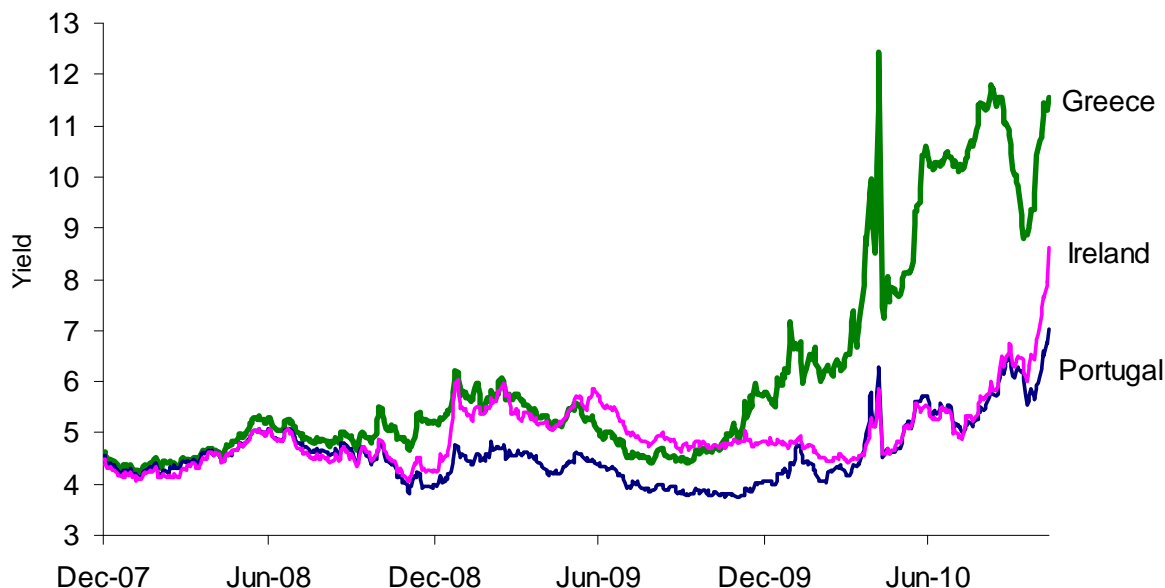


Rolling European Debt Problems – Lessons for the U.S.

Bond yields have risen sharply in Ireland (2-year at 6.2%, 10-year at 8.6%), with upward pressure on yields in Portugal and Greece and to a lesser extent Spain and Italy. **While the spike in Ireland's yields creates a severe crisis for Ireland, we don't think this latest round in Europe's rolling debt problems will have as much impact on global markets as the Greek crisis did earlier in the year.**

- 1) When Greek debt first came under scrutiny, there was a surprise factor for markets. And as the crisis evolved, the Greek government discovered misstatements in GDP, fiscal deficits and the size of the debt.
- 2) The Greece crisis caused speculation about the breakup of the euro. We don't think there was much risk of that and don't think this concern will be a factor in Ireland's crisis.
- 3) In the Greek crisis, it was unclear how Germany and the ECB would respond. They've now shown powerful authority to rearrange and buy debt and to draw in IMF resources.
- 4) Europe took strong explicit steps during the Greek crisis to regulate and restrict certain market instruments (shortselling, CDS, etc.) We think this will limit some of the volatility during this round of the European debt crisis.

Select European 10-Year Yields (euro-denominated, last obs. November 10, 2010)



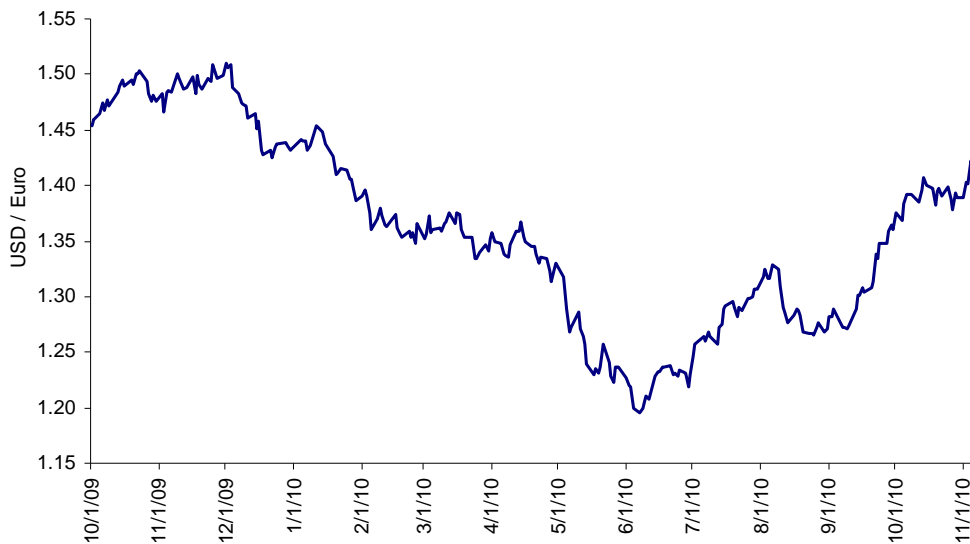
Source: Bloomberg; Encima Global

Restructuring Risks Growing

Two important changes have occurred since Greece's crisis that will bear on Ireland's (and Greece's) relationship with creditors.

- 1) German financial institutions that held weak-country debt earlier in the year have either sold the debt or isolated it in "bad banks". This means they won't lobby as hard against a haircut for private sector creditors. Whereas the Greek crisis in the first half of 2010 hit the euro hard, we don't think the Irish crisis will.

USD / Euro (last obs. November 10, 2010)



Source: Federal Reserve; Encima Global

- 2) The IMF and other official creditors hold an increasing portion of weak-country debt, as does the ECB. On October 29, the ECB implied that official creditors would be kept whole in a sovereign debt restructuring, while private sector creditors would take a haircut. It's unclear whether the ECB, one of the biggest creditors, would be considered public (no losses) or private (big losses) in the event of a debt restructuring. With some creditors protected, the losses to other creditors are magnified.

We think Europe will be relatively resilient because the debt restructuring costs are being contained to individual countries and creditors, not the euro.

- We don't know whether Greek debt will ultimately be restructured, with haircuts for private sector creditors, but we don't think there would be much global contagion from a restructuring.
- In addition, because devaluation is off the table (for Greece, Ireland and other euro-zone members), the damage to individual countries from debt restructurings would not nearly as grave as if devaluations occurred. Segments of their societies will see their living standards go down based on any legal deal with creditors, one of which will likely

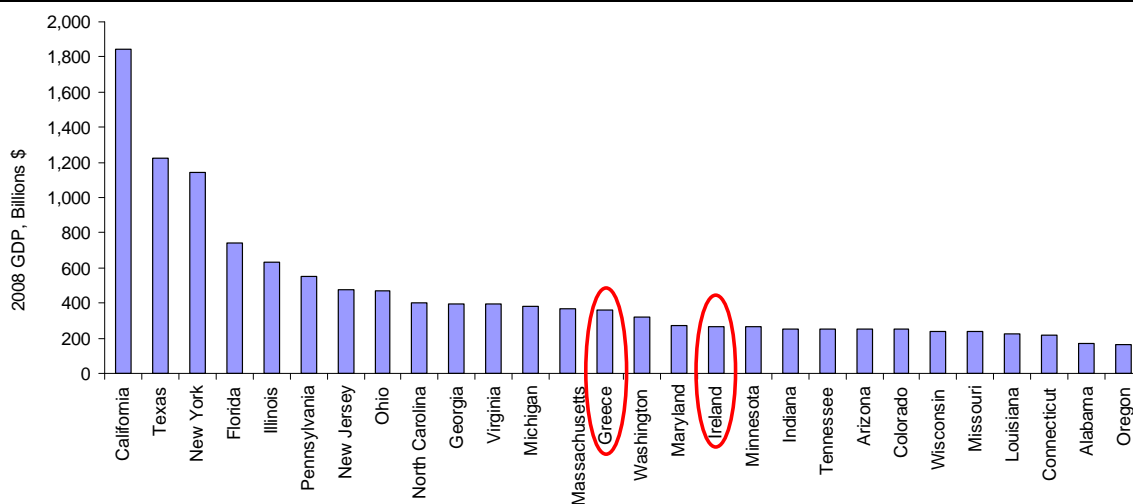
be the IMF. For example, Greece's per capita income may be set back 20% by its debt crisis, but not the 50% or more that hit Asian countries during their 1997 devaluation crisis or the even bigger losses in per capita income that hit Latin countries suffering both debt restructurings and devaluations.

Application to the U.S.

Our pieces earlier this year described our expectation of rolling debt crises. As part of the process, debt is migrating from riskier issuers (like Greece) toward safer guarantors (ECB, IMF.) We think this process of concentrating the debt risk in safer (or at least bigger) creditors is stabilizing in the short run, and worked to resolve the Greece crisis in the spring. It doesn't correct the underlying spending problems, but does kick the can down the road a bit further. (See The Euro's Greek Tragedy, and Its Lessons for America in 2/27/10 WSJ.)

- In the U.S., much of the large 2009 and 2010 fiscal stimulus packages consisted of federal transfers to states to relieve state budgets. This meant the debt was issued by the safer federal government rather than by cash-strapped California, New York and others. Federal debt has grown much faster than state, local and private sector debt, lowering the average yield on the total debt but causing accountability problems. States are further subsidized by Build America Bonds, the annual AMT tax cap and wide latitude allowing underfunded pensions. We think those will be put to the test in the lame duck session and in 2011. We expect rolling debt crises in the U.S. in 2011 and 2012 straining political and legal processes, but, as in Europe, not causing too much contagion because devaluation is not an option. The growth issue for a state in a debt crisis is the "conditionality," (the IMF term for the demands placed on debtors by creditors), applied to the debt restructuring packages and the time taken arguing about it (which freezes investment in those states.)

Ireland, Greece and Largest States 2008 GDP in USD



Source: BEA; IMF; Encima Global

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