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LGL Partners Investment Brief
Europe Tries Again
October 2011

Summary
After months of wrangling, European leaders reached a tentative agreement with private holders of Greek bonds on Thursday. This accord is predicated upon an additional €120BB bail-out by the EU and the IMF, and would involve private investors taking a 50% write-down on their stakes. It is expected that the provisions of the agreement would reduce Greek debt levels to around 120% of GDP over the next several years. (Greek debt is currently at nearly 150% of GDP—the highest in the EU.)

The terms require banks to increase reserve levels (Tier 1 capital) to 9% of risk-weighted assets to further buffer against losses. This will require additional capital raising (rather than US-style capital injections) across the sector of about €100BB by June 2012. Reserve levels are currently set at 7%.

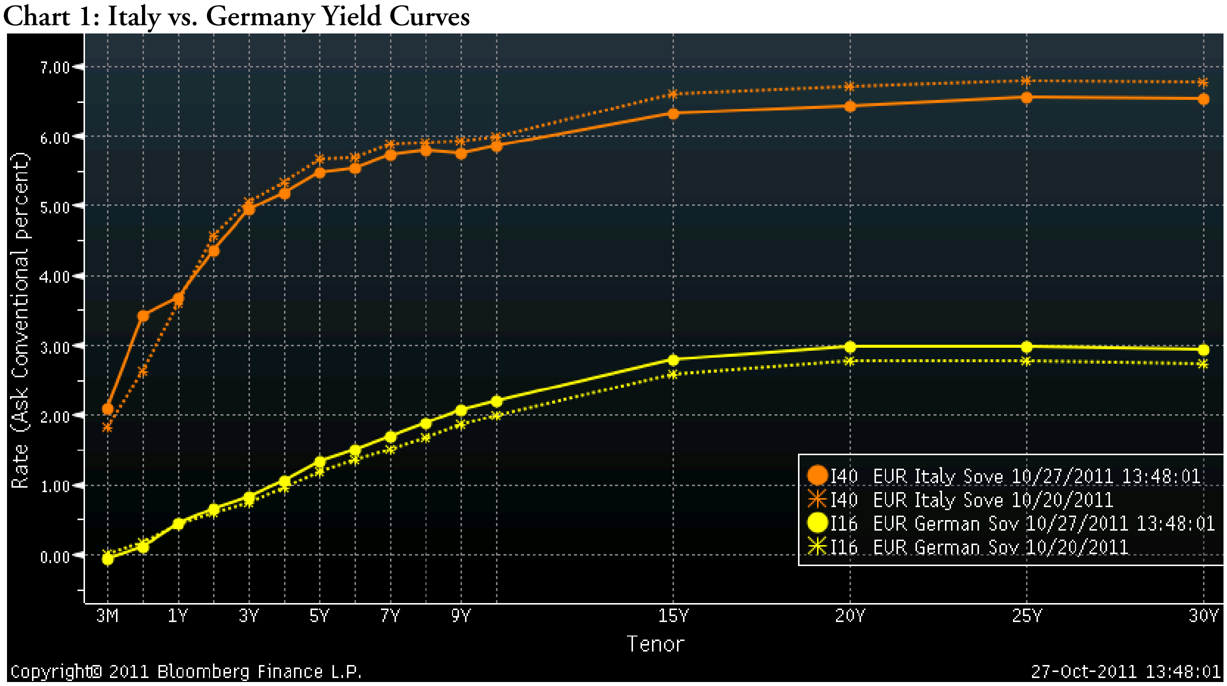
A key enhancement of the current proposal is to introduce "risk insurance" of newly-issued Eurozone bonds.

Germany's Angela Merkel suggested additional capital pledges to the so-called "European Financial Stability Facility" (EFSF) would bring its overall firepower to greater than €1TT. The EFSF currently has €440BB of capacity. According to the *Financial Times,* approximately €250BB is expected to be left after the current round of Greek bail-outs.

Market impact
The Euro rallied nearly 2% against the dollar. Safer haven currencies like the USD and Yen fell commensurately as risk appetite was rekindled.

Yields in Europe tightened, but not dramatically. For instance, the Italian yield curve has flattened, but across all maturities, Italian debt trades with a considerable yield premium to similar German issues.

Chart 1: Italy vs. Germany Yield Curves



Source: Bloomberg Finance, L.P.

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Equities rallied. By midday the S&P500 was up nearly 3% and the Euro Stoxx 50 was up nearly twice that amount—almost 6%.

At the same time, there was a strong rally in financial and sovereign credit default swaps (CDS) throughout the day. Speculative short positions had been put into place with CDS in recent weeks. A portion of today's movement indicates a reversal of some of this sentiment.

Part of the rally in equities today was due to a positive reaction to Europe, but another component was a positive response to reported 2.5% US GDP growth, year over year. An encouraging aspect of the GDP data was the announcement of healthier consumer spending on retail items.

Analysis

Given the fits and starts and false dawns during this process of Euro stabilization, investors should remain cautious and circumspect about the long-term prospects for this deal. On a practical level, many details are lacking in this scheme and questions remain, including:

- The limits on the bond risk insurance provision.
- Amount of remaining capital left in the fund, vs. the new amount pledged.
- Involvement of China in the deal.
- Interest rates and terms for new AAA bonds being issued to swap with investors' current bonds.
- The haircuts agreed to are "voluntary." What is this going to mean in practice?

And on a geopolitical level, this process has done much to destroy whatever bonhomie and simpatico existed between the north and south in Europe. While the deal affirms a begrudging acceptance that "we are all in this together" the resentment of the German people towards Greece and the Greek people towards the Germans will fester, and likely worsen.

Greece has already agreed to raise €0BB in funds through privatizations of public assets and reductions in civil service jobs. The success of those seems dubious, and this new deal features an additional €5BB expected from such actions.

The market rallied today because the agreement was forceful and committed. It might be enough to steady the ship over the near term. The additional commitments to the stabilization fund increase confidence that should Italy get off course, there are more resources available to bring to bear. But, Italy's debt, at roughly $2.5TT dwarfs Greece's; it would be a harder problem to solve. Luckily, despite sharing similar levels of debt with Greece, Italy benefits from a relatively more stable political structure and a more balanced economy.

As Chart 2, below, shows, EU membership has been a boon to some of the more marginal borrowers in Europe. Obviously, incremental borrowing growing forward will be more difficult, but the savings/borrowing imbalances that exist today are manifest in the high levels (and the increase in levels since 2000) of debt in Greece, Italy, Portugal, etc.

In short, the imbalances and structural inefficiencies that begat Euro crisis 2011 have not gone away. A reprise of this episode, or something with a strong resemblance to it, is a strong possibility.

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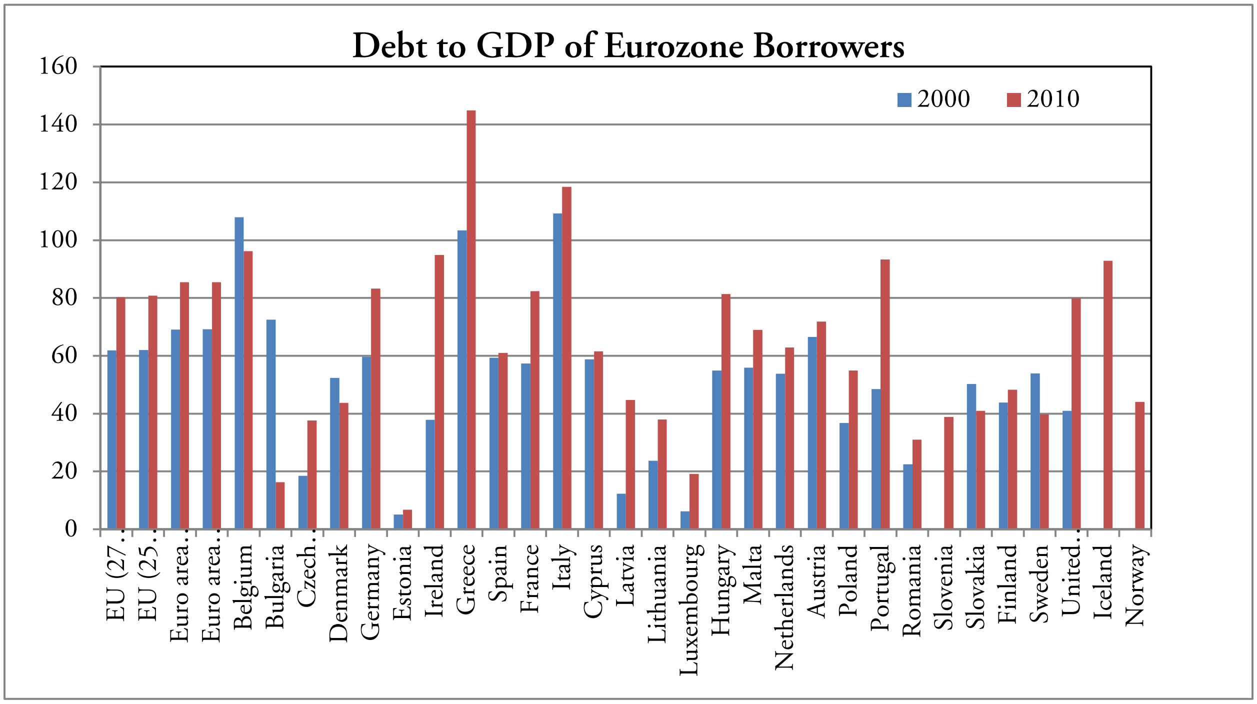
Chart 2



Source: Eurostat, the statistical office of the European Union

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