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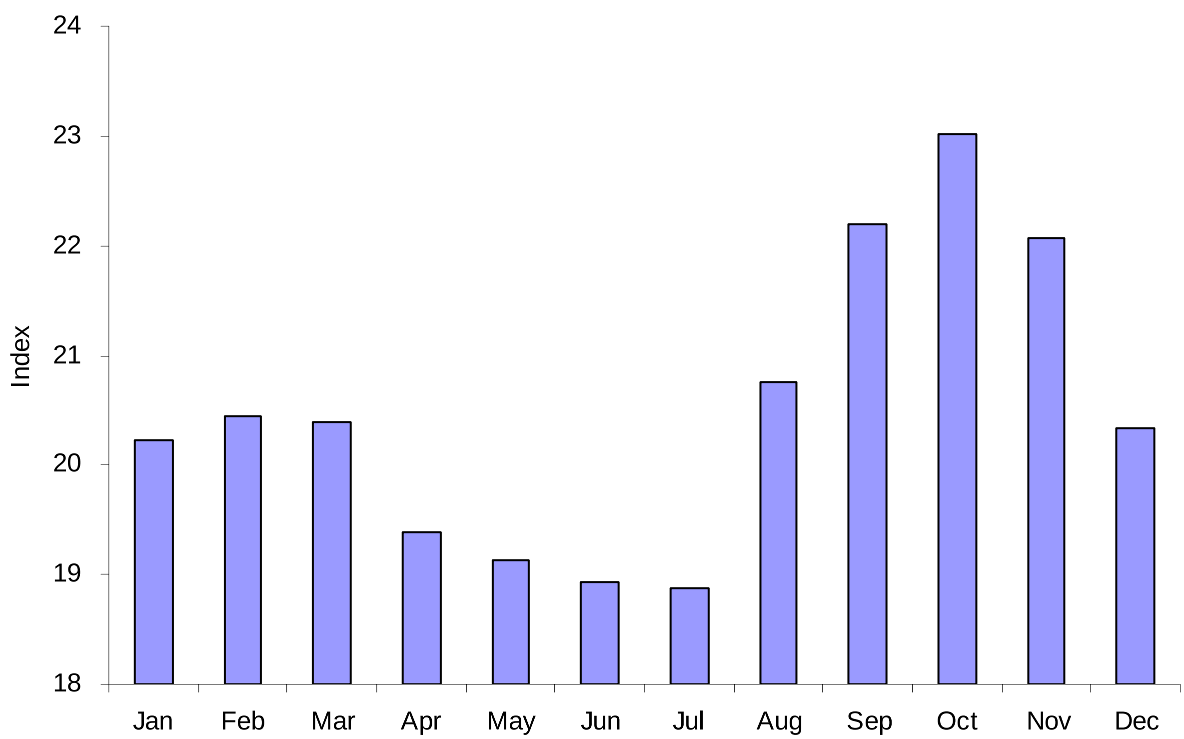
October 4, 2011

Plan Forming In Europe – ECB the Next Key

Yesterday's postponement of Greece's aid disbursement creates a better environment for European debt policy. We think there may be a respite in the bad policy and growth developments.

- We've been emphasizing the negative July-August inflection point for government policies in the U.S. and Europe and the negative implications for growth and earnings. **Our base case for 2012 is still shallow recessions in the U.S. and northern Europe unless major policy improvements are launched (more likely in Europe than the U.S.)** Our September 27 piece provided additional near-term market caution due to typical October volatility – on average since 1990, the S&P suffers its highest volatility in October, followed by September and November.

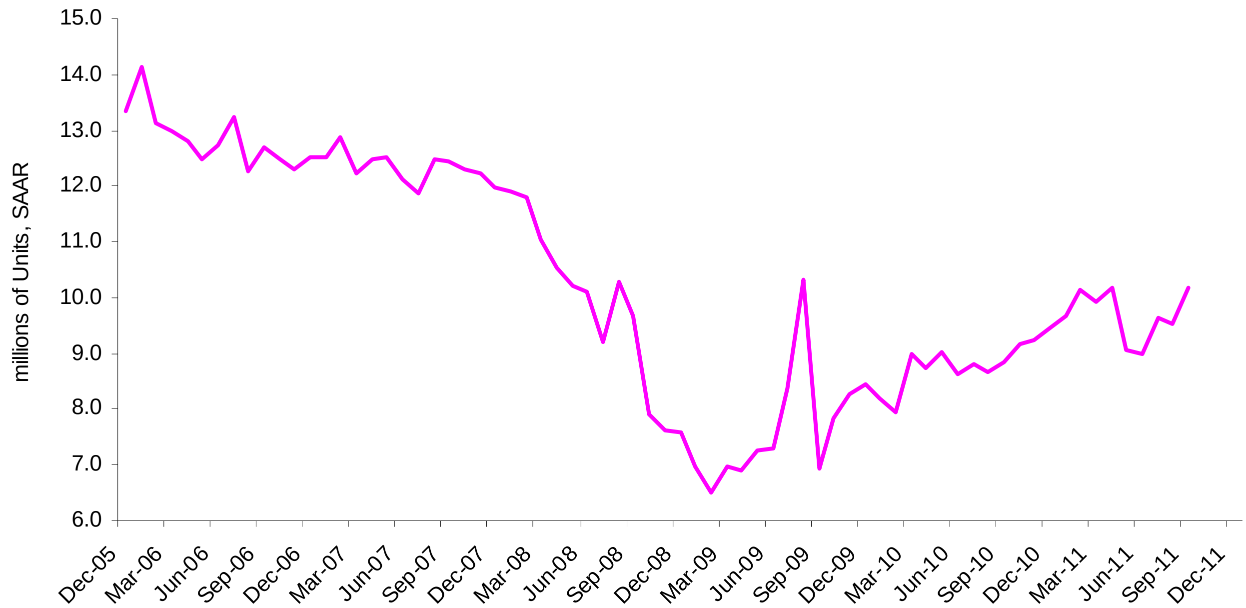
VIX - Volatility Index Monthly Average (data from 1990 - 2011)



Source: Wall Street Journal; Encima Global

- The U.S. can't decouple from Europe's debt crisis, but the news isn't all bad. The U.S. made minor breakthroughs this week on the free trade agreements and passage of another continuing resolution (through November 18.) U.S. growth data isn't collapsing, certainly not as much as bond yields have. Whisper numbers are negative for September job growth, creating the possibility of positive surprises in this week's data from ADP, jobless claims and payrolls. Auto sales, ISM, jobless claims and earnings are pointing toward 2% or more growth for the third quarter, not the "recession underway" view that dominated markets in September.

Auto Sales (last obs. September 2011)



Source: Bureau of Economic Analysis; Encima Global

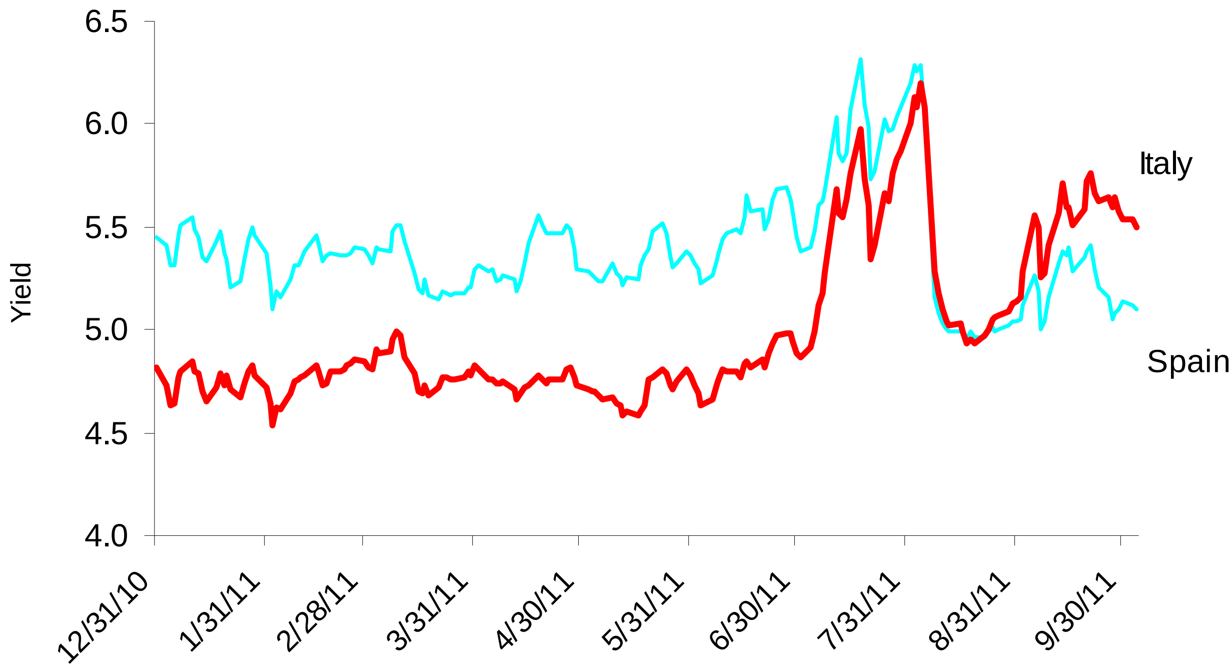
Yesterday's meeting of European finance ministers delayed the Greek disbursement but addressed several concerns including Greece's near-term cash flow, the 2012 financing gap, and the size of the private sector haircut.

- To an extent, the IMF may be forcing a more constructive European debt process. It couldn't make Greece's numbers work into 2012 unless the next aid program (the 109 billion euros agreed on July 21) includes more public funding (need EFSF up and running) and a bigger private sector haircut (may need some bank recapitalizations). **The ministers also stated clearly that there won't be a Greek default (just a voluntary restructuring); and that all euro members are expected to remain in the euro.**

- We think Europe will focus on expanding the existing bailout approach to Greece and Portugal and testing the EFSF. Rather than a broad U.S.-style bank recapitalization, we expect a narrow one consistent with the EFSF's framework. We don't think there will be "shock and awe", a big 'leveraging up' of the EFSF or a plan to handle two trillion euros in potential debt losses if Italian and Spanish debt are restructured – as pushed by the U.S. government and U.S. analysts.

- Three critical variables in whether this slow process will work: 1) the need for more ECB involvement in counteracting the bank funding problems; it has the power and latitude to resist the debt contagion and may unveil some softening -- perhaps creative bank lending facilities -- on Thursday at the 7:45am EDT announcement and then at Jean-Claude Trichet's final press conference; 2) credible structural reforms in Italy and Spain to reduce fiscal deficits; 3) signs of a floor in economic activity in Italy and Spain. There's been a welcome decline in Italian bond yields in recent days, tracking earlier declines for Spain.

Italy and Spain 10-Year Bond Yields (last obs. October 4, 2011)



Source: Bloomberg; Encima Global

The new timeline for Greek debt makes sense.

1. Remaining euro-zone nations approve EFSF expansion, with Slovakian approval expected in late October.
2. The German-led EFSF takes steps to become operational in terms of testing its borrowing power, ability to inject capital into a small group of weak banks, and active participation in debt restructurings by helping countries buy collateral.
3. Greece searches for new budget savings to win a bigger version of the second aid program outlined on July 21.
4. European leaders pressure banks to come up with a bigger haircut on Greek debt while keeping it "voluntary" in order to avoid trigger credit default swaps.

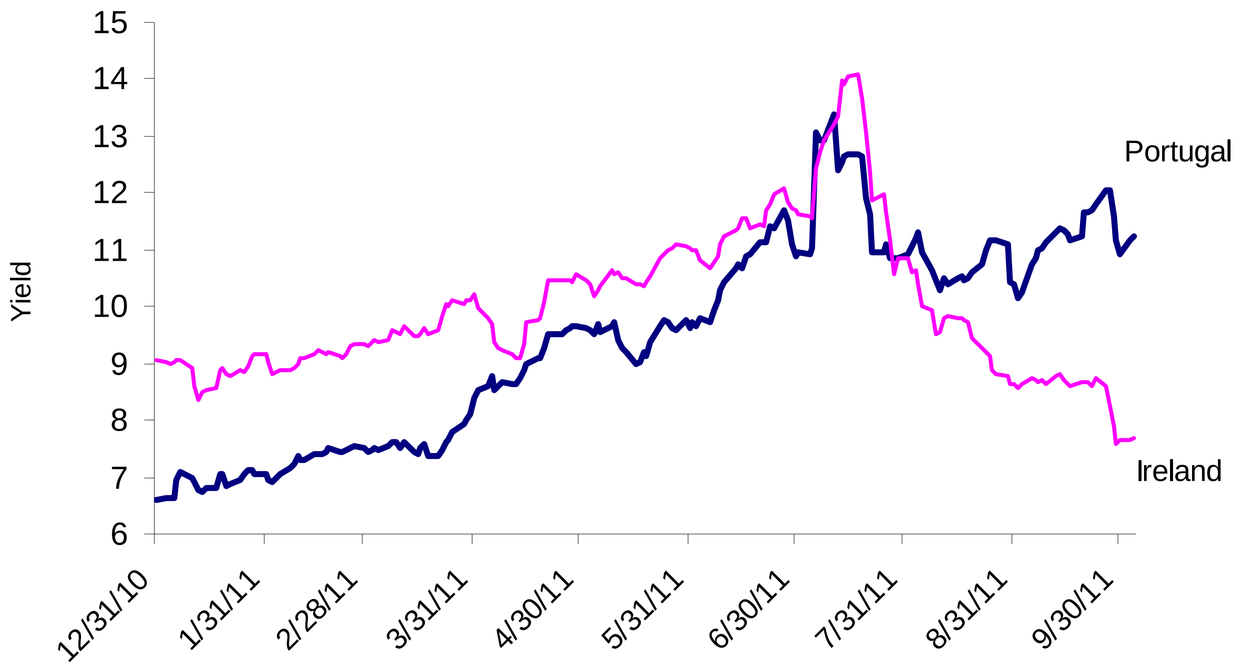
5. In November, Greece gets sixth and final tranche of the 2010 program and undertakes the 2011 program with the help of the new EFSF.
6. The old timeline started off with an IMF disbursement to an underfunded Greek reform program and didn't give time for EFSF to become operational:

We disagree with the fatality that many are applying to Europe's debt crisis. If it acts resolutely on its plan, we think Europe's crisis boils down to two solvable problems.

- Countries wasted hundreds of billions of borrowed euros over the last decade as they violated the Maastricht fiscal deficit limits. Most of these losses will be amortized (northern Europe's 30 year borrowing cost is 2.5% per year.) Another portion can be transferred to the EFSF, EU and IMF. The private sector will write off some of the loss. German politics are becoming more tolerant of loss-sharing.

- The second problem is growth and competitiveness in southern Europe. Some of the countries and leaders will rise to the occasion, others won't. Greece's and Portugal's bad experiences and Ireland's less bad experience may help the structural reform process in Spain and Italy.

Portugal and Ireland 10-Year Bond Yields (last obs. October 4, 2011)



Source: Bloomberg; Encima Global

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