The Lasting Effects of Uncertainty

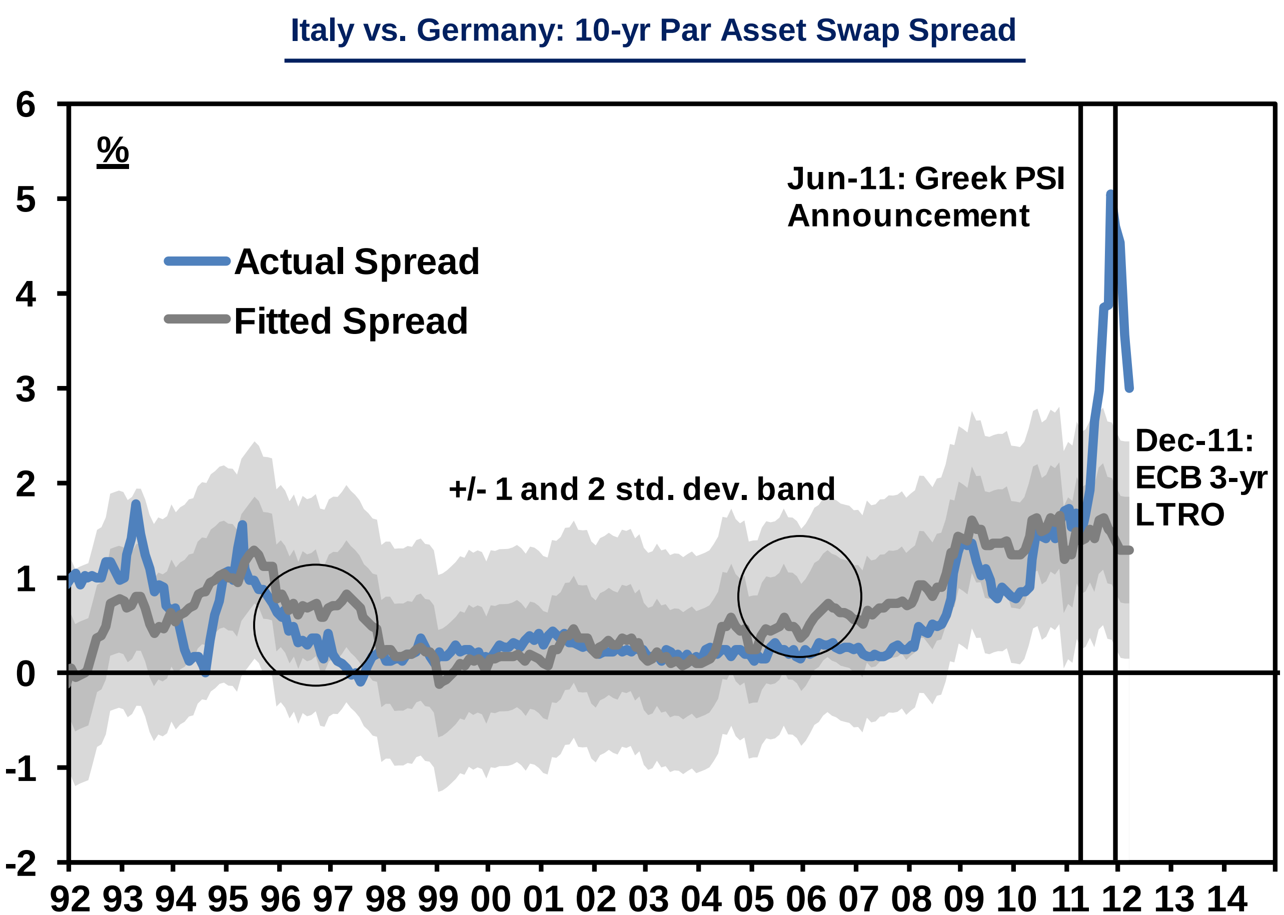
- ✓ 2008-09 cardiac arrest (a big 'outlier'): a (Bayesian) investor takes time (i.e., new evidence) to reshape her asset return distribution. Who has direct memories of 1929-33? Octogenarians account for 3% of population....

- ✓ The Greek sovereign default represents a departure from a set of priors, amplified by an erosion of confidence over policy promises. Hysteresis for EMU bond markets?

- ✓ Aug-Nov 2011 EMU 'breakup' conjecture represents an extra-institutional event (taking us into the domain of 'Knightian uncertainty').

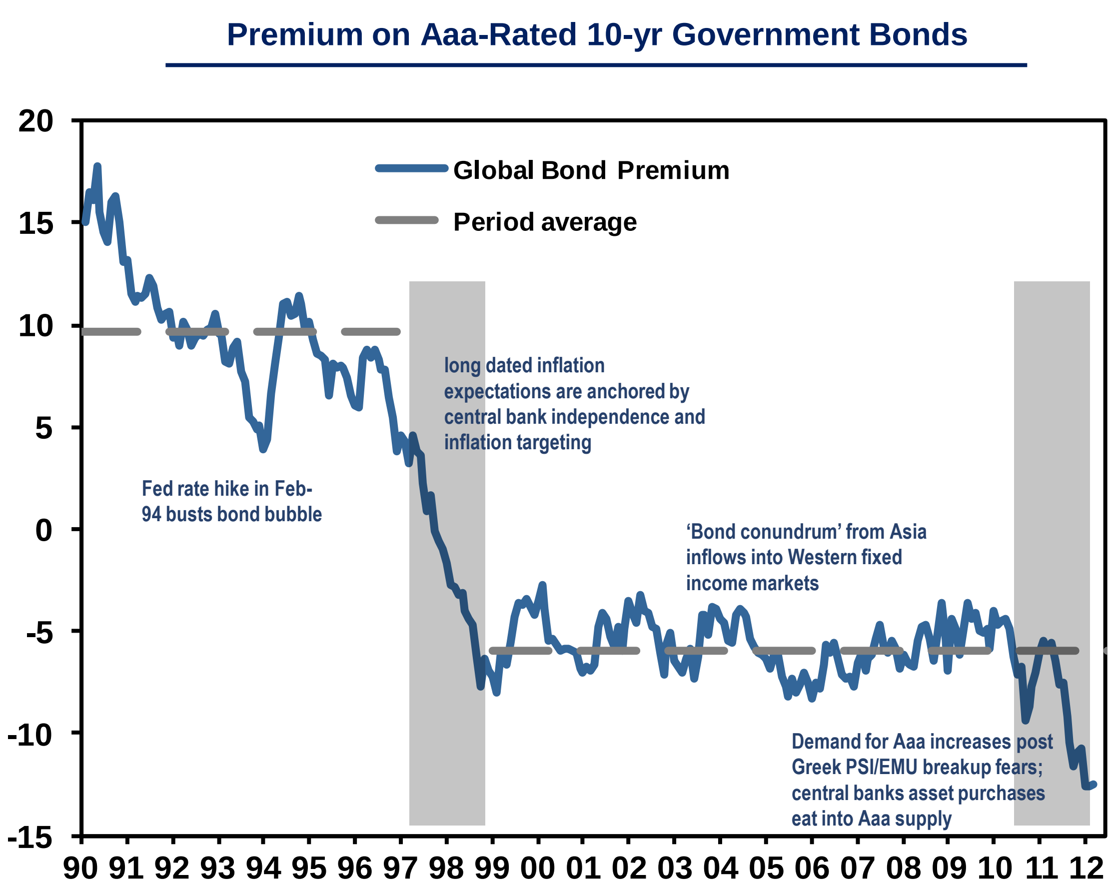
- ✓ Last but not least...shifts are underway in the underlying regulatory architecture supporting risk management.

Shift of Focus from ‘Flows’ to ‘Stocks’



Source: GS Global ECS Research

Paying More for Capital Insurance

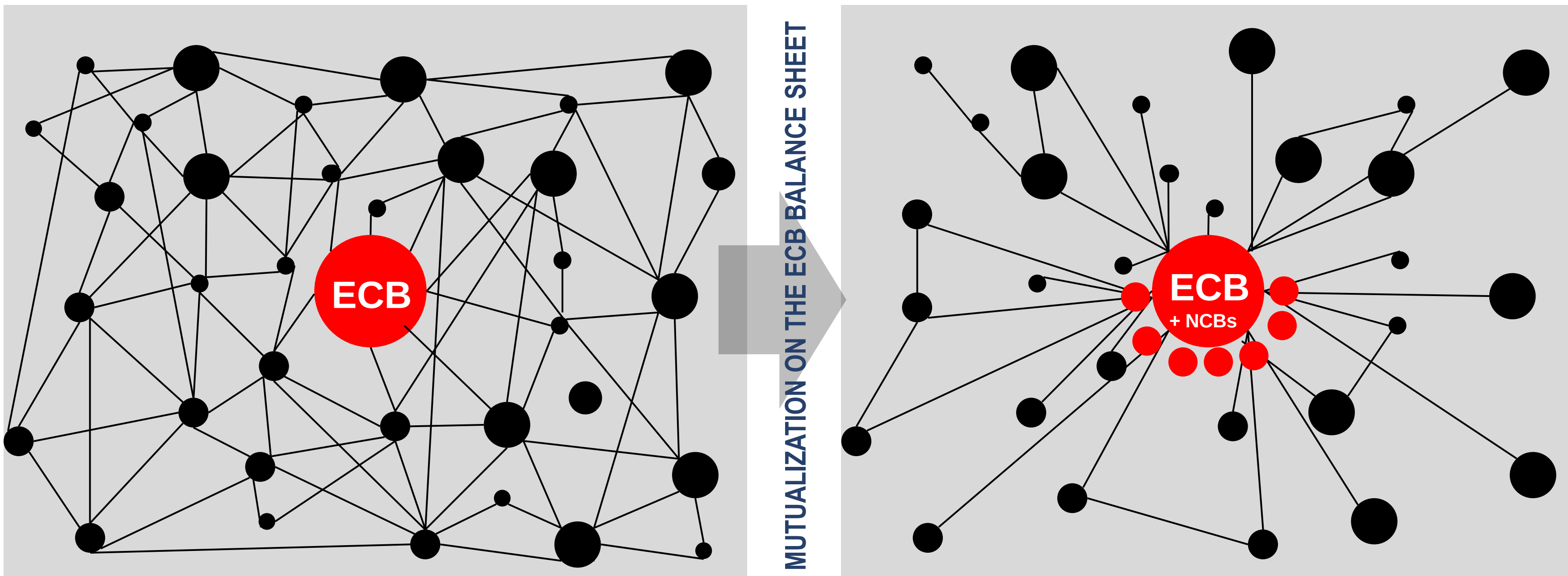


Source: GS Global ECS Research

Risk Migrations (a ‘Statler & Waldorf View’)

From an Intricate Network of Cross Border Claims...

...To a Hub-and-Spoke Risk Configuration



55% of Italian and Spanish government bonds are in the hands of non-domestic investors, largely other EMU members

Exposure of German and French banks to those in Italy and Spain is EUR150bn (source: BIS)

Foreign-held share of Italian/Spanish bonds falls to pre-EMU levels; the ECB is long 7% of the stock, and warehouses Italian and Spanish bonds as collateral.

Target 2 imbalances soar: Germany’s surplus stands at EUR500bn (+EUR138bn from Dec-10 to Dec-11); Italy and Spain’s deficit stands at EUR365bn (a EUR320bn increase)

Source: GS Global ECS Research

Which Uncertainty Has Been Removed?

- ✓ Mitigation of refunding/liquidity risk and counterparty exposure through mutualization on the ECB's joint and severally guaranteed balance sheet.
- ✓ Dampening of 'risk resonance' in a fairly closed financial system where demand is fairly homogeneous.
- ✓ Lowering of overnight rates across the area, and levelling of cost of capital; display of commitment to 'save the Euro' using quasi-fiscal powers.
- X Leverage/solvency shortfalls still need to be tackled – buffering the deleveraging cycle.
- X Potential destruction of demand for cross-border claims until explicit risk-sharing is devised (joint guarantee of deposits, e-bonds?)

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I, Francesco Garzarelli, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.

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