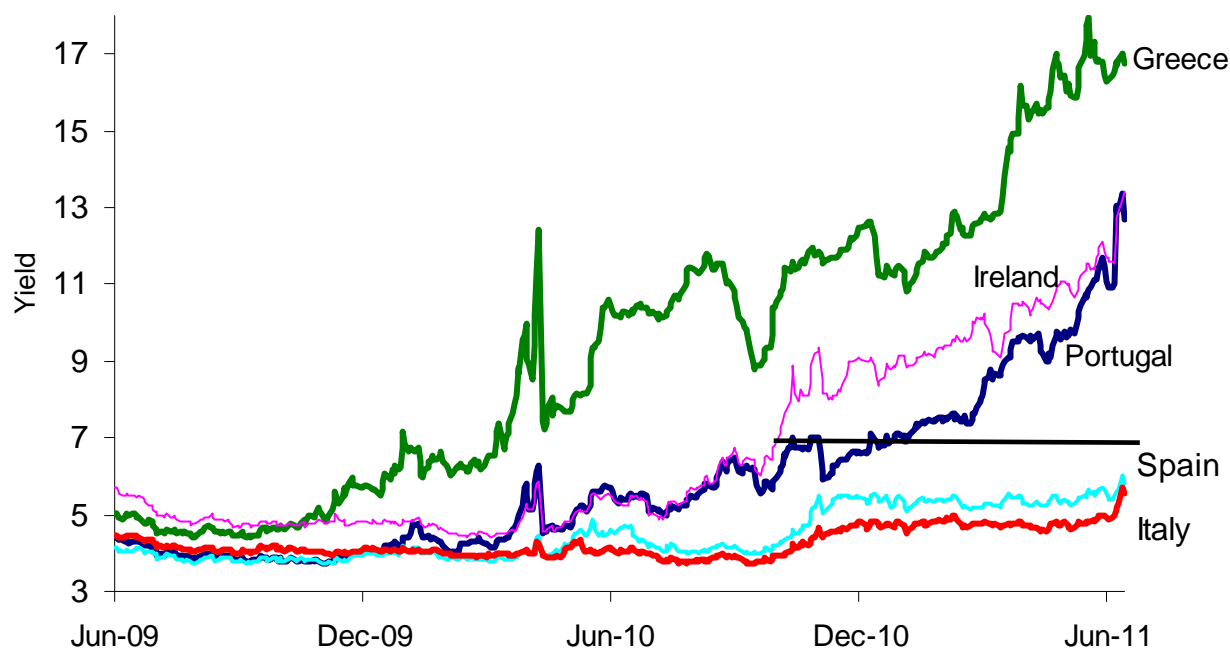


July 12, 2011

Yields Rising in Europe's Debt Crisis

Bond yields in Italy and Spain have risen with the delay in the voluntary restructuring of Greek sovereign debt.

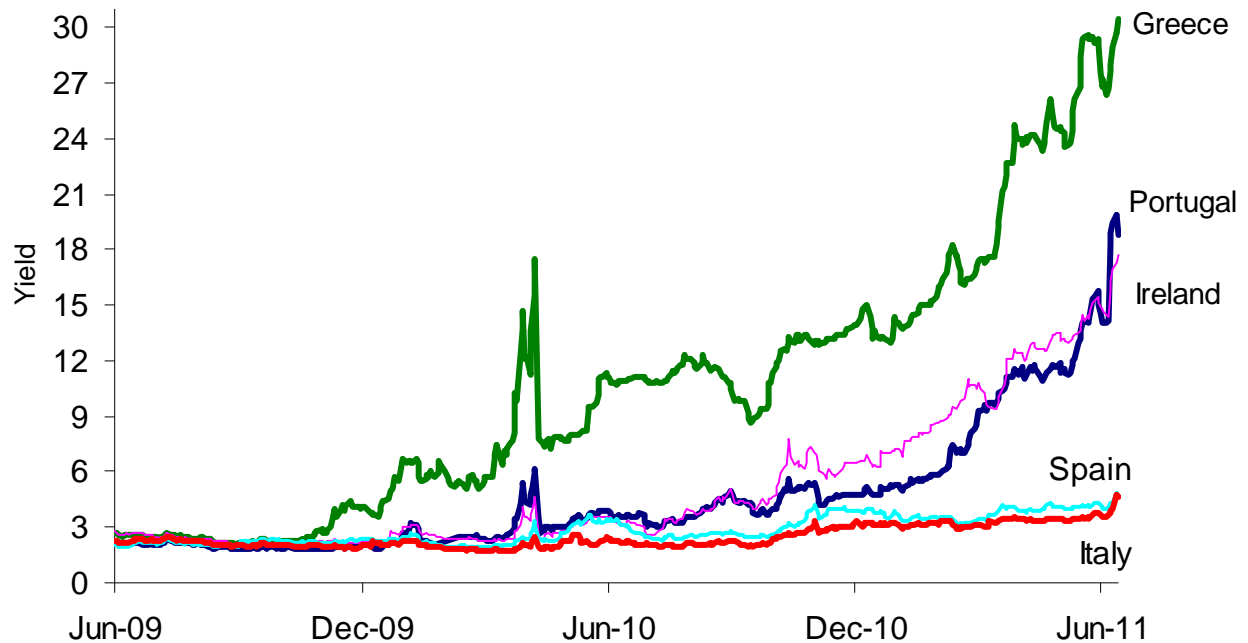
Select European 10 Year Yields (last obs. July 12, 2011)



Source: Bloomberg; Encima Global

- Ireland's credit rating has just been cut by Moody's, joining Greece and Portugal below investment grade. Three year notes were already yielding well above 15%, pricing in a large haircut in the event of a restructuring.

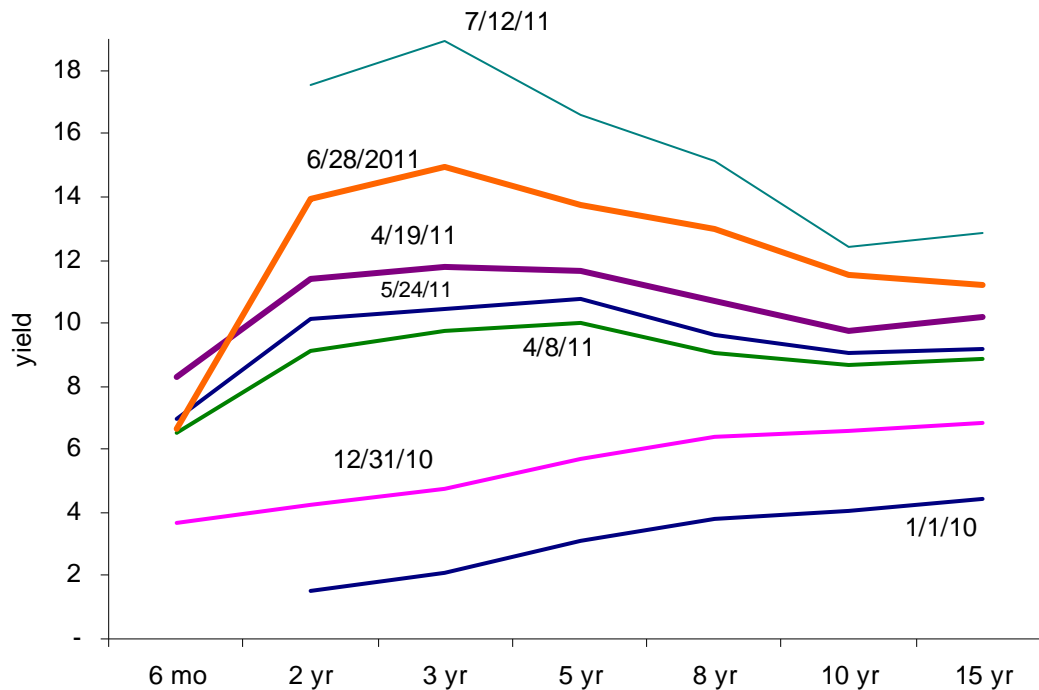
Select European 3 Year Yields (last obs. July 12, 2011)



Source: Bloomberg; Encima Global

- We note some positive developments stabilizing the euro today including a relatively successful short-term debt sale in Italy; the possibility that the ECB is buying more debt in the secondary market; rumors of Chinese investments; the prospect that Italy will quickly pass some structural reforms, with Spain also considering reforms; and continuing slow work on Greece's funding gap. There is some talk of the European Union issuing EU bonds to bring more money into the equation to possibly buy debt in the secondary market, though Germany has a constitutional problem with it.
- The current strategy in dealing with southern Europe's debt is to use voluntary reschedulings for now (avoiding CDS payouts) to allow more taxpayer money to be injected through the IMF and European Union and giving European banks more time to divest or reserve against their exposure. The delay might reduce the shock when the debt is restructured with a loss in net present value (which we expect for Greece and Portugal, perhaps in 2012.)

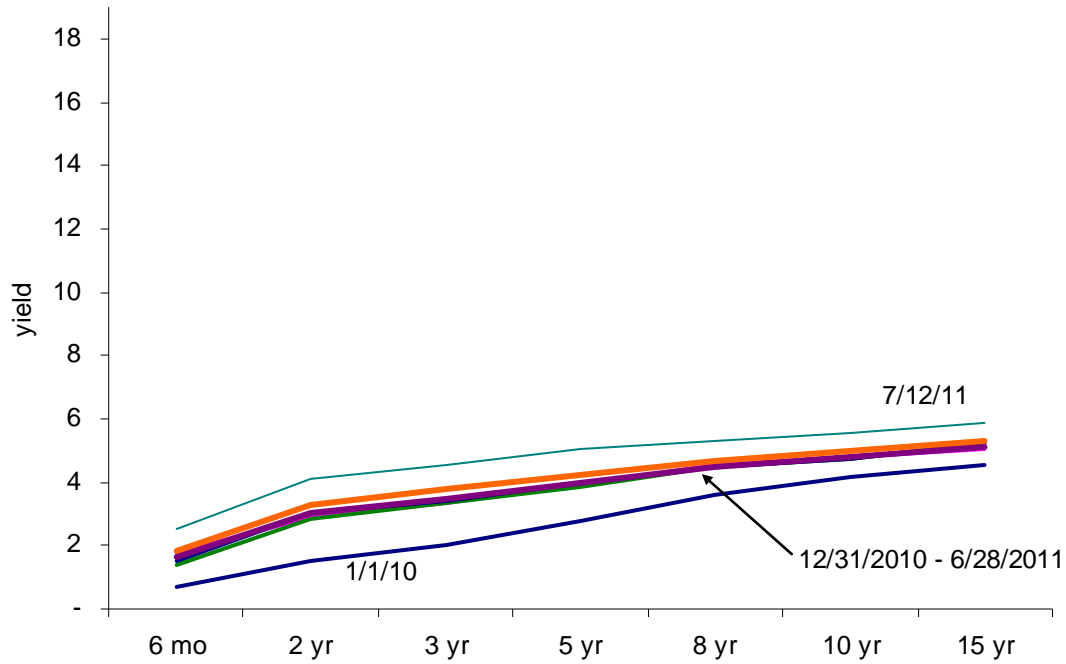
Portugal Yield Curve (last obs. July 12, 2011)



Source: Bloomberg; Encima Global

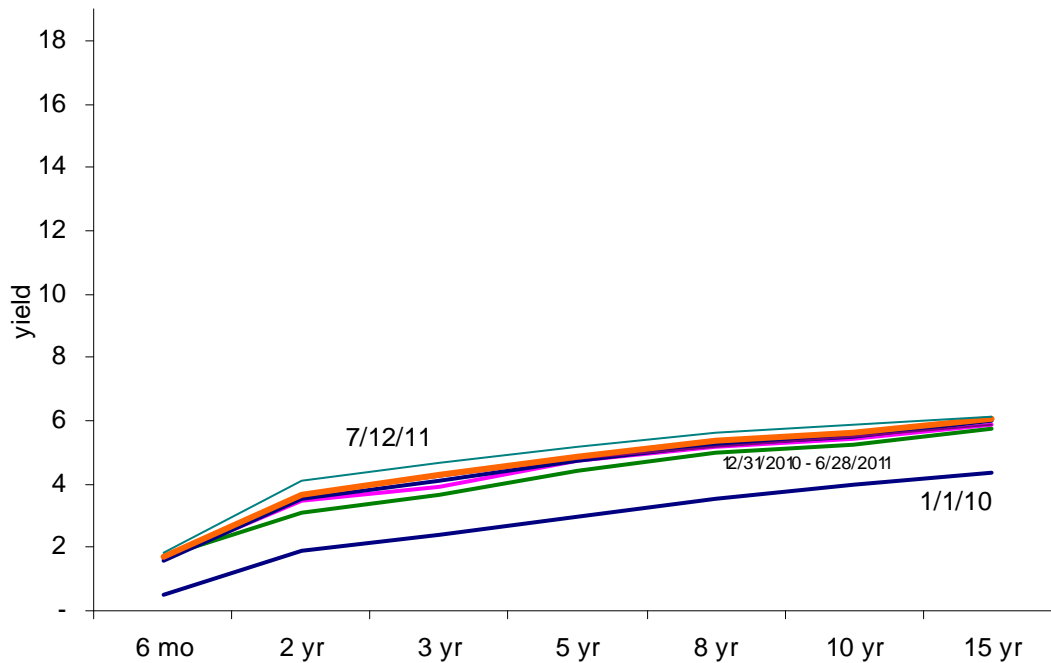
- For Italy, the problems aren't insurmountable. Italy's budget deficit, stated at about 4% of GDP, isn't as large as the others. Its banks don't have as many bad real estate loans, which should show up in the stress test due Friday. Its debt has a longer maturity structure and is heavily owned by individuals residing in Italy (a tradition that was reinforced by the smooth handover from lira debt to euro-denominated debt.)
- However, the "delay" approach for Greece harms the near-term growth picture for Italy and Spain because new investment will wait until the debt restructuring problems in their neighbors get resolved.
- The longer-term problem for southern Europe is the difficulty of trying to grow out of the current debt burden, especially if interest rates rise and populations decline. Many U.S. states face this. If debt is at 100% of GDP, the fiscal deficit has to be less than the nominal GDP growth rate in order to reduce debt relative to GDP. For Italy, nominal growth has been running below 3% of GDP (2.7% in the four quarters through March 31) while the fiscal deficit is stated as 4% of GDP. It will go higher if Italy's financing costs rise or growth slows even more.

Italy Yield Curve (last obs. July 12, 2011)



Source: Bloomberg; Encima Global

Spain Yield Curve (last obs. July 12, 2011)



Source: Bloomberg; Encima Global

In addition to fairness questions and politics, a time-consuming part of the Greek workout is the mechanics of sharing the losses -- which are large by Greek standards but not large relative to the economies and banking systems of northern Europe. A portion of the debt has already been marked down in secondary markets, so even though Greece's debt-to-GDP ratio measured at book value is very high and rising fast, the market value of the debt has taken some dips. In the end, we expect the net present value of Greece's debt to be reduced (possibly in 2012) with a substantial portion of the reduction absorbed by European taxpayers (through the EU contribution) and public sector debt holders (like German, French and Greek government-owned banks), but not by the IMF which doesn't take haircuts.

The Greek crisis has created many complicated battlefields that are delaying the resolution:

- The IMF has immense lending power due to its resources and unique off-budget status -- most U.S. contributions to the IMF don't go through the U.S. fiscal deficit or count as part of the U.S. national debt. However, the IMF's rules say it can't lend into a financing gap, meaning Greece is supposed to explain in advance the sources of finance for its fiscal deficit (e.g. financing bills, draws on the IMF program, EU resources.) The IMF routinely finesses this problem by tinkering with the numbers until the financing gap is theoretically closed. For now, the IMF is continuing its disbursements partly on the assumption that Greece will be able to borrow again soon. CDS holders, a new phenomenon, have a huge financial interest in cutting Greece off from IMF funds because it would force a quick Greek default and a massive payment to the CDS holders.
- Greek public sector employees want to retain full benefits and are pitted at least indirectly against the Greek and European private sectors. Like Wisconsin, the battle is intense over retirement age, lifetime pensions, work rules and dues collection since previous Greek politicians wrote sweet contracts but left them unfunded. So far, Greece has seen few government layoffs, privatizations or meaningful pension reforms and lots of pitched battles over other aspects of the austerity program like raising and collecting the high nationwide VAT tax rate (which can be viewed as funding the transfer of wealth from the private sector to the public sector.)

A key battle that hasn't existed in previous debt restructuring is between naked CDS holders (no economic interest in Greek bonds) and CDS issuers like banks and insurance companies. The CDS holders have made a gigantic bet that a default event will be declared.

- Fighting against the CDS holders is the powerful ECB. It doesn't want to take a loss on its own holdings of Greek debt. It has said that it would consider any non-voluntary rescheduling a default (for purposes of CDS payments.) To make clear the strength of its opposition to a rescheduling, ECB members have said that the ECB would no longer discount Greek debt if the debt were restructured. It's possible that the final deal will include a restructuring of Greek debt held by the ECB. The ECB has limited capital (about 11 billion euros) but is not itself on the hook for losses which would be passed to the member central banks (for example, the Bundesbank.) The combined capital of the Eurosystem of central banks is roughly 81 billion euros, enough to meet losses on ECB

holdings but possibly requiring some individual countries to recapitalize their central banks.

- Germany originally called for a restructuring of Greek debt that would reduce the net present value of private sector bondholders. After objections from the ECB, it now wants a voluntary deal that would not be called a default and would not trigger a CDS payout (which might hit some of its own banks and insurance companies). Complicating matters, German interests are not fully aligned with French interests for all the usual historical reasons plus German banks dumped more of their Greek paper than the French banks did (who perhaps counted on the IMF protecting them);

The Achilles heel in these Greek battles is the euro itself. If Greece converts euros into drachma, it would endanger the entire European financial system. Depositors in all of the weaker countries would have to immediately withdraw euros from banks and move them elsewhere, creating a financial collapse rivaling the Lehman bankruptcy.

- Assuming Greece stays in the euro and Greek debt is restructured at some point, the losses will be spread broadly among Greeks, European taxpayers contributing through the EU, bank equity holders, some bank creditors, the institutions that underwrote credit default swaps on Greek debt and possibly the central banks who are members of the ECB.
- Since the losses already occurred, allocating them shouldn't change the global growth outlook as long as the process can be carried out quickly enough to allow growth to restart and in a way that encourages growth-oriented structural reforms across southern Europe.

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