

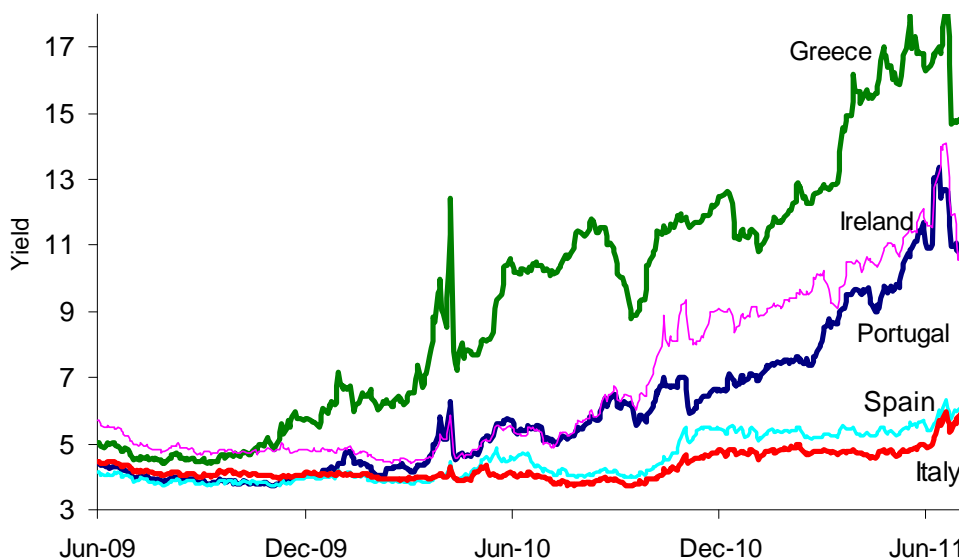
August 4, 2011

# Geuribor Spread Widens as Europe Struggles

Financial markets are in a severe sell-off. The extended U.S. soft patch is a big part of it, though corporate profits, one of the most dependable leading indicators, are holding up fine. The debt limit fiasco undermined any hope that Washington's current system of diffuse responsibility would provide spending restraint or structural reforms. Of most immediate concern, Europe's debt crisis is getting worse.

- We think Europe still has several ways to stabilize the debt situation, but it's not moving fast enough. A salvage plan would have the ECB buy periphery bonds now in large quantities, in effect funding the fiscal deficits and debt rollovers. Once the new EFSF powers are ratified (it requires national approval) the EFSF and its successor will be able to buy periphery bonds, lend directly to countries and recapitalize banks. Since the euro-zone's long-term borrowing cost is very low (German 30-year yield is 3%), the excess debt of the periphery countries could be amortized over several decades. With structural reforms including labor flexibility, lower wages for new workers and restraint on defined benefit plans, the countries could grow, move into fiscal surplus and stay in the euro.

## Selected European 10 Yr Bond Yields (last obs. August 4, 2011)



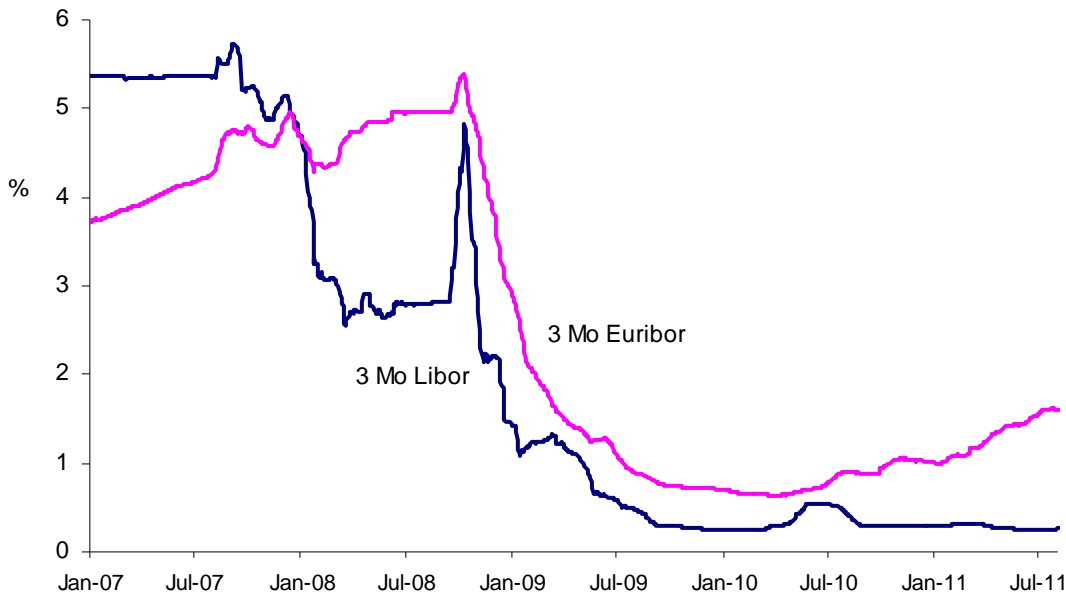
Source: Bloomberg; Encima Global

- This morning, the ECB announced it was buying periphery bonds, the first in four months. If done in size, we think it would be stabilizing. However, traders say the ECB bought limited amounts of Portuguese and Irish bonds, not Italian or Spanish bonds. Further, the Bundesbank, a key member of the ECB, opposed the resumption of ECB bond purchases, suggesting to markets that the ECB may not be aggressive in its bond buying. Yields on Italian bonds rose to 6.2% from 5.95% earlier in the day while Spain's 10-year yield rose to 6.3% from 6% this morning.
- ECB President Jean-Claude Trichet also announced that the ECB would resume supplying unlimited amounts of six-month loans to euro-zone banks. This reversed the earlier wind-down of that 2009 emergency lending program.

### Europe is facing several immediate problems:

1. The July 21 agreement to “voluntarily” reschedule Greek sovereign debt held by the private sector didn't buy much time from markets. The kick-the-can concept is to delay the problem while public funds are injected through the IMF and the European Union and reschedulings gradually reduce the net present value of the debt. The problem with this slow-motion bailout is that the contagion threat overhangs growth and investment in Italy and Spain. See our July 12 piece, Yields Rising in Europe's Debt Crisis. Even if Italy and Spain didn't have a debt-to-GDP crisis before, slower growth pushes them into one. The Greek bailout needs to be accelerated and applied to Portugal. Two critical steps – bigger ECB bond purchases and a faster EU approval of the EFSF including assured sources of funding.
2. Deposits are fleeing banks in Italy and other peripheral countries. Depositors worry that the bank will fail or the deposits will be converted into lira as part of a devaluation. Euros are being withdrawn as cash or transferred to banks in Germany, Switzerland and elsewhere. Safe deposit boxes are in heavy demand. We don't see the bank run as an insurmountable problem. It's possible it will peter out since the ECB is providing unlimited backup funding. There's no evidence of flight from the euro itself. Many of the Italian banks are sound, with good loan portfolios in eastern Europe and adequate capital in reserve.
3. Interbank euro lending has declined because banks don't have confidence in each other or the periphery governments. This is a form of mad cow disease – even if most of the cows (or banks) are sound, it's not worth the risk.
  - As a result, the euribor interbank lending rate (the euro equivalent of Libor, the rate banks charge each other) has risen more than the ECB overnight rate. Three-month Euribor now stands at 160 bps, up from 65 bps in March 2010. Three month dollar Libor stands at 27 bps.

### 3 Mo LIBOR and Euro-Zone EURIBOR (last obs. August 4, 2011)



Source: Bloomberg; Encima Global

- The 'Geuribor' spread between Euribor and German T-bills has risen to 111 bps from 40 bps in June. This is the German equivalent of the TED spread and reflects pressure in the European financial system.

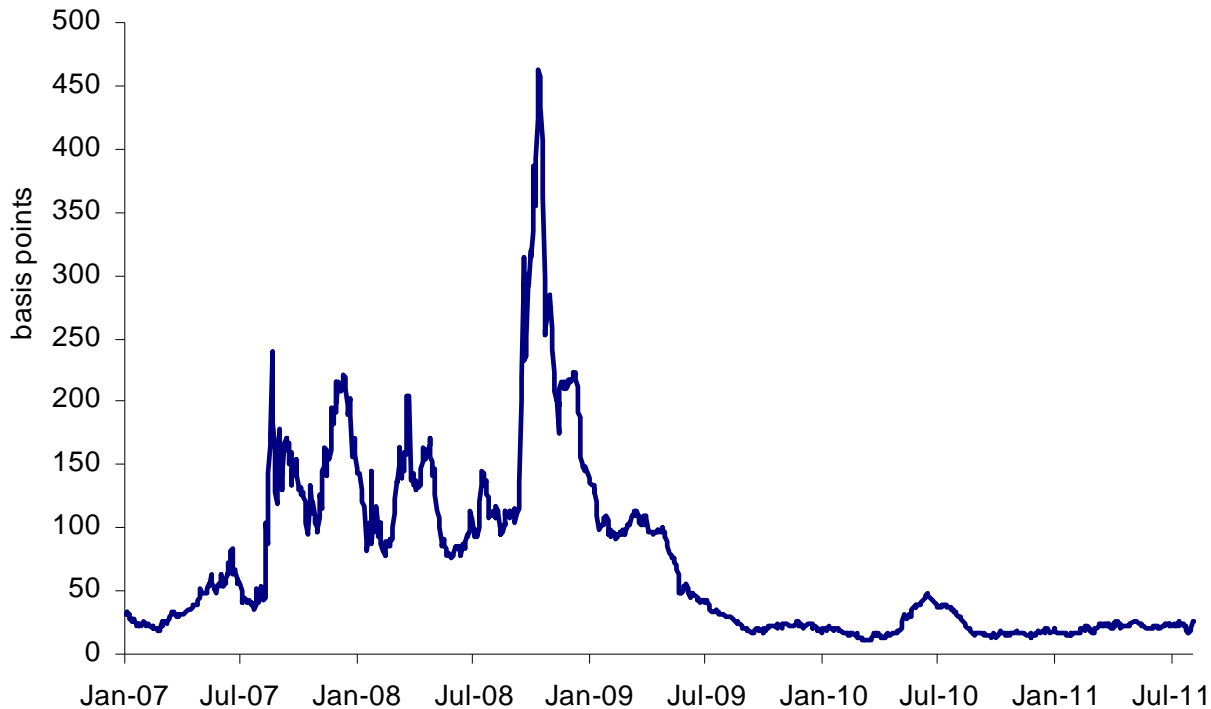
### GEURIBOR Spread – Euro IBOR less 3 Mo German Bills (last obs. August 3, 2011)



Source: Bloomberg; Encima Global

- In contrast, the TED spread -- the difference between the rate banks pay each other for dollar loans and the interest rate the U.S. government pays on Treasury bills --stands at 27bps (with T-bill rates at 0 today) and is not showing strain within the U.S. banking system. The TED spread suffered an uptick during the 2010 soft patch and concerns over a double-dip recession.

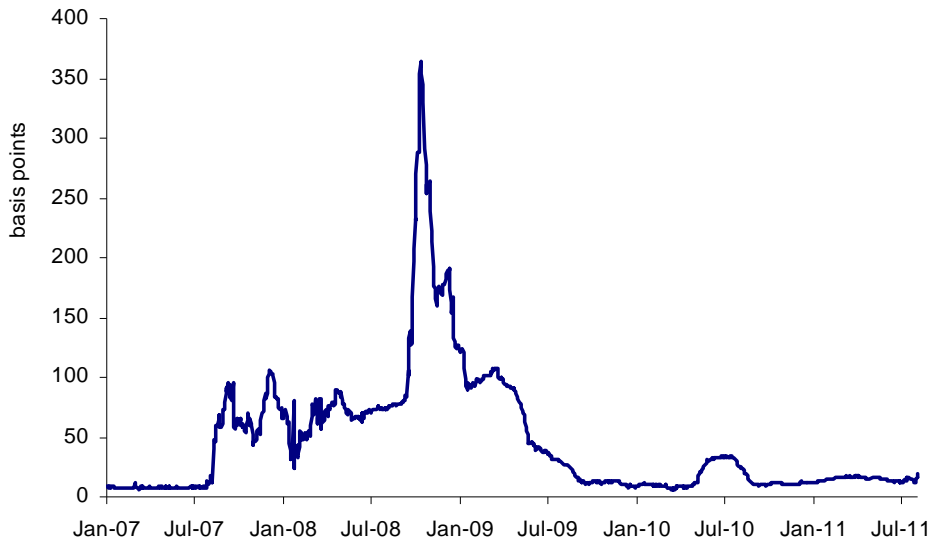
### **TED Spread – Eurodollar LIBOR less 3 Mo US Treasuries (last obs. August 4, 2011)**



Source: Bloomberg; Encima Global

- A more sophisticated version of the Ted spread is the Libor-OIS spread. It compares Libor to the Overnight Indexed Swap market (which generally tracks the effective Fed funds rate). The OIS and fed funds markets deviate from Treasury rates during severe risk aversion. The Libor – OIS spread rose to 19 bps from low teens in June. Thus, both the Ted spread and the Libor-OIS spread are showing none of the systemic problems that occurred in 2007-2008 or the tightness in the 2010 soft patch.

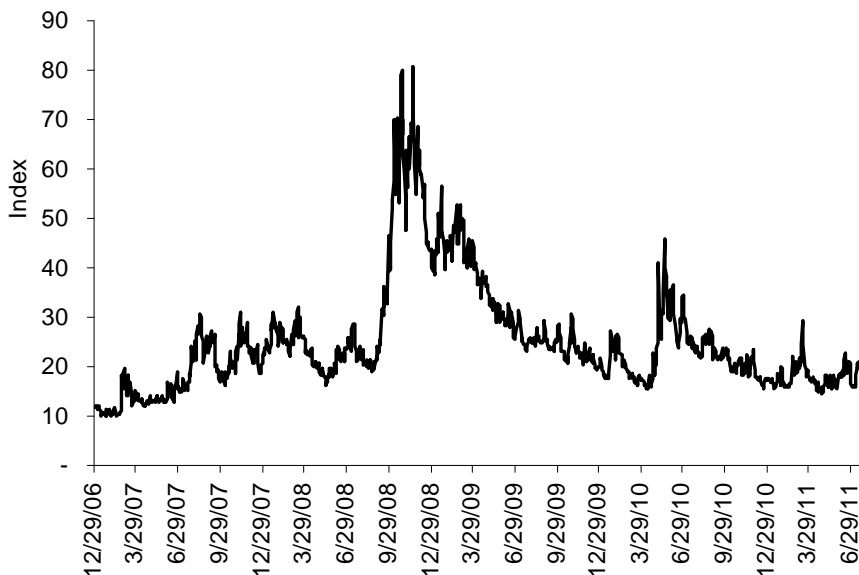
## Eurodollar LIBOR less OIS (last obs. August 4, 2011)



Source: Bloomberg; Encima Global

While there is clearly some risk to global growth and the equity outlook, part of the spike in equity volatility (the VIX) is a rebound from very low levels in April and May. The VIX has risen to 28 intraday from the 16 level in early July. The VIX peak in the 2010 soft patch sell-off was 48.

## Volatility Index (last obs. August 4, 2011)



Source: Bloomberg; Encima Global

From a global growth standpoint, we think the major issue is whether any euro country departs the euro (which would cause a catastrophic run on euro deposits in other euro countries.) As long as that ending is avoided (German Chancellor Merkel has ruled it out), then we think part of southern Europe's lost growth will be picked up in northern Europe. Global growth rates can probably hold up through a prolonged European debt crisis.

- We don't think Europe's debt crisis endangers the global financial system the way Lehman's bankruptcy filing did. Lehman had been very clearly identified as too big to fail, as reflected in its equity price immediately prior to the bankruptcy. Even though it wasn't defined as a bank in the U.S. regulatory process, it had borrowed through deposit-taking banks operating in the interbank market and through commercial paper marked at 100 cents on the dollar by money-market funds. Its liabilities totaled well over \$600 billion, large by Greek standards. When it filed, the commercial paper and interbank markets immediately froze solid, causing a meltdown of the global financial system. We don't see the equivalent in the European crisis.
- Rather than a Lehman-like crisis to the financial system, we think the Latin debt crisis (which I worked on at Treasury and State) has some relevance to Europe's plight. The Latin crisis lasted a long time from Mexico's original banking/currency collapse in August 1982 through Brady bond issuance starting in 1989 when Mexico's syndicated bank loans were converted into long maturity bonds collateralized by zero-coupon Treasuries Mexico purchased from the U.S. The countries themselves went through numerous debt-related crises and declines in per capita income in the 1980s and the 1990s including Mexico's 1994 devaluation and dollar-linked Tesobonos crisis and Argentina's total debt-related collapse following its 2002 devaluation from the currency board that had been imbedded in its constitution and contracts. Just as Argentina issued "growth warrants" in 2003 as part of its default process, Greece is being asked to pay bond holders extra if it grows fast. And like Latin America, southern Europe is probably stuck with a slow bailout that causes years of strain.

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