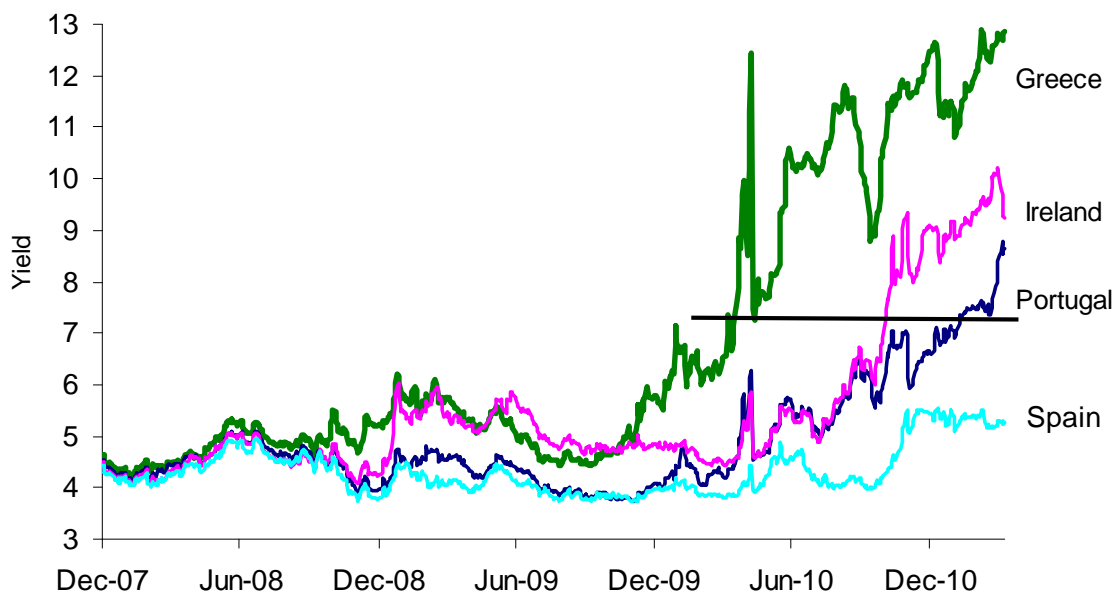


April 8, 2011

# Europe Update: Portugal Slides Toward Debt Restructuring; Spain Doesn't

As Portugal struggles to make enough spending cuts and other structural reforms to win more external aid, its ten year bond yields have surged to 8.7%. That's well above the 7% level that started Greece's crisis in 2010 (see our discussion of the 7% barrier on February 24 in Europe the Weak Link.)

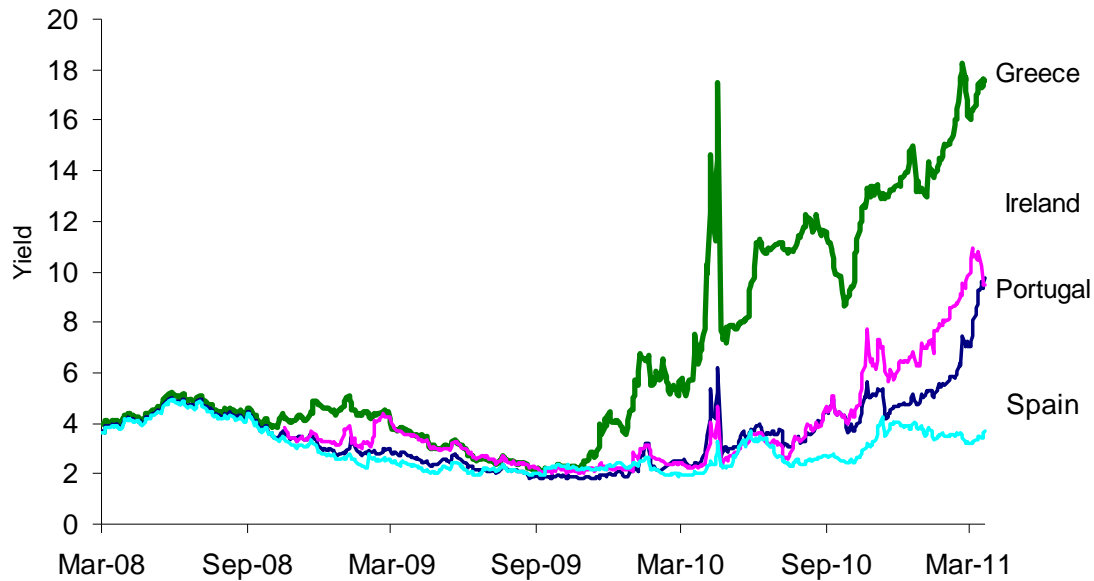
## Select European 10 Yr Yields (last obs. April 8, 2011)



Source: Bloomberg; Encima Global

- Portugal's three-year yield reached 9.8% today, up from 6% a month ago and 27 basis points above Ireland's.

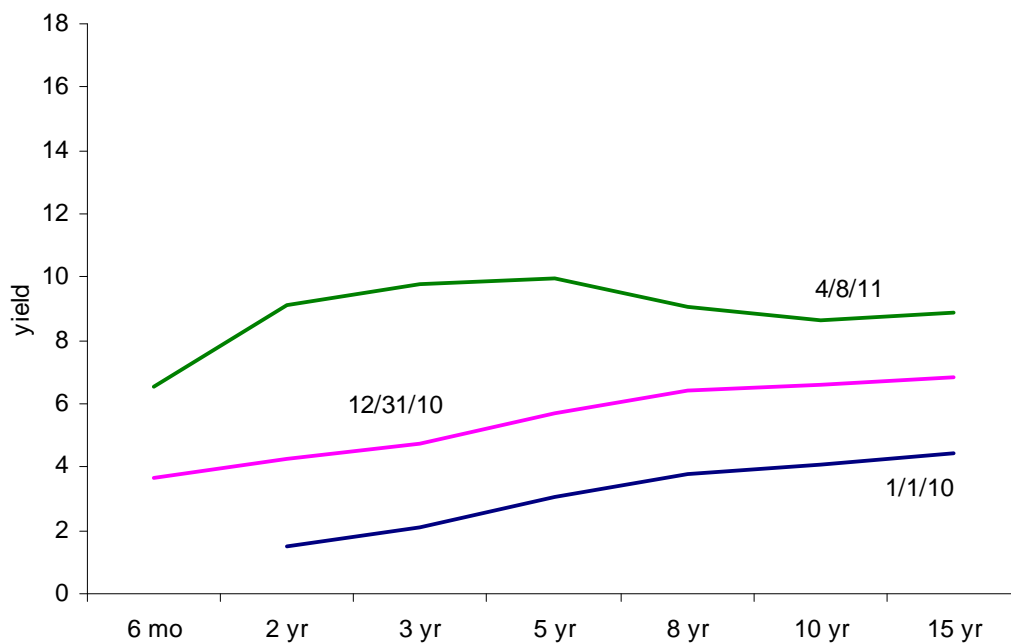
## Select European 3 Yr Yields (last obs. April 8, 2011)



Source: Bloomberg; Encima Global

- Portugal's three-year yield is well above its own 8.7% ten-year bond yield. This is the same jump in medium term yields above long-term yields that Greece suffered in April 2010 and Ireland early in 2011, signaling their rapid slide.

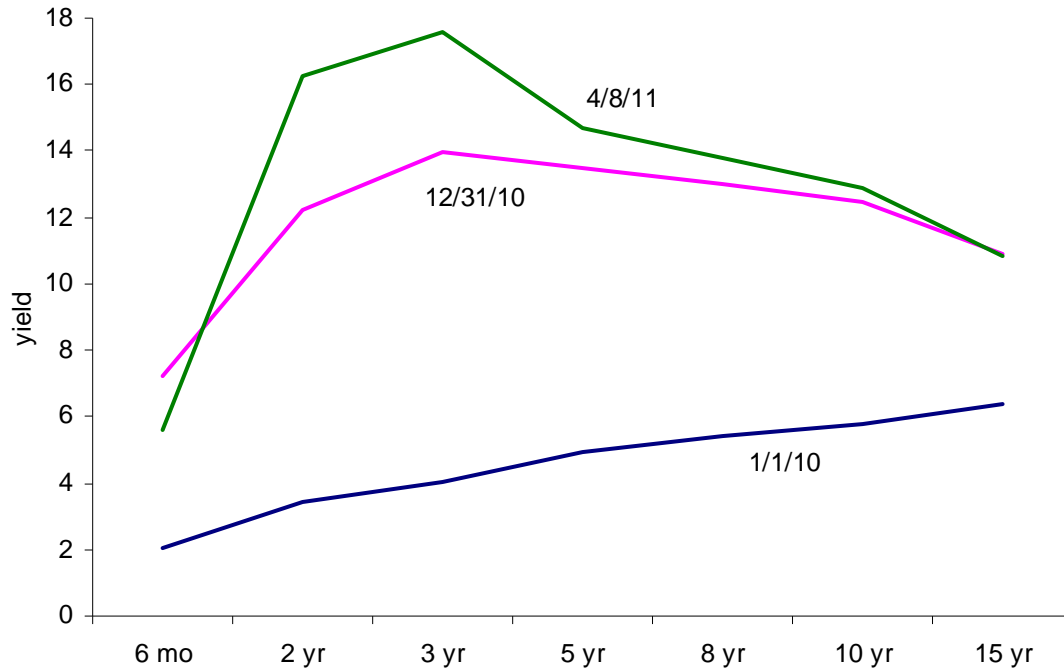
## Portugal Yield Curves (last obs. April 8, 2011)



Source: Bloomberg; Encima Global

- Greece's yield curve inverted in 2010 when its three-year yield rose above the 10-year yield.

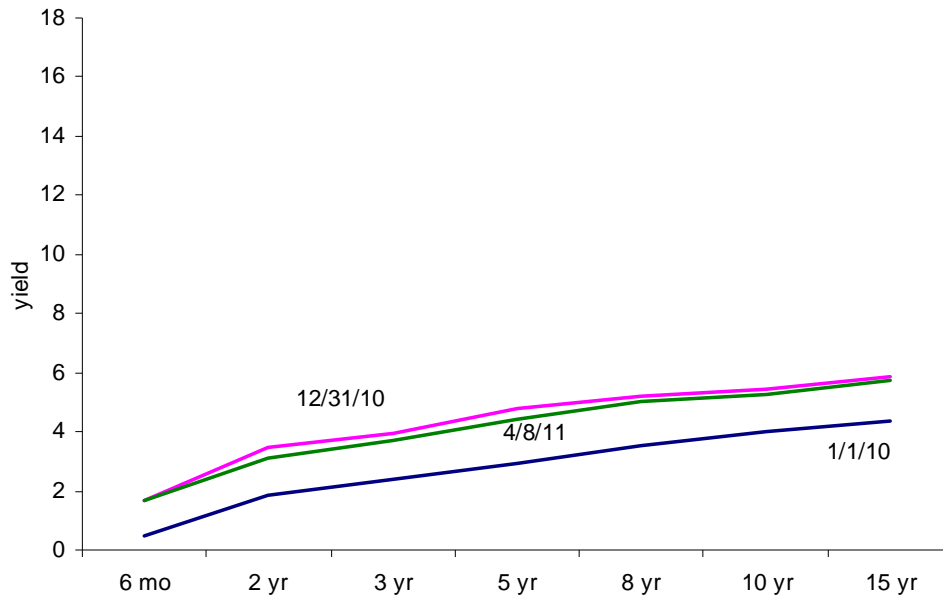
### Greek Yield Curves (last obs. April 8, 2011)



Source: Bloomberg; Encima Global

- In contrast, Spain's three-year yield remains relatively low at 3.7% and well below its 5.3% 10-year yield. While Spain's banks remain under pressure, they are in much better shape than Ireland's were prior to its collapse. The issue for Spain is whether its declining population can create enough growth, productivity, jobs, innovation and profit to pay the sovereign debt burden, some 800 billion euros and 75% of GDP (versus 90% debt-to-GDP for Portugal and 65% for the U.S.)

## Spain Yield Curves (last obs. April 8, 2011)

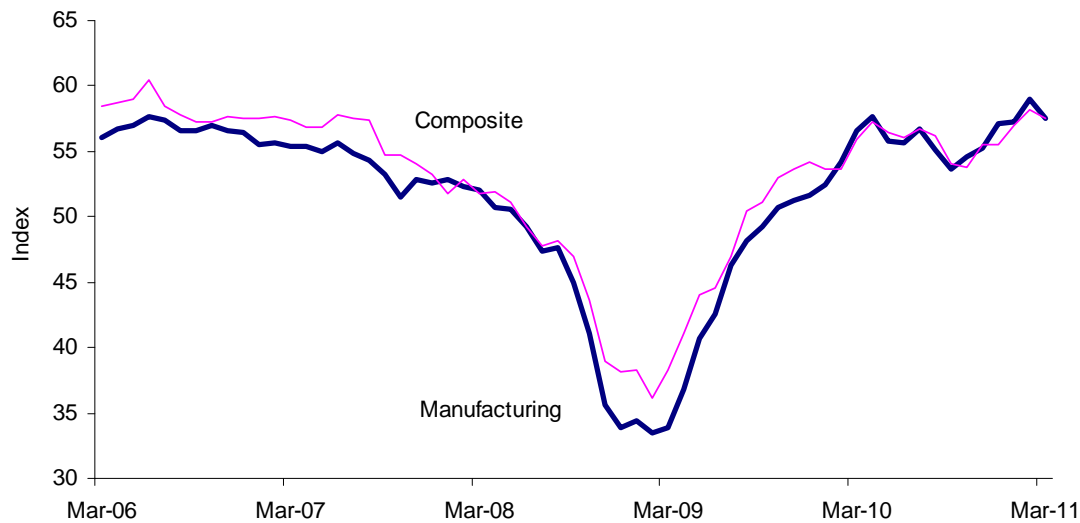


Source: Bloomberg; Encima Global

We think Europe should be able to grow moderately in 2011, while gradually isolating the severe losses in the weaker countries.

- The Eurozone purchasing managers indexes have recovered, though country-by-country performance has diverged.

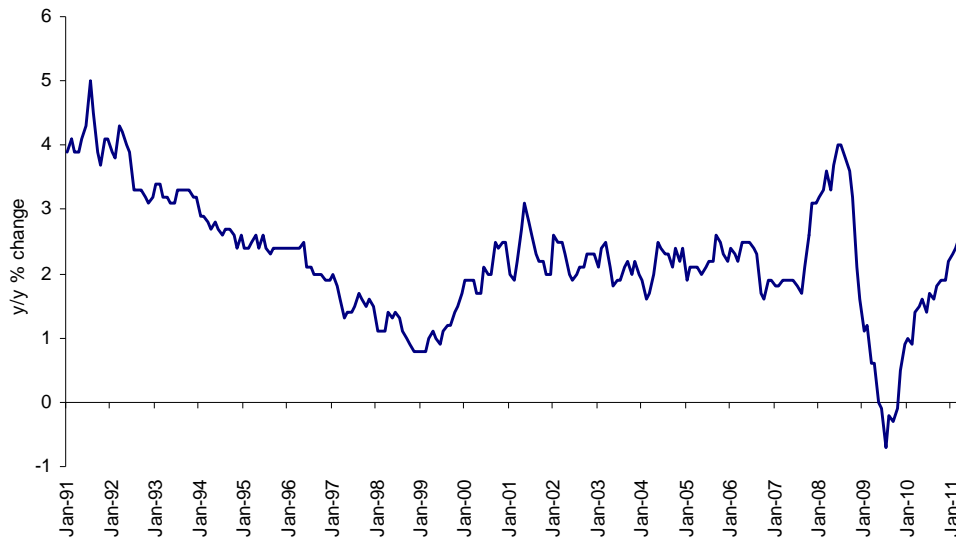
## Eurozone Purchasing Managers' Index (last obs. March 2011)



Source: Bloomberg; Encima Global

- Eurozone CPI inflation has been rising sharply in recent months.

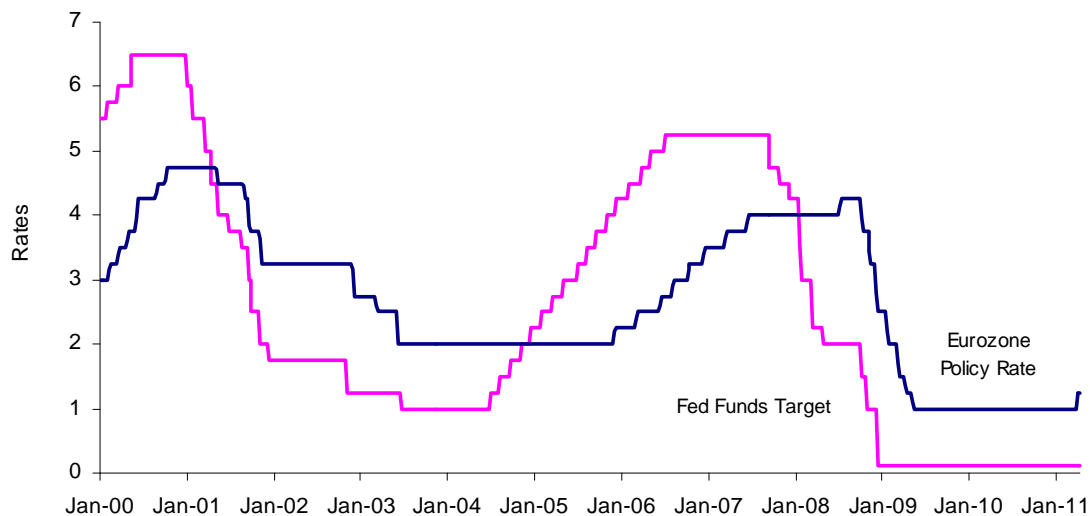
### Eurozone Inflation (last obs. March 2011)



Source: Bloomberg; Encima Global

- The ECB raised the overnight rate to 1.25% on Thursday and is expected to increase rates further in coming months in accordance with its mandate of price stability. In the U.S., the Fed will probably **keep the Fed funds rate near zero** at least into the fourth quarter of 2011 despite rising inflation and dollar weakness.

### Fed Funds Rates and ECB Policy Rate (last obs. April 8, 2011)



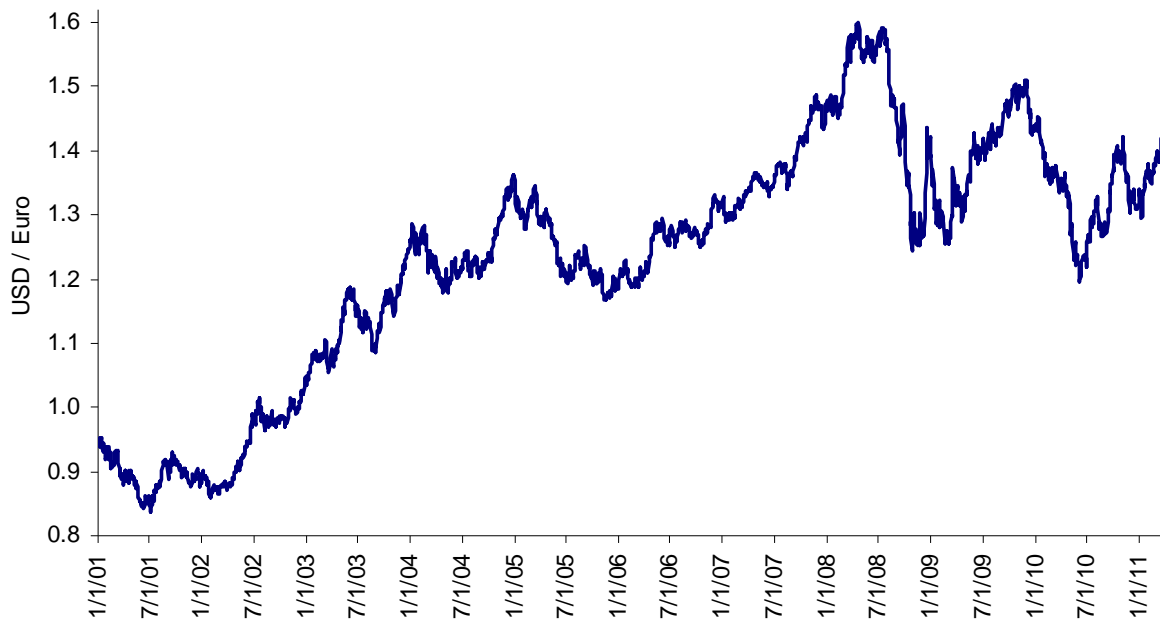
Source: Federal Reserve; ECB; Encima Global

We disagree with the view that yesterday's ECB rate increase will add to Europe's debt crisis and instability. The rate increase is holding down euro-denominated commodity prices and attracting the capital to Europe that will be needed to sustain euro-zone growth as Greece, Portugal and Ireland go through deep recessions.

- **The euro exchange rate has been relatively strong, even with the debt crisis in the back ground, reflecting the ECB's policy advantage over the Fed. Despite debt problems, we don't think the euro is at risk of devaluation or breakup given ECB and German policies. Euro stability is a key positive in Europe's outlook and an important contrast from the Asia devaluation crisis of 1997-1998.**

**USD / euro exchange rate (last obs. April 8, 2011)**

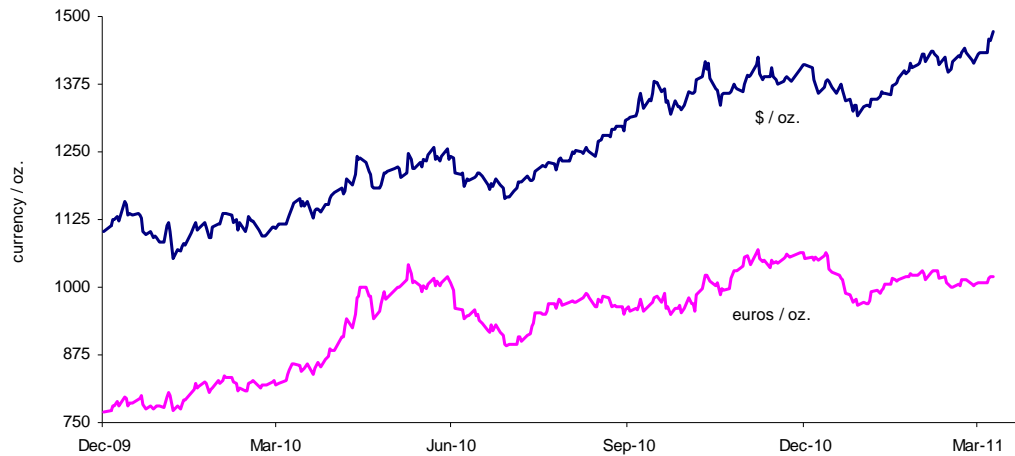
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Source: Bloomberg; Encima Global

- Gold priced in euros remains below the 2010 peaks as the ECB fights the currency weakness hammering the dollar.

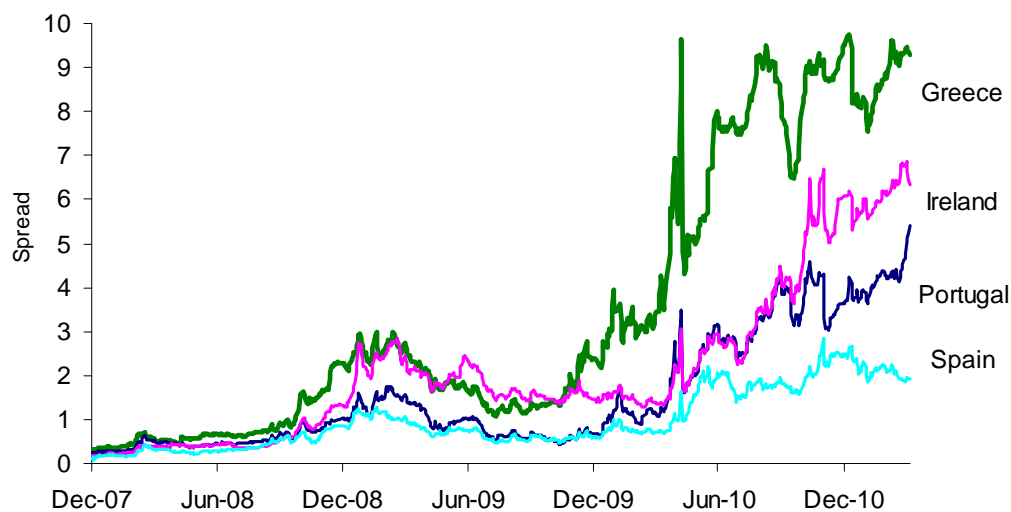
## Gold Prices in US\$ and Euros (last obs. April 8, 2011)



Source: Wall Street Journal; Federal Reserve; Encima Global

- The weaker European countries are seeing their debt burdens gradually ‘supra-nationalized’, i.e. shared by euro-zone facilities, the IMF and, eventually, haircuts for the remaining creditors many of whom will be state-owned financial institutions around Europe. If the net present value of the debt is reduced enough, economic growth will resume in the weaker countries, adding to ongoing growth in the stronger countries.
- Spain’s yield spreads are falling while Portugal’s are rising sharply, suggesting a possible break in the debt crisis. Greece, Ireland and Portugal may go through a series of debt workouts and reschedulings in coming years while Spain and other euro-zone countries survive to borrow another day.

## Selected European Yield Spreads vs German bunds (last obs. April 8, 2011)



Source: Bloomberg; Encima Global

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