

Europe Update – Key Variables

Equity markets advanced yesterday and today as it became clear that Greece would not hold a referendum. A referendum would have created a long period of uncertainty about the euro, the likelihood of a hard default on Greek debt, contagion to Italy, and a prolonged shortage of private sector funding for European banks.

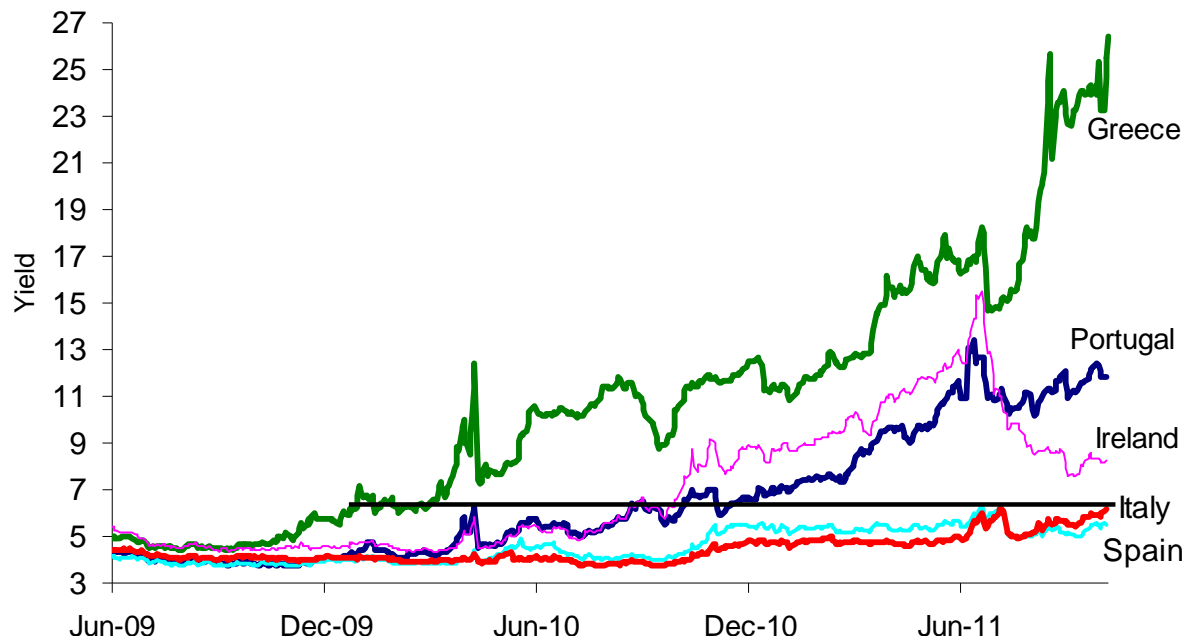
- We think today's ECB rate cut to 1.25% from 1.5% was only a neutral for markets because new ECB president Mario Draghi made clear that the ECB is not going to buy bonds faster or provide other assistance. Equities traded down after the rate cut and press conference and only began rising on news later in the morning about Greece backing away from the referendum.

With the Greek referendum probably off the table, attention should turn to other key near-term variables in Europe's debt crisis:

- Papandreou's and Berlusconi's positions face severe challenges. Greece's parliament is in the process of voting on a confidence motion. If either leader is pushed out, it's a negative because it will delay decision-making while new governments are formed.
- **Signals from China have been cool** on the EFSF and jumping into Europe's crisis. The EFSF had to postpone a bond offering this week due to uncertainty over Greece. We think the EFSF will begin to make progress on bond issuance and operations, but won't be able to take over the bond-buying burden from the ECB. With growth slowing and fiscal deficits widening, the EFSF isn't big enough to stop the contagion. **We think Europe's outlook will deteriorate until a strong new source of confidence is introduced** – though two powerful ones, ECB bond buying and U.S.-style blanket guarantees for new bank debt, aren't on the table.
- On Wednesday, **Italy was unable to make progress on the structural reforms** Berlusconi promised the ECB months ago. There hasn't been agreement on increasing the retirement age to 67 or liberalizing closed professions. The government decided not to implement them by decree. Italy's bond yields are rising and required debt issuance is going to be much heavier in coming quarters. **Italy is near the yield levels that became rapid deteriorations in Greece, Portugal and Ireland** in 2010. Several other factors add to the difficulty in rolling over Italy's debt – large size of Greece's haircut; inability to use CDS to hedge longs given the voluntary concept underlying Greece's debt restructuring; pressure on European banks to reduce their holdings of Italian debt (due to their falling liabilities and the

requirement to increase bank capital ratios); and recent pressure to expand mark-to-market.

Selected European Yields (last obs. November 3, 2011)



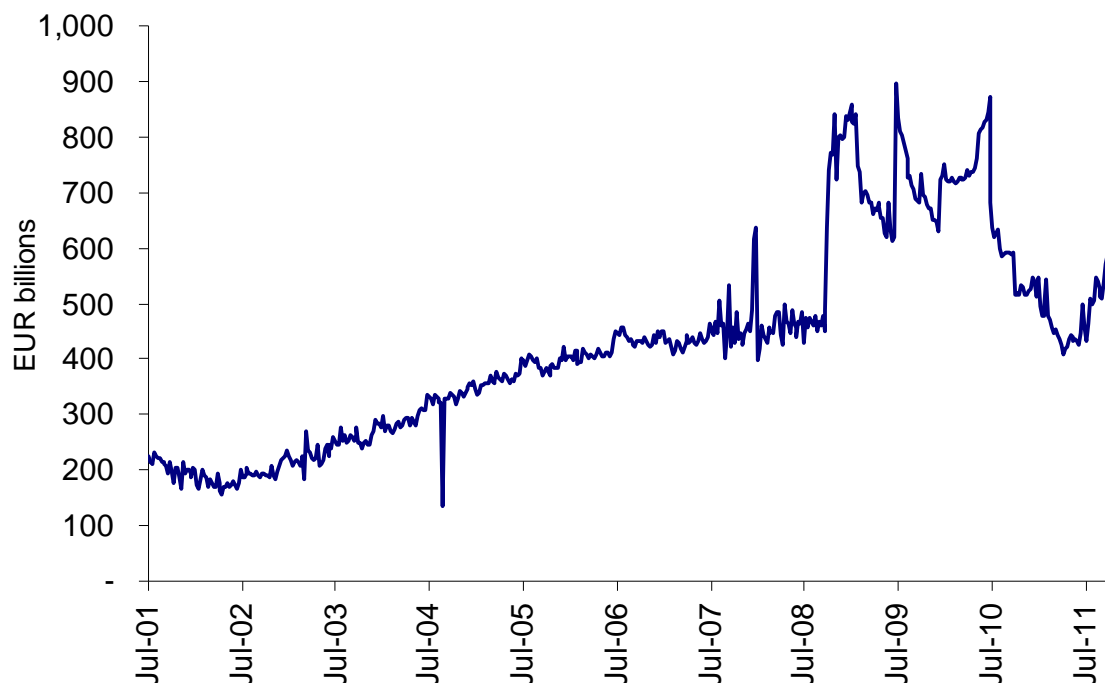
Source: Bloomberg; Encima Global

- The G20 meeting will probably make “stand ready to help” commitments and warm noises about possible funding from the IMF, Japan and other sovereigns. In the end, though, we think **Europe will try to execute the October 26 plan**. This involves structural reforms in Greece and Italy, the IMF/EC disbursement to Greece under the 2010 IMF program, small steps toward bank recapitalization, and the EFSF expansion. The problem with this approach is that growth is slowing and cash flows are worsening.

Time is of the essence -- there are two burn rates underway as discussed in our previous pieces.

- First, the liabilities of many European banks (deposits, interbank loans, covered bonds, commercial paper issuance) are declining because normal sources are not rolling over. They are being replaced by the ECB through its refinancing operations, where ECB loans to banks have reached 600 billion euros. Today Draghi emphasized the temporary nature of the ECBs sovereign bond buying program. We think the ECB may become increasingly selective about the quality of the collateral it is getting for loans to euro-zone banks, making clear it doesn't want to be in this business. As bank liabilities burn off and the ECB questions the collateral, banks will reduce their total assets by not rolling over loans and by selling assets, both of which put pressure on Europe's markets.

Rising ECB Lending to Euro Area Credit Institutions (last obs. October 28, 2011)



Source: Bloomberg; Encima Global

- Second, the governments of Greece, Italy and other peripherals face a rapid burn rate including fiscal deficits, rising roll-over requirements, declining deposits at their banks and losses at state-owned companies and pension funds. A related cash flow pressure is from forbearance (i.e. not closing banks when they are losing money as in the U.S. savings and loans crisis in the mid-1980s). The Bank of Greece has been making loans to Greek banks which need cash but aren't in a position to get loans from the ECB. The ECB will eventually limit to this type of emergency liquidity (since it puts member central banks at risk).
- In addition, the private sector haircut probably has a short half life. Just as the 21% haircut became unworkable when Greece deteriorated, the 50% haircut probably won't be workable for very long. Yet Greece's Finance Minister Venizelos said today that there would need to be 100% participation (highly unlikely) of private sector bondholders in the voluntary haircut in order to meet Greece's debt reduction needs.
- In sum, with growth conditions deteriorating in southern Europe, the cash flow burn rate at the sovereign level is worsening month by month, making strong new measures urgent and necessary once the G20 meeting ends.

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