

Are we there yet?

A perspective on the European debt crisis



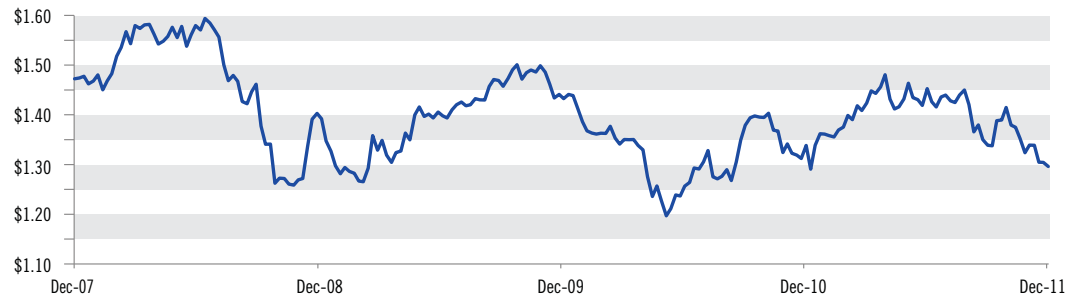
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In 2012 the European debt crisis entered its third year. We believe that we will soon witness the ultimate showdown to determine whether the European dream can survive. When all is said and done, we expect the euro currency zone, and potentially even the composition of the European Union (EU), to have a distinctively different face than it does today. The first quarter of 2012 will quite possibly indicate if Europe has the ability to weather the storm, or if it will finally succumb to its skeptics. During the course of the first quarter, European sovereigns will need to refinance over €300 billion in debt while European financial institutions have to roll an additional €230 billion. But will the markets have the appetite, and at what price? Over the course of 2012, nations such as Italy and Spain will each need to roll almost 20% of their outstanding debt. The current interest rate that the Italian sovereign has to pay to investors (more than 7%) could prove to be a crippling burden in years to come.

The European Central Bank (ECB), under the new leadership of Mr. Draghi, has dramatically shifted its stance. “Super Mario” Draghi has cut

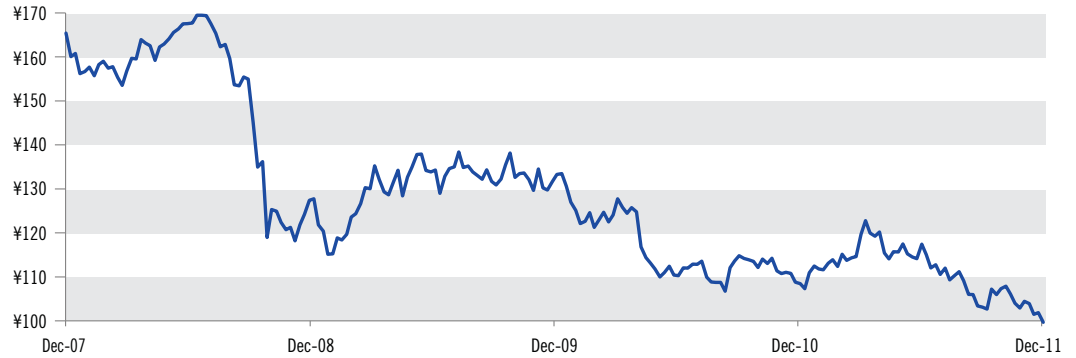
interest rates twice since taking the controls in November, reversing the two rate increases of earlier in 2011 and effectively admitting a policy error by the prior leader. On December 21, the ECB had a special Christmas present for the struggling European banking industry: it offered an unprecedented amount of liquidity (€489 billion, or about \$639 billion) to the banking system via a three-year long term refinancing operation (LTRO). More rate cuts from the ECB are now a distinct possibility. Those that are hopeful think this approach may have the capacity to stop the bleeding. We, however, are once again quite skeptical—early indicators imply that most of the funds are not finding their way into the real economy. Instead, funds are being held by the banks, reluctant to lend even to their competitors, or deposited back to the ECB. The shift in the rate regime and ongoing fear regarding the survival of the euro has weighed heavily on the currency, which is now trading below \$1.30. Given our negative view of the events taking place in Europe, we believe the exchange rate is at risk of heading significantly lower—a rate of 1:1 versus the U.S. dollar is certainly not out of the question.

EUR/USD Spot Exchange Rate



Source: Bloomberg

EUR/JPY Spot Exchange Rate



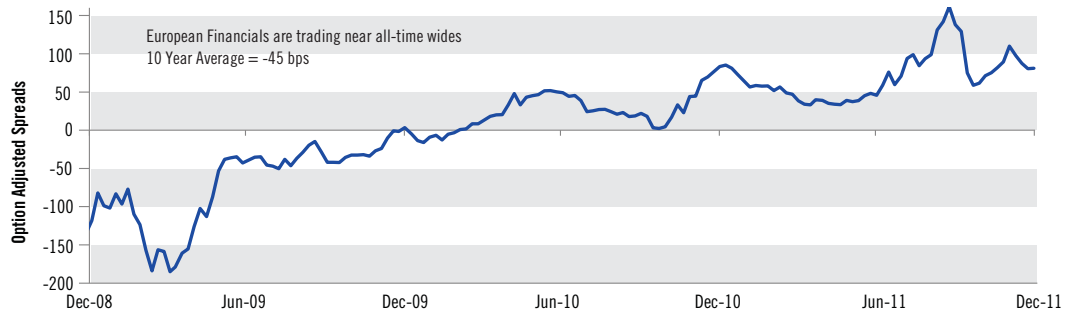
Source: Bloomberg

Negative news about European banks continues to dominate the headlines. The European banking authority has set a new 9% core capital requirement that banks will have to meet in 2012. Banks will attempt to meet these requirements by tapping the capital markets and shrinking their balance sheets. The downsizing of bank balance sheets will have some unwelcome side effects, however, as we expect financial institutions to become very picky about which clients they want to serve. Banks that become restrictive with their balance sheets might also adversely impact trading spreads in the money management community. For some banks, raising their core capital in the financial markets will not be an easy feat. Italian bank, Unicredito, had to

offer a 46% discount for its €7.5 billion rights issue; others are unlikely to fare much better. We believe that Germany's Commerzbank (absent the ability to attract Allianz Insurance to become its new majority shareholder) might be forced to seek funds from the German government for the second time since 2008 in order to reach that measuring stick. The €40 billion exposure of Austrian banks to Hungary, which could head toward default in the month to come, will be an additional burden and might leave the Republic of Austria with no choice but to bail out the Austrian banking industry. This will almost certainly cost the country its treasured AAA rating.

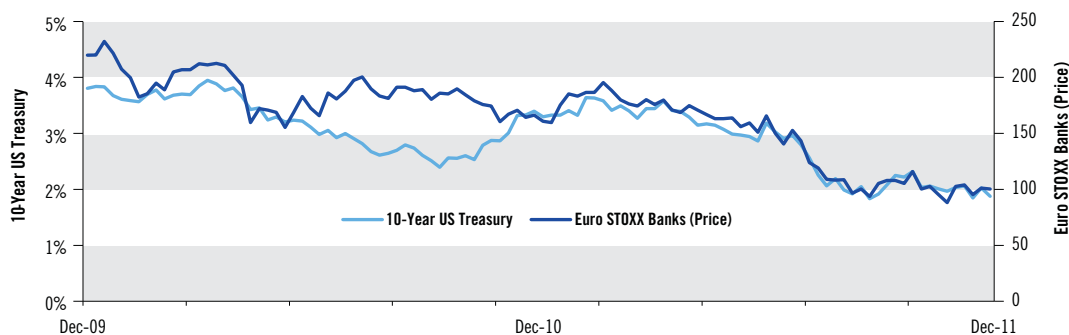
Contrary to the public statements of European politicians, we believe that the European economy

European Financials vs. U.S. Financials



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Euro STOXX Bank Index vs. 10-year U.S. Treasury



Source: Bloomberg

has entered a recession. The German economy is among the sole hold-outs, with its competitive export industry profiting from the lower exchange rate, but we believe that German growth, too, will succumb to a global slowdown, exposing it to the risk of a drastic cool off.

Papas Come, and Papas Go

The leadership carousel in the peripheral nations has picked up speed and reached a head-spinning tempo. On November 9, beleaguered Greek Prime Minister Papandreou resigned and was two days later replaced by the well-respected former ECB Governor Papademos. One day later, Italy's Silvio Berlusconi had to throw in the towel and was replaced by the technocrat Mario Monti. On November 20, the Spanish electorate finally forced out Prime Minister Zapatero's socialist party. Being well aware of the voters' dislike for his party, Mr. Zapatero had not run for reelection. The conservative Rajoy took over the reign as new Prime Minister of the Kingdom of Spain.

The current climate is not particularly kind to incumbent leaders. The fate of France's AAA credit rating might deal a cruel blow to Mr. Sarkozy's reelection bid. On April 22, Nicolas Sarkozy, the center-right President of France, will face a stiff challenge to his reelection bid from Francois Hollande, the candidate from the Socialist Party. The third candidate is Marie Le Pen from the right-wing National Front who publicly stated her goal of

leaving the euro currency in favor of reintroducing the French franc. In the latest opinion polls, Mr. Sarkozy trails the Socialist Party candidate, who, at an earlier election, beat the conservatives to take over the French Senate while the National Front came in third.

These fresh faces failed to calm the markets, though, as everyone quickly realized that while governments come and go, the harsh reality of the problems at hand remain the same. After decades of living beyond their financial means, the time has come to pay the piper. Unfortunately, the strict austerity measures taken by the peripheral nations only deepen the problems for their recession-plagued countries. These nations are burdened by high unemployment numbers, particularly among young people, which has contributed to their volatile environments. A combination of fiscal prudence and stimulus measures will be necessary if those countries want to stand any chance at seeing the other side of the tunnel, but the odds are clearly not in their favor.

The International Monetary Fund (IMF) and some within the German coalition government have become increasingly skeptical and publicly critical toward Greece, which has missed nearly every reform yardstick set in prior bailout agreements. During the month of March Greece has to redeem €17.5 billion in government debt consisting of bonds and bills, and the odds have increased that Greece might finally meet its fate and default on its

outstanding debt. The Private Sector Involvement (PSI), which asks investors to “voluntarily” accept a 50% haircut, falls short of what is needed. With the IMF maintaining a preferred-lender status and the ECB not being asked to participate, we believe the haircut will have to be closer to 80% or 90% in order to sufficiently reduce the country’s debt burden. But even such a drastic measure might not be enough to save the nation from bankruptcy. The Troika, consisting of the IMF, ECB, and EU, might have to offer some additional type of debt forgiveness in exchange for further reforms. We believe that any plan will have to include some form of infrastructure and business development component to stimulate the Greek economy, which has been decimated by harsh austerity measures, in order to be successful. Unfortunately, neither the Greek government nor the members of the Troika give us hope that such a deal can be reached.

The EU governments have worked hard to avoid the stigma of a credit event that would trigger the credit default swaps, but time is running out for such gimmickry. Based on the inability of the Greek government to push forward and implement the necessary reform process, we now believe that the probability of an outright Greek default, with Greece voluntarily leaving the European currency, is high.

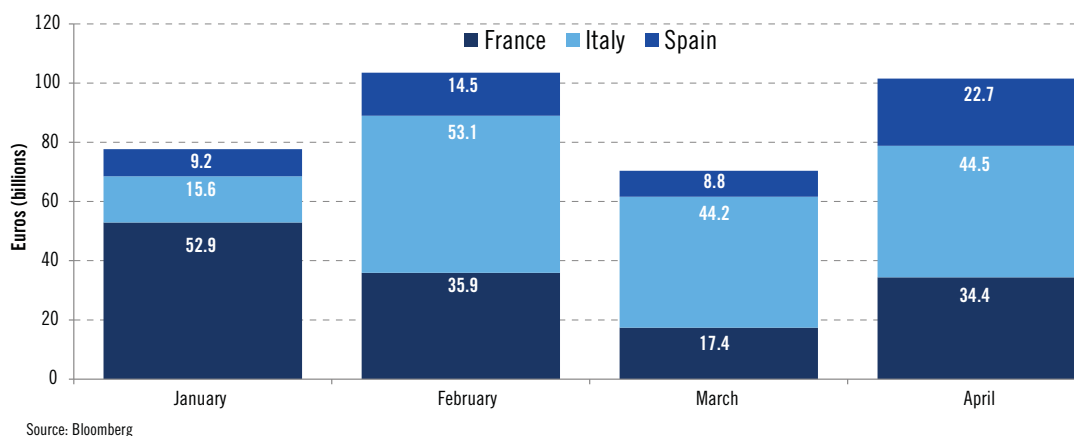
Under a Greek default scenario, it would become extremely difficult for Italy and Spain to refinance in the capital markets. The spotlight will

be on Italy when it has to refinance €41.8 billion in debt between February and April. We have stated in the past that the ability to successfully ring fence a Greek credit event will hold the key to the survival of the common currency. The potential for this bipolar outcome will command the attention of all global investors.

The most positive outcome would enable Italy and Spain, along with the rest of the peripheral nations, to survive this confidence crisis by tapping into the European Financial Stability Facility/ European Stability Mechanism (EFSF/ESM) umbrella with some additional assistance by the IMF. We expect that in a Greek credit event, some form of quantitative easing would be offered by the ECB to successfully end the current crisis.

It is, however, the negative outcome—the fat-tail event—that worries us most. What has long been unthinkable could become a shocking reality: the break-up of the euro currency zone. A scenario which would lead to either a soft southern euro and a hard northern euro or a return to old national currencies would almost certainly shake the global markets and inevitably lead to a pronounced global recession. A collapse of the common currency would exponentially increase the risk of the fragmentation of the European Union and would have dire consequences for global trade. While this is not our base-case scenario, we are no longer in a position to rule it out.

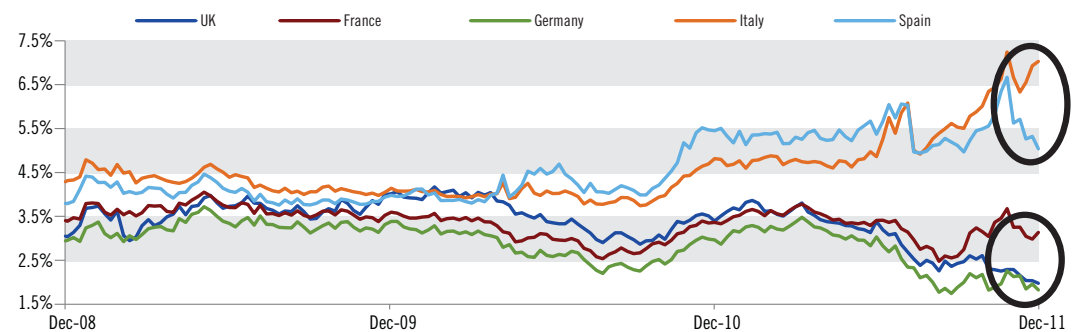
Global Bond Maturities - January through April 2012



We continue to believe that when faced with the possibility of a global financial meltdown and subsequent pronounced recession of the global economy, developed and developing nations will circle the wagons to secure a financial support package for the struggling peripherals—even if their only motivation is self-preservation.

A positive resolution of the European debt crisis, with painful austerity and entitlement reform, closer fiscal integration, and intelligent stimulus measures, could serve as a global blue print for the United States and Japan. Such a resolution could also lead to the reemergence of a stronger Europe.

European 10-Year Sovereign Yields



Source: Bloomberg

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