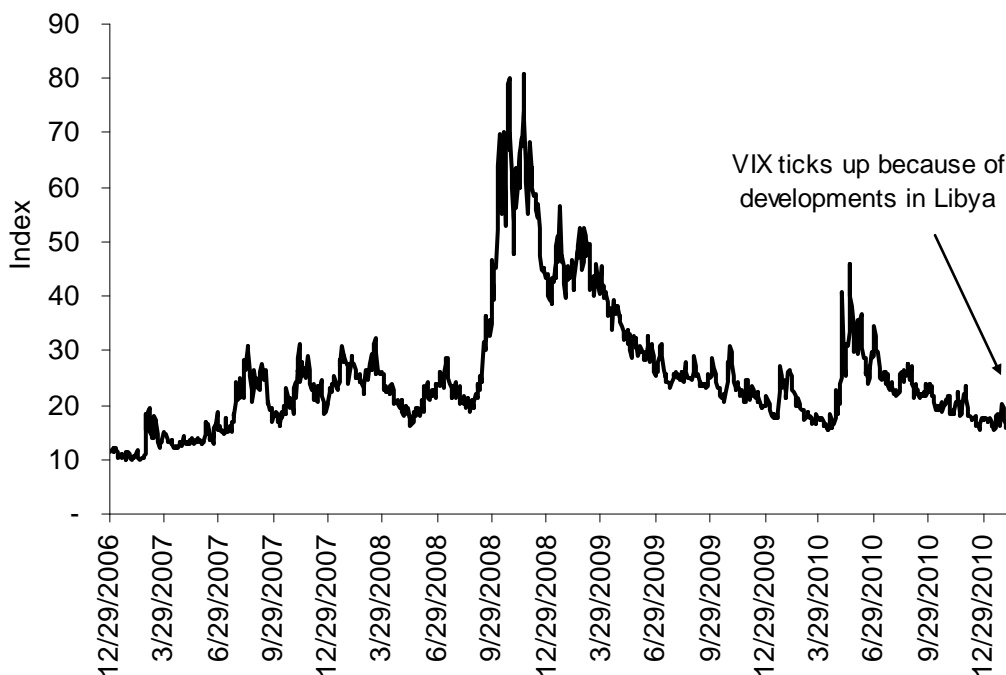


North Africa Turmoil: Europe, Not Oil, the Weak Link

We expect a let down in U.S. and global growth in coming months, but not a double dip and probably not a 'soft patch' (which took second quarter 2010 U.S. growth down to 1.7%.) Ultra-loose U.S. monetary and fiscal policies are harmful, but we don't think those mistakes can stop global growth at this early point in the expansion.

- Market volatility has increased some with events in Libya. We don't think it signals a full market correction – higher volatility makes sense given the complacency of the 2010-2011 'risk-on' uptrend.

VIX - Volatility Index (last obs. February 24, 2011)



Source: Bloomberg; Encima Global

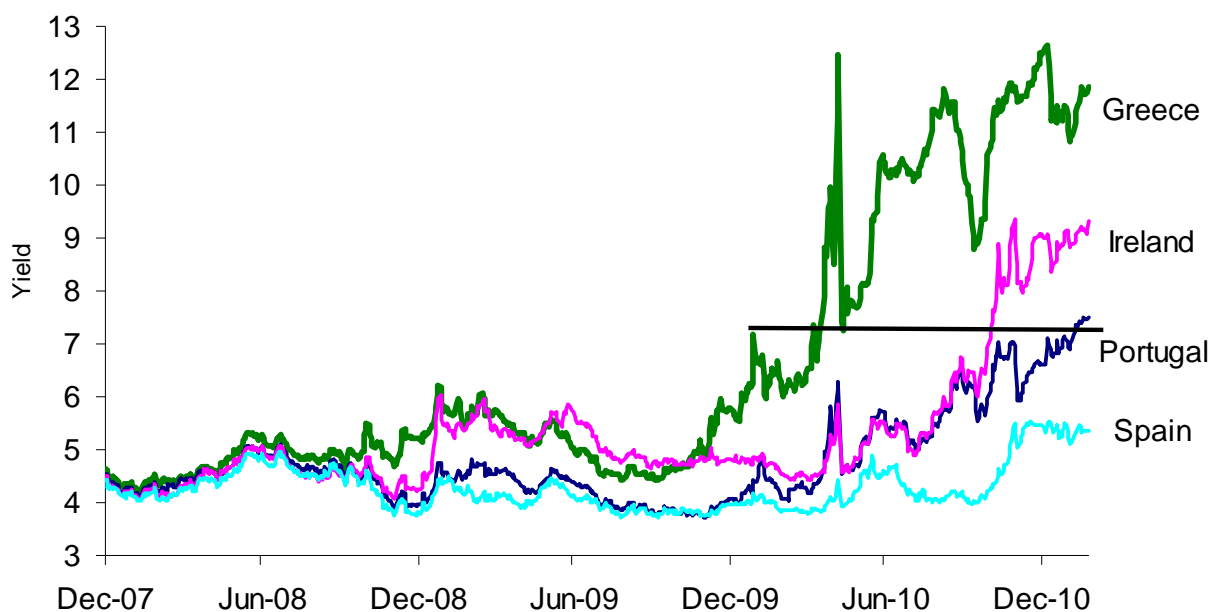
Our market concerns aren't centered on Libya or \$100 oil. Global growth hasn't been that sensitive to oil prices, and the world is finding oil and BTU equivalents quickly. Libya's oil and gas production could be met by other suppliers. Qaddafi's departure would be a plus.

- Egypt is much more important than Libya due to population, the Suez, Israel, Gaza, the Red Sea, implications for Saudi Arabia and more. For now, the Egyptian military appears to be in control.
- The many threats to Israel and Saudi Arabia don't seem that much worse now than before (e.g. Iran's threat to itself, Israel and regional stability is about the same.)

However, the threats to Europe have increased. Southern Europe is exposed to the turmoil in North Africa at a time when its economies are already at risk from high unemployment and debt. Europe has a big population from North Africa, and refugees will cause political and economic complications. Turmoil in North Africa raises terrorism risks for Europe.

- Recent developments in northern Europe add to the pressure. Axel Weber declined to be considered to head the European Central Bank. German Chancellor Merkel's party lost heavily in Hamburg elections. German voters are showing no inclination toward the concessionary interest rates needed for loans to Greece, Ireland and elsewhere. Ireland is suffering emigration, adding to the medium-term growth and debt problem.
- Debt yields for weaker European countries remain elevated. Portugal's 10-year sovereign yield crossed above 7% in late January and has topped 7.5% during February. This high a yield level signaled crisis for Greece and Ireland in 2010. We expect the European debt crisis to take years to resolve, with corresponding economic weakness in southern Europe.

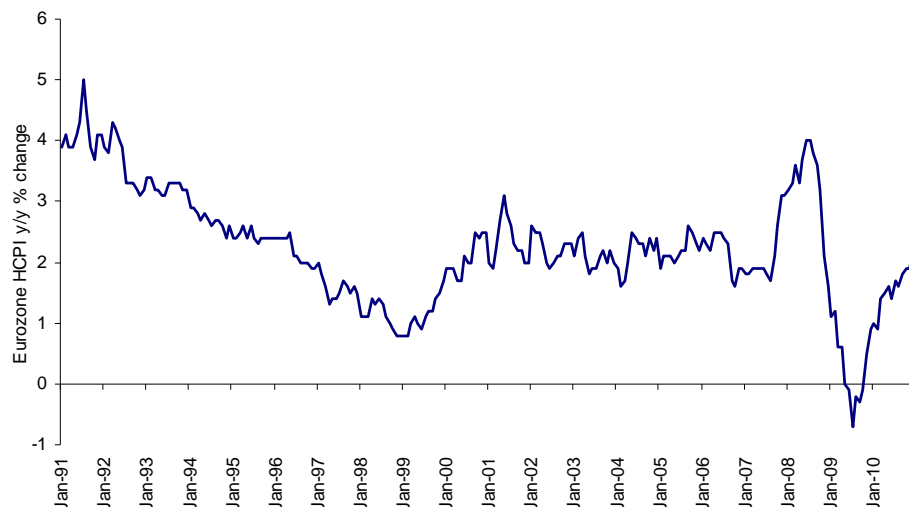
Select European 10 Year Yields (last obs. February 24, 2011)



Source: Bloomberg; Encima Global

- European inflation is already rising. Turmoil in North Africa will add some to those pressures.

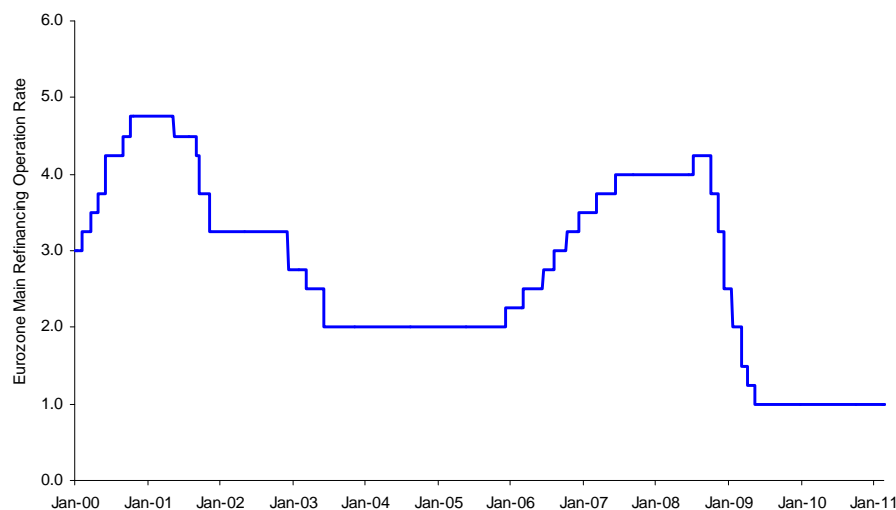
Eurozone Inflation (last obs. December 2010)



Source: Bloomberg; Encima Global

- We expect the European Central Bank to increase the refi rate in mid-2011 in accordance with its mandate to provide price stability.

ECB Policy Interest Rate (last obs. February 24, 2011)



Source: European Central Bank; Encima Global

- **While turmoil in North Africa creates a new downside risk for Europe, we are still of the view that southern Europe's problems will not cause much drag on global growth due to the pro-growth shift in investment toward northern Europe discussed in our previous pieces.** Eurozone purchasing indexes have recovered after a brief soft patch in the third quarter of 2010.

- **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.**

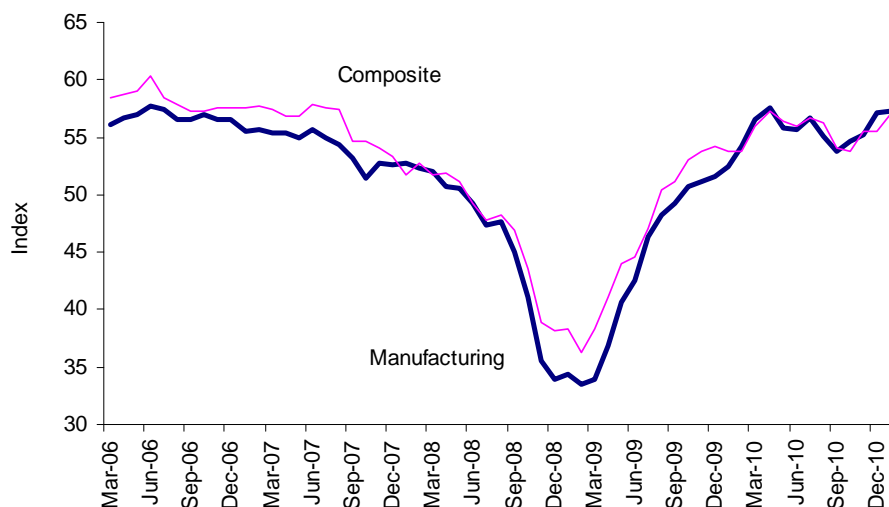
US \$ / Euro (last obs. February 24, 2011)



Source: Federal Reserve Board; Encima Global

- Eurozone purchasing indexes have recovered after a brief soft patch in the third quarter of 2010.

Eurozone Purchasing Managers' Index (last obs. January 2011)



Source: Bloomberg; Encima Global

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