Catalyst Calendar: A Sovereign Roadmap
February 2011

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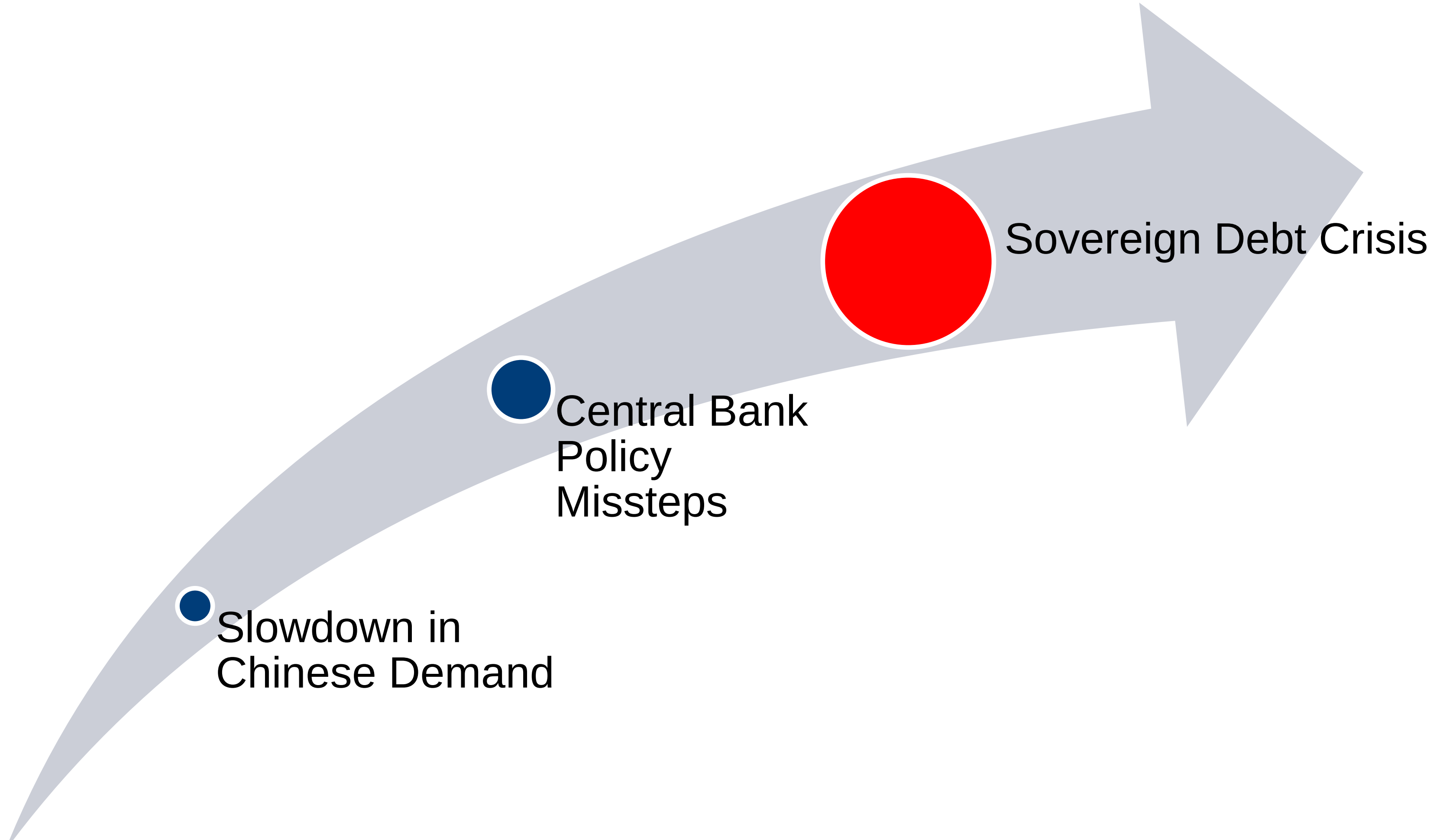
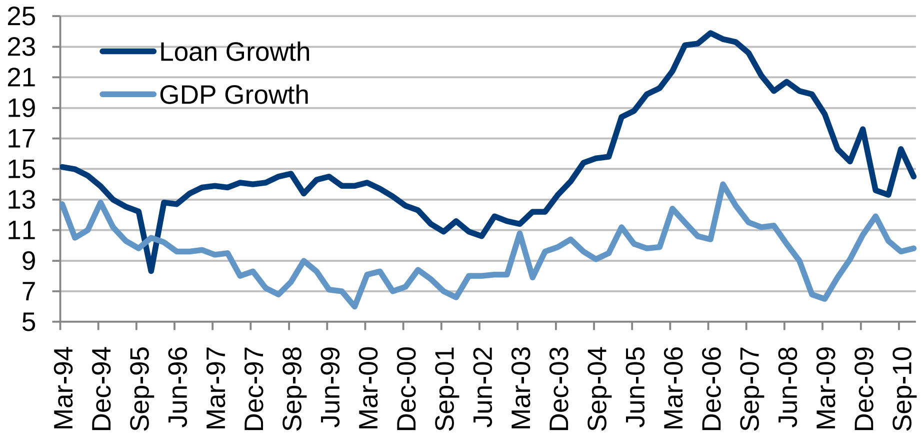
Please see analyst's certification and important disclosures in Appendix A of this report.

Latent and Active Catalysts – Three Threats

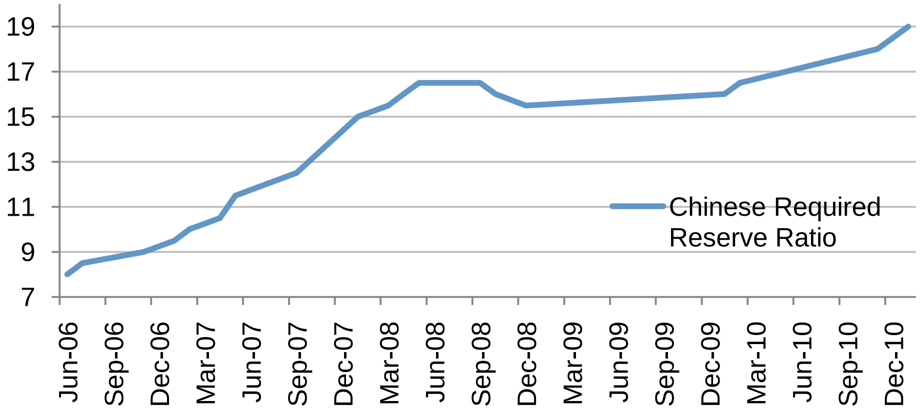


Slowdown in Chinese Demand

Chinese Loan and GDP Growth (% Change YoY)



Chinese Required Reserve Ratio for Major Banks

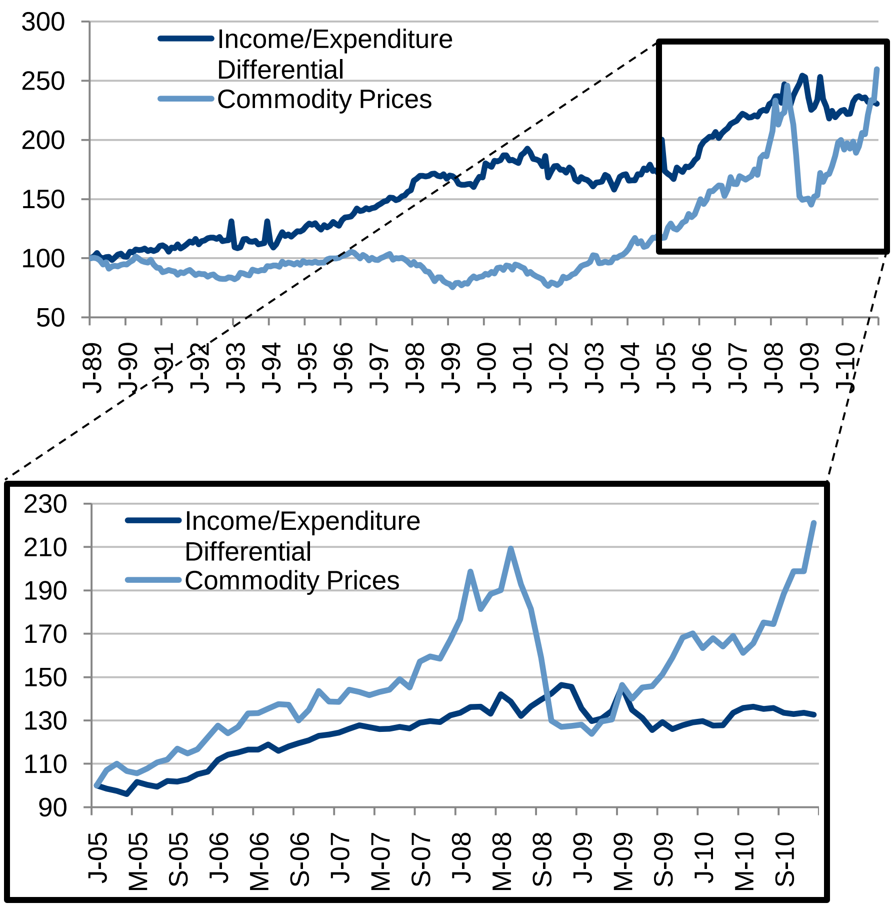


Source: The People's Bank of China; Bloomberg; Knight Research

- NYT article 2/2/2011 stating China is poised to hike rates within one month
- Mixed PMI data recently; new 5M low and second consecutive decline for January
- Chinese press reported 2/1/2011 that the PBOC may implement price controls to stabilize inflation
- PBOC may be backing away from differentiated RRR in 2011 as liquidity is tight (around New Year)
- Salient Questions:
  - **Is China like Japan in that it absorbs more global growth than it provides?**
  - **How much will the RE and banking sectors be shielded from a slowdown?**
  - **Is it a normal cycle or a bubble?**

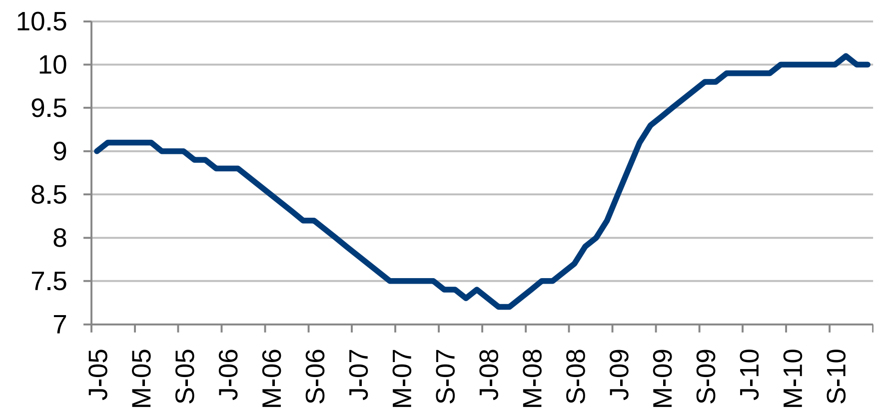
Central Bank Policy Missteps – Inflation and Credit Problems vs. Job Growth

U.S. Inflation and Credit



Source: Bureau of Economic Analysis; NYBOT; Bloomberg; Knight Research

Eurozone Unemployment (%)



Source: Eurostat; Bloomberg; Knight Research

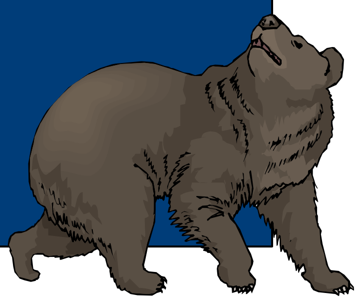
SOVXWE

Source: MarkIt; Bloomberg; Knight Research

Makeup of European Spreads

Non-Externally Supported Spreads

- Reflects
  - High levels of indebtedness
  - Aging population
  - Higher market sensitivity to sovereign risks
  - Global indebtedness
  - Banking system risk



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Eurozone Membership Mitigant

- Reflects
  - Belief in fiscal unity
  - Possibility of central treasury
  - Continued bailout efforts

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Observed Markets

- Reflect Combination of Both Cases

- Market expectations are dependent on the prevailing belief in both the risks inherent in sovereigns on a stand-alone basis and the mitigants associated with Eurozone membership. Both are moving targets, with the stand-alone spread defining process being iterative in information and the risk mitigant factors subject to numerous political factors. Understanding the catalysts that move these factors is key to understanding European sovereign risks.

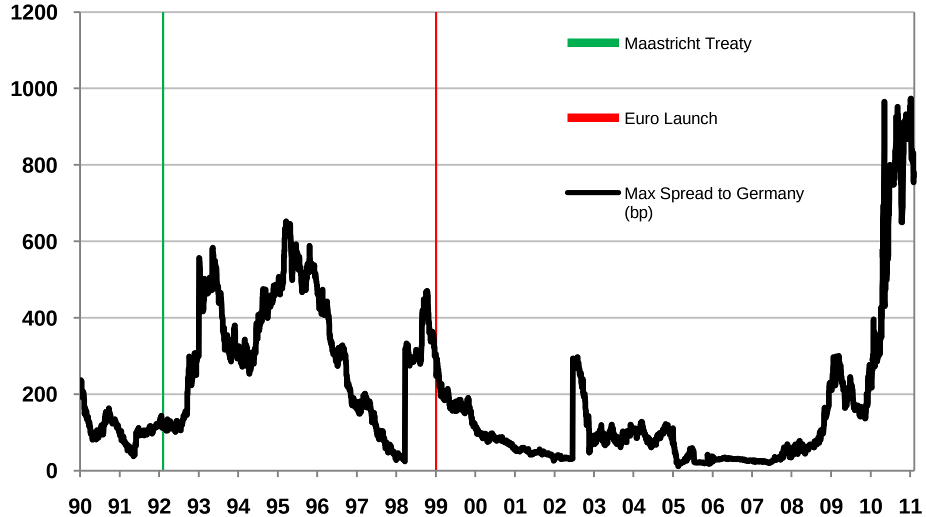
Risk Pricing in Peripheral Europe – A Return to Normal

Deterioration of Periphery Maastricht Treaty Indicators Since Euro Formation

	Greece	Ireland	Italy	Portugal	Spain
Maastricht Treaty					
Budget Deficit	-11.1	-2.9	-8.6	-4.1	-3.5
Debt/GDP	87.8	92.5	108.1	54.4	46.8
EMU Launch					
Budget Deficit	-3.3	2.7	-1.7	-2.8	-1.4
Debt/GDP	94	48.5	113.7	51.4	62.3
Current					
Budget Deficit	-13.6	-14.4	-5.3	-9.3	-11.1
Debt/GDP	115.1	65.5	116	76.1	53.2
Since Maastricht Treaty					
Budget Deficit	-2.5	-11.5	3.3	-5.2	-7.6
Debt/GDP	27.3	-27	7.9	21.7	6.4
Since EMU Launch					
Budget Deficit	-10.3	-17.1	-3.6	-6.5	-9.7
Debt/GDP	21.1	17	2.3	24.7	-9.1

Source: EuroStat; OECD; Knight Research

Max EMU Member Spread to Bund (10Y, bp)



As of 2/7/11
Source: Bloomberg; Knight Research

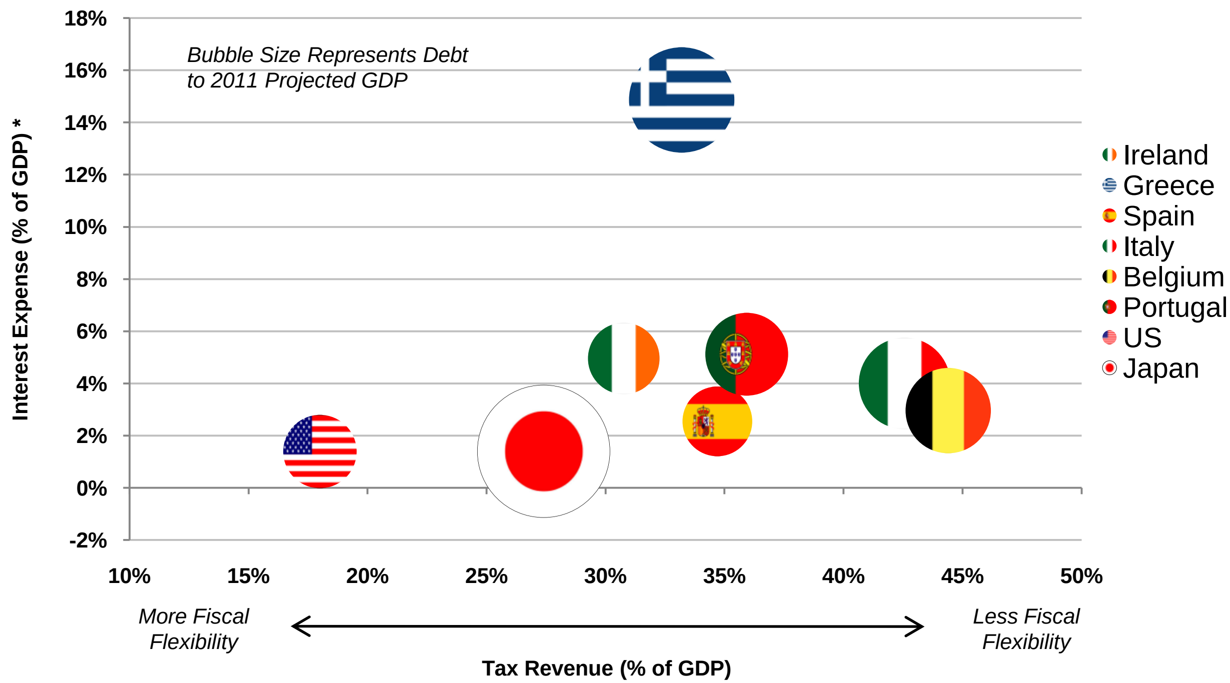
Europe Faces Rising Debt Burdens and Limited Fiscal Flexibility

Global Debt Rankings *(USD)*

	Country	Debt (MM)
1)	Japan	10,744,088
2)	United States	8,998,373
3)	Italy	2,122,356
4)	France	1,684,882
5)	Germany	1,656,882
6)	United Kingdom	1,653,165
7)	Spain	835,838
8)	Canada	605,947
9)	Greece	444,142
10)	Belgium	423,532

- Italy and Spain are the largest debtors in the periphery
- Italy is more heavily indebted with more onerous rollover requirements
- Italy, Belgium, and Portugal have a high sensitivity to funding costs

European Tax Revenues vs. Interest Expense



* Represents interest expense if total debt were priced at current levels.

European Debt Burdens

		Greece		Italy		Ireland		Portugal		Spain		Belgium		US		Japan
GDP	€	233,046	€	1,520,870	€	159,646	€	168,046	€	1,053,914	€	339,162	$	14,119,000	$	5,069
Debt	€	293,755	€	1,557,670	€	94,975	€	137,696	€	607,956	€	310,873	$	8,890,643	$	10,458
Average Rate Debt Burden % GDP		14.44%		4.19%		4.92%		5.23%		2.58%		3.19%		1.39%		1.40%
Stressed Scenario		12.46%		10.13%		5.88%		8.10%		5.70%		9.06%		3.15%		8.25%

As of 1/4/2011, Stressed Scenario: +700 over current bunds for Euro Periphery, 5% for US, and 4% for Japan

Source: Eurostat; World Bank; Bloomberg; Knight Research

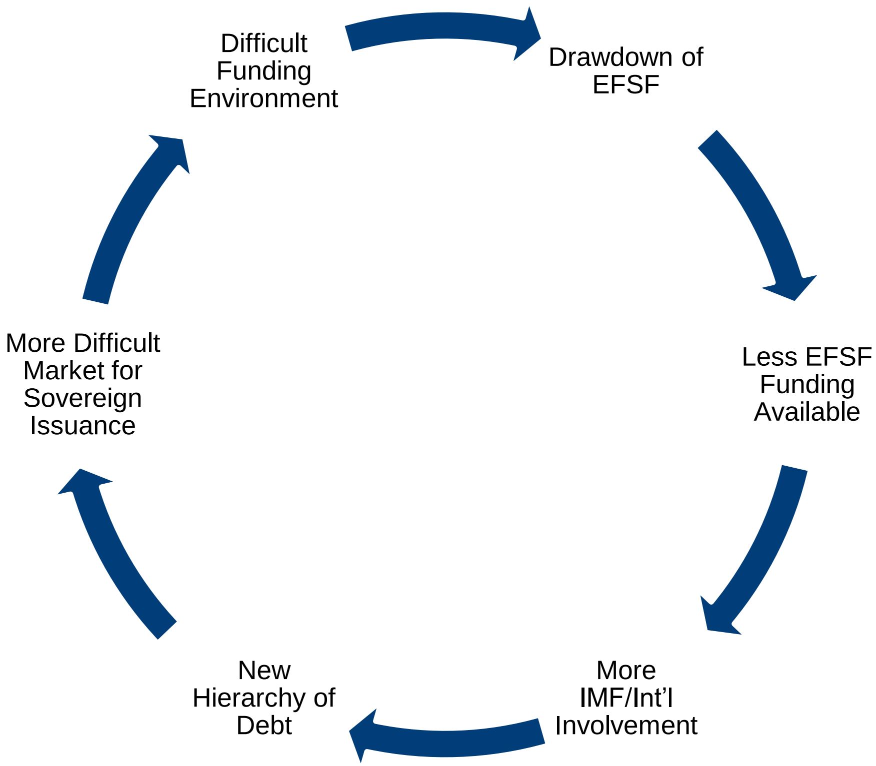
Growth Projections Seem Predicated on Fiscal Responsibility Not Being Contractionary

Economic Growth Forecasts (YoY, % change)

			Projections		Difference from October 2010 WEO Projections	
	2009	2010	2011	2012	2011	2012
United States	–2.6	2.8	3.0	2.7	*0.7*	*–0.3*
Germany	–4.7	3.6	2.2	2.0	*0.2*	*0.0*
France	–2.5	16	16	18	*0.0*	*0.0*
Italy	–5.0	10	10	13	*0.0*	*–0.1*
Spain	–3.7	–0.2	0.6	15	*–0.1*	*–0.3*
Japan	–6.3	4.3	16	18	*0.1*	*–0.2*
United Kingdom	–4.9	17	2.0	2.3	*0.0*	*0.0*
Canada	–2.5	2.9	2.3	2.7	*–0.4*	*0.0*

Source: WEO Update, January 2011; Knight Research

EFSF – CDO Solution, Quasi-Treasury, or Debt Spiral?



Senior
- IMF/Int'l Loans
- Domestic Bank Deposits

- EFSF Loans
- Sovereign Bonds

Junior
- Bank Capital Borrowings
- Offshore Bank Deposits

Expansion to Bond Purchases Raises More Questions than Answers:
- *Price sensitivity of sellers*
- *Potential sellers considering price sensitivity*
- *Voters realize this is debt transfer/subsidization*
- *Direct issuance an ever clearer signal to voters*
- *Legal and ratings issues*
- *<€440B available versus >€3.2T periphery debt load (treasury level only)*

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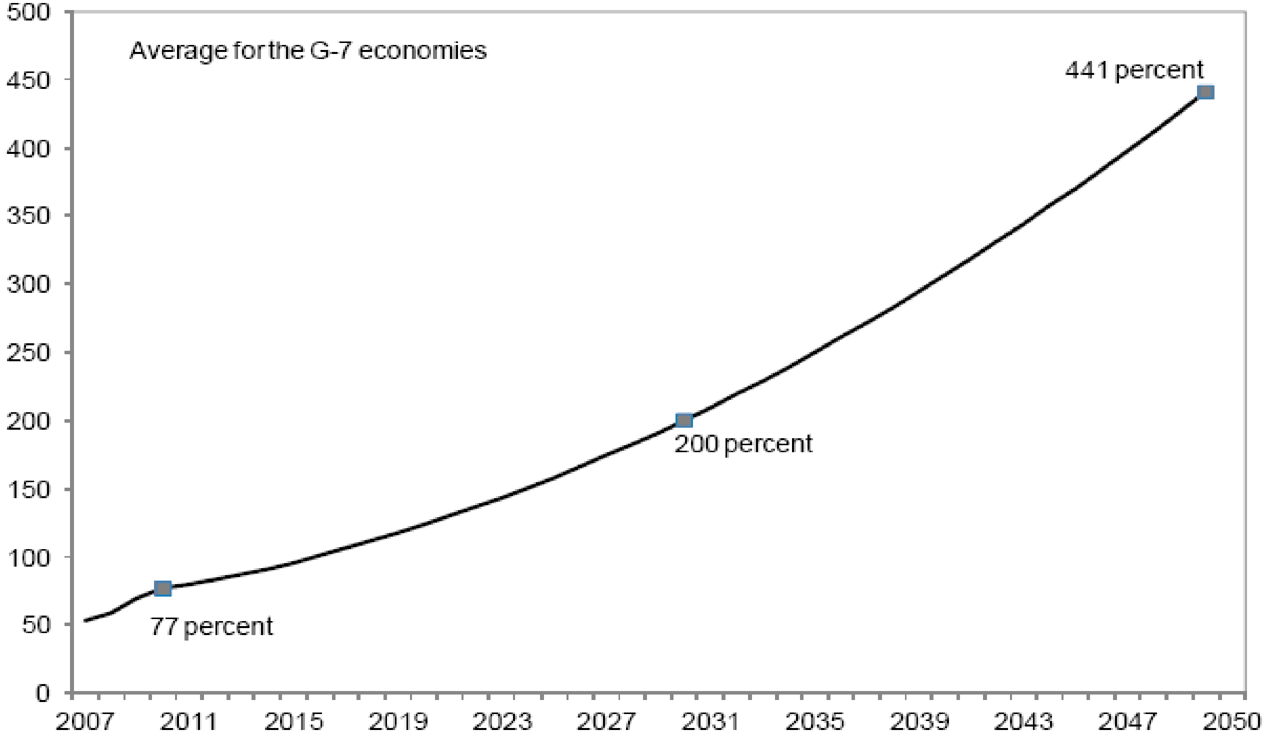
Advanced Economies' Projected Path is Unsustainable

General Government Net Debt Scenario Under 2010 Policies
(In percent of GDP)

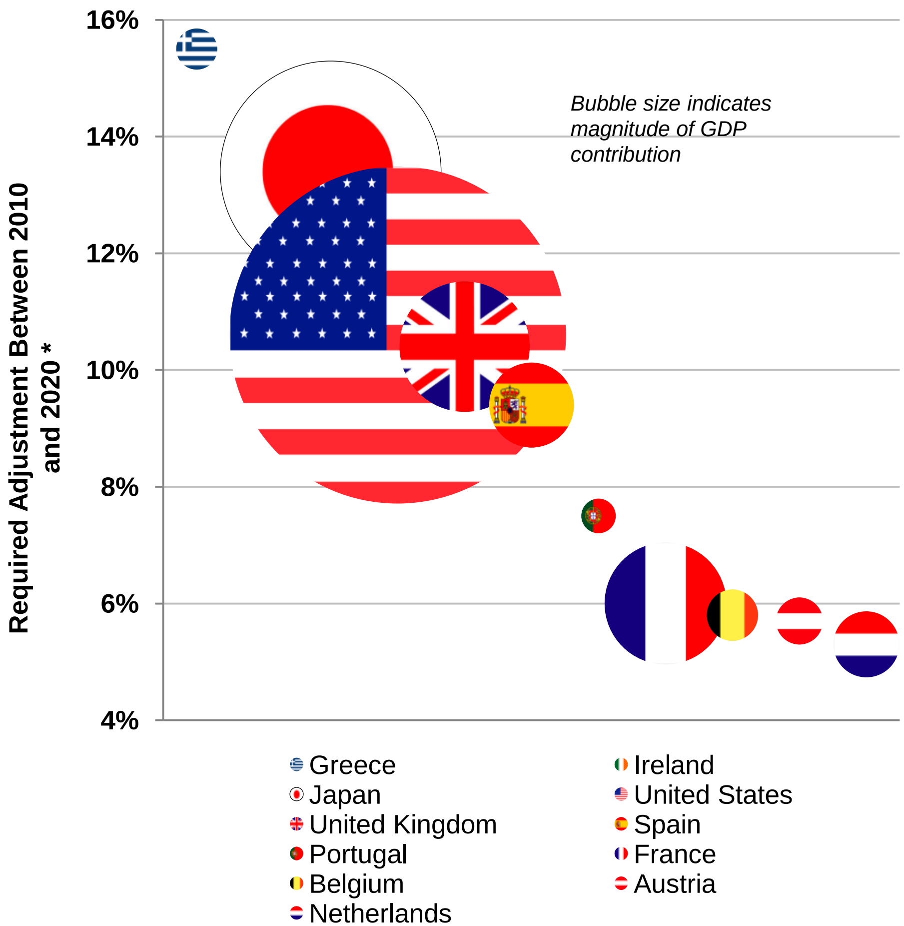


Source: IMF

•Public debt has increased to unprecedented levels, rising from a postwar low of 34% in 1974 to a projected record high of 110% by YE2010
•Unprecedented adjustments are required across the G-7
•The status quo is not an option

Unprecedented Fiscal Imbalance Creates Policy Conundrum

Indebted Countries' Contribution to World GDP

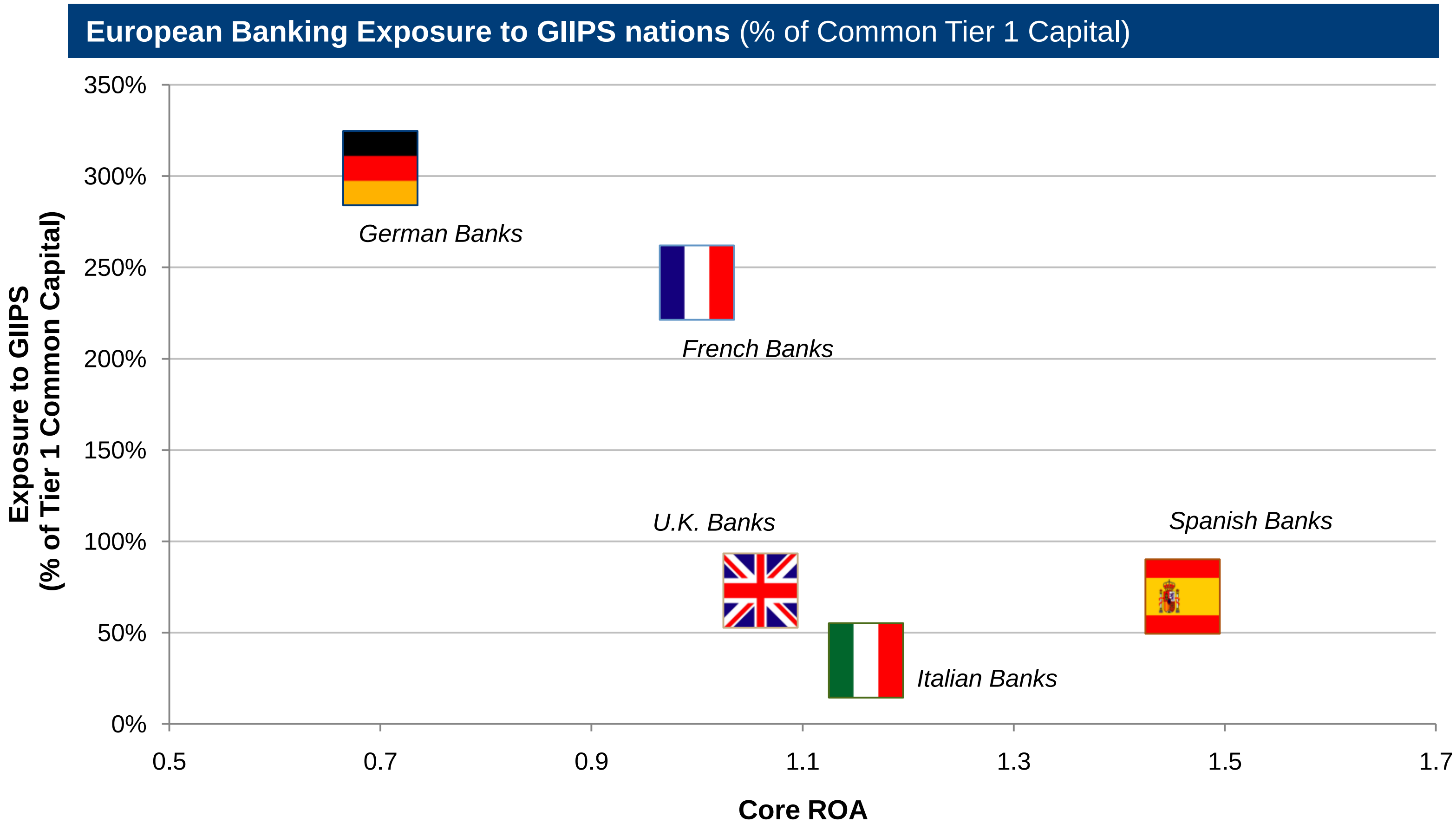


- Nearly a dozen countries require fiscal adjustments, representing approximately 54% of global GDP.
- Policies that promote near term economic growth are mutually exclusive to policies that are fiscally responsible.
- Policy choices are affected by election cycles.
- This elevates monetary, fiscal and regulatory policy risk to new levels, which in turn affects economic growth prospects.

* Reflects fiscal adjustment needed to reduce a country's debt/GDP
2009 Gross domestic product in constant 2000 U.S. dollars

Sources: IMF; WEO; WDI

Die Deutsche Frage – A Difficult Balancing Act



Sources: BIS; SNL; Knight Research

March Madness - Political Risk Is High and Rising

- Funny thing about democracies is the feedback loop between electorates and national policy
- Policy risk remains tethered to national, and even regional political risk across the European Union
  - Higher risk within coalition governments
  - Breakdown of coalition (i.e. Ireland) can lead to snap elections and uncertainty around policy action
- Two primary sources of political risk as it relates to the Euro sovereign crisis
  - Stressed states (periphery Europe) lose the electoral support to carry out reforms, trim deficits, and curtail debt
  - Core Europe or payer states (e.g. Germany) lose electoral support to bail out Peripheral Europe or debtor states

Eurozone Political Sound Bites:

"We believe that Ireland may be left with no option, in the absence of a renegotiated deal, but to write down the value of the bonds in the Irish banks or face the prospect of a hugely damaging sovereign default"

Fine Gael, Irish Opposition Party, February 2, 2011

"62% of [German] voters oppose further bail-outs of weak euro members…."

The Economist, January 13, 2010

"49% of Germans would like to have a return of the D Mark"

YouGov Insitute, December 26, 2010

It may be "useful for the €440 billion European Financial Stability Facility to buy government bonds"

Jean-Claude Trichet, January 26, 2011

March Madness – German Regional Elections Will Signal Voter Sentiment Toward Bailouts

- Irish national election on February 25, 2011
  - First national election spawned by crisis
  - Fine Gael positioned to form coalition government with Labour
  - Election one year ahead of requirement

- Spanish national election due in March 2012
  - 13 autonomous regions hold elections in 2011

- Portugal national election late 2013

- Italian national elections due in April 2013
  - Early election could materialize in Spring 2011

- German federal election in 2013
  - 7 regional elections in 2011
  - Four elections in February and March
  - In 3 of those elections the CDU (Angela Merkel's party) is in the ruling coalition
  - Losses in the states will reduce the ruling parties' representation in the Bundesrat, the upper house at the national level

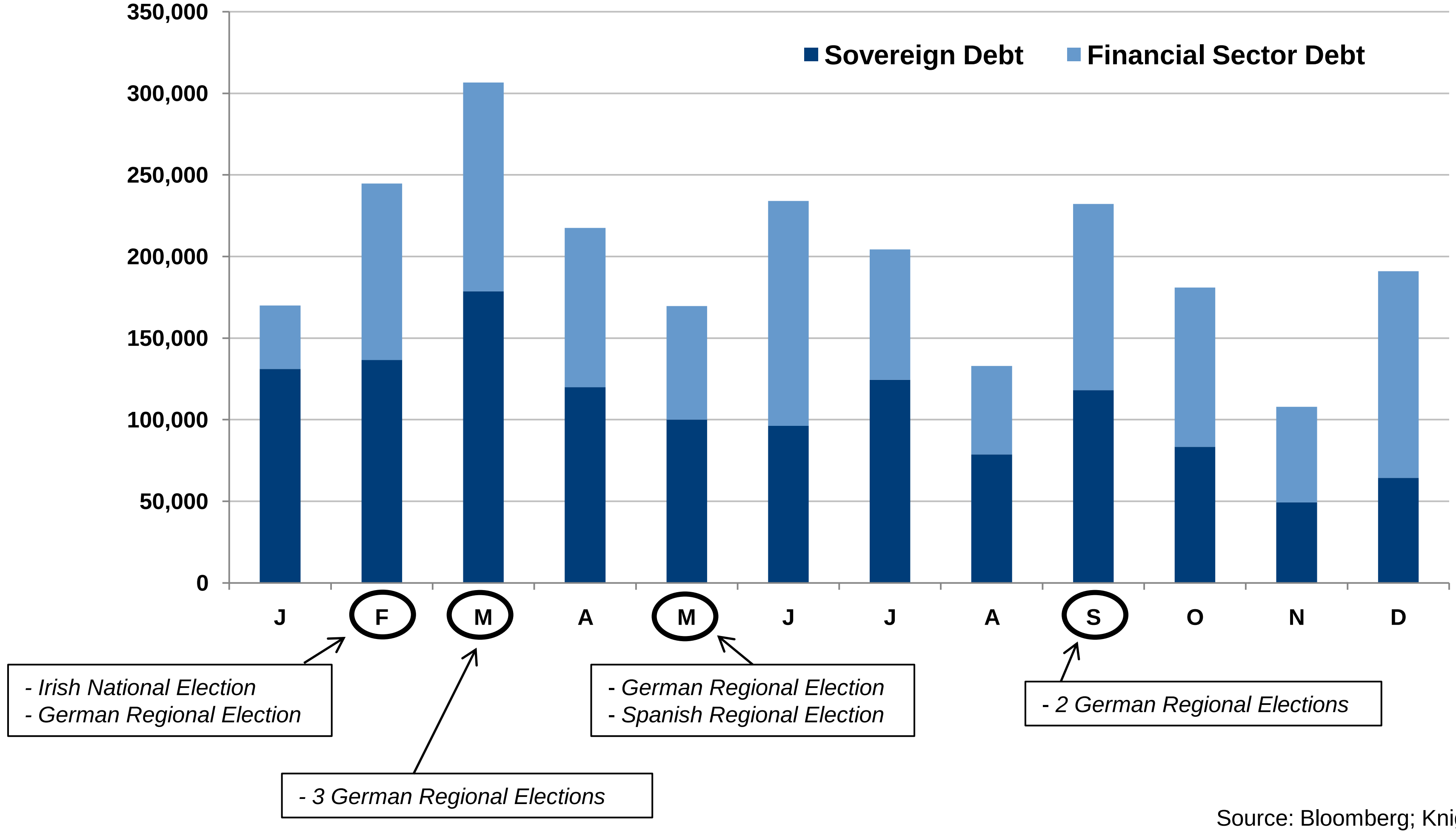
- French national election June 2012

- Greece national election due in 2013

Image Courtesy of www.expansys-usa.com

March Madness – Debt Maturities Heavily Loaded in March

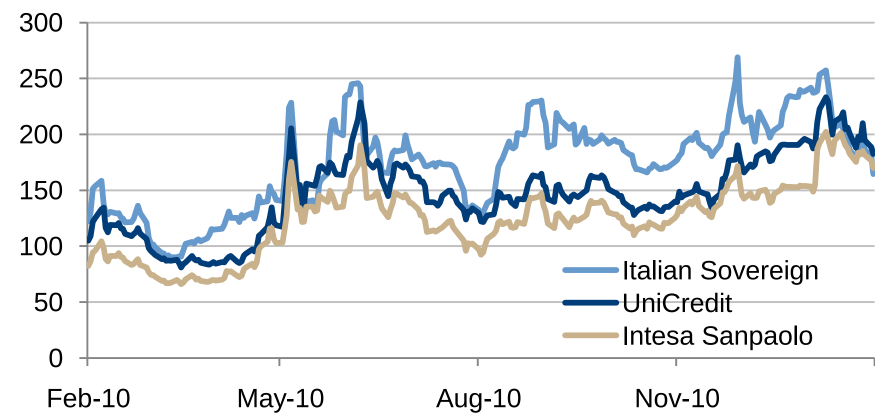
2011 Total Eurozone Monthly Debt Maturities: Sovereign and Financial (€, MMs)



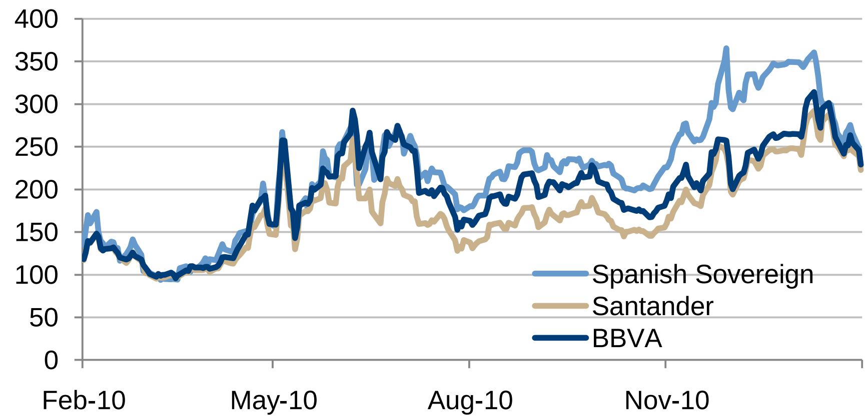
Source: Bloomberg; Knight Research

Risk Premiums

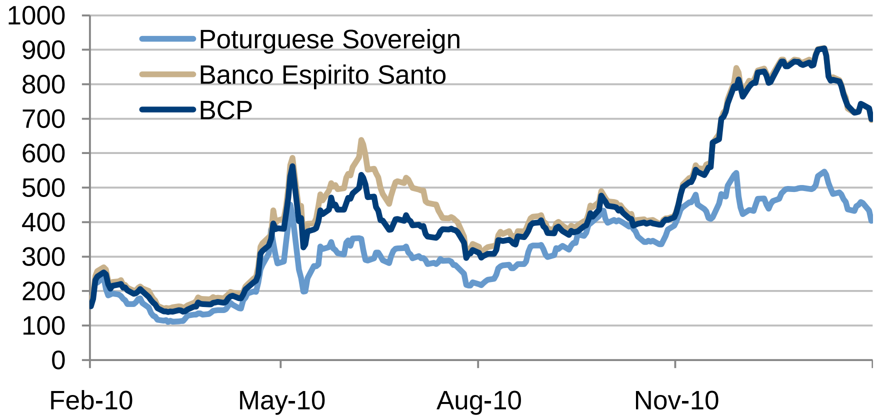
Italian Sovereign vs. Financials (5Y CDS)



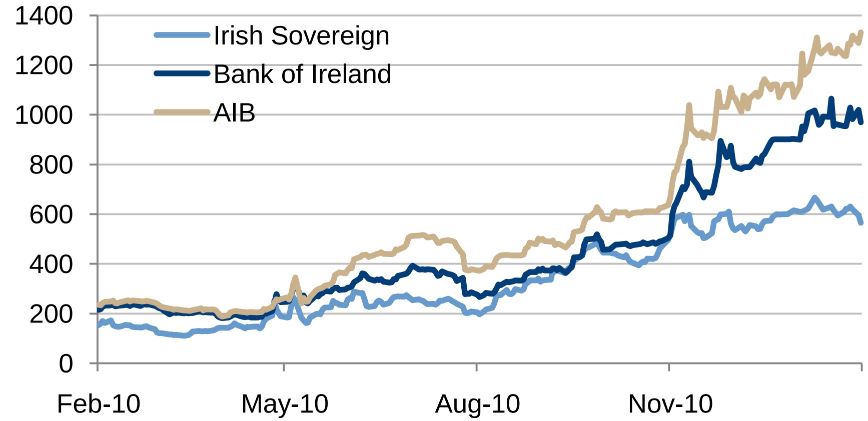
Spanish Sovereign vs. Financials (5Y CDS)



Portuguese Sovereign vs. Financials (5Y CDS)



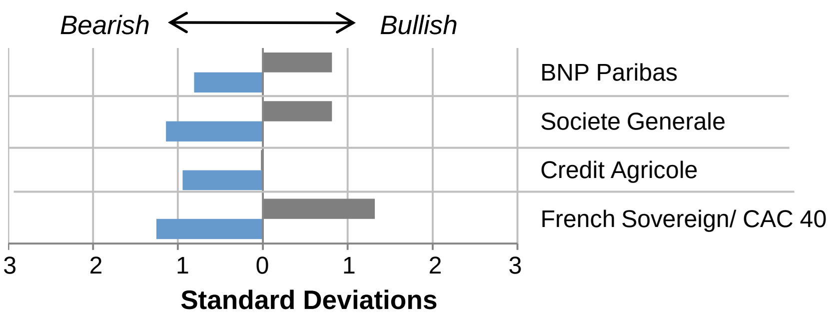
Irish Sovereign vs. Financials (5Y CDS)



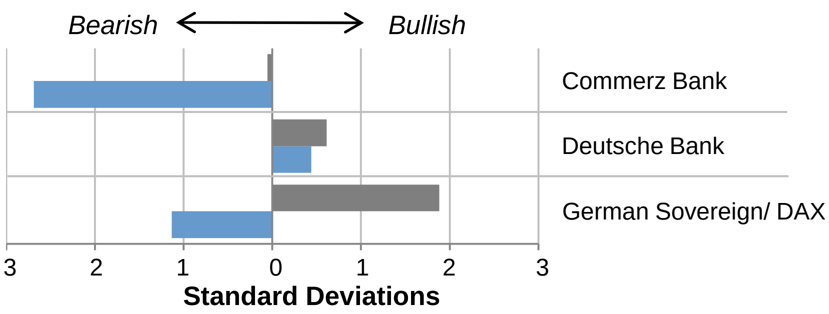
Source: Bloomberg; Knight Research

Volatility in Non-Externally Supported Nations

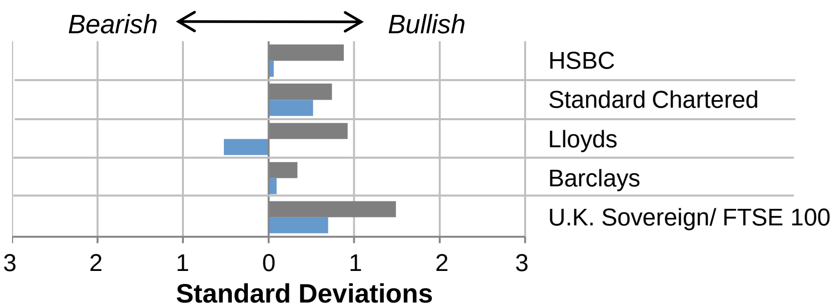
France (Deviations from 2Y Mean)



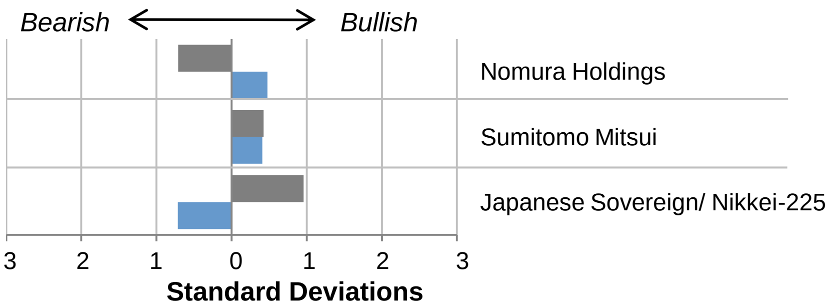
Germany (Deviations from 2Y Mean)



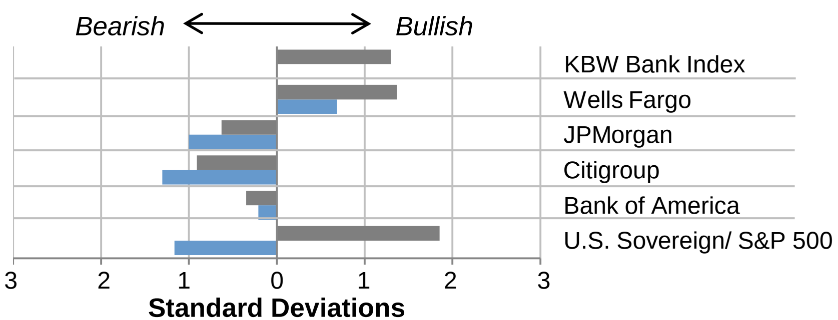
U.K. (Deviations from 2Y Mean)



Japan (Deviations from 2Y Mean)



U.S. (Deviations from 2Y Mean)

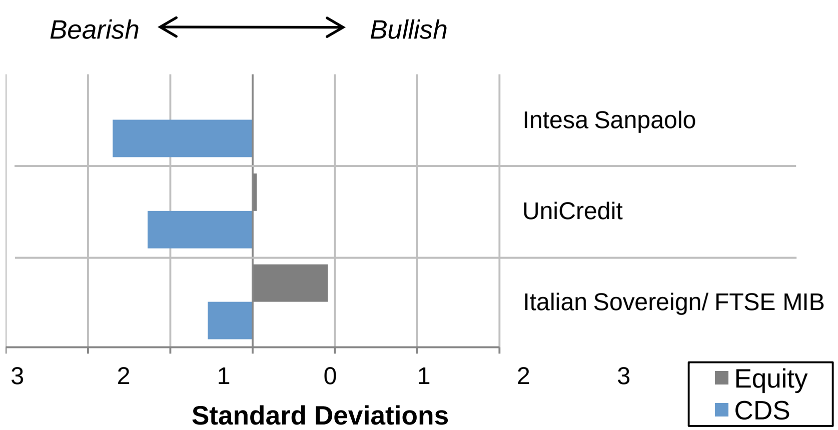


Equity
CDS

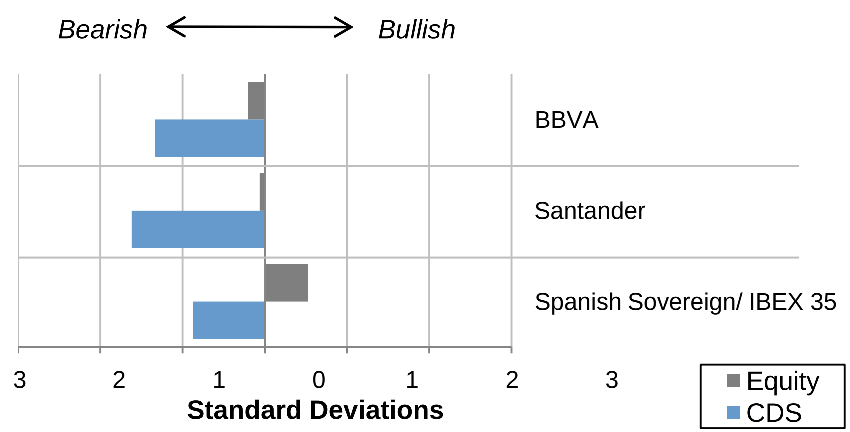
Source: Bloomberg; Knight Research

Volatility in Externally Supported Nations

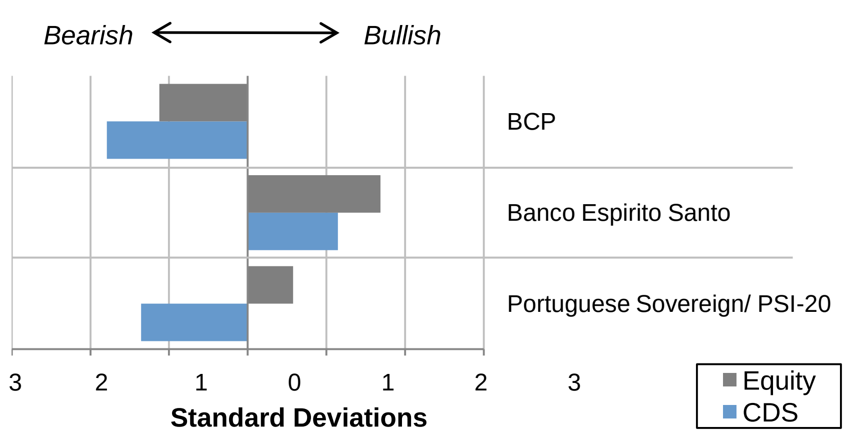
Italy (Deviations from 2Y Mean)



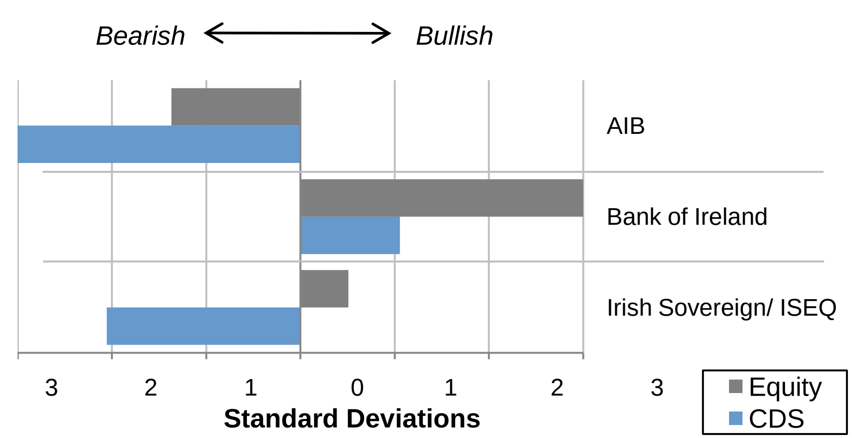
Spain (Deviations from 2Y Mean)



Portugal (Deviations from 2Y Mean)

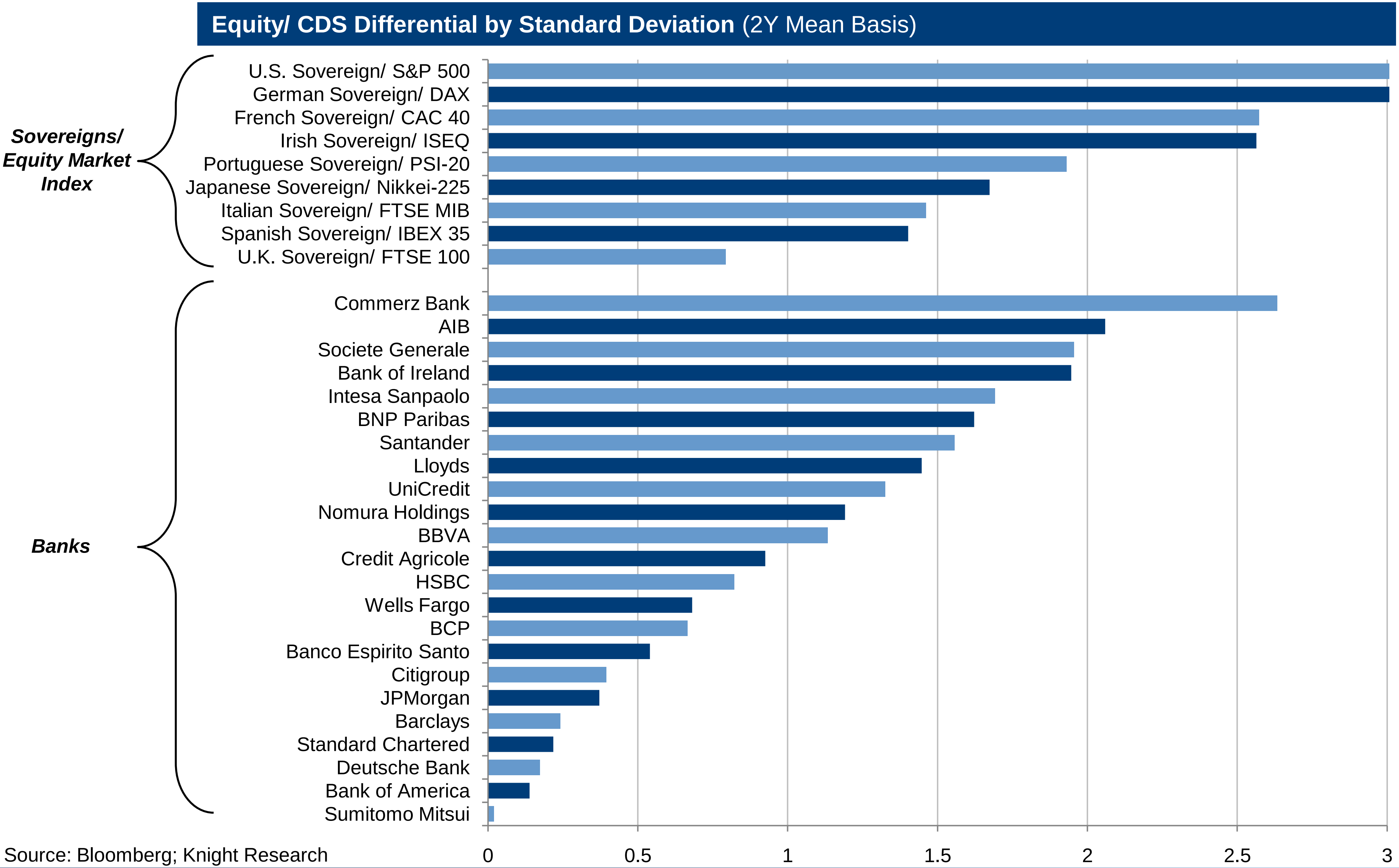


Ireland (Deviations from 2Y Mean)



Source: Bloomberg; Knight Research

Total Divergence



Source: Bloomberg; Knight Research

Key Takeaways

- Primary catalytic events revolve around two key themes
  - Slippage on fiscal reform in the GIIPS
  - Popular (read voter) revolt in both the adjusting countries (e.g. GIIPS) and/or the paying countries (e.g. Germany)

- Volatility should remain a defining market characteristic in the coming year as policy action attempts to simultaneously address
  - A sluggish economic recovery
  - High unemployment
  - Record levels of fiscal imbalance

Notes

- Notes to Slide 10, “Advanced Economies’ Projected Path is Unsustainable”: Weighted average by PPP-GDP. The debt scenario assumes that the cyclically adjusted primary balance, corrected for fiscal stimulus measures, remains constant at the 2010 level (in percent of GDP). Nominal GDP is assumed to grow by 3 percent per year. The interest rate–growth differential (r-g) is assumed to equal zero until 2014 and 1 percentage point afterwards. Moreover, the scenario accounts for the estimated increase in aging-related spending.
- Note to Slide 11, “Unprecedented Fiscal Imbalance Creates Policy Conundrum”: Countries included need at least a 5% change in fiscal policy to bring debt/GDP to 60%. Diagram excludes Cyprus, which also requires a fiscal adjustment greater than 5% of GDP.

Acknowledgements

- Slide 10, “Advanced Economies’ Projected Path is Unsustainable”: Graph entitled “General Government Net Debt Scenario Under 2010 Policies” from IMF Staff Position Note: “Long-Term Trends in Public Finances in the G-7 Economies” by Carlo Cottarelli and Andrea Scheachter, September 2010.

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Data as of February 4, 2011

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