and Fed Chairman Bernanke didn't improve U.S. policy direction or reduce uncertainties. We expect U.S. fiscal and monetary policy to remain ultra-loose, hurting growth.
- Developments in Europe continue to worsen, with Greece not complying with its IMF program, growing German resistance to supporting Greece's fiscal deficit, dissension apparent at the ECB over bond-buying and interbank risk widening to a new high today.
- We think it will take a major policy change in either the U.S. or Europe to stop the deterioration in the global growth outlook.

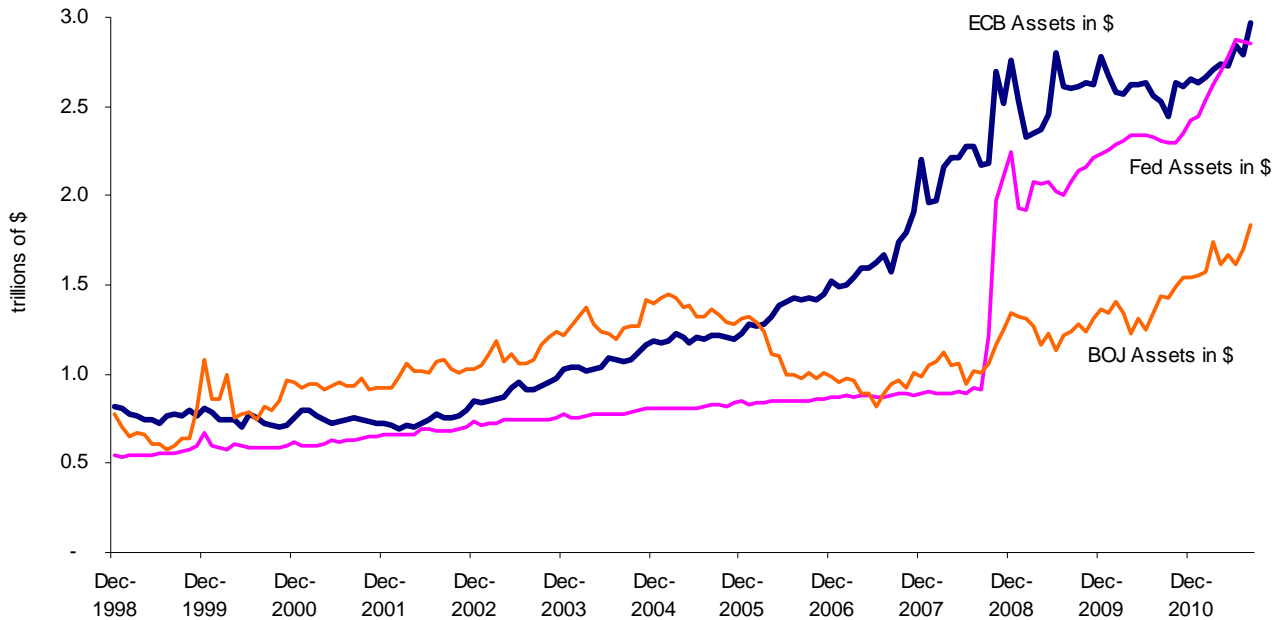
Euribor less OIS (last obs. August 2011)



Source: Bloomberg; Encima Global

- Chairman Bernanke’s Minneapolis speech yesterday maintained the U.S. weak-dollar policy and left open the possibility of the Fed increasing its holdings of long-maturity Treasury bonds. It could buy bonds and pay for them with either excess reserves (QE3) or by selling shorter-term bonds from its \$2.9 trillion in assets (operation twist).

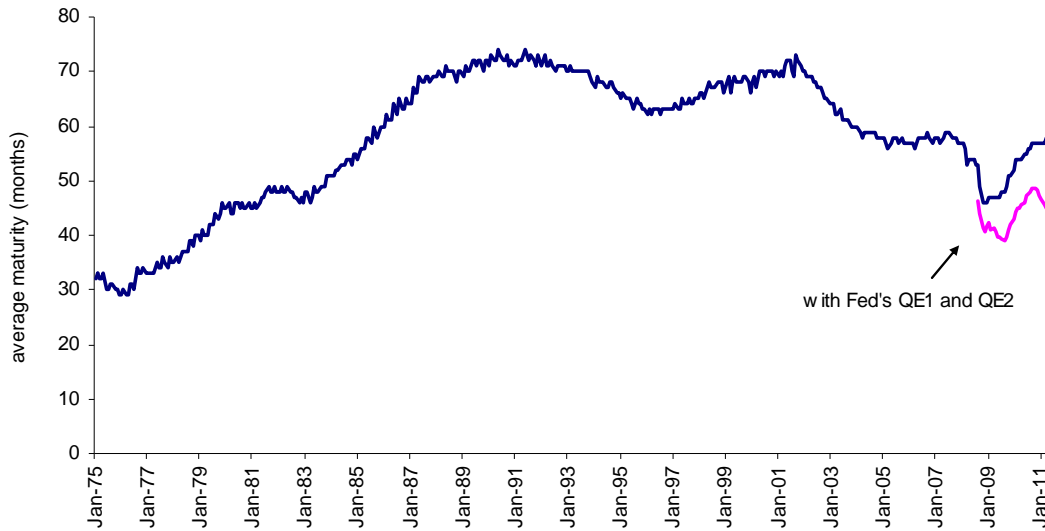
Federal Reserve, ECB and Bank of Japan Assets (last obs. August 2011)



Source: Federal Reserve; ECB; Bank of Japan; Encima Global

- Either Fed approach would be harmful for growth because it would shorten the already-short effective maturity of the national debt, further disrupt the already devastated short-end of the yield curve, and deepen the government distortion of the longer-end of the bond market. We make a sharp distinction between this Fed overreach in a market that is otherwise functioning well (it’s absurd for the Fed to consider buying a 10-year Treasury yielding 2%) and the ECB’s purchases of 5%-yielding Italian and Spanish bonds and the Fed’s 2008-2009 purchases of MBS when spreads over Treasuries were 100 or 150 bps.

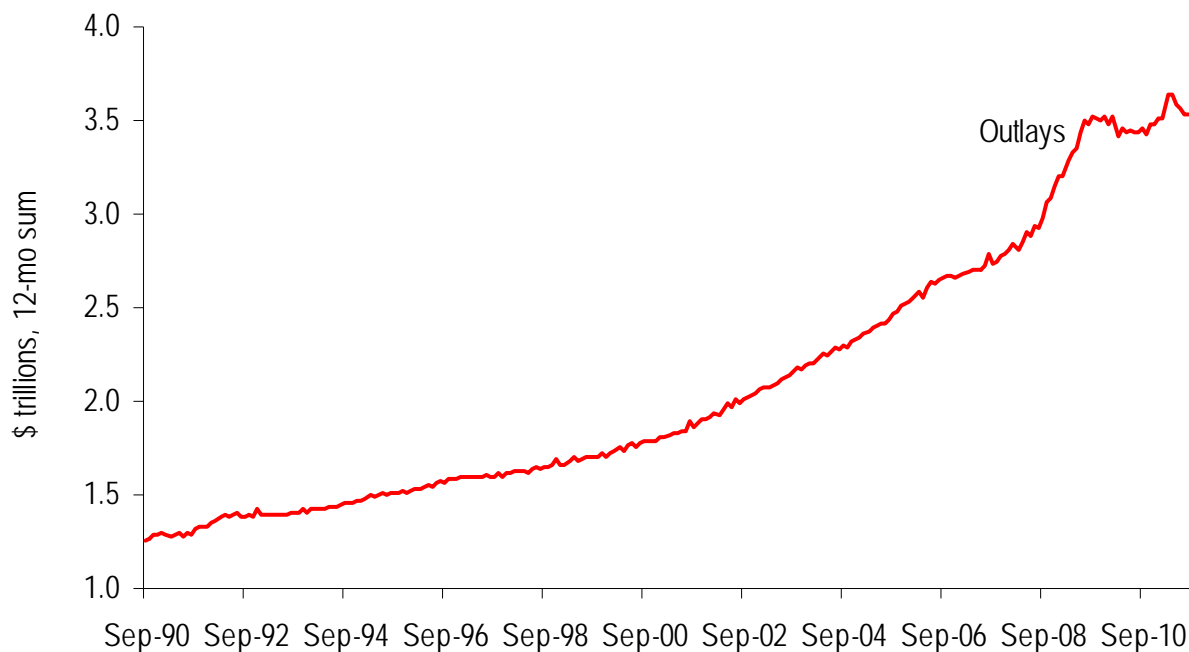
Average Maturity of Public Debt (last obs. August 2011)



Source: Federal Reserve; ECB; Bank of Japan; Encima Global

- President Obama's speech proposed an extension of the existing policy direction, including temporary tax credits and additional support for state budgets. We think this approach will improve the growth outlook only if Washington uses the bipartisan interest in jobs to develop new budget processes. The speech rejected regulatory relief, didn't propose spending cuts to offset the increases, and went backward on budget process by requesting that Congress simply pass the massive bill. The President expressed a willingness to consider Medicare reform and said more details on his budget proposals would be released on September 19. We think procedural changes will be needed to create a process for tax reform and spending restraint (to sell assets, eliminate unnecessary programs and agencies and consider actual spending cuts.) We think Washington will instead continue the budget impasse through the 2012 election – see yesterday's piece, U.S. Fiscal Outlook Getting Worse.

Federal Outlays (last obs. August 2011)

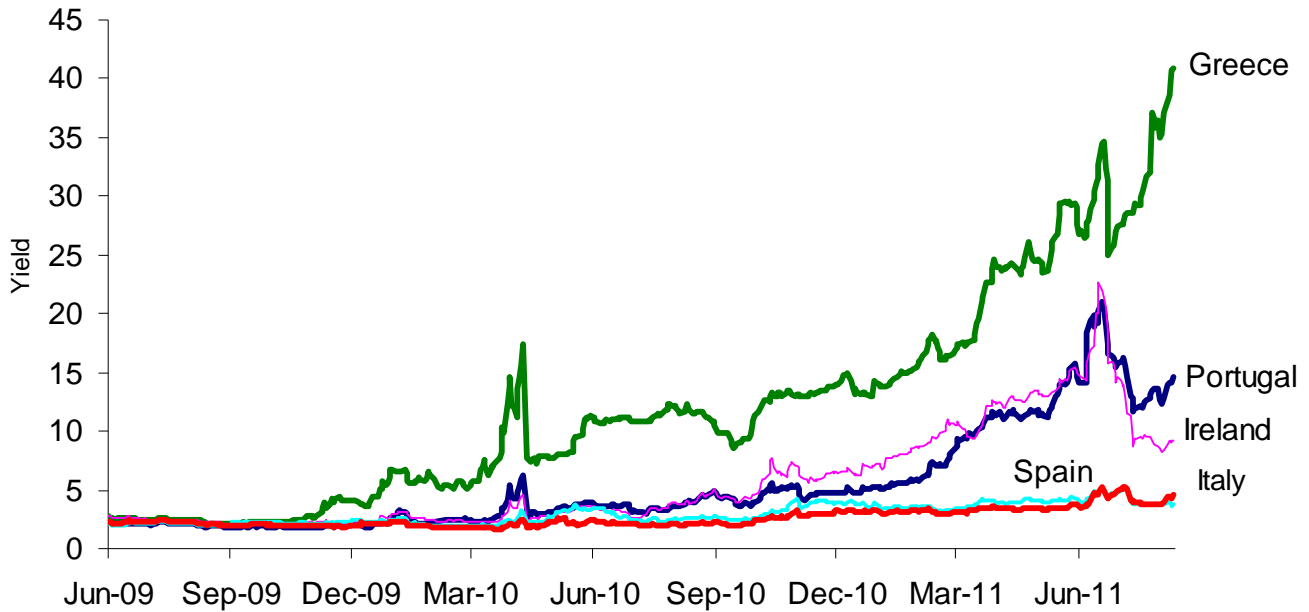


Source: U.S. Treasury Dept.; Encima Global

Europe developments have worsened. The muddle-through approach broke down after the July 21 agreement on Greece, accelerated by the August 16 Paris summit.

- Greece says it will comply with the anti-growth program but its economy and tax receipts are falling too fast to make that credible. We've been critical of the Greek program and many other IMF austerity programs because of their reliance on tax increases including VAT tax increases. The programs hurt growth and don't collect the agreed-on revenues, usually breaking down.
- The ECB isn't increasing its bond purchases. Finland's demand for collateral from Greece remains an obstacle. Meanwhile, Germany wants to see Greece change its economic and fiscal culture toward Germany's and is losing its willingness to allow funding for Greece's large fiscal deficits.
- There are rumors circulating of a Greek default in the near future. Part of Europe's can-kicking exercise was to delay a Greek default while injecting new funds from the IMF and the EFSF to give private-sector banks time to reduce their Greek exposure. Markets expect a Greek default and have priced it into Greek sovereign bond yields. On Friday, Bloomberg reported on a German plan to support German banks in the event of a Greek default.

Selected European 3 Yr Bond Yields (last obs. September 9, 2011)

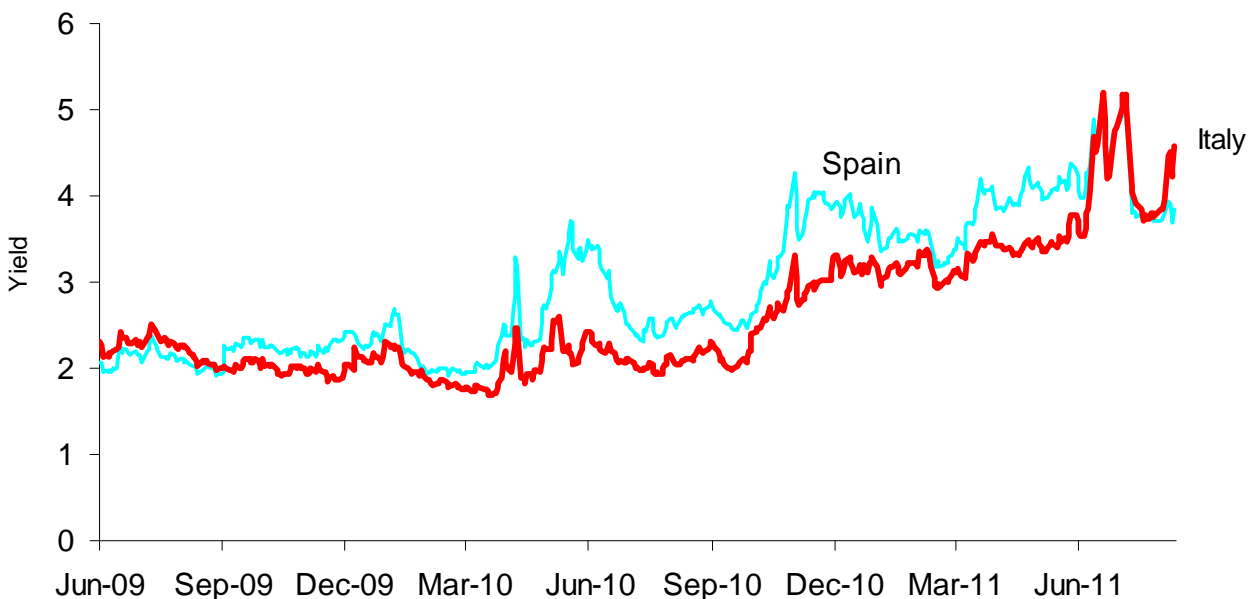


Source: Bloomberg; Encima Global

Issues if/when Greece defaults:

- Will contagion to Italy and Spain worsen? We think it depends on ECB bond buying (which appears severely limited) and structural reform actions in Italy and Spain (unclear how growth oriented.)

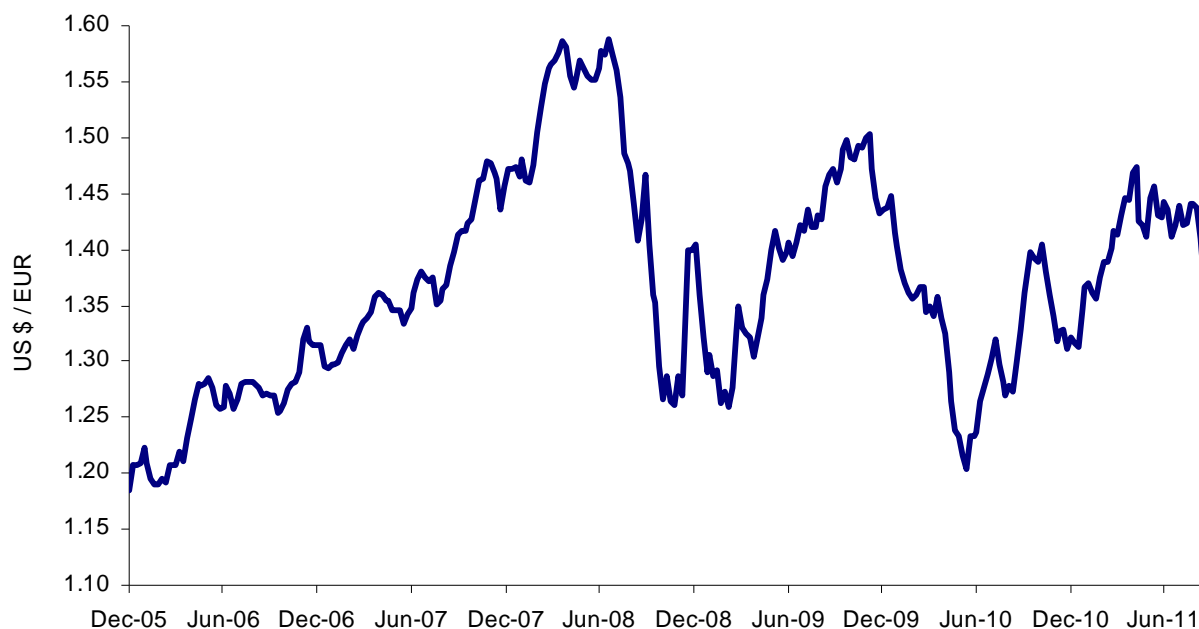
Selected European 3 Yr Bond Yields (last obs. September 9, 2011)



Source: Bloomberg; Encima Global

- Will Greece leave the euro? We don't think so. There's no exit process. We disagree that there's a similarity to Argentina's disastrous 2002 exit from its currency board – Argentina devalued both peso bank accounts and peso currency, whereas Greece's euro bank accounts are connected to physical euros which can't be devalued. The reintroduction of the drachma or another local currency would be catastrophic for Greeks and would be very harmful for European and global growth. We think the euro will strengthen if Greece or another euro country starts using a local currency – it makes the euro more valuable – and note the euro's weakness in recent days, probably a signal that weak countries won't exit.

USD / Euro (last obs. September 9, 2011)



Source: Bloomberg; Encima Global

- What other consequences would there be from a Greek default? Defaults are unpredictable. It's possible that some European financial institutions are more exposed to Greece than markets expect. There might be legal findings that complicate the situation (for example, some Greek debt is subject to New York state law, as was the case in Argentina's default.)

Our conclusion: There is still the possibility that the Greek program will be put back together to allow Europe to muddle along a few more months. However, for now, European developments remain negative. As long as there's not a breakdown of the euro itself, we think the global growth outlook depends more on structural reforms in Italy and Spain and the U.S. Unfortunately, none is moving in a growth-oriented direction.

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