Bridgewater®

Daily Observations

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(203) 226-3030

Ray Dalio
Nick Reber
Jason Rotenberg
Sean Macrae

It's Time to Revisit Plan B-1

Now that everyone recognizes that Plan A doesn't work and that what we call Plan B-2 has the problems we observed in past *Observations*, it's time to revisit Plan B-1. To remind you of our thinking on these, we have excerpted it from our September 18 *Observations* and provided it below:

"**Plan A is to maintain lenders' confidence in sovereign debt and bank lending by providing a) a few hundred billion euros of lending from sovereigns and b) moderate ECB support.** This is the plan that policy makers have been following for the last 18 months and that most everyone now agrees has failed and, if pursued, will lead to an unmanaged explosion of the debt bomb. This plan was extremely naïve from the outset because policy makers did not think about who the investors are and what motivates their actions. While the amounts of debt that debtors needed to sell were well known, the error came in estimating the amounts of private sector purchases in order to determine the sizes of the funding gaps. Because the private sector demand was much lower than they expected, the funding gaps were much larger, so the amounts of credit that governments and the ECB blew through were also much larger. As it became apparent that the amounts allocated were inadequate, governments and the ECB were forced to reflect on what they wanted to do. The governments decided not to increase their contributions and the ECB has been silent. It is now clear to most people that Plan A has failed and that continuing down this path will lead to an unmanaged debt bomb explosion.

"There are two broad types of Plan B. While both plans require backstops for the banks, they differ in the following ways:

"**Plan B-1 is to defuse the bomb via managed restructurings with EFSF and ECB funds targeted to help make the restructurings safe.** In this plan, banks are backstopped and/or restructured and sovereigns that can't service their debts go through managed restructurings (of the sort that the IMF has a long history of doing) with EFSF funds used to facilitate these adjustment processes when debtor country and IMF funds fall short. Debt-equity exchanges will be an important part of the process in various ways that we won't digress into. In this plan the ECB would run monetary policy in a manner that is consistent with its mandate – i.e., to create enough money and credit to meet its targets (which we believe will be amounts that offset the declines in money and credit arising from the restructurings and that will keep nominal interest rates below nominal growth rates). This plan would bring about the restructurings that would position banks' and sovereigns' balance sheets so that they get these debt problems behind them and rebuild, in much the same way as the GM restructuring did for GM. This plan would move these debtors from being zombies (not dead but not really alive because they are too indebted to operate normally). Our calculations show that this path is achievable, it will be less painful than Plan A (which will lead to an unmanaged debt bomb explosion) but it will be more painful over the short term than Plan B-2 though it will be less painful over the long run than both Plan A and Plan B-2.

"**Plan B-2 is to pursue the Plan A direction of trying to save almost everyone and to get around the limitations arising from not having enough resources by leveraging up the EFSF commitments.** We won't digress into the ways that this leveraging can happen, but we will highlight the big, obvious implications of this path. Most importantly, this is the least risky and least disruptive path over the short term, it will not provide enough buying power to fill the gap for more than a year or two, it will leave all parties more indebted over the long term, it will not leave the parties adequately restructured to move forward so they will remain "zombies" and, if done via the ECB doing the leveraging, it will require the ECB to stretch or break from its mandate for managing monetary policy so that it can be a big structured lender."

Before going into why we believe Plan B-2 will not work (we describe our rationale below), we first describe our thoughts on Plan B-1.

Why We Believe That Managing Debt Writedowns by Targeting Limited Funds Toward Systemically Important Entities (Plan B-1) Would Work

To give you an indication of the impact of focusing on the systemically important rather than on everyone, we estimate that the funding gap for the peripheral sovereigns could be reduced from €1.6trln to about €460bln by allowing for a 50% haircut on peripheral sovereign debt. We would also want to provide the peripheral governments with sufficient capital to fund their ongoing deficits in the years immediately following the restructuring (we estimate this to be another €125bln). When these amounts are added together, the total (€587bln) is only a bit more than the remaining bailout funds available – if the remaining bailout packages for Portugal, Ireland and Greece are dissolved and redeployed. If they are not dissolved and redeployed, the additional cost would be roughly €240bln.

In total, there are €3.4trln of peripheral sovereign exposures outstanding (including Italy and Spain). Given our estimates of these countries' funding gaps and their ability to service their debts, we pencil in a 50% writedown of these debts. Given a 50% writedown on peripheral debt, we estimate that roughly €595bln would be necessary to save the systemically-important entities across Europe (€462bln for periphery institutions). This includes €537bln to recapitalize the banks and €58bln to recapitalize the insurance companies. In the core countries, recapitalization funds can be provided by the local governments; in the periphery, recapitalization funds will need to come from either asset sales or the EFSF. It is worth noting that there may be both politically and financially important entities outside the banks and insurance companies that are necessary to save, but we pencil in no necessary transfers as the majority of these entities are unleveraged and could sustain modest hits to wealth (however unpleasant).

Holdings and Required Funding Needs for Peripheral Sovereign Debt Holders (€bln)								
	Holdings of Peripheral Gov't Debt				Recaps Needed For Systematically Important Entities			
	Core	Periphery	Other	Total	Core	Periphery	Other	Total
Banks	**236**	**1,101**	**98**	**1,395**	**116**	**420**	**0**	**537**
Large	204	418	70	662	116	270	-	387
Small	32	490	28	540	0	150	-	150
Insurance Companies	**137**	**112**	**83**	**332**	**15**	**42**	**0**	**58**
Pension/MF/Central Bank	**363**	**820**	**245**	**1,428**	**?**	**?**	**0**	**?**
EU/IMF	**-**	**-**	**-**	**90**	**0**	**0**	**0**	**0**
ECB	**-**	**-**	**-**	**130**	**0**	**0**	**0**	**0**
Total Finacial Backstop	**736**	**2,032**	**426**	**3,375**	**131**	**462**	**0**	**595**
Gov't Budget Deficits	**-**	**-**	**-**	**-**	**521**	**125**	**-**	**646**
Total	**736**	**2,032**	**426**	**3,375**	**652**	**587**	**0**	**1,241**

Below we go entity by entity and describe their ability to take losses and the necessary backstops required.

Banks

The banks represent the lion's share of the necessary backstop in the event of a sovereign default with €1.2trln of peripheral sovereign exposures (120% of capital). Of course, not all banks would need to be treated in the same way. Large, systemically-important banks would need to be recapitalized and kept operational to maintain a reasonable functioning of domestic lending markets; smaller banks are of less systemic importance and could have their equity wiped out and be wound down (though for all banks it would likely be necessary to pay depositors in full to avoid bank runs). In both cases, it is likely that the ECB would need to play a role in providing a liquidity backstop to prevent funding issues in the short to medium term. This is similar to the role the ECB is playing in Ireland and Greece. Through very relaxed collateral standards (most notably in their ELA facilities), the ECB and national central banks are both plugging the hole made by domestic deposit outflows and providing the implicit guarantees necessary to prevent a complete bank run. This process allows for a more orderly wind-down or recapitalization of insolvent entities. We would see a similar path but on a larger scale as a necessary component of ensuring bank stability through a sovereign default.

Large European banks (here we define "large" as greater than €100bln in assets or greater than 10% of a country's banking system) would require the largest amount of recapitalizations. These institutions hold €622bln of peripheral exposures (100% of capital). On top of this, they already have insufficient capital given the new Basel III standards. In aggregate we estimate that even before sovereign debt defaults, large European banks will need €177bln over the next two years. For example, the Spanish banks (particularly the large cajas) are likely to need €48bln in capital mostly due to legacy residential and commercial mortgage exposures made during the boom. A sovereign debt restructuring would cause another €284bln of losses to large European banks, causing a total capital hole of €387bln. Of this, €270bln would be borne by the peripheral banks and €116bln would be borne by the core banks. It is worth noting that for this analysis we assume that banks must meet an 8% core tier I capital requirement as outlined in the new Basel III standards, which we would view as a relatively aggressive assumption. The required capital raise could very possibly be lessened either by relaxing these standards or by allowing banks to write down their sovereign exposures over a long period. Furthermore, for the purpose of this exercise we assume that all non-depository liabilities (e.g., debt securities, covered bonds) would be paid in full; to the extent that these securities were allowed to default the required capital raises could be substantially less.

European Bank-by-Bank Exposure to European Periphery & Capital Adequacy: Large Banks (€bns)	Risk Weighted Assets	Core Tier 1 Capital	Total Periphery Exposure	Loss on Sovereign Bonds	Capital Needed From Non-Sovereign Exposures	Total Capital Raises Needed
						Default
Total Euro-Area	**7,414**	**627**	**622**	**284**	**177**	**387**
Total Periphery	3,044	225	418	191	137	270
Italy	1,085	80	171	80	36	103
Spain	1,365	99	184	86	48	105
Greece	203	21	35	12	5	16
Portugal	208	15	17	7	20	22
Ireland	183	11	11	5	29	25
Total Core	4,369	402	204	93	40	116
Germany	1,197	111	67	30	22	43
France	1,914	161	84	38	13	50
Netherlands	657	70	14	6	1	7
Belgium	253	29	30	14	0	10
Austria	215	18	2	1	0	0
Luxembourg	13	2	3	1	0	1
Finland	43	5	0	0	0	0
Cyprus	54	4	5	2	2	4
Slovenia	21	1	0	0	1	0
Malta	3	0	0	0	0	0

As noted above, small banks in Europe require less capital than large banks both because they represent a smaller share of the banking system and because it is likely not necessary to recapitalize and keep them operational to have a functioning lending market. For example, it would be possible for governments to simply guarantee depositors, wipe out equity and then either roll the institution into a larger, healthier entity or take over the bank and wind it down slowly over time. Small banks in the core, particularly those in Germany and France, tend to hold very little peripheral government securities. Therefore, the majority of the problems are likely to arise in the small peripheral banks. Combined these entities hold €490bln of peripheral sovereign debt against €152bln of capital. We estimate that these banks have made non-sovereign loans that will cause losses in excess of earnings in the amount of €73bln. If we then add in sovereign losses (we estimate €228bln), the total losses for peripheral small banks would be €302bln, which would create €150bln of negative equity that would need to be replenished in order to make depositors whole.

Note that we have included in these numbers the Italian postal bank which holds €193bln in Italian government bonds (nearly all of its assets) and has only €12bln of capital. While this institution operates like something of a mutual fund for Italian households, it is organizationally a bank, employing high leverage and getting nearly all of its funding from retail deposits. We suspect that these deposits would need to be backstopped just like other retail deposits, though the postal bank itself could be wound down given that it has no other systemic impact. As such, it could likely be treated like other small banks that would need to be wound down.

European Bank-by-Bank Exposure to European Periphery & Capital Adequacy: Small Banks (€bns)	Risk Weighted Assets	Core Tier 1 Capital	Total Periphery Sov Exposure	Sov Loss w/50% Loss	Loanbook Losses in Excess of Earnings	Total Losses in Excess of Earnings	Necessary Capital to Avoid Unwind
Total Euro-Area	**4,143**	**354**	**522**	**242**	**102**	**346**	**150**
Total Periphery	1,870	152	490	228	73	302	150
Italy	965	81	340	160	17	178	**98**
Spain	589	45	101	47	34	82	**37**
Greece	95	10	18	6	5	11	**1**
Portugal	158	12	28	13	10	22	**11**
Ireland	63	5	3	1	7	9	**4**
Total Core	2,273	202	32	14	30	44	0
Germany	814	77	9	4	16	20	-
France	769	65	11	5	8	13	-
Netherlands	88	9	5	2	3	5	-
Belgium	69	8	2	1	1	3	-
Austria	389	31	2	1	-	1	-
Luxembourg	16	2	0	0	-	0	-
Finland	85	6	1	1	2	2	-
Cyprus	12	1	0	0	0	1	-
Slovenia	5	0	0	0	-	0	-
Malta	26	3	0	0	-	0	-

Insurance Companies

Insurance companies are large holders of sovereign debt (€290bln). Were a default of these exposures to occur without a backstop, there would be capital inadequacies throughout the insurance industry that would result in insurance contracts being broken and policies going unpaid. Given that there is some risk of policy-flight in insurers (though not as severe as deposit-flight in banks) and the social and political pain associated with a breakdown on the insurance system, it seems more likely than not that the insurance companies cannot be left to default. The toll for this backstop would be relatively minor (we estimate €58bln total, of which €15bln from the periphery).

One reason why the backstop would be relatively small is that policy holders bear some of the risk of declining asset values at insurance companies. Insurance companies often guarantee their policy holders a small minimum return over the life of their policy, and it is only when the return is below this threshold that the company takes losses. So the policy holder is on the hook for the first amount of loss and the insurance company is on the hook after that. Of the €145bln in total losses at insurance companies, we estimate that policy holders would bear €39bln and the insurance companies would bear €105bln. Furthermore, given that most insurance companies currently hold an excess of capital, the backstop necessary would be only €58bln by our estimates.

European Insurance Company Exposure to The Periphery

	Peripheral Holdings		Losses Given PIIGS Default					
	Direct	For Policy Holders	Borne by Insurance Co	Borne by Policy holders	Total	Capital	Capital in excess of Required	Required Capital Raise PIIGS Defualt
Total	**92**	**197**	**105**	**39**	**145**	**256**	**47**	**58**
Core	***39***	***99***	***49***	***20***	***69***	***171***	***34***	***15***
Germany	22	36	22	7	29	68	14	8
France	12	50	21	10	31	64	15	6
Netherlands	1	5	2	1	3	25	2	0
Belgium	1	4	2	1	3	7	2	0
Austria	1	3	1	1	2	4	1	1
Other Core	1	1	1	0	1	3	1	0
Periphery	***40***	***73***	***42***	***15***	***56***	***40***	***0***	***42***
Italy	32	59	34	12	45	33	2	32
Spain	4	7	4	1	5	5	0	4
Ireland	4	7	4	1	5	2	-2	6
Greece	-	-	-	-	-	-	-	-
Portugal	-	-	-	-	-	-	-	-

Pension / Mutual Funds / Central Banks

The majority of pension funds, mutual funds and central banks have no leverage and hold portfolios that are somewhat diversified across countries and sectors. So while there may be a material hit to wealth associated with a default, there is unlikely to be a massive financial ripple as a result of losses in this sector. That being said, there may be individual entities that may be backstopped for social or political reasons.

EU / IMF

The EU has exposures to peripheral sovereigns both via bilateral loans to Greece and via the existing bailout packages to Ireland and Portugal. These exposures are both small (€90bln in total) and would not cause any material cash-flow concerns for the individual sovereign governments.

ECB

The ECB has exposures to the periphery both via secured bank lending and direct government bond purchases. Given that we assume the banks are recapitalized, the only losses the ECB would take are on its €130bln of peripheral sovereign debt. Overall, we would suspect that losses to the ECB from these exposures will not be important or system-altering. First, the ECB's bond purchases were made at market value. Given the spreads at which they were active in the market, we estimate that nearly all the ECB's debt purchases were made at a discount to par (we estimate the average bond price to be roughly 75% of par). Therefore, a writedown to 50% would only incur about €43bln of losses. Furthermore, the ECB has taken losses on credit assets before (e.g., on its exposures to Lehman and the Icelandic banks). To pay for these, the ECB raised reserves from the individual national central banks, which will likely be able to write down the loss over a very long period of time. While we are not certain how they will deal with future losses, it seems as though a similar process could very well occur for defaults on their sovereign debt exposures.

Government Deficits

As previously mentioned, on top of the cost of bailing out systemically important institutions, bailout funds will still be required to cover budgetary shortfalls even in a post-default world. We estimate that even with a debt restructuring (which for the purposes of our calculations we assume alleviates near-term interest rate debt service burdens altogether), every periphery country will still be running a deficit that needs to be financed, the cost of which will be €125bln over the next two years.

Estimated 2-year Peripheral Budget Deficit, €bln

	Total	Interest Expense if No Default	Primary Deficit
Italy	149	142	7
Spain	129	43	86
Portugal	18	11	7
Ireland	29	11	18
Greece	34	27	7
Total	**360**	**235**	**125**

As mentioned these calculations are meant to be broadly indicative rather than precise. They are meant to make the point that restructurings can occur without being systemically threatening and at costs that are materially less than those arising from trying to prevent restructurings. We believe that it is both preferable for the overall economic conditions of Europe that this general path is followed rather than that of taking on more debt and printing more money in an attempt to push the problems down the road. The manner in which this managed restructuring should occur should not be abrupt. For that reason, temporary guarantees and other mechanisms should be employed.

Why Plan B-2 Looks Unlikely to Work

Leading up to the market turmoil in the last couple of weeks, the leveraging of the EFSF with the private sector was already something of a stretch; now it seems very unlikely indeed (at least in the quantities that will be required). We estimate that for a Plan B-2 to be viable, it would require investors to purchase in excess of €1.1trln of Italian and Spanish sovereign debt with less than a 20% guarantee from the EFSF (5x leverage) on top of the €500bln in unleveraged EFSF bonds to be issued. With Italian and Spanish spreads around 500bps even with large ECB support, it seems unlikely that a relatively small guarantee will lower spreads enough to make for a sustainable bond yield for either of these countries. In fact, even Klaus Regling, head of the EFSF, said as much last week, stating that the "political turmoil of the past 10 days probably reduces the potential for leverage". Furthermore, even unleveraged EFSF bonds are struggling to find buyers. EFSF paper is now trading at spreads of 175bps, and last week even a relatively small €3bn transaction failed to be fully subscribed. So, while the EFSF can now lever, it doesn't look as though the marketplace will bear much in the way of additional resources.

To arrive at our estimate that the EFSF will need 5x leverage, we first calculate that the EFSF has about €276bln in available bailout resources remaining. At inception, the EFSF received guarantees from the 17 members of the Eurozone of €780bn. However, available capacity has fallen due to modest outlays and the exclusion of Greece, Ireland and Portugal as participating states. Further, it is at least somewhat likely investors will reject Italy and Spain as effective guarantors, since both will likely soon be primary beneficiaries of the EFSF support. If this does turn out to be the case, then the effective pre-leverage equity capacity of the EFSF is reduced to €480bn. The EFSF has also made a number of future commitments which tie up capacity. Specifically, we estimate that €50bn has been earmarked for Ireland and Portugal, and, based on our best interpretation of the EU communiqué, we believe that an additional €135bn will be set aside for the second Greek package. Since it is unlikely that investors will provide leverage to the EFSF on loans to bailed-out states, this €185bn needs to be deducted from the leverageable capital, leaving the EFSF with €276bn to stretch for Italy and Spain. Note that the remaining capacity is a bit lower if the EFSF seeks to maintain its AAA rating due to the way the rating agencies view individual country credit support.

	Total Guarantees	AAA Guarantees*
EFSF	**780**	**440**
- Already Used Funds	-9	-9
- Overcollateralization for Already Used Funds	-7	0
Unused Capacity	**764**	**431**
- Greece, Portugal, Ireland Contributions	-53	0
- Italy Contribution	-138	0
- Spain Contribution	-92	0
Total Capacity Remaining	**480**	**431**
- Bridgewater Estimated Commitment to Greece	-135	-135
- Commited but not yet disbursed funds to PRT, IRL & potential Cyprus Bailout*	-50	-50
- Overcollateralization for EFSF Issuance	-19	0
EFSF Money that can be Leveraged to Fund Italy & Spain	**276**	**246**
+ Remaining EFSM Money that can be used but NOT levered	11	11
+ Futher IMF Participation	?	?

* NOTE: This assumes that France retains its AAA rating

We estimate that this €276bln in equity will have to cover about €1.510tln in government funding needs, making for a leverage ratio in excess of 5x. Even if the ECB continues to support peripheral bank funding needs (which are climbing rapidly), we estimate that peripheral sovereign funding needs in excess of what has already been allocated by existing EU bailout packages will be €596bn between now and the end of 2012, €470bn in 2013, and €444bn in 2014. We roughly estimate that a backstop should be equal to three years of funding needs so that the sovereigns have time to demonstrate their ability to make the necessary fiscal adjustments in the interim. The vast majority of these needs come from Italy and Spain. While we believe that Portugal, Ireland and Greece will require more money (or default) when their current packages run out, this is not likely to occur over the next 12 months.

Sovereign funding needs are the sum of government debt rolls, government deficits and money for bank recapitalizations not provided by the private sector. While our numbers for required bank recapitalizations are much larger than the EU's (our estimates of total European bank recaps are €375bn vs. €100bn for the EBA), for the next 12 months' needs we plug through the numbers from the EBA's stress test because that is what the banks will be required to raise by June 2012. However, over the longer term, we believe the banks will be forced to raise additional capital, which we have penciled in for 2013-4.

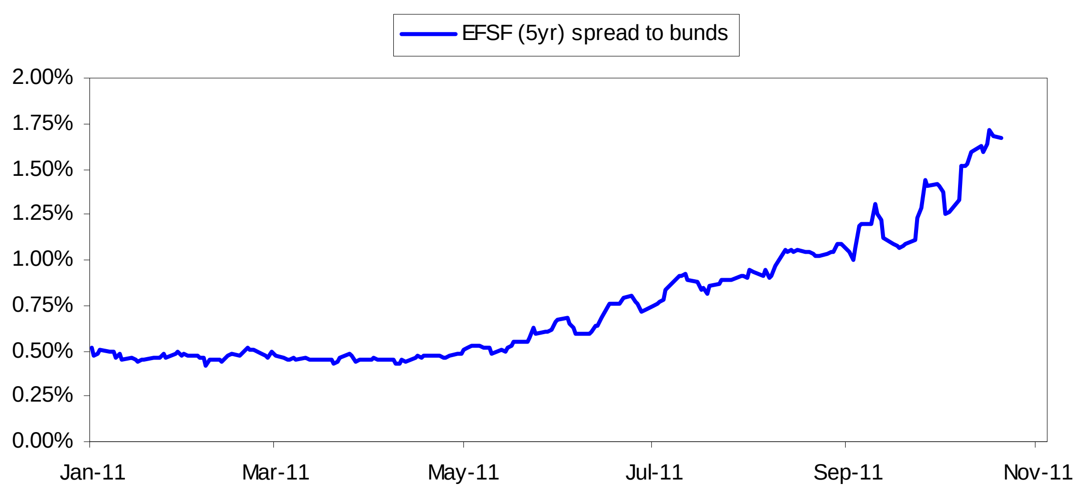
Peripheral Sovereign Funding Needs (€blns)	Italy	Spain	Portugal	Ireland	Greece	Total
Next 12 Months	**409**	**185**	**3**	**0**	**0**	**596**
Government Debt Rolls	348	100	38	17	43	545
Fiscal Deficit*	47	58	6	18	12	141
*of which Primary Balance**	*-47*	*31*	*0*	*10*	*-2*	*-8*
*of which Interest Expense**	*94*	*27*	*7*	*8*	*14*	*149*
Bank Recaps (from EBA)	15	26	8	0	30	79
Already committed**	0	0	-49	-35	-85	-169
2013	**238**	**164**	**41**	**27**	**0**	**470**
Government Debt Rolls	177	79	18	10	10	293
Fiscal Deficit*	14	51	7	15	8	94
*of which Primary Balance**	*-89*	*19*	*-2*	*5*	*-5*	*-71*
*of which Interest Expense**	*103*	*31*	*9*	*10*	*13*	*165*
Bank Recaps (BW Estimate)	46	35	17	9	0	107
Already committed	0	0	0	-7	-18	-25
2014	**211**	**152**	**42**	**40**	**0**	**444**
Government Debt Rolls	170	79	23	20	12	304
Fiscal Deficit*	10	49	8	14	9	89
*of which Primary Balance**	*-120*	*8*	*-3*	*1*	*-8*	*-122*
*of which Interest Expense**	*123*	*41*	*11*	*13*	*17*	*212*
Bank Recaps (BW Estimate)	31	23	11	6	0	71
Already Committed	0	0	0	0	-20	-20
Total Funding Needs Next 38 Months	**858**	**500**	**86**	**66**	**0**	**1510**

* Negative = Surplus

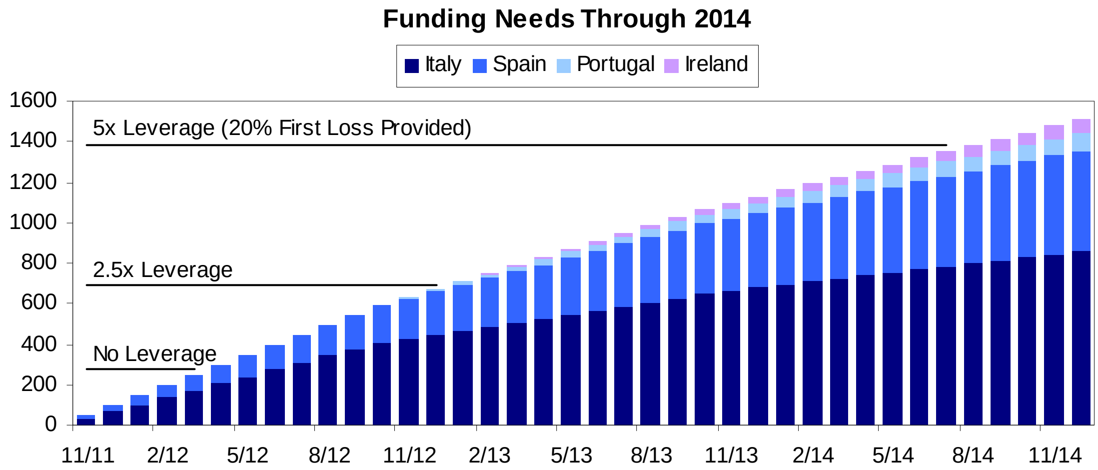
Note that we are assuming that the EFSF will meet Portuguese and Irish funding needs when their bailout packages run out, and that this funding will not be leveraged.

Applying leverage to EFSF capacity

The EFSF is unlikely to get any sort of leverage resembling the 5x that we estimate will be required. While it is difficult to know what the demand will be for EFSF debt and we don't yet know how these investors will react to an Italian bond with 20% first loss protection, we do know that many of the traditional and current bond holders bought Spanish and Italian bonds when spreads were basically nil under the assumption that they were "riskless". Even if a 20% guarantee made these bonds a reasonable investment (which we do not believe to be the case), it's unlikely that investors who are looking for a safe asset will want to roll their exposures. Furthermore, even the EFSF bonds that would be used as guarantees are trading at elevated spreads given the strains on France, Belgium and other core countries. These bonds have sold off and are now trading at spreads of 175bps.



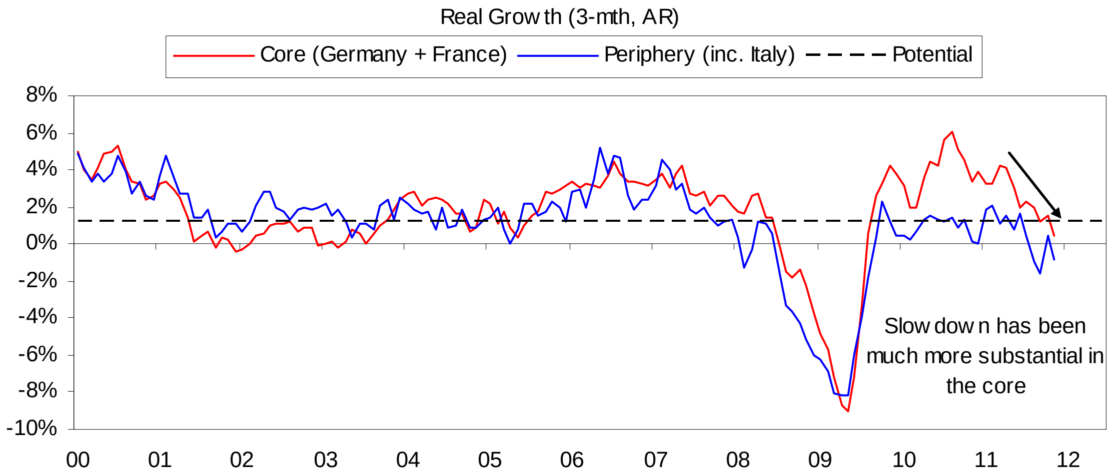
Below, we pencil in some numbers to see how much capacity the EFSF has to provide various amounts of protection vs. the amount of debt that Spain and Italy need to issue in the next several years. As you can see, each turn of leverage that the EFSF can get adds about six months to the capacity of the EU bailout fund.



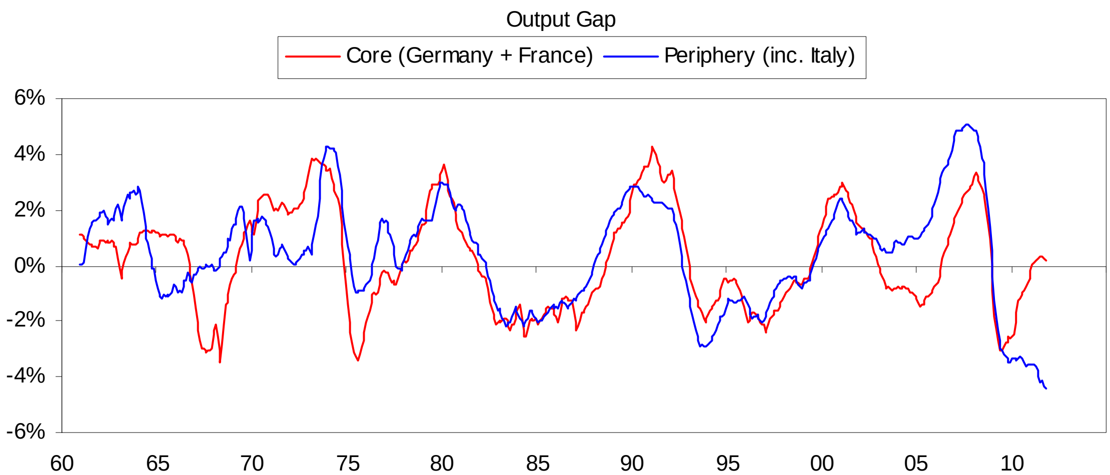
Euroland Growth Slowdown is Now Being Driven by the Slowdown at the Core

Growth in Euroland's core has slowed sharply over the past several months, weighed down by the tightening of domestic financial conditions as well as weakening external demand. While GDP prints still may show average growth rates for the third quarter, our growth measures are now barely above zero as growth deteriorated over the course of the quarter. The effects of recent market-based tightenings are still flowing through and are likely to lead to sustained weakness. September demand, production and employment stats were broadly weaker in both Germany and France, and surveys point to continued deterioration in October. Household demand, which had already looked weak in the second quarter, has been particularly soft. This weakening in domestic demand is passing through to a slowdown in production at the same time as external demand is also weighing on production growth. Strong export demand has been a key support to production growth in the core, particularly in Germany, and should weigh heavily on business spending in the fourth quarter. This should put additional pressure on household spending as business hiring slows and the potential for income growth weakens. Additionally core growth faces headwinds in 2012 as fiscal tightening plans are scheduled to increase, possibly creating an additional drag of 0.5%-1% relative to 2011.

Below we take a closer look at conditions in Germany and France. Growth has slowed from over 4% at the beginning of the year to around 0.5% currently. Most of the slowdown in Euroland is being driven by weakening core conditions; peripheral growth has slowed but is only a bit weaker than it was at the beginning of the year.



Output levels at the core are roughly neutral, while output levels in the periphery continue to be quite depressed. At current growth rates conditions should no longer be tightening at the core.



More up-to-date surveys have been indicating a sharp slowdown in underlying conditions for several months, but the sharp contraction in production stats in September was one of the first confirmations from real economic stats that conditions were weakening. Both business and consumer surveys continue to be quite weak. German and French manufacturing PMI's are indicating an outright contraction, while France's services PMI reading of 44.6 is as weak as any time since the beginning of 2009. Consumer confidence measures have also weakened sharply since earlier in the summer. Retail sales measures for both Germany and France are extremely choppy, but looking at August and September together it looks like household spending has been weakening.

October service PMI's weak, particularly in France

Core demand measures are choppy but appear to be weakening towards the end of the quarter

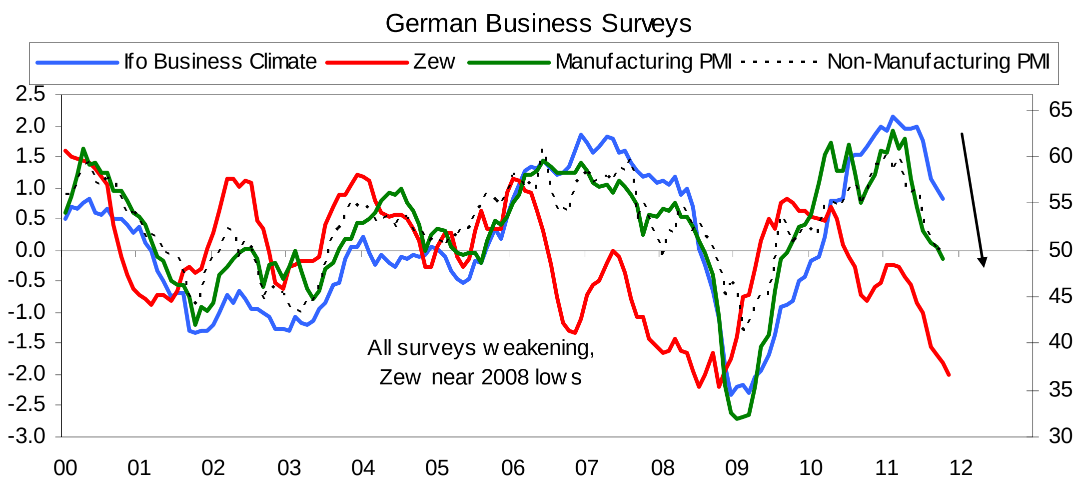
Statistic	October	Sept	August	July	June	May
Euroland Retail Sales	--	**-0.7%**	**0.0%**	**0.2%**	**0.6%**	**-1.2%**
German Retail Sales	--	0.4%	-2.7%	0.3%	3.9%	-1.7%
French Consumer Spending	--	-0.5%	0.2%	-0.3%	0.8%	-0.1%
Euroland Services PMI	**46.4**	**48.8**	**51.5**	**51.6**	**53.7**	**56.0**
German Services PMI	50.6	49.7	51.1	52.9	56.7	56.1
French Services PMI	44.6	51.5	56.8	54.2	56.1	62.5
Euroland Consumer Confidence (z)	**-1.1**	**-1.0**	**-0.6**	**0.1**	**0.3**	**0.3**
German Consumer Confidence (z)	0.5	0.7	0.9	1.7	1.9	1.8
French Consumer Confidence (z)	-0.7	-1.2	-0.9	0.0	0.1	0.1
Euroland Industrial Production	--	**-2.0%**	**1.4%**	**1.0%**	**-0.6%**	**0.2%**
German Industrial Production	--	-2.7%	-0.4%	3.2%	-0.8%	0.8%
French Industrial Production	--	-1.7%	0.5%	1.5%	-1.6%	1.8%
Euroland Manufacturing PMI	**47.1**	**48.5**	**49.0**	**50.4**	**52.0**	**54.6**
German Manufacturing PMI	49.2	50.3	50.9	52.0	54.6	57.7
French Manufacturing PMI	48.5	48.2	49.1	50.5	52.5	55.0

Consumer confidence has fallen substantially over last several months

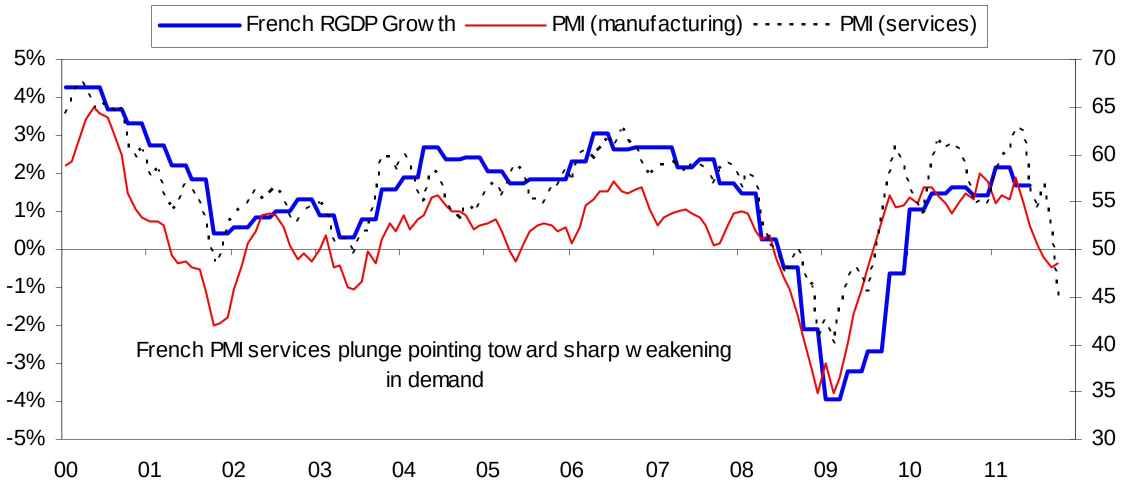
Production growth weakened sharply at the end of Q3, in line with deterioration in surveys

October German manufacturing PMI's point to weaker production growth

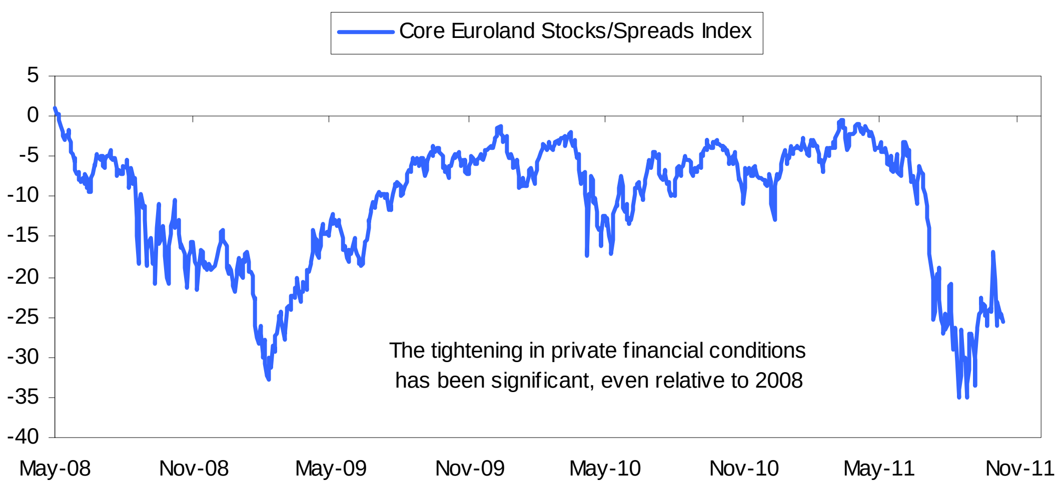
Business surveys are pointing toward a sharp contraction in German production. The Zew survey of economic sentiment released this morning was as weak as any time since 2008, and while other business surveys are not at quite such weak levels, they have been deteriorating sharply for several months.



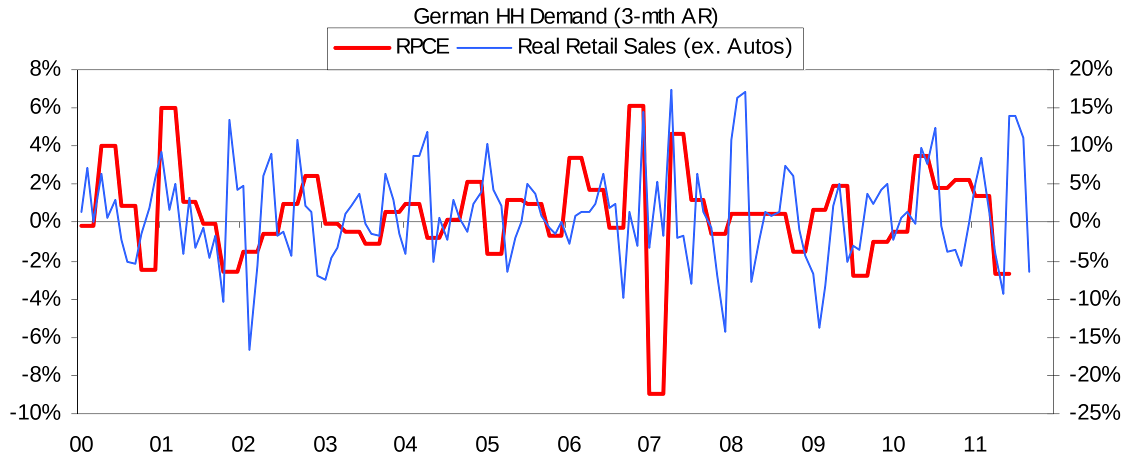
The French purchasing manager's surveys are also pointing toward a sharp weakening of conditions. Since August when financial conditions began to tighten rapidly, the services PMI has fallen by over 10 points and is at its weakest levels since the beginning of 2009.



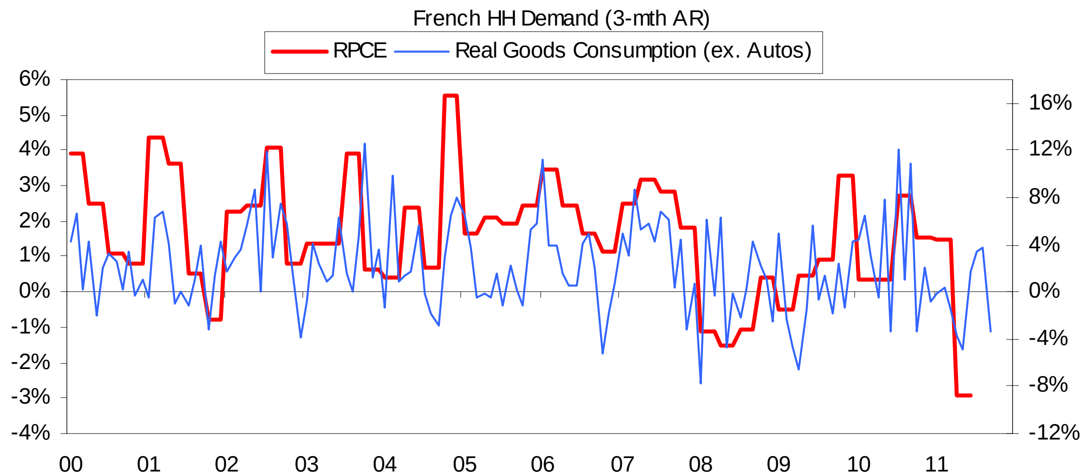
Household demand is sensitive to financial conditions through a number of channels, but most directly through borrowing conditions and the impact on household wealth from price changes in financial assets. The sharp deterioration in conditions since August is impacting households along both these channels, as banks are less likely to make loans and households feel the pain from falling equity prices. The chart below gives a rough sense of how collapse in equity prices and blowout in spreads compares to what occurred in over the last several years. The August collapse has been extreme.



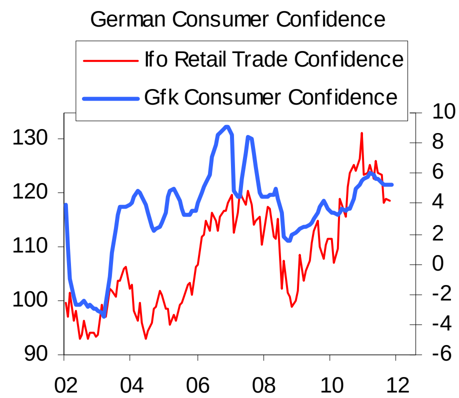
Household spending in Germany was already quite weak in the second quarter, and while it appears to have recovered somewhat in the middle of the summer, the most recent retail sales data points toward a slowdown. Historically, retail sales haven't tracked consumption particularly well (they only make up around a third of what goes into personal consumption), but the weakness is also in line with the PMI services and consumer confidence figures.

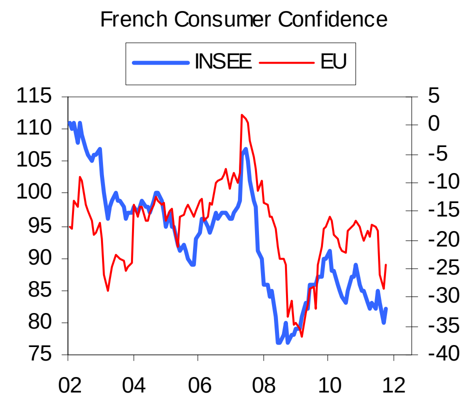


Like in Germany, household spending in France was particularly weak in the second quarter. Some of that weakness was driven by an end to auto stimulus plans, but even excluding autos consumption looked quite weak. Through September household spending looks like it has weakened, although only modestly. Like in Germany, up-to-date surveys such as the services PMI and consumer confidence point toward much weaker household spending.

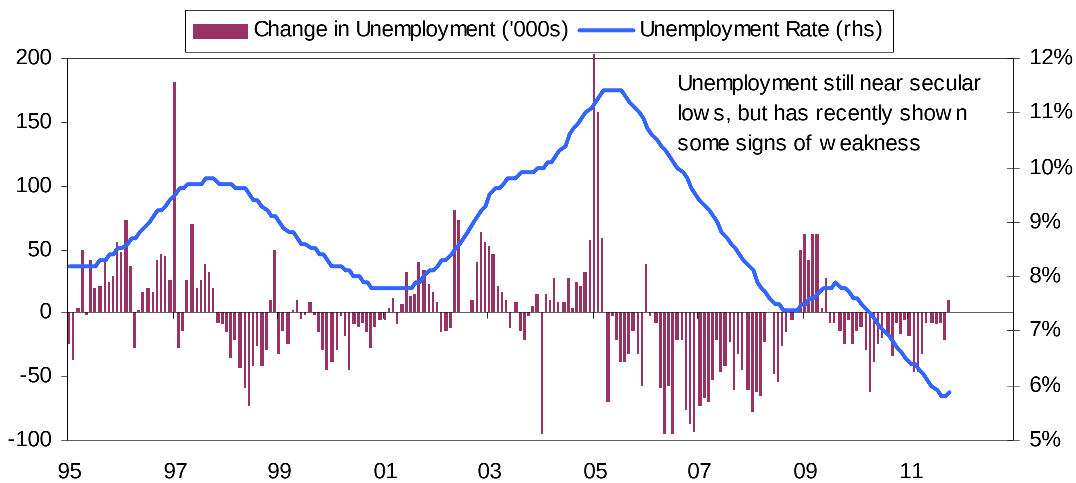


Consumer confidence measures have been weakening fairly sharply in France, while the deterioration in Germany has only been modest so far. Underlying conditions for German households remain fairly healthy, with relatively low levels of debt and healthy employment. If the weakness in production and business spending continues and begins to weaken the labor market, confidence will likely weaken further.

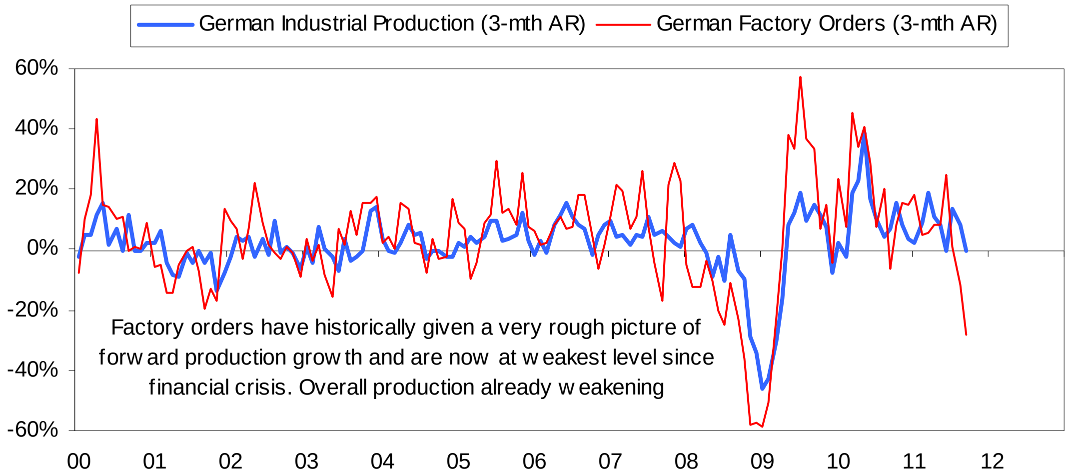




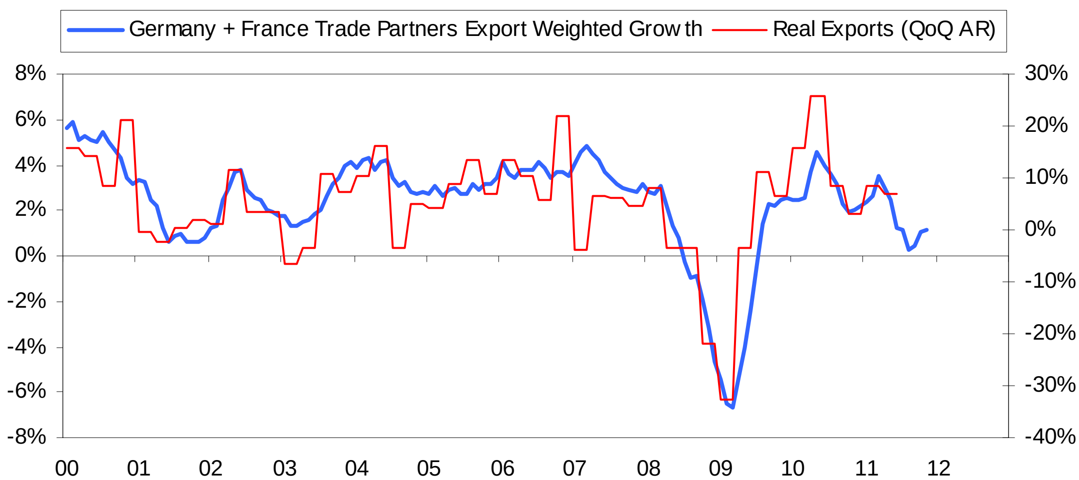
October was the first month since June 2009 that German unemployment increased. Employment typically lags and demand has been weakening for a few months now so we will likely see some softer labor data going forward. While this should be a negative for household demand, German labor conditions remain pretty tight and it would take a fair amount of firing to shift that picture materially.



September saw a sharp deterioration in both German and French production figures, in line with weakening demand in and out of the euro-zone. So far the slowdown in production hasn't been severe, but there are indications that production will likely slow further, such as the more volatile but sometimes forward-looking factory orders report. Surveys are also pointing toward a significantly larger slowdown than we have seen through September.



While it recently looks like the picture of US growth has improved, some of the slowdown in core production is likely still stemming from weaker global growth. Strong export growth, fueled by surging demand from the emerging world along with ongoing competitiveness gains in Germany, has helped provide a significant boost to the rebound in the core. While competitive export industries should continue to be supportive to exports regardless, the slowdown from weaker export partners should be a drag of almost 1%.



Germany and France will also both begin to face larger headwinds to growth from fiscal tightening going forward into 2012. The pace of fiscal cuts in 2012 is hard to know with any precision at this point, but according to current government plans it appears that Germany and France will both accelerate their cuts in 2012.

Cyclically Adjusted Fiscal Consolidation Plans (% of GDP)

	Euroland	Germany	France
2011	-0.9%	-0.3%	-1.0%
2012	-1.3%	-1.0%	-1.7%

Core growth has been the primary driver of the recovery in Euroland over the past two years, but has clearly slowed over the past several months. Tightening financial conditions and weaker external demand both appear to be significant drags on growth over the past several months, while the ongoing fiscal cuts continue to weigh on demand as well. The stressed financial conditions will likely continue to weigh on household spending and credit growth, which should be a drag on production at a time when external demand, which had been a support for much of the past two years, has weakened.