SOM Macro Strategies
State of The Markets: Europe Exposed to US Housing Meltdown

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SOM Macro Strategies
The Four Step Investment Process

- Step 1: Identify the macro theme that could reprice markets
  - European economy was slowing in 2008, but the ECB was focusing on fighting rising inflation
  - Could the US mortgage meltdown push Europe into a recession changing the focus of the ECB
- Step 2: Build the Fundamental Framework for the theme
  - European banks are linked to the US mortgage meltdown through both sides of their balance sheet
    - They held trillions of dollars of US assets backed by US mortgages
    - They funded these dollar assets using US money market funds and Euro based wholesale funding swapped into dollars
    - Asset write-down would put pressure on banks through capital writedown and funding problems
    - Europe would be pushed into a recession as European banks tightened credit
  - Impact on Europe from the US mortgage meltdown
    - European corporates are more dependent on bank credit given that 80% of supply of credit comes from banks vs 20%in the US
    - European banks have roughly 3 times the leverage of US banks
- Step 3: Identify events and the likelihood of those events being realized over the next 12 months
  - Events would be ECB would stop focusing on inflation and start cutting rates as Europe slides into a recession
  - Recession in Europe typically follows by 2 to 3 quarters a US recession
- Step 4: Find the best implementation
  - After initially following steepening of the US yield curve, the European yield curve had flattened
  - Curve caps provided substantial upside if the ECB started to cut rates
    - Buy 1-year 2s-10s European curve caps, payouts close to 10 to 1

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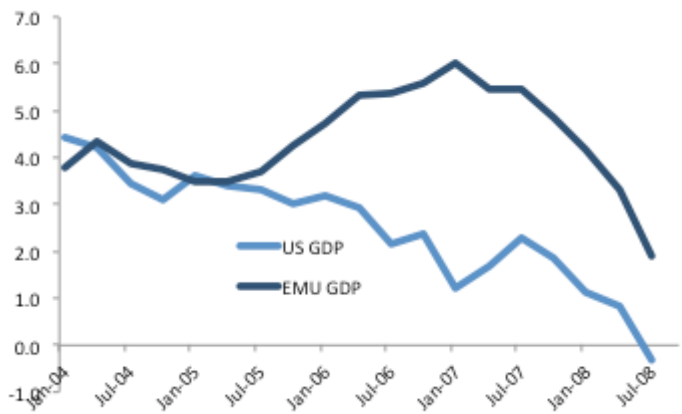
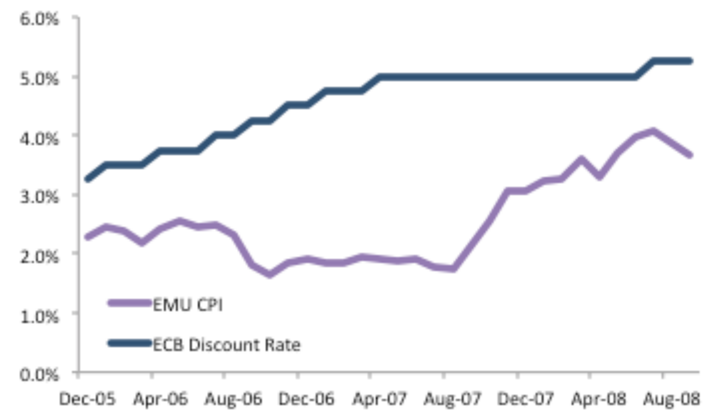
Step 1: Identify A Macro Theme

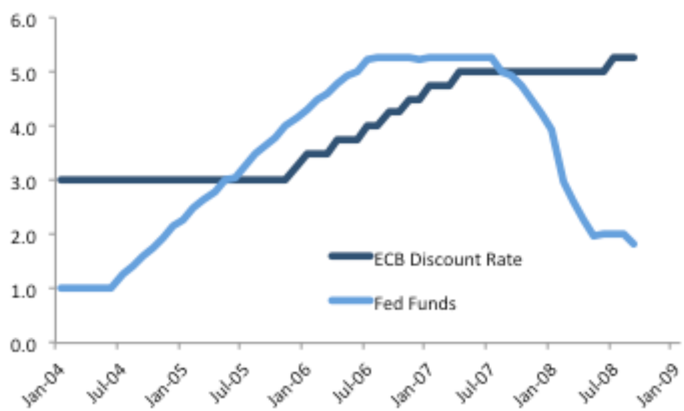
The European Economy Was Following The US into A Recession



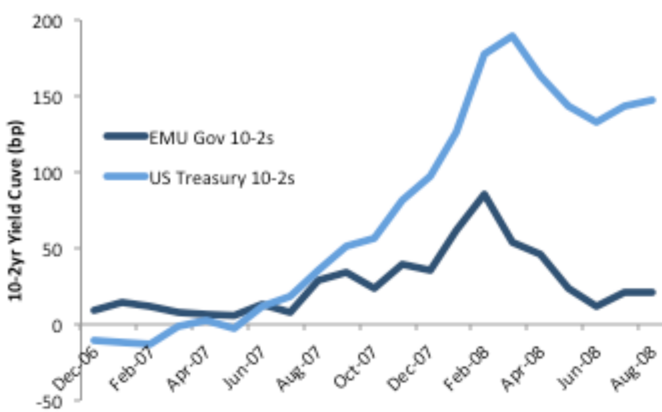
The ECB Was Focusing on Inflation Risk Rather then Recession Risk



In Contrast to the Fed, The ECB Was Raising Rates



European Markets Where Pricing in More of the Same



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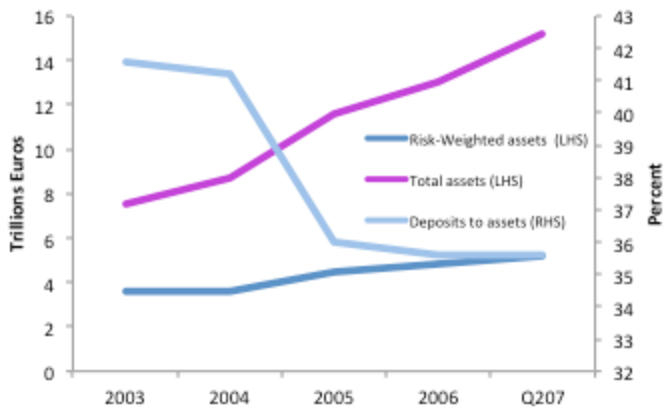
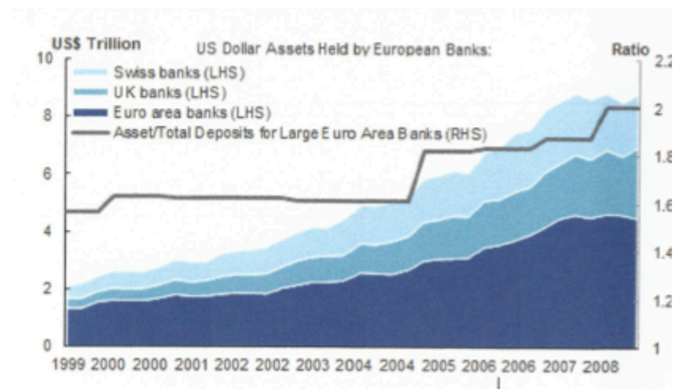
Step 2: Create a Fundamental Framework

European Banks Were Exposed to US Mortgage Assets and Dollar Funding

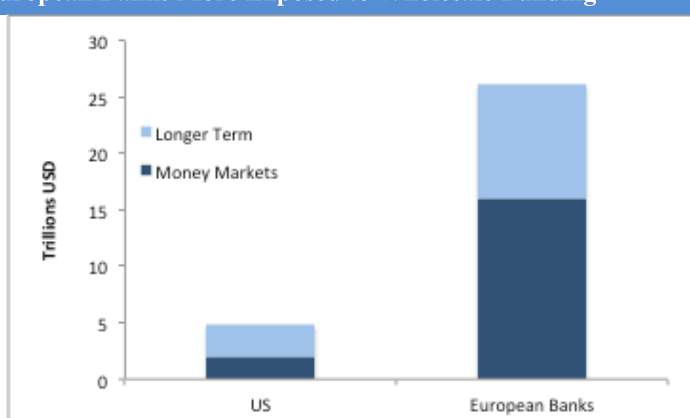
European Banks Had Increased Leverage Using Highly Rated Assets Funded With Wholesale Liabilities
(Large US and European Banks)



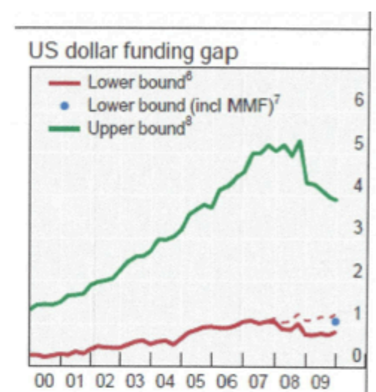
Banks Had Leveraged Using US Mortgage Assets



European Banks More Exposed to Wholesale Funding



European Banks Had A Dollar Funding Risk



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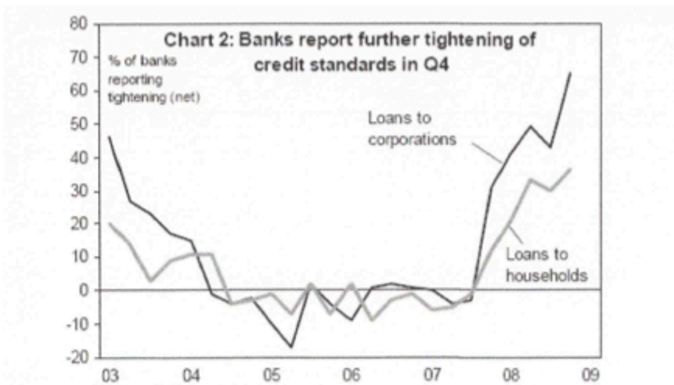
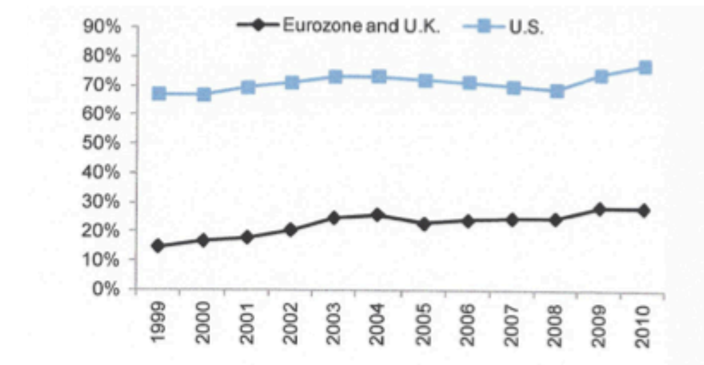
Step 3: Determine Events

European Would Follow the US Into Recession Forcing the ECB Change its Focus

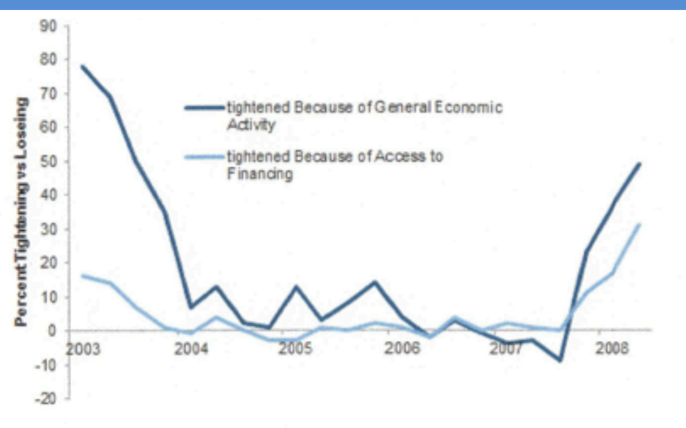
European Banks Started to Tighten Credit in late 2007



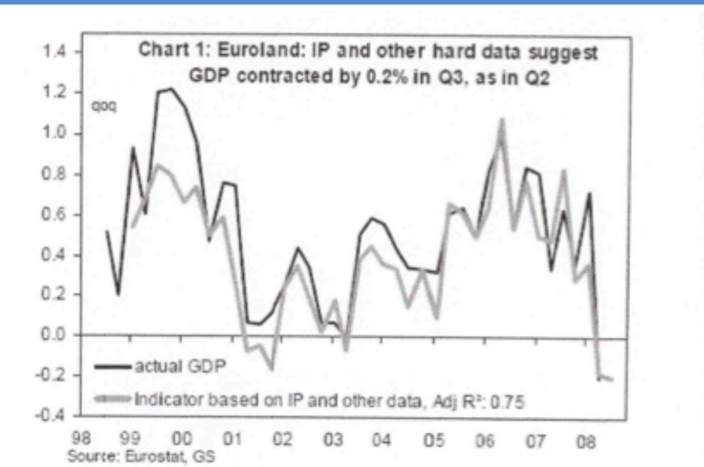
European Economies Even More Exposed to Bank Credit Than In the US



They Tightened Because of Funding and Asset Concerns



Europe Would Follow US into A Recession in Q4 2008



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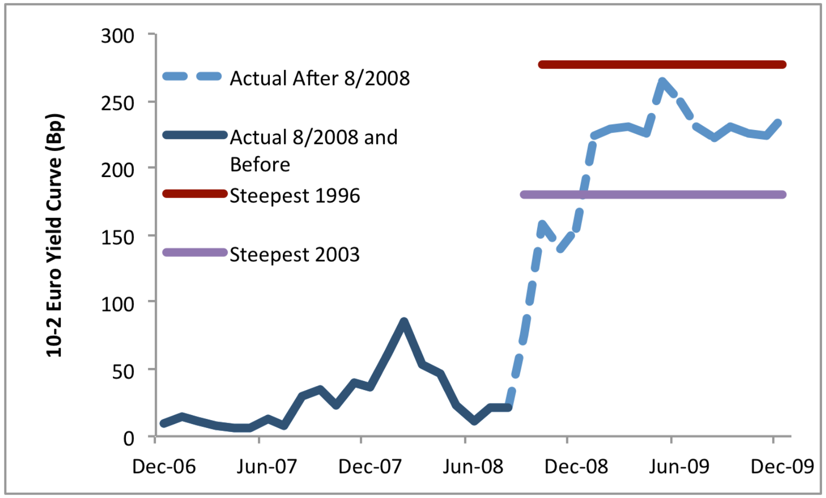
Step 4: Find Best Implementation

Most Direct Consequence of ECB Cutting Rates Was A Yield Curve Cap

Yield Curve Could Steepened Substantially If ECB Cuts rates



1-year Curve Caps Provide Greater Than 3-1 Payouts

	2s10s Result	Gross Payout	Net Payout Rato
Average of 1996	254	235	5,9 to 1
Steepest 1996	277	258	6.6 to 1
Average of 2003	160	141	3.1 to 1
Steepest of 2003	179	160	3.7 to 1

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