

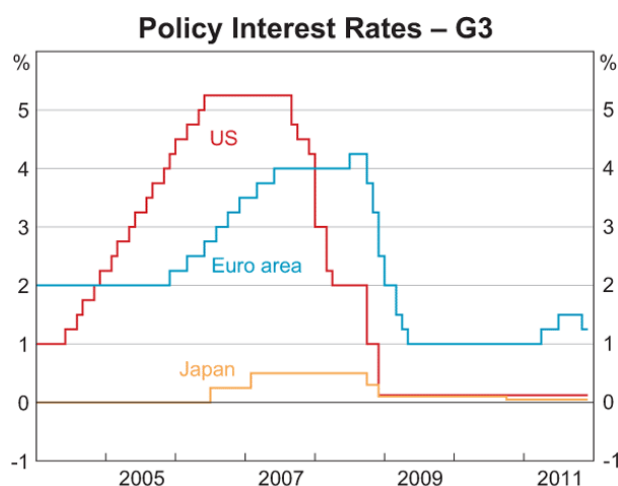
What's next for Europe?

The on-going concern regarding the sovereign debt crisis in Europe and subsequent equity market volatility continues to test investor patience. This volatility is likely to persist, as Europe faces several sovereign debt milestones in the first half of 2012:

- Banks are required to recapitalise to meet 9.0% tier 1 capital requirements. Plans must be submitted in January 2012 and implemented by 30 June 2012.
- For these banks, 230bn in euro bonds mature in Q1 2012. Weak loan growth and high savings rates are however likely to reduce funding pressures.
- Total Italian debt funding in short and long term debt of ~120bn euros is due in the March quarter 2012.
- The March 2012 deadline for European agreement on a unified fiscal package representing a zero structural deficit of 0.5% GDP annual deficit and debt limit of 60% of GDP. Most of Europe is currently in excess of these levels.

It has been argued by market participants that the European Central Bank (ECB) has not done enough during this crisis in providing quasi-fiscal or liquidity support to troubled European sovereigns. However, faced with the choice between financial stability and the avoidance of disorderly sovereign defaults, the ECB is likely to choose financial stability, as it did in May 2010. To do otherwise would risk much of the US and European banking system.

Indeed, the ECB has recently made liquidity available to banks for maturities of up to three years and has expanded the acceptable collateral to include Asset Backed Securities backed by real estate and commercial loans. It appears that this funding is in turn allowing the banks to acquire European sovereign debt and therefore - suggests the ECB - is indirectly assisting the trouble European nations. The ECB is also likely to reduce cash rates from current levels which, as illustrated, is well above comparable US rates.



Source: central banks

Our expectations for GDP growth in the Euro zone is in line with consensus. We expect December 2011 quarter and March 2012 figures to be weak, with the calendar year contraction of 0.5%.

It is clear that European sovereign debt crisis will take time to resolve. The ECB will not directly support sovereign states, however its recent funding program illustrates the indirect measures taken. There are a number of refinancing hurdles and milestones that European member states must meet in the first half of 2012 and market volatility is likely to persist heading into these events.