



Europe's Decline – Can U.S. Decouple?

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Please read the important disclosure information in the Addendum section of this presentation.

Overview

- **The policy outlook for the U.S. and Europe got worse beginning in July. Current policies point toward recessions after temporary strength in Q3 related to Japan's earthquake recovery.**
- **Europe is attempting a slow-motion bailout. This contributes to a deep recession in southern Europe and even larger fiscal shortfalls and debt downgrades. It's hard to put enough capital into banks to handle deteriorating assets. Europe should be focusing on stopping the debt contagion from Greece into Italy and Spain and the deepening recessions and rising bond yields there.**
- **On the current path, we expect narrow bank nationalizations and some capital injections using EFSF aimed at withstanding a Greek debt restructuring. Germany has rejected a Tarp-like broader bank capitalization program big enough to allow banks to withstand sovereign losses beyond Greece.**
- **We expect Washington to maintain anti-growth fiscal, regulatory and monetary policies at least through the 2012 election. Both political parties will talk about the need for a big fiscal package, but probably not achieve it. Third quarter GDP will be less bad than consensus expectations (we're at 2.5%) and corporate earnings growth will be reasonably strong. But fourth quarter GDP growth (we're at 1%) and earnings will be weaker and the U.S. won't be able to decouple from Europe.**
- **We don't agree with many of the more pessimistic views. That the U.S. is already in a recession. That the euro has to break up. That China's growth will slow hard to 5% (was 9.1% in Q3). That we're heading for a Lehman crisis or a Japan-style deflation. Some of those might happen, but there might as easily be a policy revelation in the U.S. or Europe that allows the private sector to get back on track.**
- **The most likely outcome is slower growth and increasing European debt problems until policies change in 2012.**

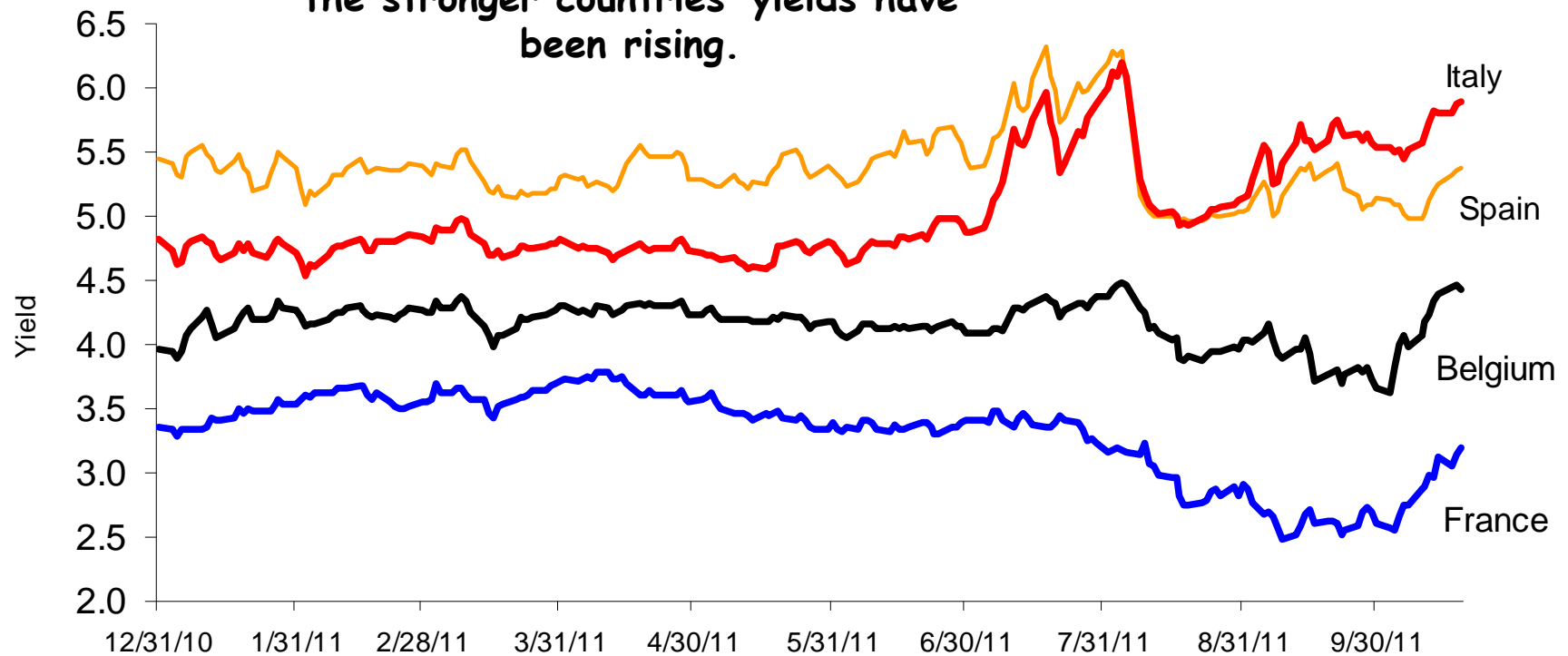
Europe

- **Europe needs to contain the debt restructurings to Greece and Portugal. Italy and Spain are too big to restructure; yields on their existing debt should be brought down closer to Germany's by ECB and EFSF purchases or guarantees. Structural reforms are key. Instead, Europe is focusing on increasing bank capital ratios enough to allow more debt defaults. We don't think this approach will work.**
- **ECB has limited its role. Trichet will leave without lowering rates or buying sufficient Italian bonds to stop the contagion. Draghi, will have difficulty reversing course in time.**
- **EFSF is needed for Greek aid, purchases of collateral for Greece's restructuring and buying weak sovereign bonds. The latest proposal is for it to also guarantee sovereign bond issues despite the ongoing rating downgrades. We don't think this approach will lower bond yields, stop the contagion from Greece into Italy or make up for the ECB's inaction.**
- **A second Greek package will be harder to negotiate and implement than the 2010 package. Greece's government is running large monthly losses. Its banks are losing deposits. The public is opposing the first IMF package's austerity measures (mostly tax increases and a few reductions in government workers.) It's hard to see Germany agreeing to a second package without extensive reforms and private sector debt forgiveness, but equally hard to see Greece, banks and donors all reaching agreement again. A bigger private sector haircut will be hard to achieve. The ECB owns Greek debt but won't take a haircut. Bigger Greek bond losses have negative implications for banks and sovereigns**
- **Weakened leaders. Berlusconi survived a close no-confidence vote last week and may stay for more than a year. The French election on April 22 will likely lead to a Hollande-Sarkozy run-off on May 6, with Sarkozy increasingly a lame duck. Merkel's CDU party has lost a series of state elections, but no other leaders have emerged. Spain is expected to replace Zapatero with conservative People's Party leader Mariano Rajoy in the November 20 general election.**

Selected European 10 Yr Yields

(last obs. October 19, 2011)

Since the end of September some of the stronger countries' yields have been rising.

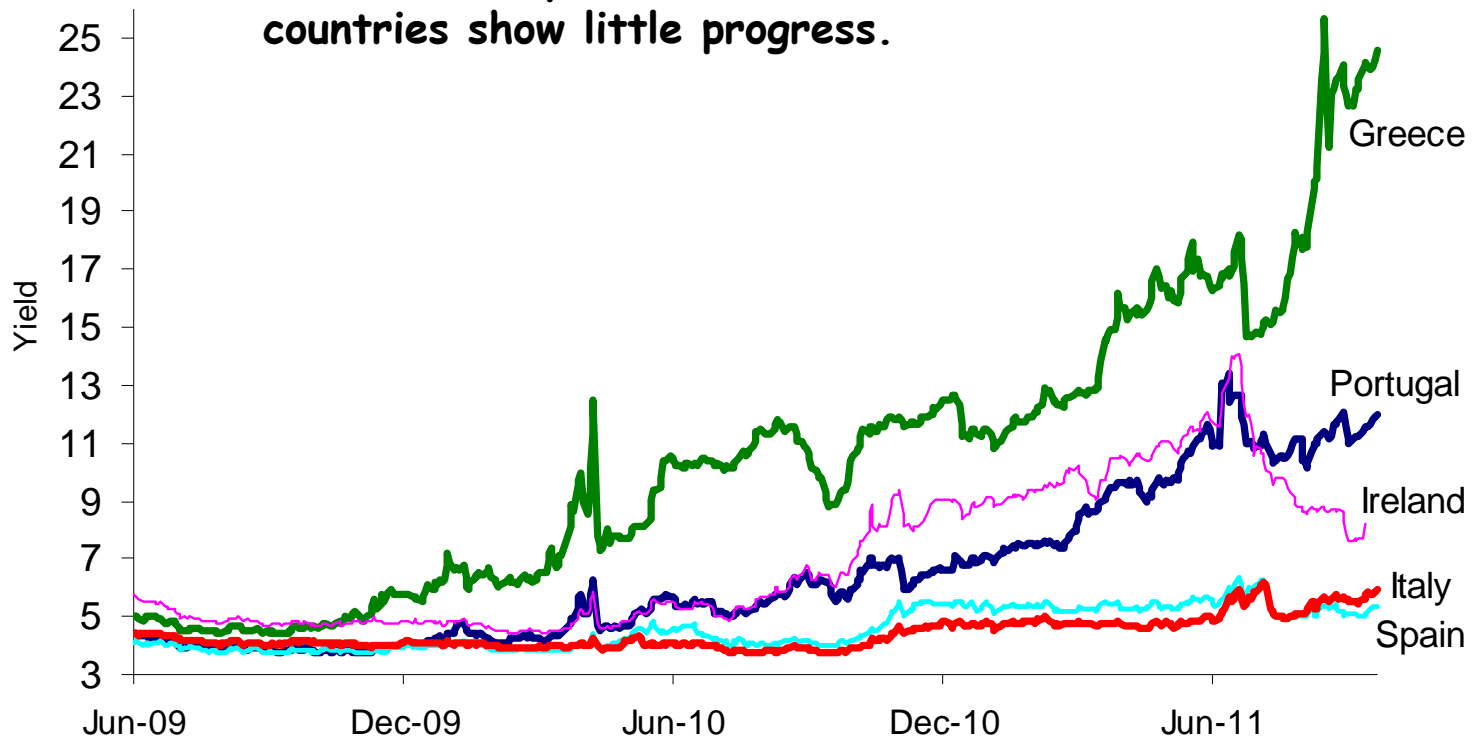


Source: Bloomberg; Encima Global

Selected European 10 Yr Yields

(last obs. October 19, 2011)

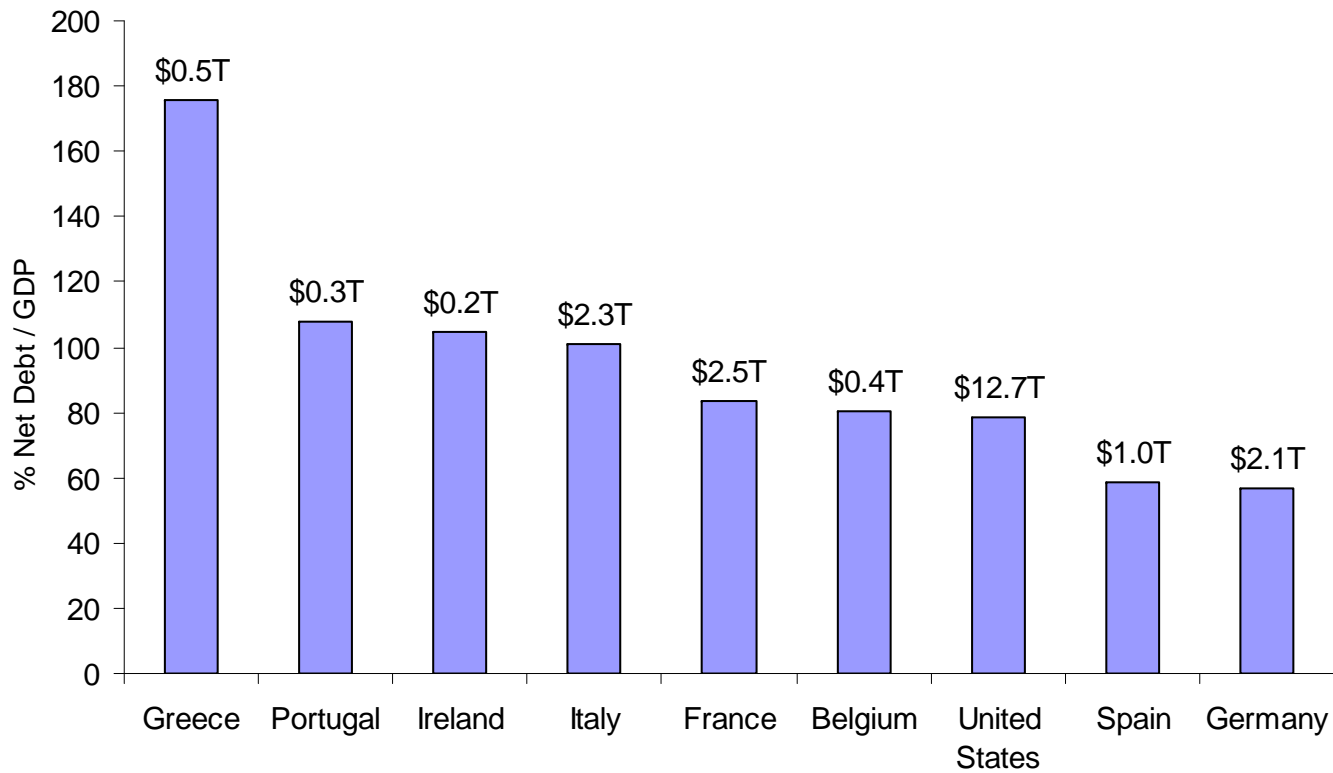
Ireland has improved, but other countries show little progress.



Source: Bloomberg; Encima Global

Net Debt / GDP

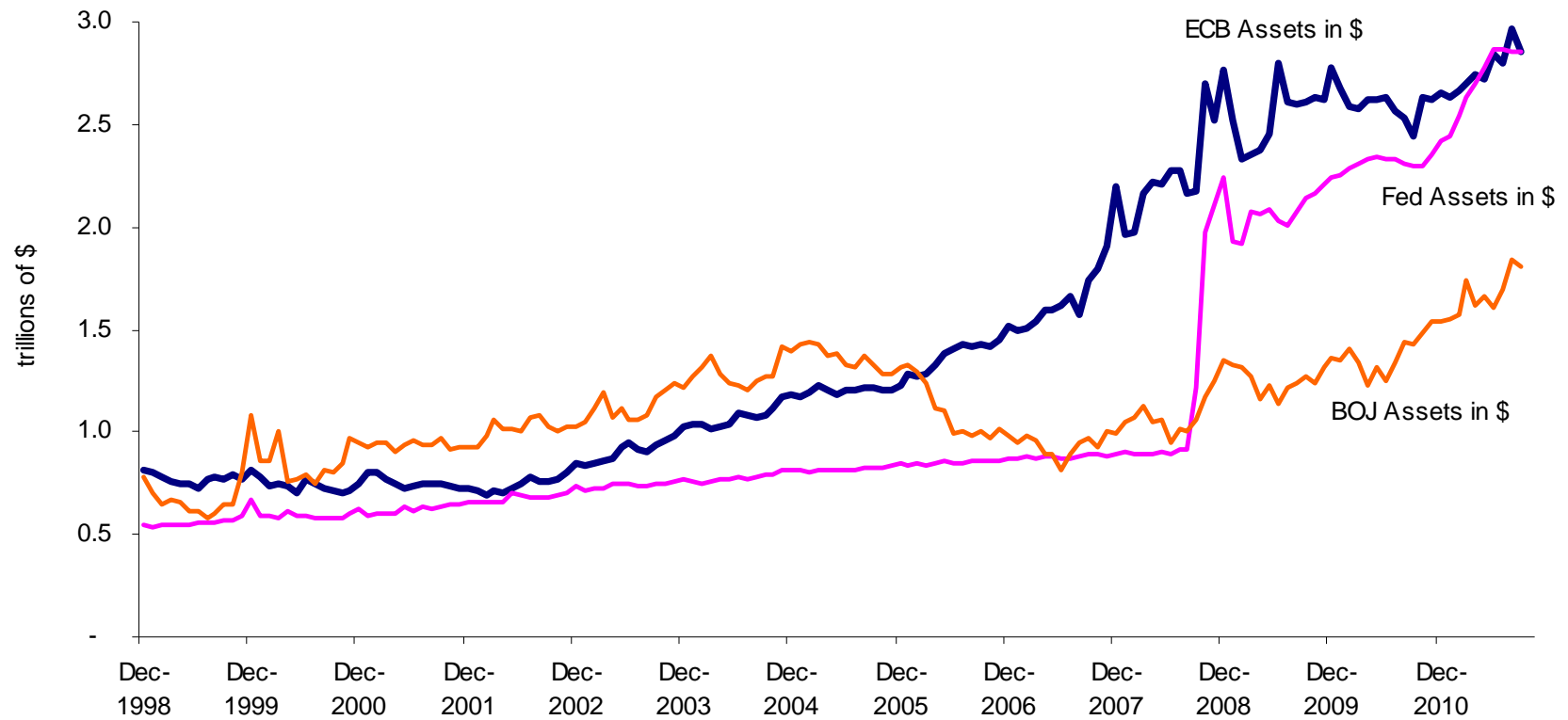
(General govt incl state and local; nets out intra-govt debt; IMF projections for 2012)



Source: IMF; Encima Global

Central Bank Assets: ECB; Fed; BOJ

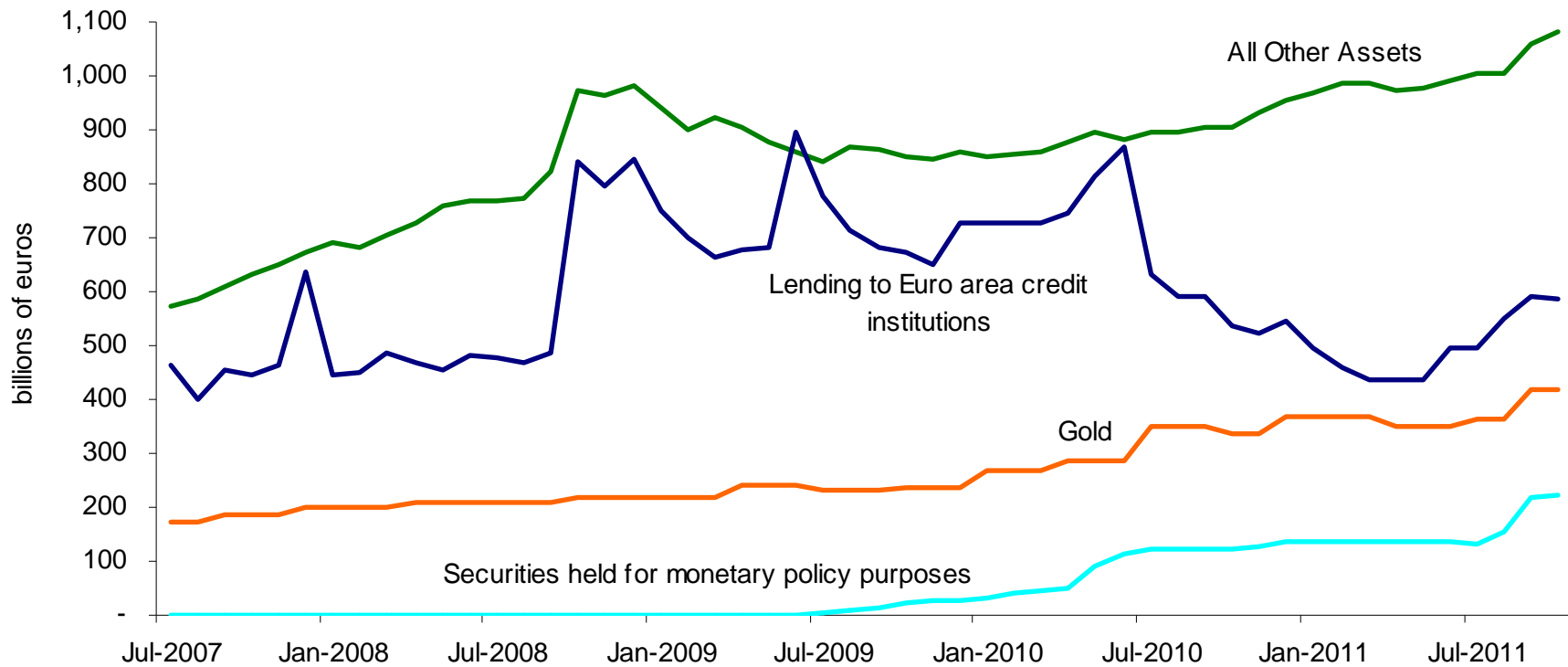
(last obs. September 2011)



ECB Balance Sheet

(last obs. October 14, 2011)

The ECB has expanded less rapidly than the Fed, buying Greek, Italian and other bonds for 'monetary policy purpose' with yields over 5%.

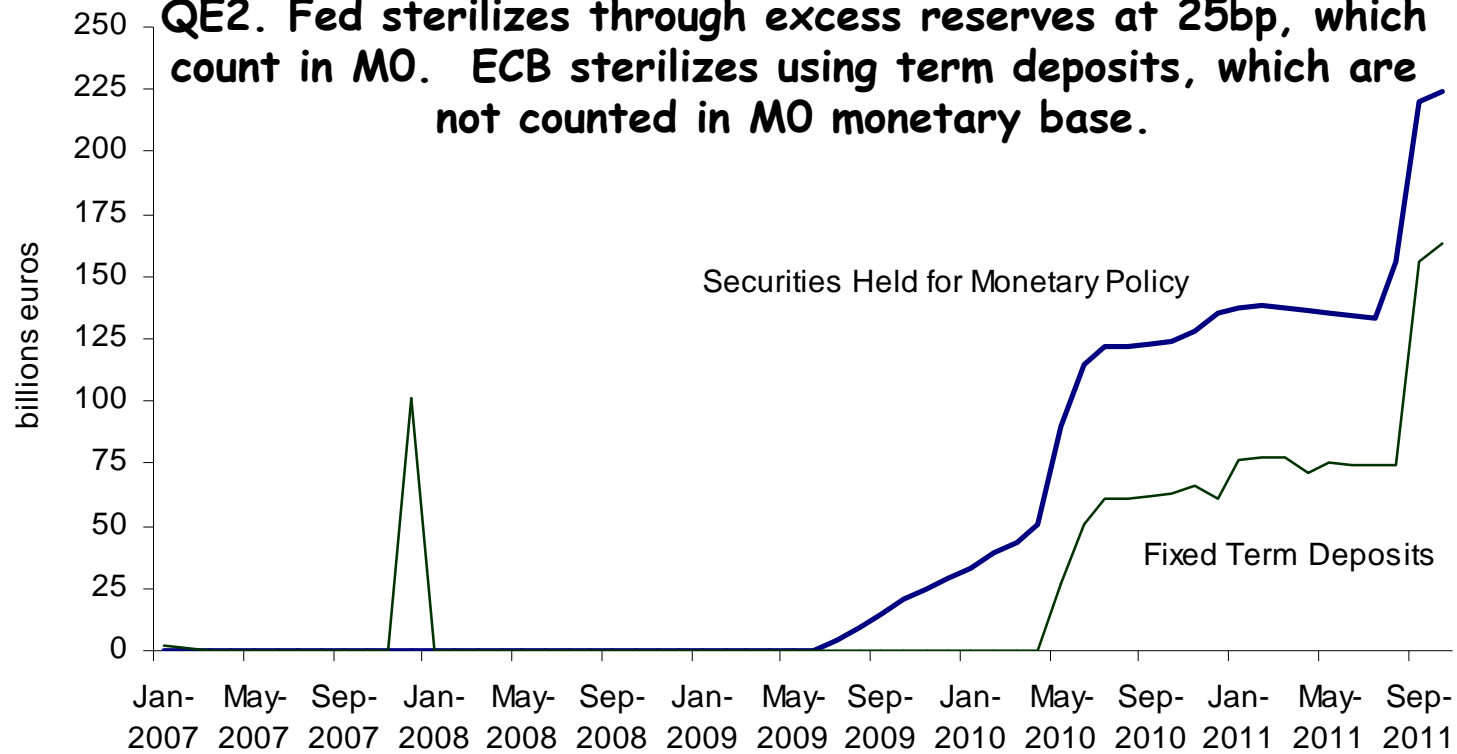


Source: ECB; Encima Global

ECB Sterilizing Bond Purchases

(last obs. October 14, 2011)

ECB bond purchases still small compared to Fed's QE1 or QE2. Fed sterilizes through excess reserves at 25bp, which count in M0. ECB sterilizes using term deposits, which are not counted in M0 monetary base.

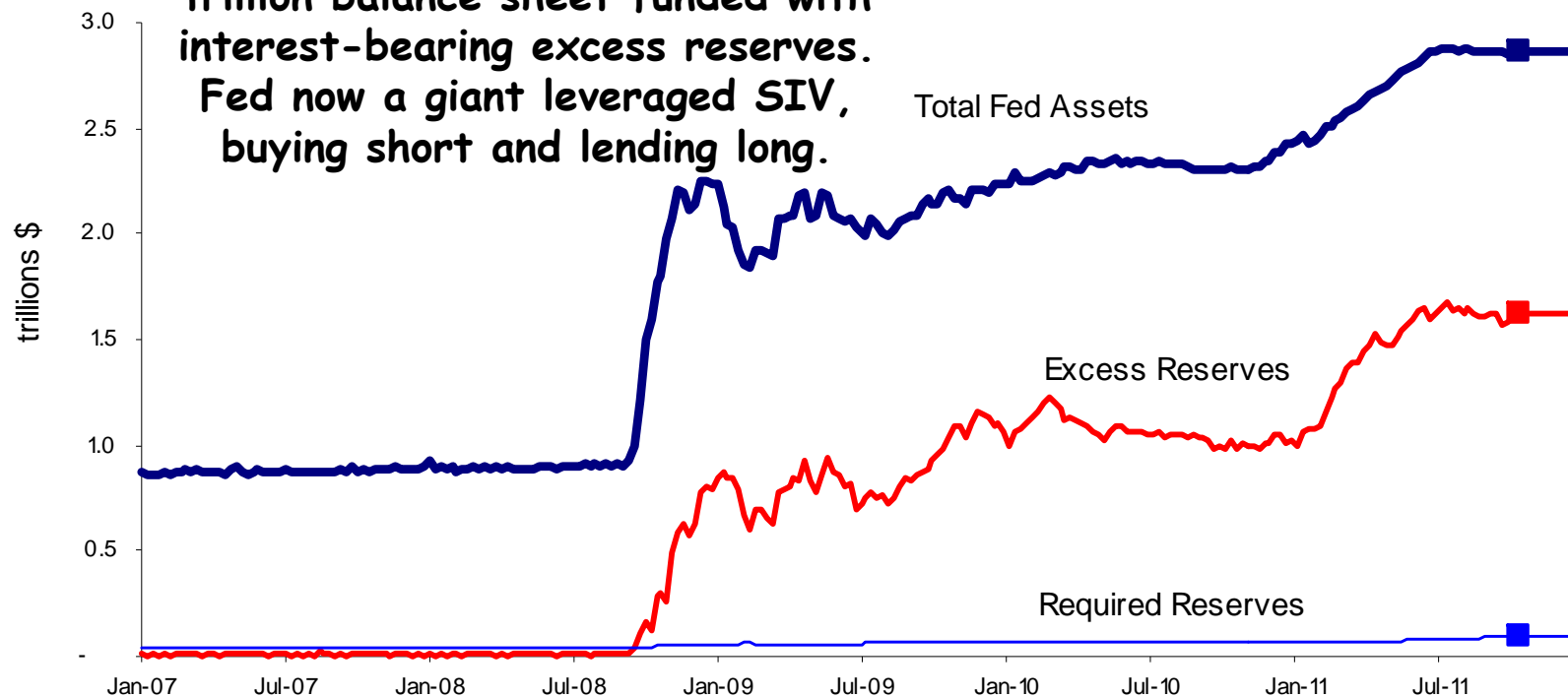


Source: ECB; Encima Global

Fed 'Sterilized' QE2 Through 25bp rate and Credit Rationing -- 'Pushing on a String'

(last obs. October 12, 2011)

The fed will maintain a \$2.9 trillion balance sheet funded with interest-bearing excess reserves. Fed now a giant leveraged SIV, buying short and lending long.



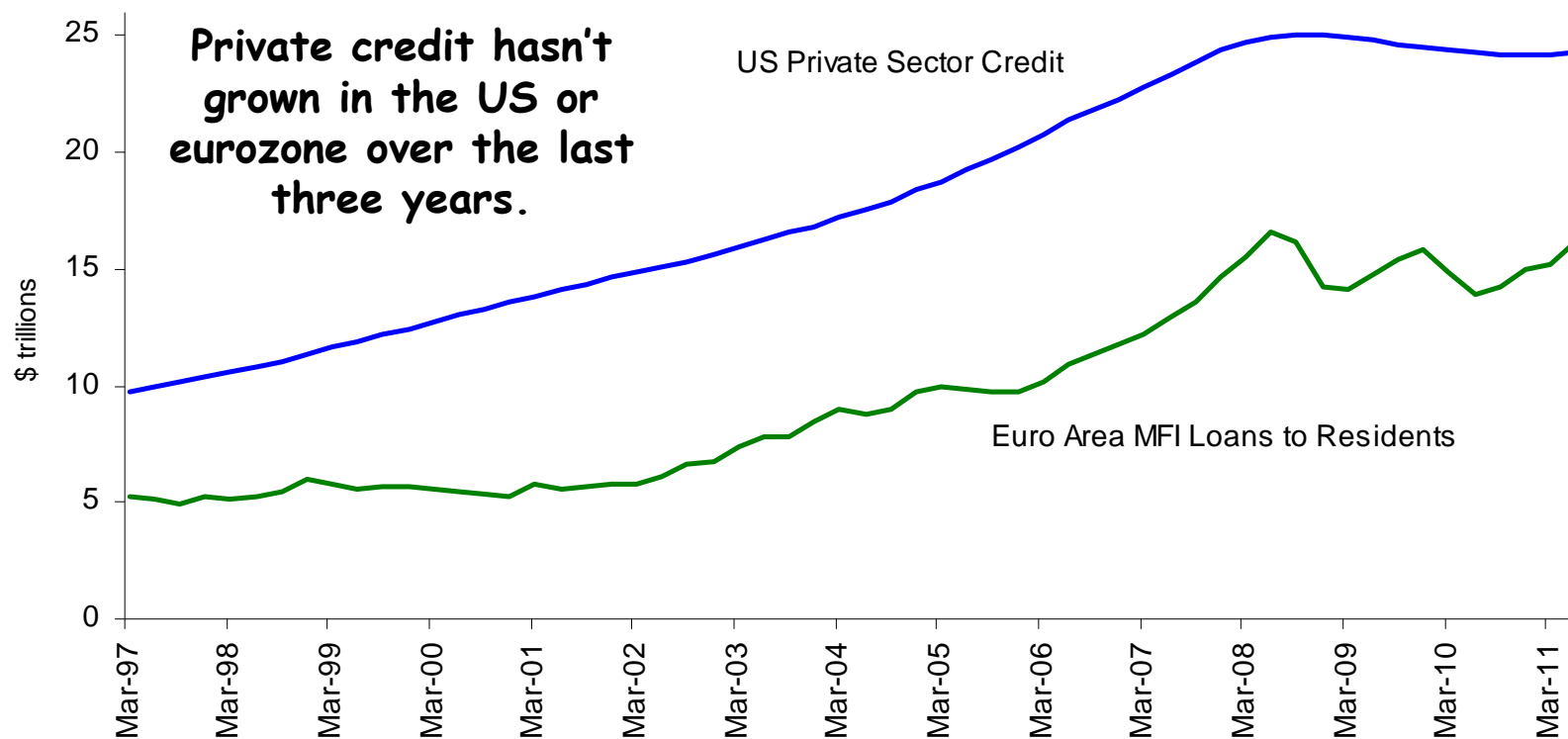
Source: Federal Reserve: Encima Global

Greece Issues Unresolved

- Greece's government is running such a large negative cash flow that the 8 billion euro disbursement won't last long. The Greek central bank is covering some of the financing gap with the ECB as a funder, an arrangement that can't last much longer.
- The next Greek aid program will need much more public sector funding than the 109 billion euro agreement outlined on July 21 -- due to worse-than-expected economic and fiscal performance.
- The public sector and Greece want a bigger private sector haircut. It's hard to see how a deeper haircut can be achieved voluntarily. Under the July 21 agreement in principle, 135 billion euros of pre-2020 Greek maturities (90% of the 150 billion euros outstanding) would be voluntarily rolled into new collateralized bonds with longer maturities and a 21% reduction in net present value (as calculated by creditors.) In one type of bond, the EFSF would lend Greece money to buy zero coupon AAA bonds to provide collateral for the new bonds.
- Greece is taking on a mountain of non-reschedulable debt with the IMF and the ECB. While the EFSF debt does not have the same preferred creditor status, the loans it makes are 100% discountable at the ECB, making future haircuts problematic. In combination, the new debt would lock Greece into heavier payments than its current economy and enlarged government structure can support.
- Many European banks are progressively losing their access to private sector credit – e.g. U.S. money market funds, European interbank markets, European bond markets, in some cases bank deposits. The longer it takes Europe to announce programs to address these problems, the more the damage to bank lending and equity markets.

U.S. and Euro Zone Private Sector Credit

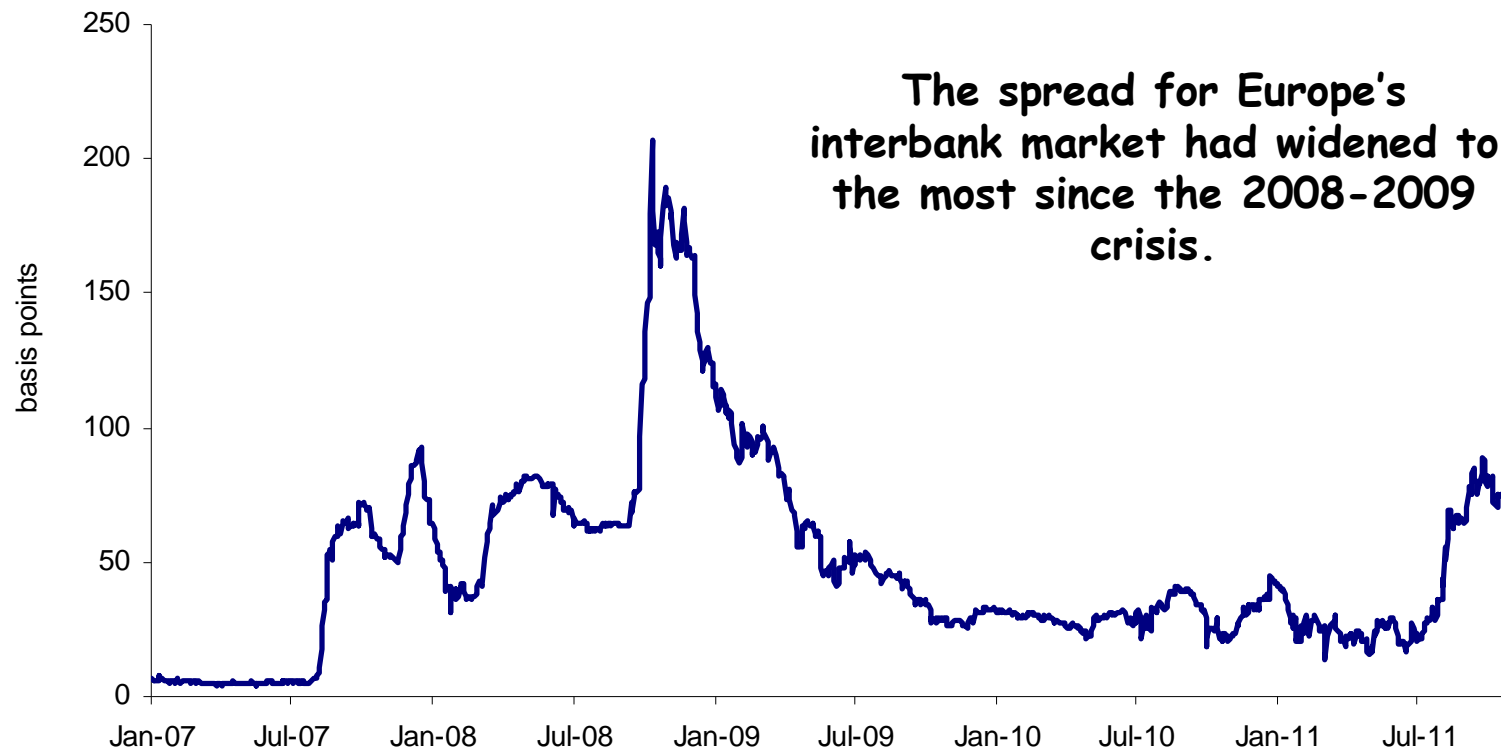
(last obs. Q2 2011, Euro area converted to dollars)



Source: Federal Reserve; ECB; Encima Global

EURIBOR - OIS Spread

(last obs. October 19, 2011)



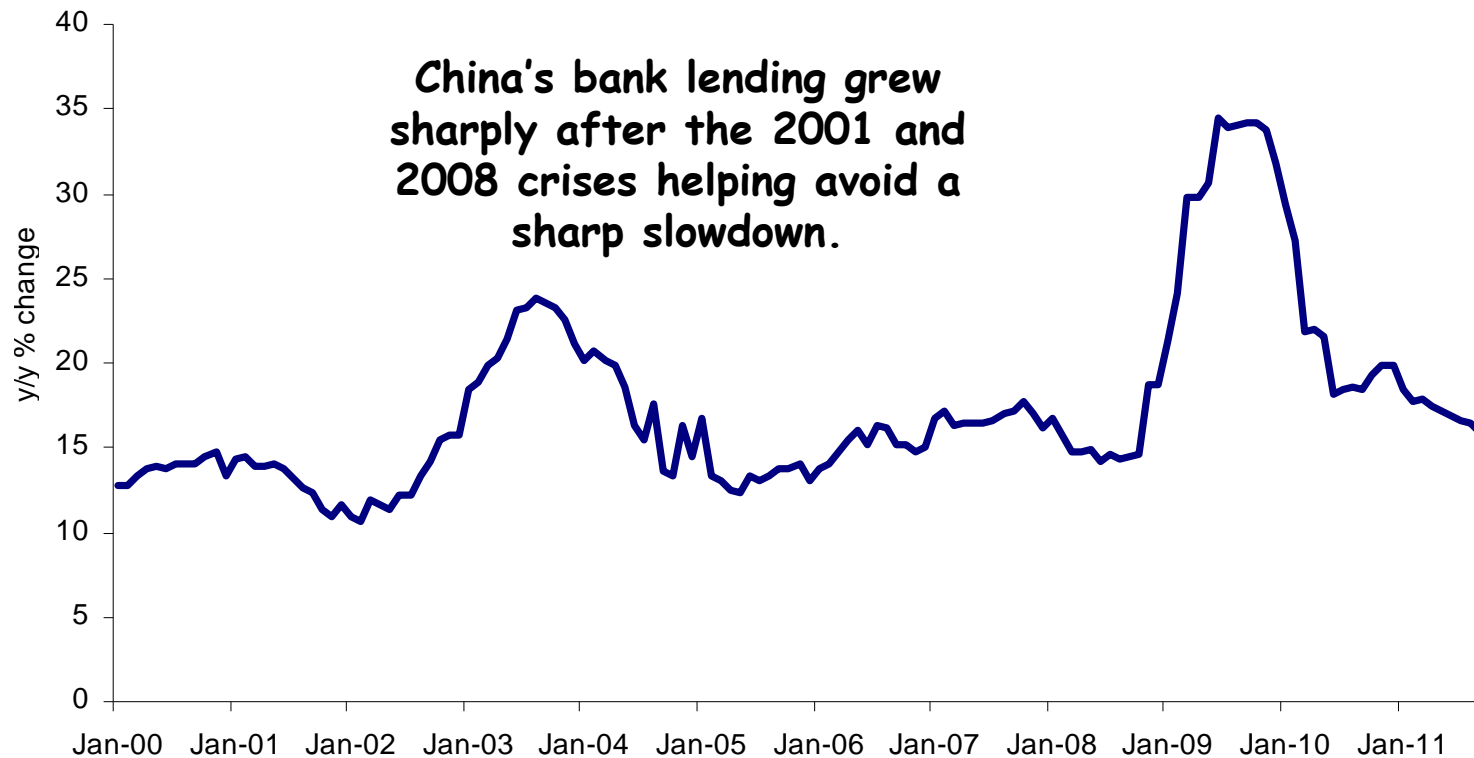
Source: Bloomberg; Encima Global

Global Regulatory Policy In Flux

- **With near-zero interest rates, U.S. monetary policy is now primarily based on regulatory rationing of credit rather than price-based allocation.**
- **China practices counter-cyclical credit rationing (restrict lending during booms, allow lending after a bust.) The U.S. practices pro-cyclical credit policy (few controls during boom, heavy controls after busts including forced increases in bank capital, aggressive mark-to-market, regulatory scrutiny.)**
- **U.S. and European regulators still pressing for capital injections, arbitrary capital premiums, capital penalties for too-big-to-fail institutions, mark-to-thin-markets, and divisive Basel III capital standards. We expect weaker financial institutions and more dynamism in non-bank financial innovation. One loser – small businesses that depend on relationship banking.**

China's Countercyclical Bank Lending Policy

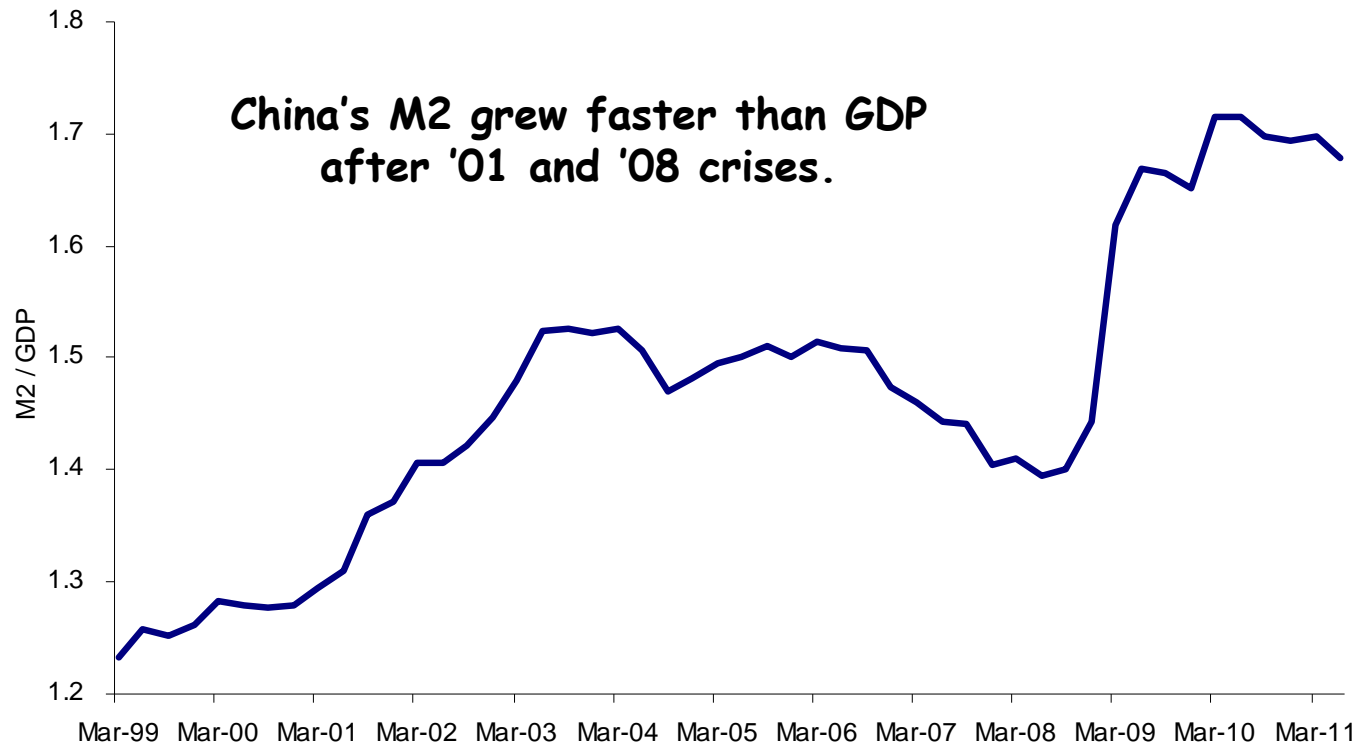
(last obs. September 2011)



Source: Bloomberg; Encima Global

China's M2 / GDP

(last obs. Q2 2011)



Source: China National Bureau; People's Bank of China; Encima Global

US M2 / GDP

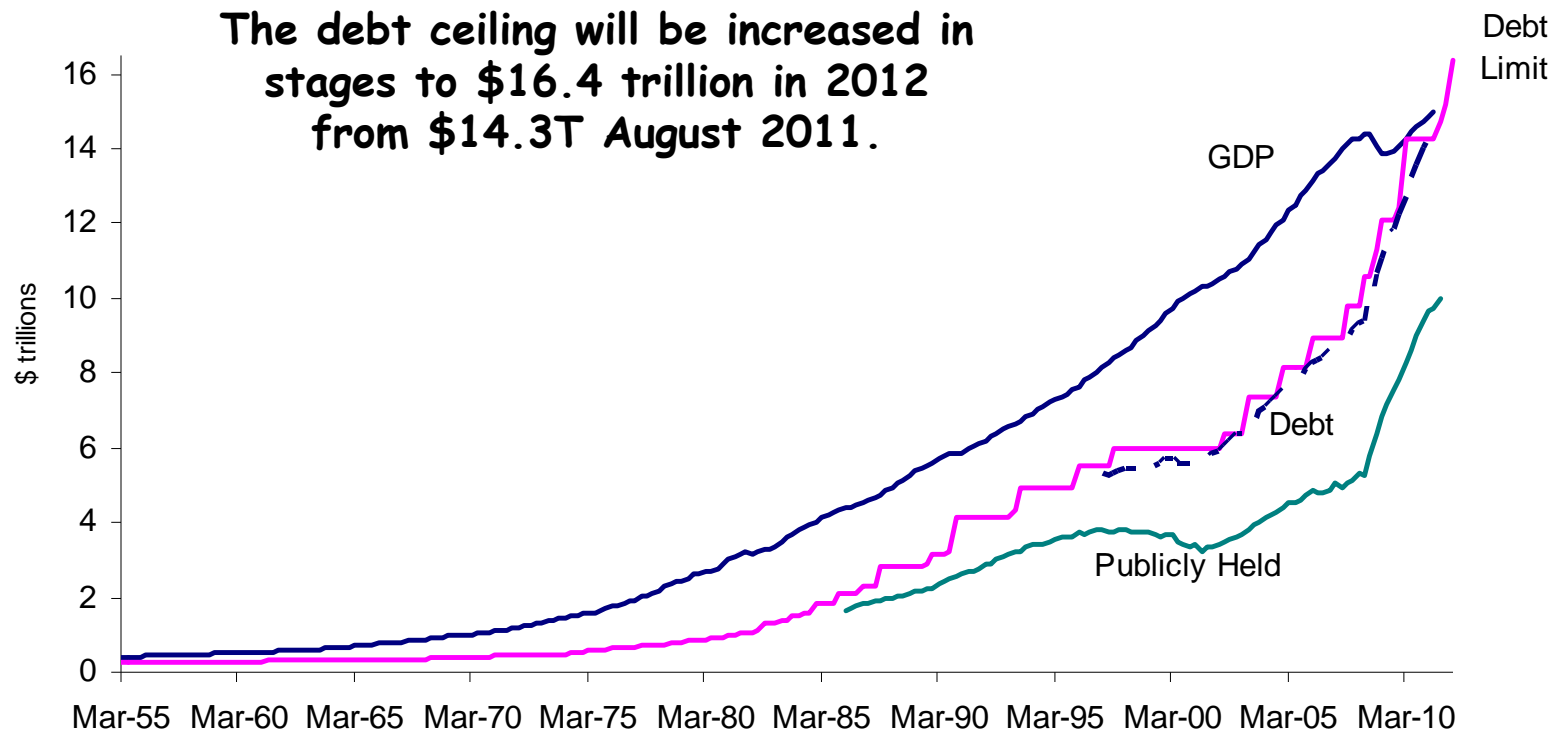
(last obs. Q2 2011)



Source: Federal Reserve; BEA; Encima Global

Publicly Held Debt Reaching 70% of GDP

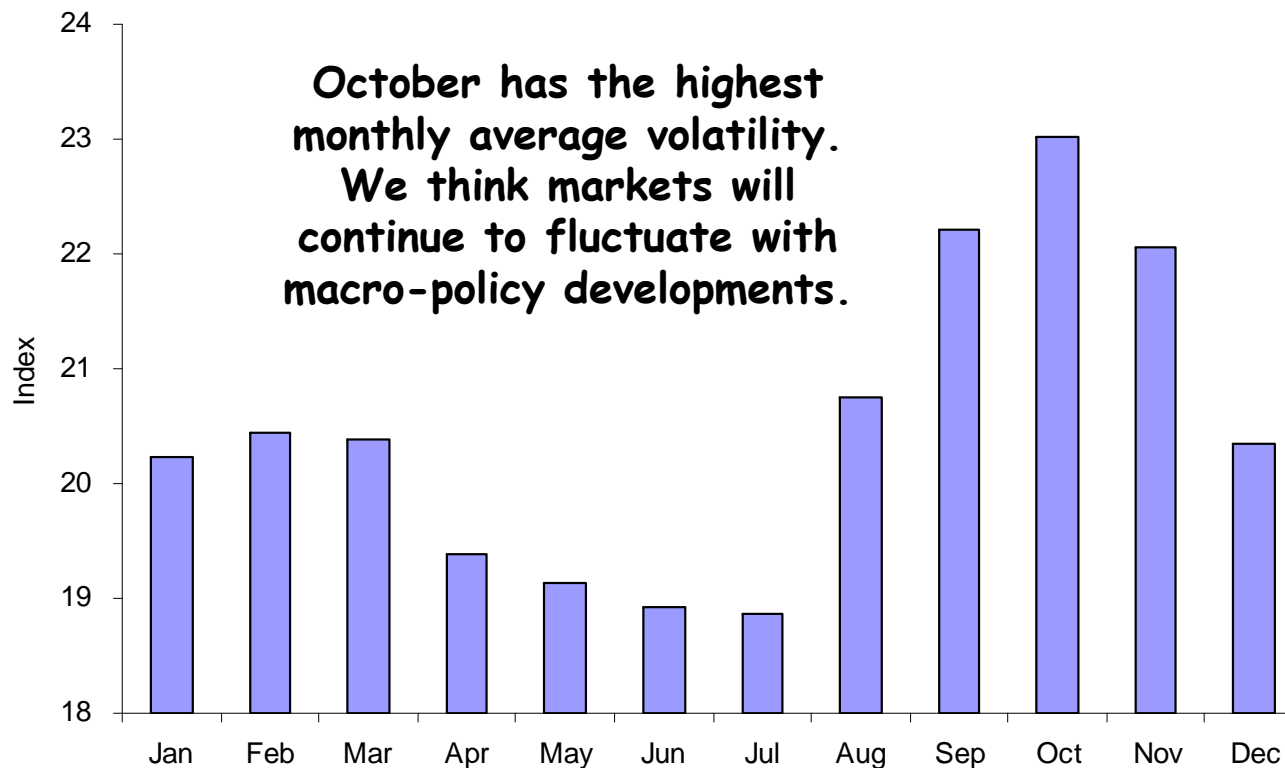
(last obs. Q3 2011, Q1 2012 for debt limit)



Source: Bureau of Economic Analysis; U.S. Treasury; Encima Global

VIX Monthly Averages

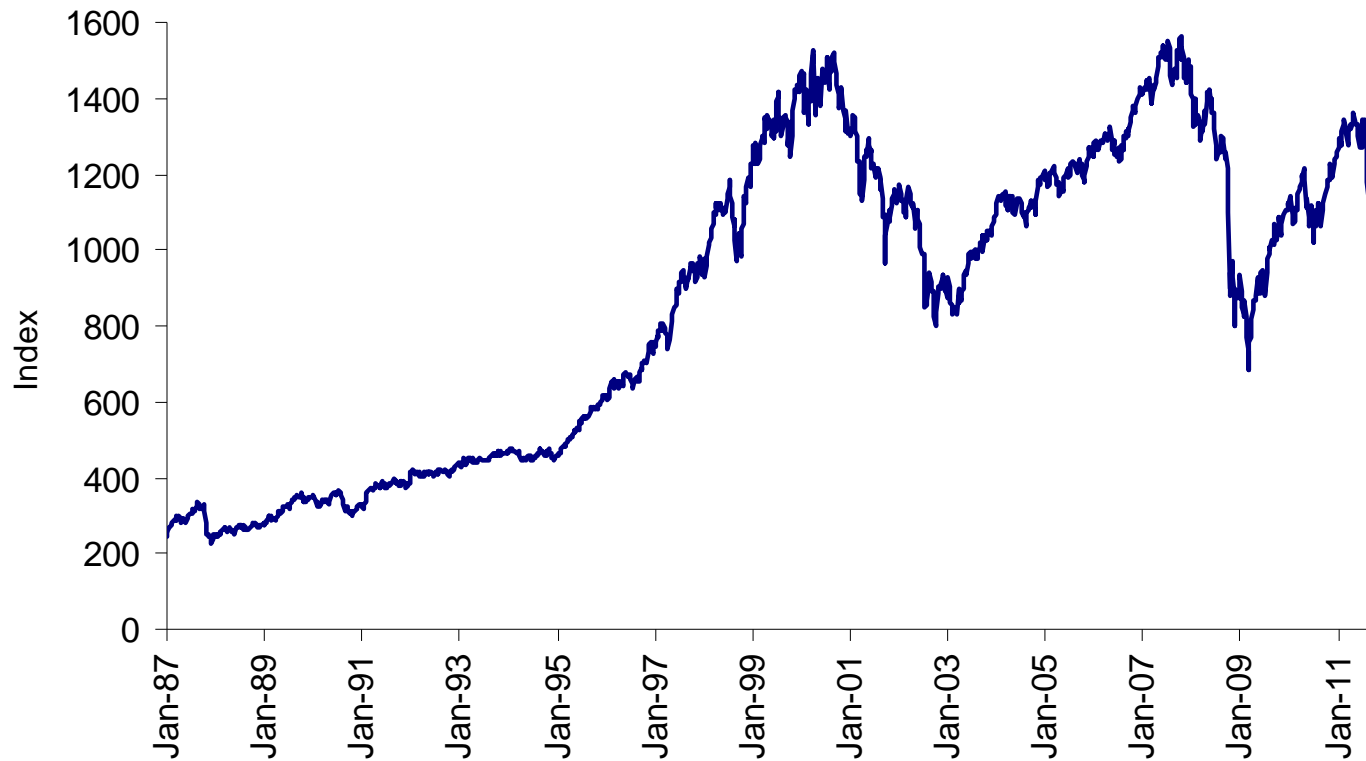
(data from 1990 to 2011)



Source: Wall Street Journal; Encima Global

S&P 500

(last obs. October 18, 2011)

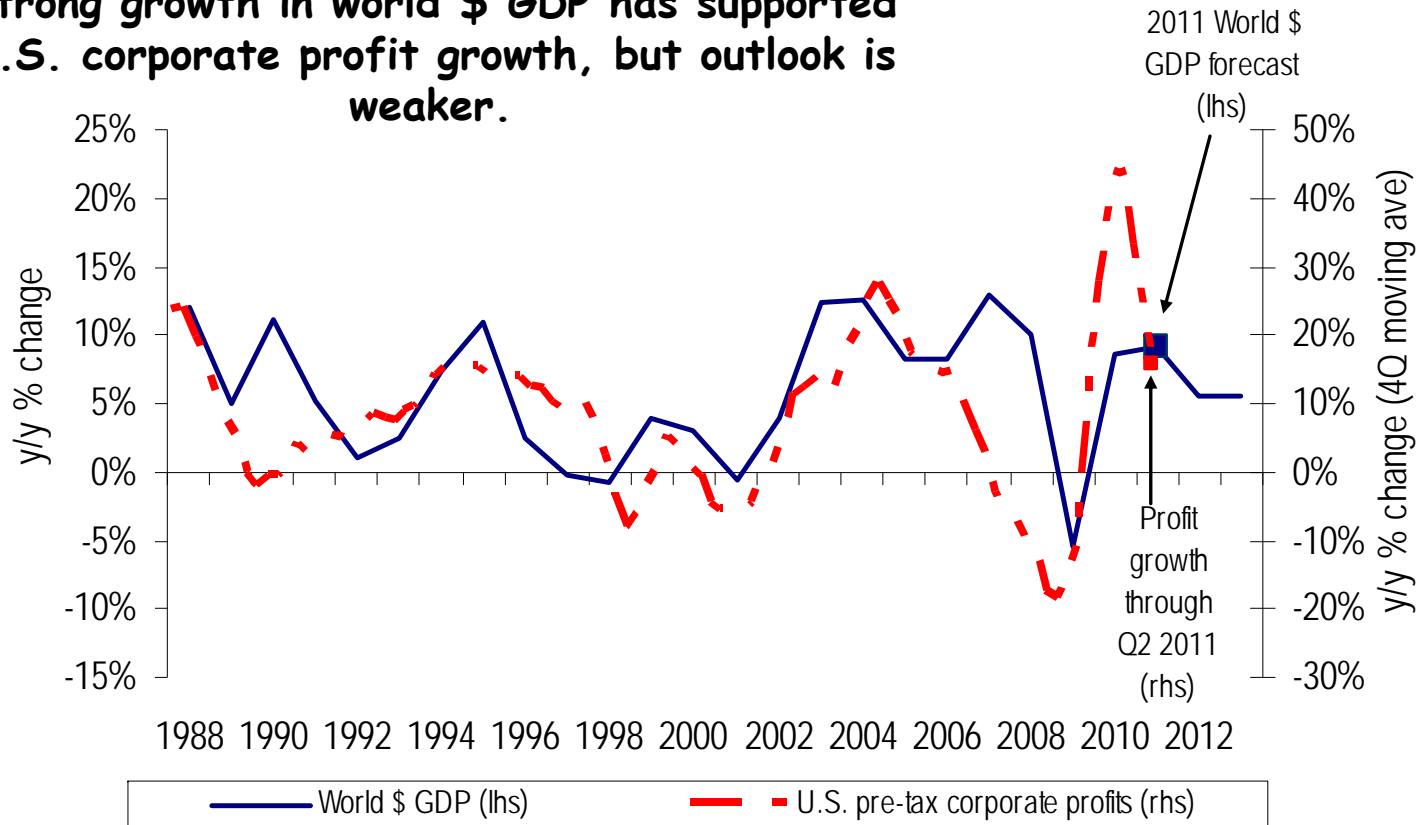


Source: Wall Street Journal; Encima Global

U.S. Corporate Profits Grow with World \$ GDP

(last obs. Q2 2011 for NIPA corporate profits, IMF forecasts for \$ GDP to 2013)

Strong growth in world \$ GDP has supported U.S. corporate profit growth, but outlook is weaker.



Source: Bureau of Economic Analysis; IMF; Encima Global

10 Year U.S. Treasury Yield Too Low

(last obs. October 19, 2011)

Investors have to buy bonds to protect against deflation, and gold to protect against inflation, leaving less capital for growth. We think both bonds and gold are in a bubble if policy improves or fear abates.



Source: Federal Reserve Board; Encima Global



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