

September 15, 2011

Policy Freeze Points to Recession

Europe has had minor positive developments this week, causing equity gains. However, we think the underlying policies in both the U.S. and Europe are still deteriorating. On the current course, we expect a global slowdown extending into 2012, with shallow recessions in the U.S. and northern Europe. We note weakening economic data in Europe (IFO, southern Europe in recession) and in the U.S. (jobless claims, Philly Fed, Empire index, retail sales). We expect U.S. corporate earnings estimates -- the principal underpinning for the equity market -- to decline materially from the current \$108 consensus for 12-month forward earnings.

U.S. Developments

The U.S. is likely to maintain ultra-loose fiscal and monetary policies including trillion dollar plus deficits and near-zero interest rates.

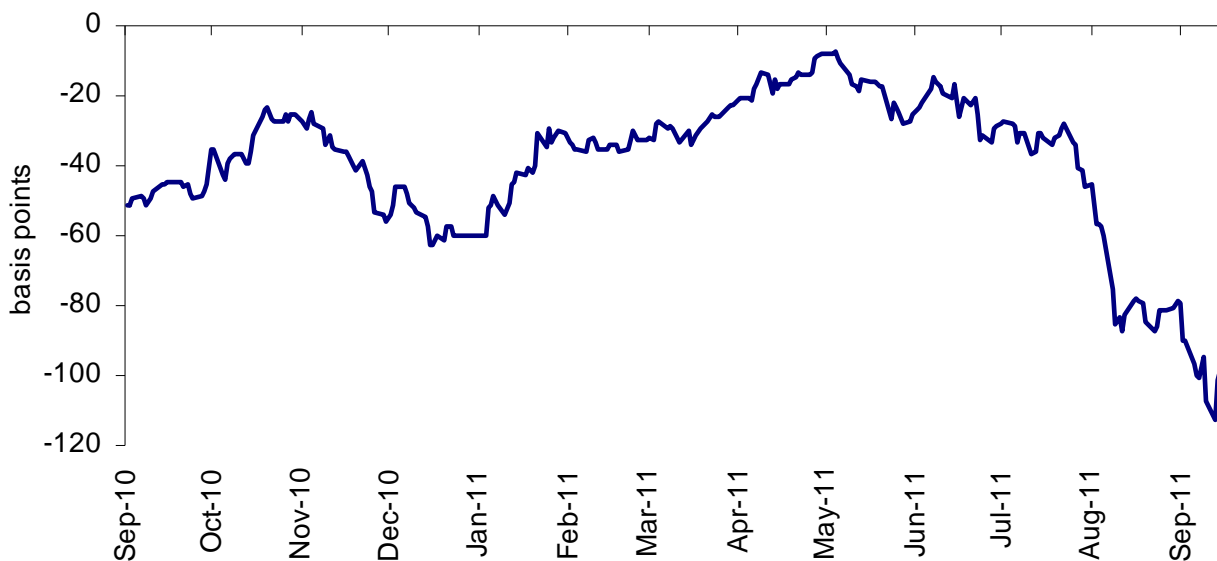
- Only limited legislation will pass before the 2012 election, making fiscal improvements such as tax reform unlikely.
- The Administration isn't offering much in the way of spending cuts or entitlement reform to offset its jobs bill, making it more difficult for Congress to find areas of agreement. On Monday, the Administration proposed a limitation on the exclusion for muni bond interest, a political non-starter that ducks the spending offset issue. On Thursday, the Administration hinted that it would not offer entitlement cuts in its September 19 plan. We don't think the super committee will be able to bridge these differences in approach. The sequester doesn't take effect until 2013, so the path of least resistance is for Congress to do the minimum through the election.
- The Administration might attempt another mortgage reform program, but Treasury appears to be letting FHFA and the GSEs guide the reform effort. This limits its impact because they want to hold down their losses.
- We think regulatory relief from forced bank capitalization requirements would help growth but are unlikely. We expect increasing strains on bank profits as economic growth remains weak. The interbank lending market is shrinking, hurting funding for some banks. To the extent that operation twist flattens the yield curve, it hurts bank profit. A cut in the interest rate the Fed pays for excess reserves would also reduce bank earnings.

- The Fed is maintaining a weak-dollar policy and pushing near-zero interest rates out the yield curve, causing increasing damage. In the September 20-21 FOMC, it may decide to buy more long-term Treasuries, financing them with either excess reserves under QE3 or the sale of shorter-term bonds under operation twist. We think bond markets have already over-priced these possibilities, neither of which will help growth or earnings.

European Developments

Today the ECB started providing three-month dollar loans to European banks using its long-standing dollar swap lines with the Fed. Euribor/libor basis swaps (a measure of euro funding strain) narrowed from 112 on Monday to 82 today (the post-Lehman trough was -210).

Euro Basis Swap (last obs. September 15, 2011)



Source: Bloomberg; Encima Global

- The euribor to OIS spread is now at 77 versus a high of 85 on September 12.

Euribor less OIS (last obs. September 12, 2011)



Source: Bloomberg; Encima Global

- We think ECB lending is a holding action, a neutral development. It confirms the severity of the problem (a drying up short-term funding markets for European banks) and makes clear the temporary government solution (ECB liquidity.) It's not a surprise -- we discussed the likelihood of the ECB providing dollar liquidity to European banks using its Fed swap lines in our August 18 piece, Europe's Bank Funding and Spreads Not As Big A Problem As Slow Growth.
- After yesterday's Germany/France conference call with Greece, Germany again stated its view that the euro-zone would stay intact. Despite statements by other German officials, we don't think this was in doubt at this middle stage of the European debt crisis. Germany would be a massive loser if the euro-zone split. Germany's neighbors and principal trading partners would see their dollar GDP and consumption power cut in half or worse. It's good to have Merkel once again state Germany's position with clarity, but it doesn't solve the deepening growth problems.
- Over the weekend, Greece added a property tax to its existing austerity program. The IMF/EU/ECB troika returned to Athens. **We think it is likely that Greece will receive the next tranche in its support program, allowing Greece to muddle along toward year-end.**
- At the weekend G7 meeting, Christine Lagarde softened the IMF's concerns about the capital adequacy of European banks. However, the communiqué reiterated the G7's support for the Basel III bank regulatory process (that Jamie Dimon says disadvantages U.S. banks.) We think the pro-cyclicality of the U.S. and European regulatory capital process (forcing banks to increase equity when its most expensive) is one of the major

obstacles in the growth outlook but has plenty of room for compromise if U.S. and European regulators wanted to encourage growth.

We think this week's generally positive European developments are minor compared to the negative developments in previous weeks.

- Bond yields in Italy and Spain remain high, stifling growth. Industrial production is running -4.6% year-over-year in Italy and -5.7% yoy in Spain, an indication of recession. We think Europe has to engineer convergence of bond yields (meaning a decline in Italy and Spain) in order to salvage growth. Italy and Spain keep announcing ever-deeper austerity programs rather than growth programs, so it's unlikely they can grow their way out of the debt trap.
- Italian 12 month yields at 3.67% today remain near the recent high of 3.86%. In our view, this wide a spread with Germany (one-year at 0.5%) will severely limit investment in Italy. To dramatize, Italy's one-year yield is more than seven times Germany's.

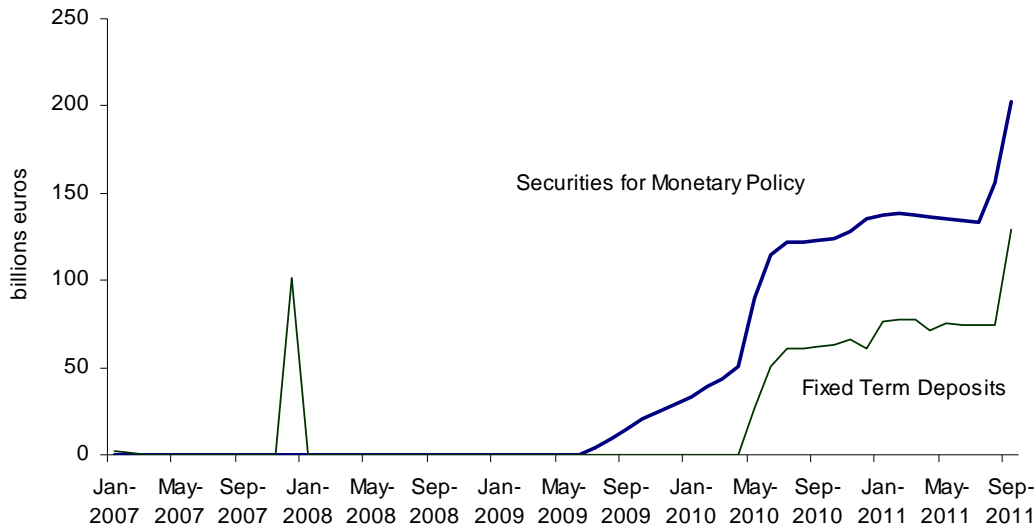
Italian 12 month Yields (last obs. September 15, 2011)



Source: Bloomberg; Encima Global

- The ECB has shown no inclination to accelerate its purchases of Italian and Spanish bonds. A German board member resigned over the small bond purchases already made. We think the ECB has practically unlimited capacity to buy these higher-yielding bonds at a profit, causing yield convergence and GDP growth as the Fed did with its 2008 MBS purchase announcement. But the ECB feels constrained by legal, political and institutional objections that will persist into the incoming Mario Draghi presidency.

ECB Securities for Monetary Policy (last obs. September 9, 2011)



Source: ECB; Encima Global

- The expansion of the EFSF's funding and authority will have limited value due to changes being made in the parliamentary approval process. There is the possibility that these will be worked out, creating a powerful new European intervention authority, but recent polls and state votes in Germany, committee votes in Austria, and demands for collateral by Finland already point to a weakened EFSF. Given that trend, the voluntary private sector participation in the proposed Greek debt restructuring is still limited.
- The underlying problem is that southern Europe's governments are running at a loss. Greece's fiscal deficit remains staggeringly large, 9.5% of GDP in the latest official reports. The IMF is not supposed to lend into a "funding gap", but will probably bend the rules again with its upcoming disbursement. With longer-term financing unavailable, Greece's government is making payments to civil servants, the military, pensioners and other government services through: 1) rapidly dwindling tax receipts; 2) limited funds from the IMF and the EFSF; 3) financing from its central bank. The latter mechanism, called Emergency Liquidity Assistance and available to national central banks under a euro-zone memorandum of understanding, allows the Greek central bank to lend to the illiquid Greek institutions which are rolling over Greek treasury bills but losing bank deposits. We think there is a limit to the amount of deficit financing available through this mechanism (the risk ultimately resides in undercollateralized assets at the ECB.)
- Bottom line: Our expectation is that Greece may be able to muddle along for a few more months while a voluntary private sector restructuring is put together. The ECB can provide liquidity. But looking forward, Greece will be in a deep recession and end up with large non-reschedulable loans from the IMF and the ECB. With bond yields high in Spain and Italy, their recessions will deepen, creating new pressure on European banks.

Notes: This email and attachment are confidential and intended solely for the use of the individual to whom they are addressed. Encima Global LLC does not accept liability for the content, or for the consequences of any actions taken on the basis of the information provided. The information is not necessarily complete, and we make no warranty as to its accuracy.