



# Lazard Insights

Conference Call Series

## The European Debt Crisis, Quantitative Easing, and Basel III: **The Outlook for 2011**

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Please refer to the last slide for some additional important disclosure information.

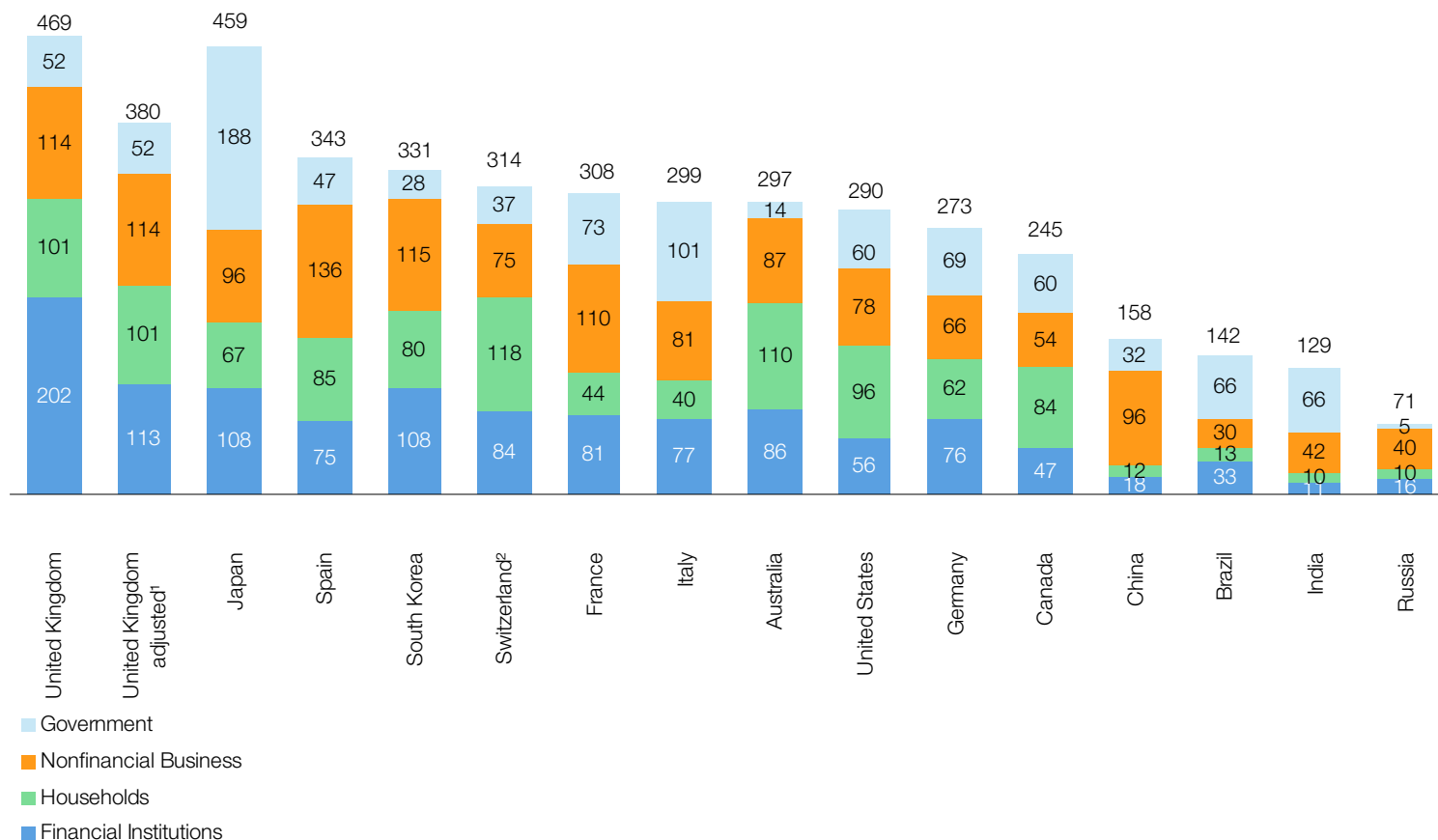
## Agenda

- A. European Debt Crisis
- B. Quantitative Easing
- C. Basel III
- D. The Outlook for 2011

# Numerous Nations Face Heavy Debt Burdens

## Debt by Country, 2008

(% of GDP)



Data as of 31 December 2008

1 The U.K. financial sector was adjusted to reflect its position as a financial hub.

2 Data for Switzerland represents year-end 2007.

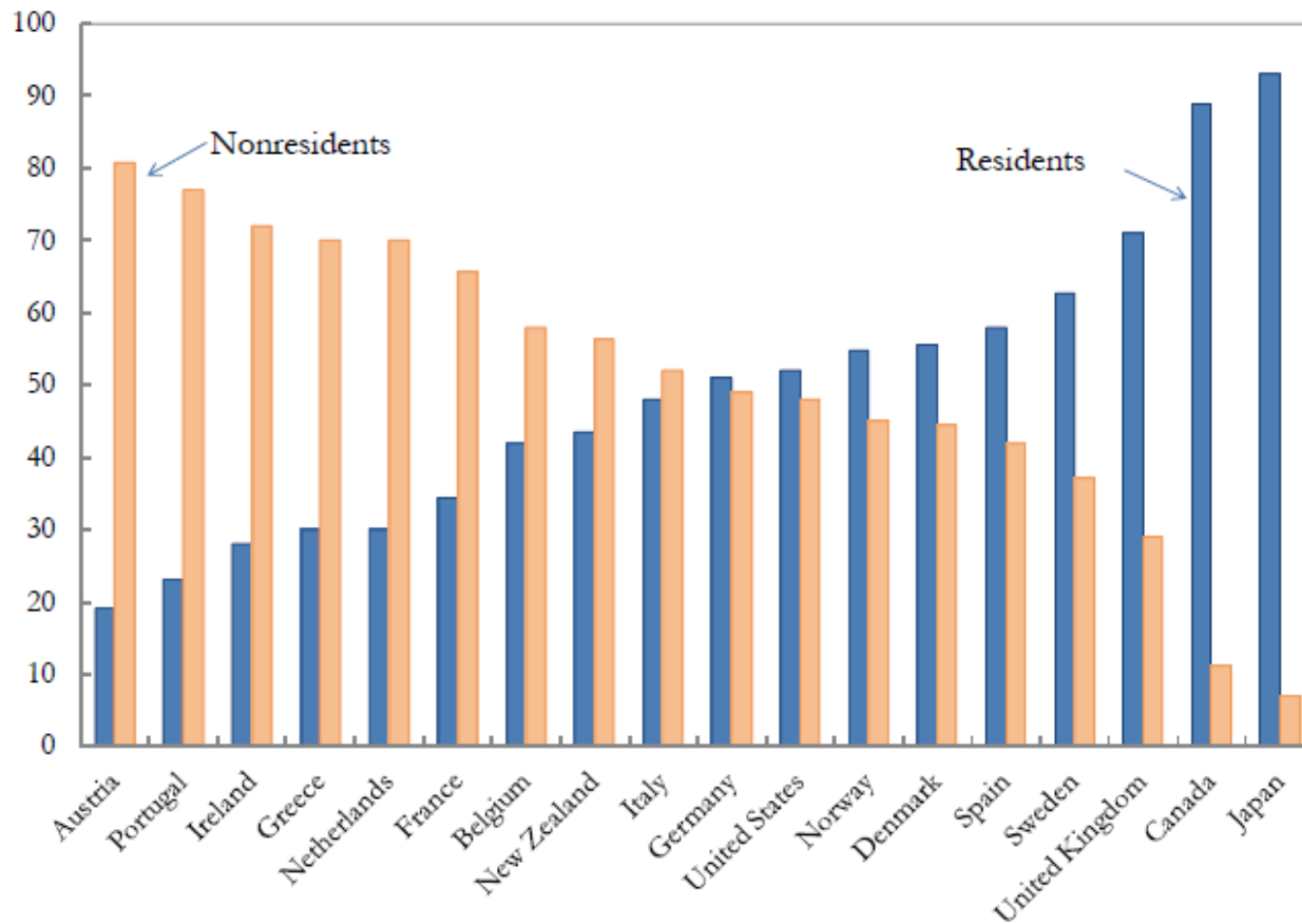
Note: The data above reflect adjustments made by McKinsey Global Institute to facilitate comparability across countries

Source: Haver Analytics, McKinsey Global Institute, Morgan Stanley, CIA World Factbook

# Yet Each Country Faces Different Circumstances

## Government Debt Holding by Resident

- Key considerations when evaluating debt carrying capacity include the currency in which the debt is originated, whether the issuer can print that currency, degree of foreign ownership, and maturity spectrum of the debt
- The countries facing particularly severe problems now lack the ability to increase their own money supply to create demand for bonds.

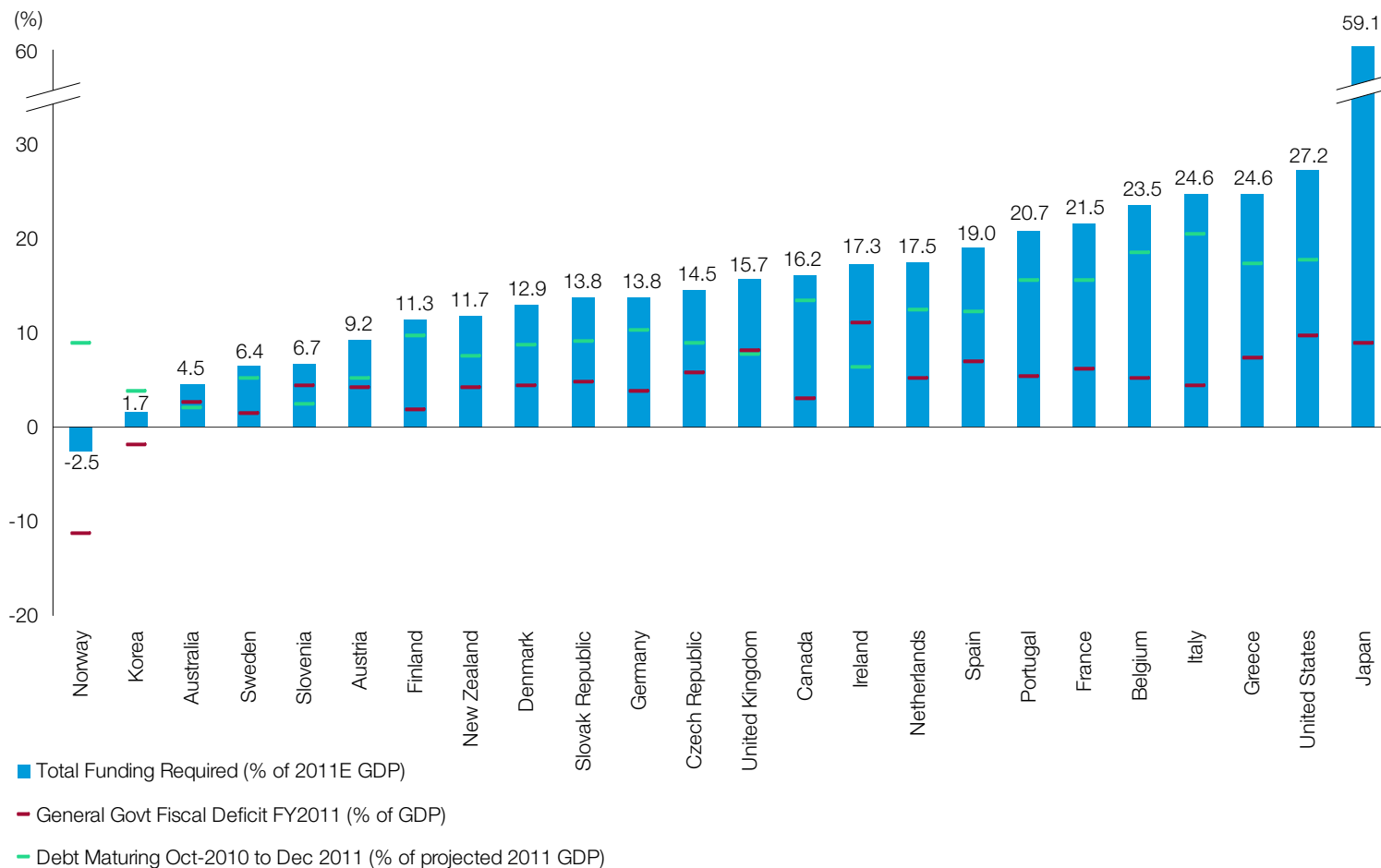


Data as of August 2010  
Source: IMF – Fiscal Monitor, “Fiscal Exit: From Strategy to Implementation”, November 2010

# Sovereign Funding Needs in 2011 Are High

## Sovereign Funding Requirements through 2011

- While the average maturity of government debt is interesting, it is not the entire story
- It is also important to examine how much debt must be refinanced each year as well as how much net new debt is required to finance incremental deficit spending
- Large fiscal deficits combined with short-dated funding strategies have left Japan, the U.S. and the "PIIGS" at the vulnerable end of the spectrum

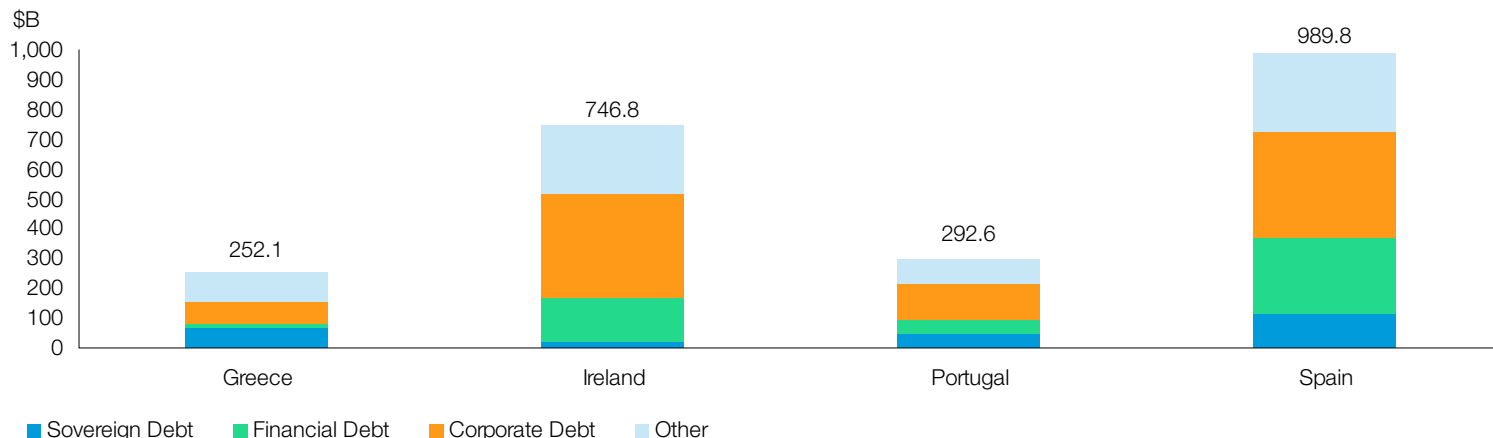


Data as of 30 September 2010  
Source: IMF, Global Financial Stability Report: Sovereigns, Funding, and Systemic Liquidity, October 2010

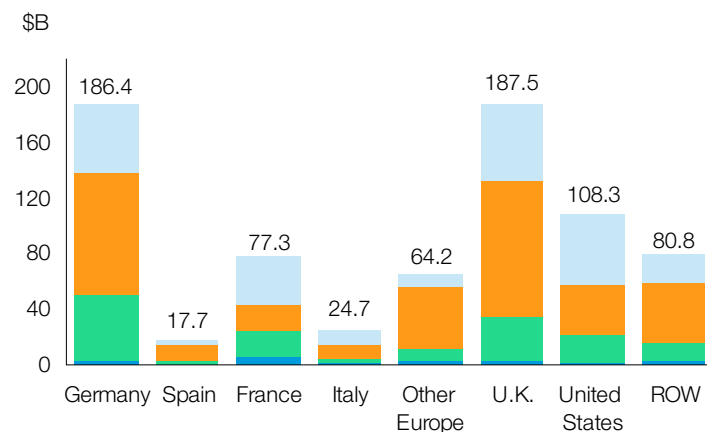
There is no guarantee that the stated estimates or projections will be realized.

# Globalization and Interdependency have Increased Contagion Risk

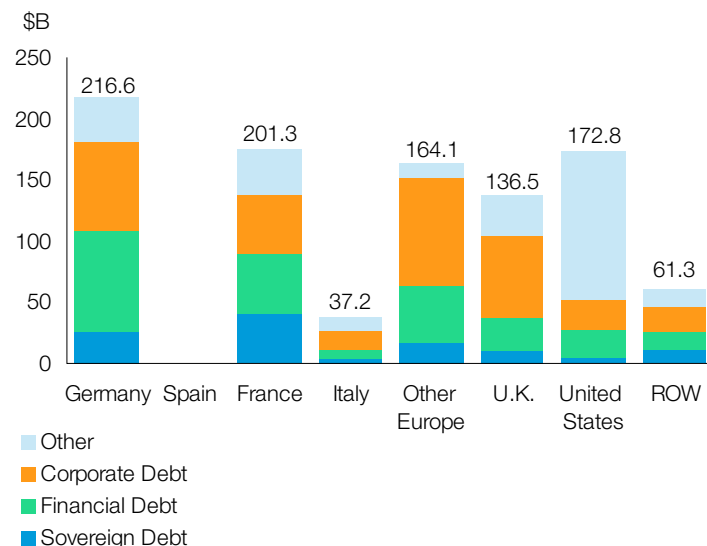
## European Bank Foreign Exposure by Country



## Exposure to Ireland by Country



## Exposure to Spain by Country



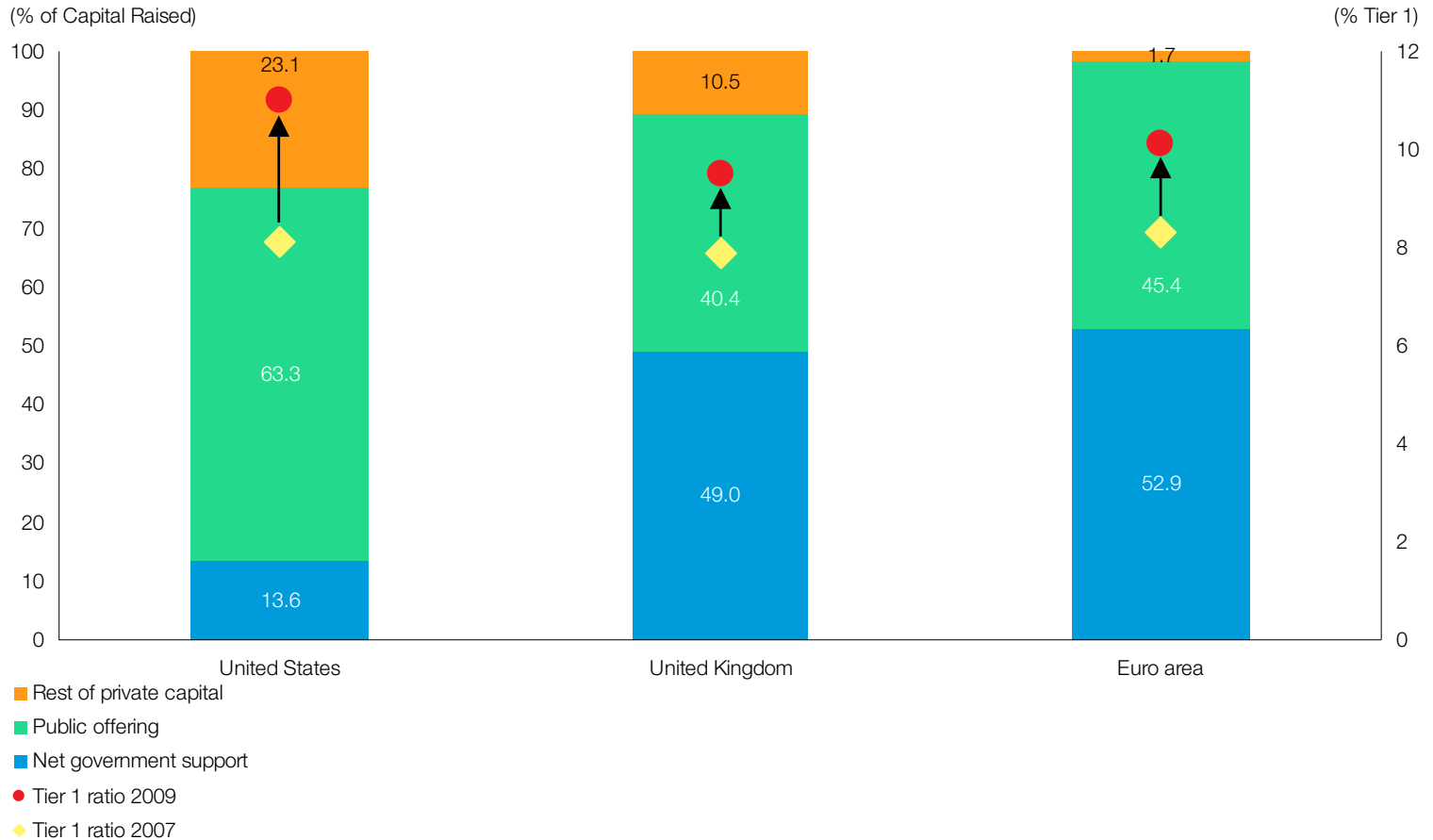
Data as of 30 June 2010  
Source: BIS Quarterly Review – December 2010

- While it might appear that problems in Ireland are unique to that country, it is clear that Ireland's problems are Europe's problems
- From a political perspective, some governments might prefer to participate in multilateral bail-out facilities even while scolding the nation being assisted
- In reality, one could argue that these collaborative bail-outs reflect little more than domestic self-interest as banking crises would be the likely result of any sovereign default

# Eurozone Banks Have Recapitalized Largely with Public Funds

## Capital Raised by Banks and Tier 1 Ratios

- Unfortunately, the national regulators in the Eurozone have not forced banks to raise as much capital in the public markets as has the U.S.
- The result is that governments in the Eurozone have taken on increased risk from the financial sector which is itself very exposed to the public sector through the region



Data as of 31 October 2010  
Euro area includes those countries that use the Euro.  
Source: IMF, Global Financial Stability Report: Sovereigns, Funding, and Systemic Liquidity

## European Debt Crisis Implications

We believe:

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- We expect choppiness as markets digest ongoing twists and turns on the political and monetary front
  - If the ECB does not engage in substantial QE, we could see a situation similar to what occurred in the U.S. in the Fall of 2008 when Congress rejected TARP
  - We believe the current EFSF is not large enough to accommodate the potential calls for funding
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- The current hiatus is likely to be brief
  - Debt levels need to be reduced meaningfully
  - The ECB can delay the day of reckoning, but cannot resolve the underlying problems
  - Even with an ECB QE program, the Eurozone faces existential issues that need to be addressed to sustain monetary union
    - Create an exit mechanism for profligate spenders
    - Relinquish substantial national sovereignty on fiscal affairs – a federal approach
  - The European debt crisis has extended the window of opportunity for the U.S. to address its fiscal issues, but the timeline has an end

## Quantitative Easing could Achieve Several Goals

### What are the “stated” goals of QE?

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- Quantitative easing can be viewed as a means to increase demand and reduce the risk of deflation
  - There is no guarantee that QE will be effective or that it will have the intended consequences
  - Even while some people have worried that QE will lead to inflation in the U.S., it might succeed by creating inflation outside of the U.S.
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- Avert deflation and instead generate moderately positive inflation
- Create a “wealth effect” by attempting to inflate the value of financial assets and put a floor under property prices

### What might be the “unstated” goals of QE?

- Narrow the competitive advantages of certain countries with fixed or managed exchange rates
  - Inflate input costs such as commodities with a flow through to labor costs
  - Devalue labor costs in real terms
- Devalue the returns on capital, forcing investors out the risk curve into investments that might create jobs

## **QE's Success or Failure is Impossible to Predict**

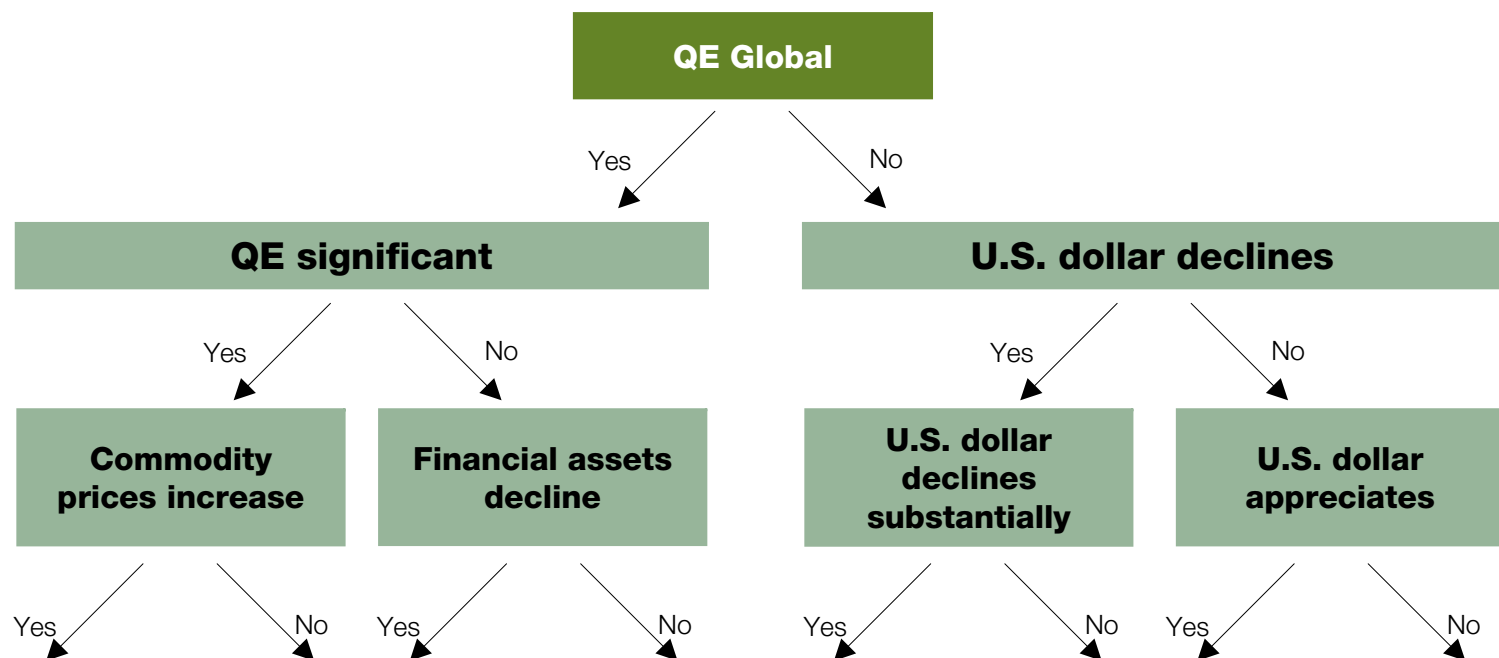
**What are the key determinants of the success or failure of QE?**

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- To date, we have seen QE announcements from the U.S. and Japan
  - At some point, we expect that the ECB may well join the Fed and BoJ
  - To the extent central banks across developed markets engage in QE, the question of how central banks in emerging markets will respond becomes the focal point
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- Timing and magnitude
- Actions/reactions of other central banks globally
- Chain of events resulting from central bank actions
- Exogenous variables including sovereign fiscal factors
- Degree to which demand response is triggered

## One Possible Approach to Analyzing QE

- Developing a framework for evaluating QE is challenging
- The sequence of events resulting from QE is pivotal to success or failure
- Implications across asset classes vary significantly
- While risk assets might be highly correlated in the lead up to and immediate aftermath of an announcement of QE, the dispersion could be substantial thereafter within and across asset classes



**Other variables to consider include, but are not limited to:**

- Number of central banks engaging in QE
- Scale of QE (absolute and versus expectations)
- Commodity price response
- Financial asset price response
- Wage implications by labor type and region
- Discretionary spending implications
- Variations in composition of CPI metrics globally

- Competitive implications for EM if capital flows accelerate
- Relative wealth implications within countries
- Government policy responses to capital flows
- Velocity of money implications
- Pension funding assumption implications
- Etc.

While the schematic above is illustrated with yes/no branches, the actual analysis is likely to be assessed on a continuum.  
Shown for illustrative purposes only.

## Quantitative Easing Implications

- Contemplating QE is more akin to thinking several moves ahead in a game of chess
- Actions provoke reactions in a tangled global web of trade and capital flows. Put another way, assessing QE as if the U.S. were a closed economy is fraught with hazard
- Across asset classes, we believe investors should contemplate the range of scenarios that might occur as well as the potential asymmetric risk/reward profiles that could occur

- New policy tools introduce new complexity to investing
- QE could create significant volatility and dispersion amongst and within markets

### Bear Case Scenario

- Commodity prices increase
- Developed market discretionary spending power decreases
- EM input costs increase forcing central bank tightening
- EM growth slows while developed markets stagnate
- Commodity prices fall

### Base Case Scenario

- Commodity and financial asset prices increase
- Central banks globally respond in moderate ways
- ECB QE extends the window for the Eurozone to address key issues
- Economic growth begins to heal debt overhang across developed markets

### Bull Case Scenario

- Developed markets avoid deflation
- EM inflation remains low, allowing central banks to avoid aggressive tightening
- Real estate prices stabilize
- The U.S.'s competitive disadvantage narrows over time
- Economic growth begins to heal debt overhang across developed markets

Shown for illustrative purposes only.

## **Global Regulatory Changes – Basel III Capital Requirement**

### **Quantity of capital will increase:**

- We believe the implications of the Basel III bank leverage and liquidity requirements are not fully appreciated
  - Many elements of Basel III were agreed formally at the G20 meeting in Seoul in November
  - Primary implications of Basel III are a) less credit available, b) at a higher price and c) with more pressure for disintermediation
- Higher risk weightings on certain assets
  - Higher capital ratio requirements
    - Tier 1 capital requirements increase from 4.0% to 8.5% by 2019
    - Common equity ratio increases from 2.0% now to 7.0% by 2019
  - Incremental capital required in periods of “excess credit growth” (up to 250bps) and for systemically important financial institutions
  - Non risk-based leverage ratio of 3% implemented by 2018

### **Quality of capital will improve:**

- Common equity much greater portion of total capital
- Limits on cross-holdings, mortgage servicing rights and deferred tax assets as a proportion of Tier 1 capital

As of 12 September 2010  
Source: Basel Committee on Banking Supervision

## **Global Regulatory Changes – Basel III Liquidity and Funding and Dodd/Frank**

### **Quantity of capital will increase:**

- Liquidity Coverage Ratio
- Net Stable Funding Ratio

### **Dodd/Frank adds to the pressure in the U.S.:**

- **Consumer:** Overdraft/NSF fees, debit cards, mortgages, Bureau of Consumer Financial Protection (BCFP)
- **Investment Banking:** Volcker Rule, derivatives, private equity and hedge fund investment limits, securitization risk retention and transparency
- **Capital:** Exclusion of trust preferred securities from Tier 1
- **Too Big to Fail:** Resolution, authority, Financial Stability Oversight Committee
- **New Oversight:** Hedge funds, insurance, credit ratings agencies

As of 12 September 2010  
Source: Basel Committee on Banking Supervision

## Regulation Implications

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- While many uncertainties remain regarding regulatory change, Basel III's outlines agreed to date have clearly negative implications for bank profitability and for the companies that rely on bank funding
  - Dodd/Frank reform in the U.S. merely compounds the challenge for financial firms
  - Companies and consumers likely will face a different borrowing situation going forward
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- Banks have to hold more capital due to higher ratios and higher risk weightings on assets
- Quality of capital will be higher with more in the form of common equity
- Liquidity rules will raise the cost of credit lines and decrease returns banks can earn on maturity transformation
- Companies will have to adapt their liquidity planning and balance sheets for a Basel III world
- Dodd/Frank will also affect availability and pricing of credit
- Reinforces our view of characteristics you want to own

## Outlook

- Equities versus fixed income
  - Fixed Income: A story of asymmetric risk/reward
  - Equities: Positioned for increased dispersion
- Regional opportunities in equities
  - U.S.: Positioned to shine
  - Emerging markets: Volatility could create opportunities to add
  - Europe: Waiting for resolution
- We believe security selection based on forward-looking fundamental research will be pivotal

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