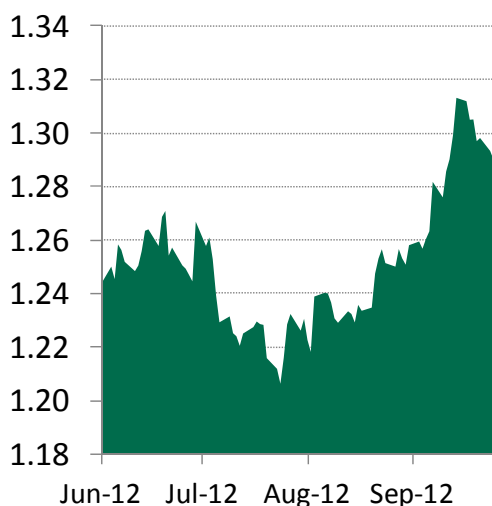


**REALITY CHECK FOR EUROPE**

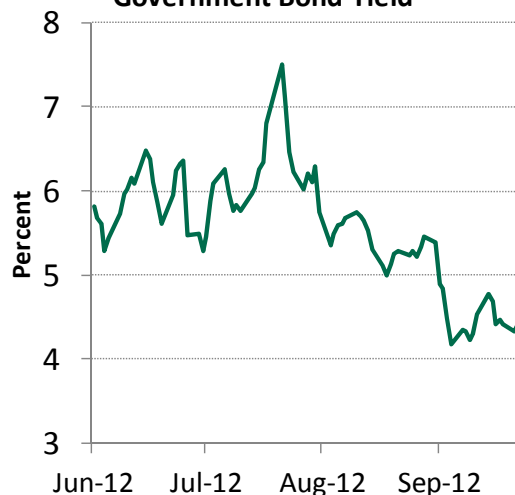
Over the past two years, the markets have gone through cycles of escalating concern about Europe punctuated by brief periods of calm. Investors vacillate from fearing defaults and dissolution of the euro to feeling confident that the European Central Bank (ECB) has things under firm control.

Unfortunately, it appears that the pendulum is swinging once again towards disorder. The weeks leading up to, and immediately following the ECB's announcement of a sovereign bond purchase program saw the euro rally and borrowing rates decline. Both are now in retreat.

**Dollar/Euro**



**Spain: 5 Year Government Bond Yield**



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In the wake of the September 6 ECB meeting, we observed that the announcement of a bond purchase program and the execution of that program were two very different things. ECB President Draghi used the term “conditionality” to summarize the steps separating the two: most significantly, the establishment of a pan-European banking supervisor and agreement between the target country and the IMF on austerity measures.

Getting these foundations in place is proving more difficult than the market may have assumed. National governments are caught between rioters protesting reductions in public spending and international financiers who are insisting on such steps. As a senior European official observed, “We all know what to do...we just don't know how to get re-elected after we've done it.” Achieving consensus among EU nations on ECB supervision of banks is also proving difficult.

Unfortunately, Spain (among others) is running out of time. With heavy debt maturities to roll over and an acute need to reassure markets, Spain is counting on ECB support within the next two months. Upcoming reports on the budget and bank health there may only raise the stakes.

Announcing an intention to act is not sufficient to rule out tail risk in Europe. This remains a significant concern for world markets and policy makers in the weeks ahead.