

# September Cautions, but Not a Recession Yet

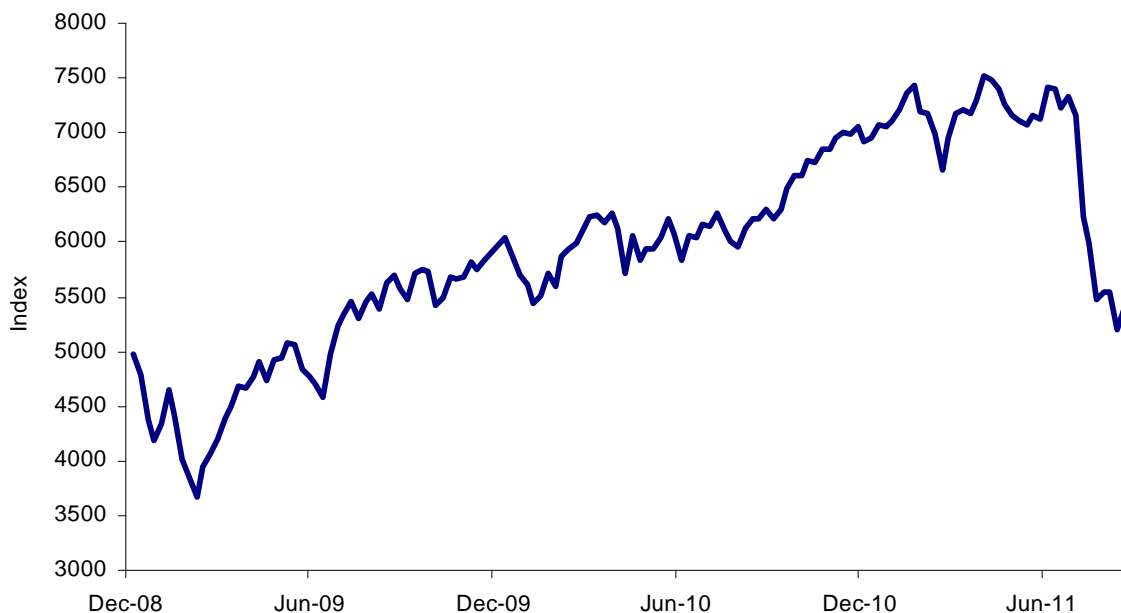
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We don't think the U.S. or Europe is in recession yet. It will depend on government policies, which deteriorated in August. **Today's developments were helpful but limited.**

- European equities rebounded strongly today from lows. The German Dax rose over 4%.

## DAX – Stock Price Index (last obs. 5406 on September 7, 2011)

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Source: Financial Times; Encima Global

- The market is rightly relieved that economic data is not showing a recession now. However, after the April-June soft patch from Japan's supply disruptions, we are probably **in the middle of a more serious second wave of confidence-related weakness** caused by harmful U.S. tax, spending, regulatory, trade and weak-dollar policies and the European debt contagion undercutting banks and economic growth. Policy developments on bank capitalization will be particularly important.
- The European Commission is expected to delay its proposals for 1) the allocation of losses to senior bondholders of failing banks and 2) requirements for bank shutdown plans. The latter is parallel to the U.S. bank shutdown plans being required by the Fed and FDIC under Dodd-Frank that have hit Bank of America stock.

- Separately, the IMF is apparently backing off Christine Lagarde’s Jackson Hole call for more bank capitalization. We have commented since 2008 on the harmful pro-cyclical U.S. and European bank and accounting standards (which tighten as things get worse and loosen as things get better) versus China’s counter-cyclical approach (which allows growth in loans and M2 during a recovery and then restrains). Our July 21 piece about bank regulatory capital (when Bank of America said it wouldn’t have to raise equity capital) noted the extreme sensitivity of bank equity prices to regulatory capital nuances. The piece jumped the gun badly in terms of the market, but we think developments on bank capital regulation remain critical -- in 2009, the equity bottom for banks and broader markets was set by a March 12 Kanjorski hearing when Congress forced FASB to limit FAS 157’s mark-to-market impact (which was hurting bank capitalization.)
- We think Europe still has to take more steps to resolve the bank funding problems which are related to high yields on Italian and Spanish debt. The Euribor spread to the Overnight Indexed Swap market fell only slightly, to 77 bps today from a new post-08 high of 78bps on September 6. It measures strain in European interbank markets.

### **Euribor – OIS spread (last obs. September 7, 2011)**

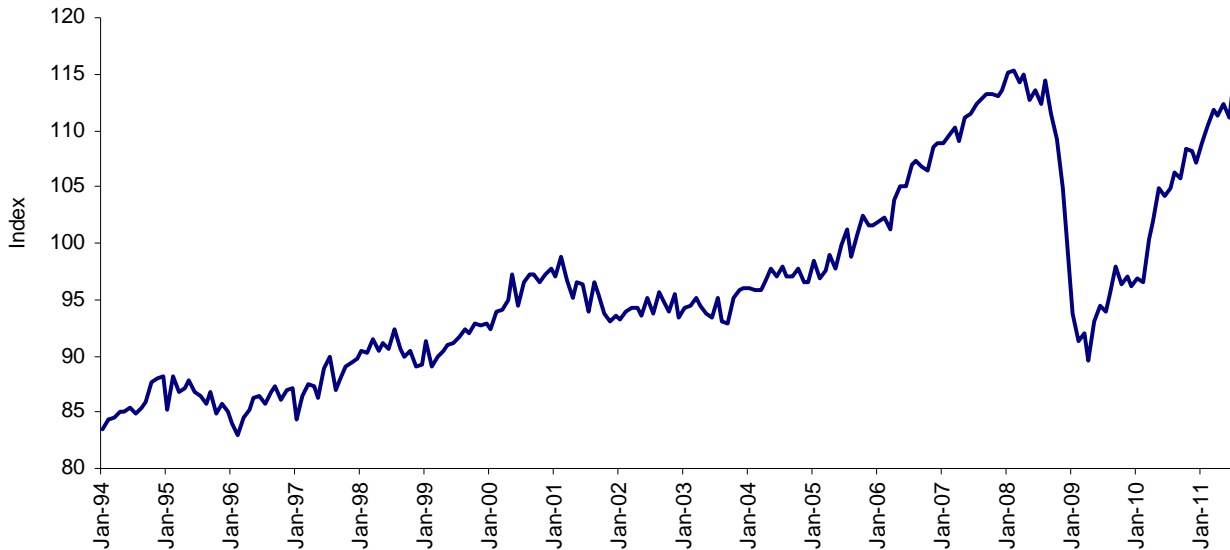


Source: Bloomberg; Encima Global

- As expected, Germany’s high court held that the Greek bailout and the EFSF are constitutional. However, it found that the Bundestag has veto powers, which undercuts the hope of Eurobonds being used to support future fiscal transfers. This German interpretation will probably spread to other countries -- either through their court systems or through parliamentary negotiations -- as they work to approve the expansion of the EFSF. On net, we don’t think these developments are positive because they undercut the value and effectiveness of the EFSF as discussed in our September 5 piece. We think today’s market improvement (higher equities, Italian bond yield falling from 5.5% to 5.2%) will be temporary because contagion is still slowing growth across Europe.

- German industrial production rose 4%, but that was a July rebound from a Japan-weakened June level. We expect a decline in August.

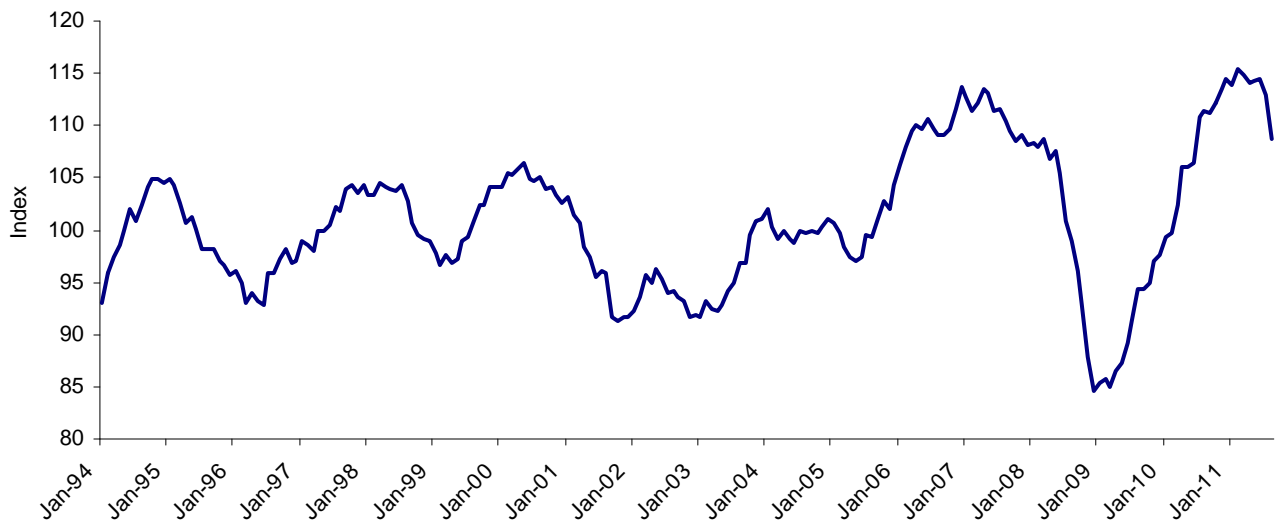
### German Industrial Production (last obs. July 2011)



Source: Bloomberg; Encima Global

- However, the August IFO index is newer information, is more forward looking, and was substantially weaker, falling to 108.7 from 112.9.

### German Business Sentiment (last obs. August 2011)



Source: Bloomberg; Encima Global

- We think Switzerland's 1.20 franc per euro peg to the euro is a good development because it shows bold action (unlimited, unsterilized buying of euros) and emphasizes the profitability of the interest rate arbitrage available to European central banks. The Swiss National Bank can borrow any quantity at near-zero and buy euros yielding 1.5% or more. In contrast, ECB purchases of periphery bonds have been too small to lower their yields much and have been sterilized to restrain bank lending. (The Fed achieves the same monetary sterilization by paying above-market rates for excess reserves and participating in aggressive regulatory oversight of bank lending.)

### Swiss Franc / Euro (last obs. September 7, 2011)



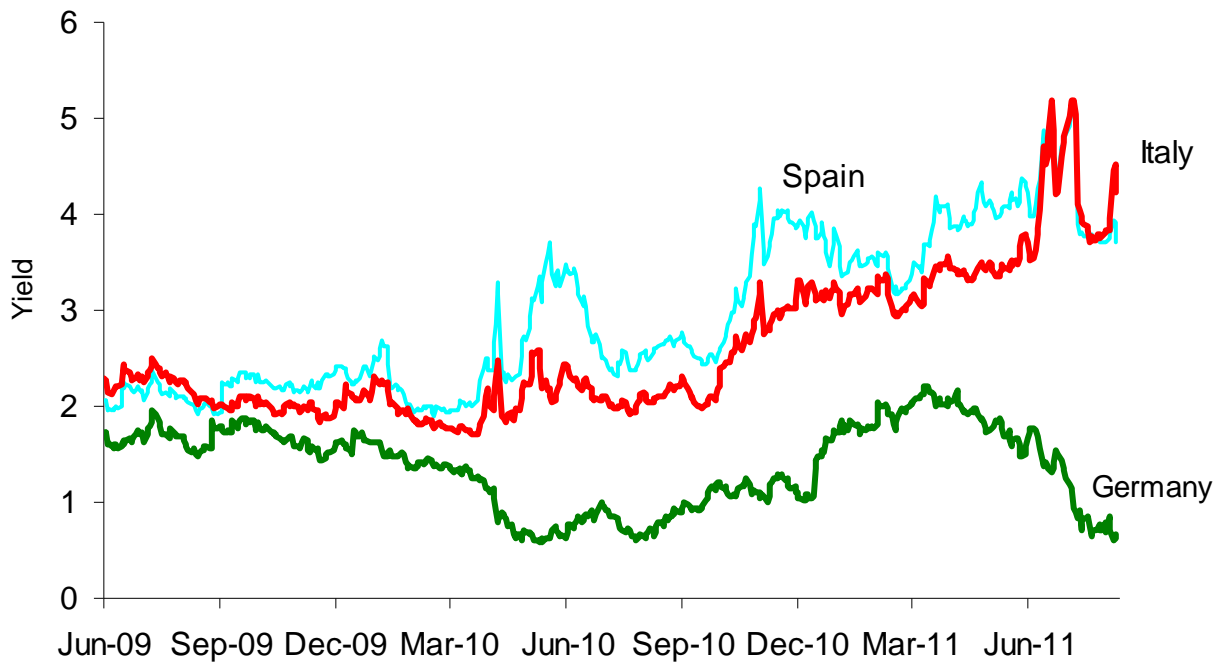
Source: Federal Reserve Board; Encima Global

### Several upcoming events will probably be disappointing.

- Contagion in Europe hasn't been addressed effectively. It threatens a country by country debt sell-off with rising naked CDS prices causing funding problems for banks and countries, bond downgrades, bank losses and less economic growth.
- The austerity programs in Greece, Italy and elsewhere are not growth oriented. The market tends to celebrate austerity at first (for example, Italy's VAT increase today). We're skeptical these programs will resolve the contagion.
- Parliamentary approvals of the EFSF expansion are taking longer than expected.
- The possibility is diminishing of the ECB buying a sufficient amount of peripheral debt to reverse the momentum out of that debt (see discussion in our September 5 piece.) The interest rate for three-year Italian bonds has increased to 4.2% from 3.5% in July versus a decline in German three-year yields to 0.7% from 1.8%. Like the Swiss National

Bank, the ECB's funding cost is low and would allow it to profitably buy peripheral debt in size.

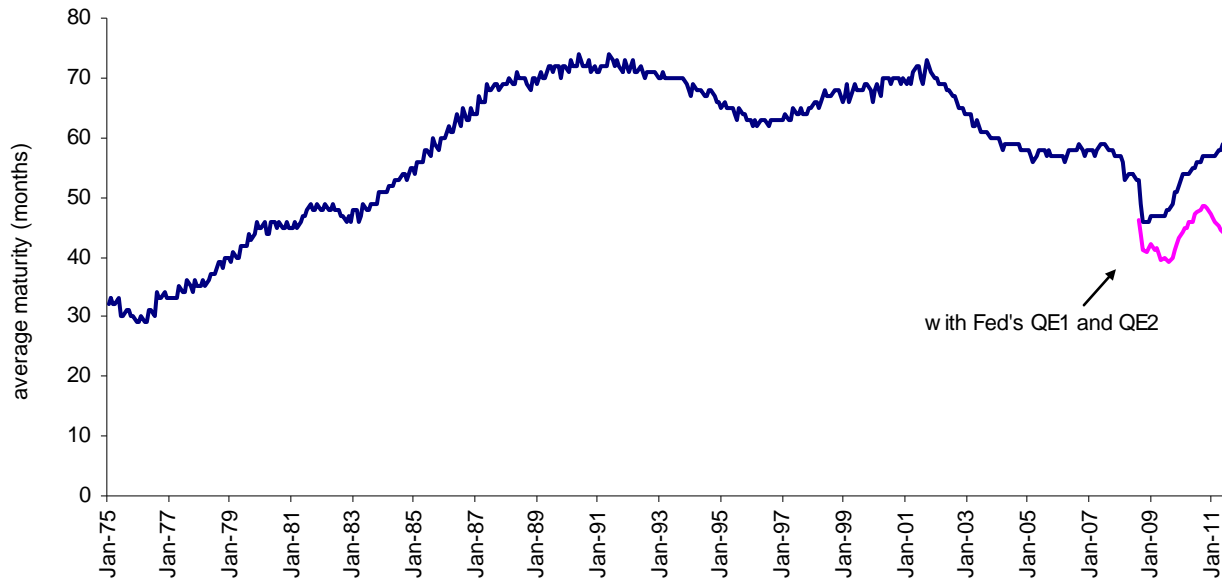
### Select European 3 Year Yields (last obs. September 7, 2011)



Source: Bloomberg; Encima Global

- In the U.S., President Obama's September 8 speech looks like it will extend current policies and propose expanding on them rather than triangulating into new policies as President Clinton did. We don't expect an economic lift.
- Similarly, we don't think the September 20-21 FOMC meeting will cut new ground or cause stimulus. It won't put an end to the weak-dollar policy. The Fed might launch "operation twist" to lengthen the maturity of its assets, but we think that would be viewed cautiously by financial markets. Bill Gross has an interesting piece in today's FT explaining that banks and investment firms have little ability to benefit from a flatter curve. Our views on the harm from QE2 and longer maturities relate both to the disruption of the short end of the curve (part of Gross's point) plus the shortening of the effective maturity of the U.S. national debt as the Fed buys back long maturities. Operation Twist would shorten effective maturities at a time when it is critical for the U.S. to be extending the maturity of its national debt.

## Average Maturity of Public Debt (last obs. June 2011)



Source: U.S. Treasury; Encima Global

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