Global Equity Strategy

Research Analysts

Andrew Garthwaite
44 20 7883 6477
andrew.garthwaite@credit-suisse.com

Luca Paolini
44 20 7883 6480
luca.paolini@credit-suisse.com

Marina Pronina
44 20 7883 6476
marina.pronina@credit-suisse.com

Mark Richards
44 20 7883 6484
mark.richards@credit-suisse.com

Sebastian Raedler
44 20 7888 7554
sebastian.raedler@credit-suisse.com

Niall O'Connor
44 20 7883 8761
niall.oconnor@credit-suisse.com

STRATEGY

Greece: what if?

There are three inter-connected problems in peripheral Europe: a) most serious, a loss of competitiveness (ex Ireland) that we think requires more wage deflation than the economic consensus forecasts; b) excessive private sector debt (at c230% of GDP in Portugal and Spain, cf to 160% of GDP in US); and c) high public debt, where a haircut of 36%, 25% and 32% is probably needed in Greece, Portugal and Ireland (but CDS are now more than pricing this in).

Our base-case scenario is that this is not a systemic risk (as the cost to core Europe of not bailing out peripheral Europe is at least 2x the cost of bailing it out), Spain (which is 12% of European GDP) does not require a haircut and the ECB will end up repo-ing more and more peripheral European debt to offset deposit flight (the recap of the ECB has to be done by core Europe; this makes it a core European problem). We believe there is a 75% probability of a delayed and 'agreed' default in Greece: a roll-over of government bonds will be implemented, allowing GGBs to be used as collateral with the ECB, with restructuring being postponed until Greece runs a primary surplus, banks are better capitalised (each year PPP are 3% of loans) and the ESM is set up.

What if? We believe there is a 15% probability of a unilateral default within six months, but this would be met by a quick European policy response. In this scenario, European markets are likely to fall 10% but offer an attractive buying opportunity (as the ECB will likely have to do QE). Lastly, we see a 5% probability of a unilateral default with a poor European response, a break-up of the Euro, a 5% fall in European GDP and a c20% decline in markets (and a 5% probability of Germany withdrawing from the Euro).

We agree with our European credit strategist, William Porter, that leaving the Euro-area would just be an expensive way to default: if any peripheral European country left the Euro, we estimate GDP would fall by 20% or more (owing to the reliance on ECB funding and the need to tighten fiscal policy, as all these countries are running primary budget deficits).

Investment conclusions: buy domestic Germany (eg, Deutsche Wohnen, Commerzbank); stay short of domestic plays in peripheral Europe (eg, FCC, Brisa); buy Italy (eg, Enel): it looks abnormally cheap and should not be considered part of the periphery, in our view; the euro could easily weaken to €/$1.35; banks do not offer sufficient appeal until they trade 10% lower (we are overweight the life companies); and we stay underweight Continental Europe.

Figure 1: **Greek debt crisis scenarios**

Stage 1		Stage 2	
Description	Probability	Description	Probability
No Greek default - "Muddle-through"	75%	Austerity & EU/IMF support continue, voluntary roll-over of debt, restructuring postponed until 2013	75%
Greek unilateral default	20%	Quick policy response	15%
		Poor policy response	5%
Core Europe stops supporting Greece	5%	All emergency support stops: default	5%

Source: Credit Suisse research

DISCLOSURE APPENDIX CONTAINS ANALYST CERTIFICATIONS AND THE STATUS OF NON-US ANALYSTS. FOR OTHER IMPORTANT DISCLOSURES, visit www.credit-suisse.com/ researchdisclosures or call +1 (877) 291-2683.
U.S. Disclosure: Credit Suisse does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Table of contents

Greece: three inter-connected problems 3
1) Loss of competitiveness 3
2) Over-leverage of private sector 5
3) Public sector debt 6
We believe peripheral Europe does not pose a systemic risk 8
What could turn the current situation into a systemic crisis? 10
An exit of Greece from the Euro looks counterproductive and unlikely 12
What are the possible scenarios? 13
'Muddle-through' scenario – 75% probability 13
Greek unilateral default – 20% probability 16
Core Europe stops supporting Greece – 5% probability 19
Investment conclusions under the 'muddle-through' scenario 20
1) Buy plays on Germany 20
2) The Euro should weaken slightly (maybe to €/$1.35) 24
3) Stay underweight domestic peripheral stocks 26
4) European banks need to be trading on 0.8x TB to be considered a buy 28
5) Buy cheap Italian domestic stocks 29
6) It's too early to be overweight Continental Europe 31
Appendices 34
Appendix 1: REER after sovereign defaults 34
Appendix 2: Country risk table 35
Appendix 3: European and US company credit ratings versus their governments 36

Greece: three inter-connected problems

We continue to believe that the problems in peripheral Europe can be distilled into three inter-connected issues:

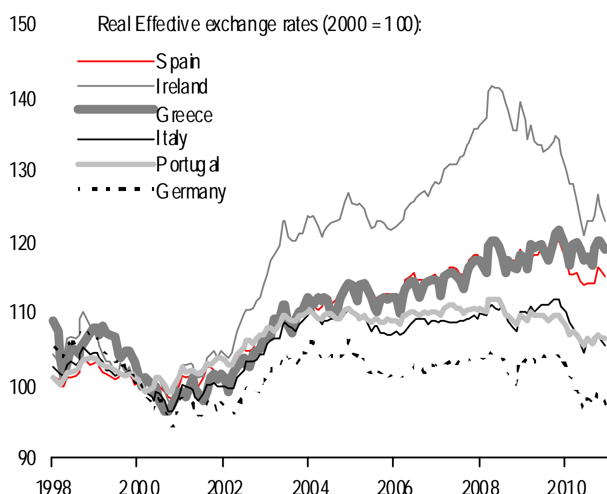
- The loss of competitiveness that can only be regained by an extended period of painful supply-side reforms and deflation, which makes the fiscal targets more difficult to achieve (in our opinion, this is the biggest problem in Portugal and Greece).
- An exceptionally overleveraged private sector (outside of Greece).
- Unsustainable public debt levels in Greece, and to a lesser extent in Ireland and Portugal.

We look in detail at these three issues below:

1) Loss of competitiveness

The overvaluation of real effective exchange rates and the size of the current account deficits are clear signs of a significant loss of competitiveness in peripheral Europe and the lack of a significant adjustment so far, outside of Ireland.

Figure 2: **REER in peripheral Europe**



Source: Thomson Reuters, Credit Suisse research

Figure 3: **Current account and trade balance deficit still too big**

	% of GDP (latest)	
	Current account	Trade balance
Spain	-4.6%	-4.7%
Greece	-9.5%	-6.4%
Portugal	-9.2%	-6.1%
Ireland	-0.7%	18.6%
Germany	5.6%	5.4%

Source: Thomson Reuters, Credit Suisse research

We believe that, after a major credit crisis, a country has to end up either with a current account surplus (to generate excess savings) or a clearly undervalued currency (to attract foreign capital). After emerging market crises in the past, real effective exchange rates have typically fallen by about 50%, compared with only 2% so far in Greece (see Appendix 1).

Countries that go through a period of abnormally slow growth typically end up with a rapid improvement in their current accounts (due to depressed imports). The worry is that despite the weak growth in peripheral Europe, the current account position is still poor (with the exception of Ireland). Even the trade deficit is still abnormally high (the difference between the current account and the trade balance being interest, dividends or profits paid to foreign holders of their domestic assets).

Given that devaluation is not an option open to the Euro-area members, the only feasible path towards restoring competitiveness for the periphery is a decline in unit labour costs ('internal devaluation'). This can be achieved via higher productivity and/or an outright decline in the wage level. We estimate that, even under optimistic assumptions (2.5% productivity growth in the periphery and 2.3% wage inflation in core Europe), the decline in wages required to restore the competitiveness to the level of 10 years ago is about 9% over the next five years in Greece.

Figure 4: Outright deflation required in peripheral Europe to restore competitiveness…a 9% decline in wage growth in Greece is required in peripheral Europe even under an optimistic scenario

Required change in wage level to regain competitiveness level of 2000 (relative to Germany)

Country	Optimistic scenario		Pessimistic scenario		Nominal GDP growth	
	Wage level, % change over next 5Y	Wage growth p.a. over next 5Y	Wage level, % change over next 5Y	Wage growth p.a. over next 5Y	2011e Consensus	2011-5E IMF estimates
Greece	-9%	-1.8%	-15%	-3.3%	-1.4%	1.9%
Italy	-5%	-1.0%	-12%	-2.5%	2.7%	3.4%
Spain	-5%	-0.9%	-11%	-2.4%	2.2%	3.3%
Portugal	-2%	-0.4%	-9%	-1.8%	-0.2%	1.8%
Ireland	-1%	-0.2%	-8%	-1.6%	0.2%	3.2%
Germany	12%	2.3%	9%	1.8%	4.3%	3.0%

Source: Thomson Reuters, Credit Suisse estimates.

Optimistic scenario: productivity growth of 2.5% in the periphery, 2.5% wage growth in core Europe.

Pessimistic scenario: productivity growth of 1.5% in the periphery, 2% wage growth in core Europe.

The assumptions underlying this calculation are, if anything, optimistic as:

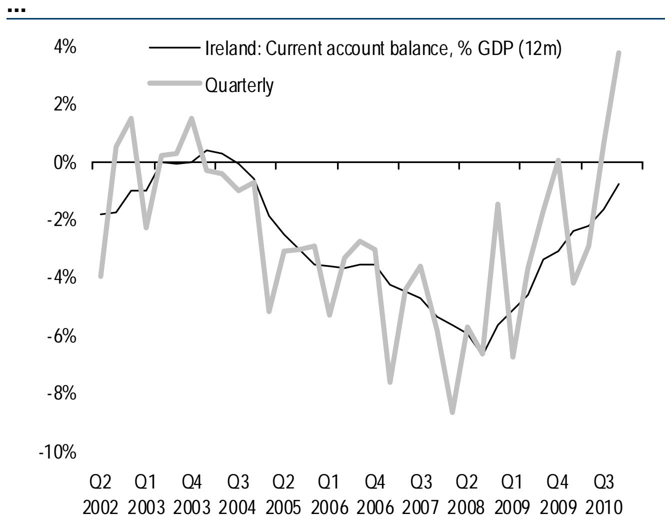
- We assume that competitiveness only has to return to a 10-year average, but realistically, currencies may have to be cheaper.
- The projected productivity gains in the periphery and inflation in core Europe could be too high. If, say, productivity growth was 1.5% a year over five years (owing to limited restructuring), and wage inflation in core Europe was just 2% a year, the degree of wage deflation required in Greece, Ireland, Spain and Portugal would be 15%, 13%, 11% and 9%.

We think such a degree of wage deflation is possible within a fixed currency regime (Ireland and Estonia have seen a 10-20% decline in wages). Only Ireland seems to be at an advanced staged of the required adjustment, having already reduced the current account deficit to almost zero in the last 12 months from a peak of 9% during 2008.

Yet, given that wages account for almost half of GDP in Greece, a fall in wages will likely mean a fall in nominal GDP, which in turn makes it even harder to meet fiscal targets. The wage deflation required seems bigger than the decline in nominal GDP expected by consensus this year (-1.4%).

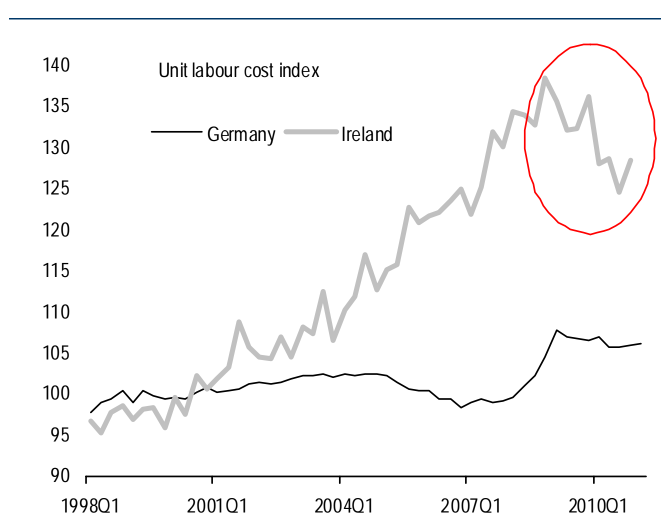
On a positive note, the exceptional turnaround in the Irish trade balance and the fall in Irish unit labour costs shows that there can be a quick and significant restoration of competitiveness - if there is the political commitment to restructure.

Figure 5: Irish current account balance rapidly improving ...



Source: Thomson Reuters, Credit Suisse research

Figure 6: ...partly due to a decline in labour costs



Source: Thomson Reuters, Credit Suisse research

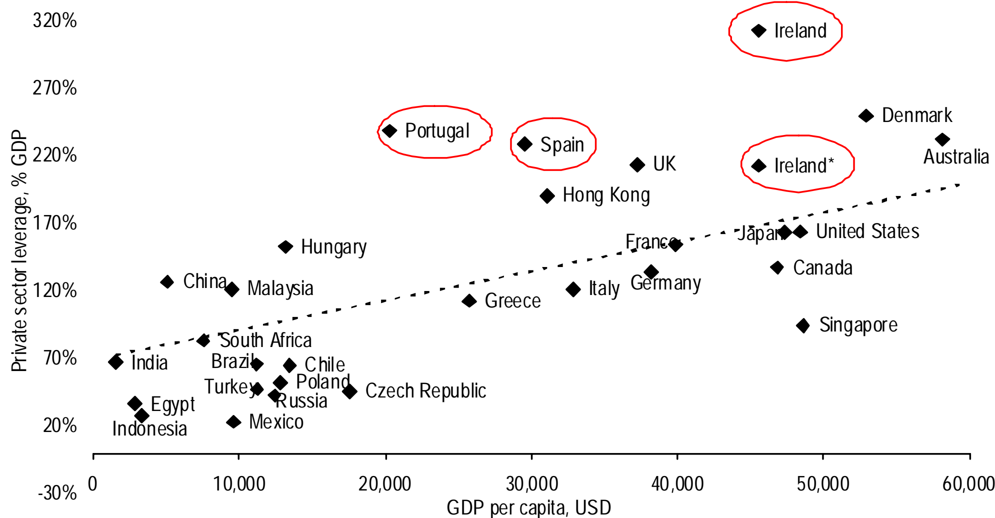
We suspect that when it comes to the political willingness to accept the pain to restore competitiveness, Portugal is particularly vulnerable because – unlike Greece, Ireland and Spain – it did not receive a growth dividend from the introduction of the Euro in 1999 and thus there may be more reticence in participating in austerity.

2) Over-leverage of private sector

Private sector overleverage is a problem for Spain, Ireland and Portugal (not Greece) and, so far, there has been limited deleveraging.

An international comparison of non-financial private sector leverage relative to GDP per capita suggests that Portugal and Spain require a fall in their private debt equivalent to c70% of GDP.

Figure 7: Spain, Ireland and Portugal have overleveraged private sectors



*Source: Thomson Reuters, Credit Suisse research. *Excluding foreign corporate holdings of Irish debt*

This is consistent with the observation that in previous major banking crises, on average, non-financial private sector leverage has fallen by a third within five years (in Spain, for instance, private sector debt is currently around 230% of GDP – hence, a 30% reduction in this debt would be equivalent to around 75% of GDP).

Figure 8: **Deleveraging in previous banking crises**

Country	Peak leverage		Deleveraging	
	Date	*Private sector debt to GDP*	*Peak-to-trough change in debt levels*	*Duration (m)*
Argentina	Feb-99	24%	-43%	60
Mexico	Apr-95	35%	-16%	20
Sweden	Nov-90	56%	-26%	62
Thailand	Jan-98	170%	-40%	48
Average		71%	-31%	47
Median		46%	-33%	54

Source: Thomson Reuters, Credit Suisse research

Yet, so far, the deleveraging process has only just begun, with declines in private sector debt of between 1% and 2% of GDP (with the exception of Ireland, where the reduction in debt levels is more advanced).

Figure 9: **Deleveraging has been limited so far**

Country	Peak leverage			Deleveraging			
				Implied		So far	Still required
	Date	*€, bn*	*% of GDP*	*€, bn*		*% of GDP*	
Spain	Jun-10	2,413	228%	750	71%	1.4%	69%
Portugal	Sep-10	402	235%	125	73%	1.1%	72%
Ireland	Dec-09	526	329%	163	105%	9.8%	95%
Greece	Jun-10	267	115%	83	32%	1.7%	30%
Total				1,122	68%	2.2%	66%

Source: Thomson Reuters, Credit Suisse research

3) Public sector debt

This is the focus of investors' attention right now. Assuming that a third of the required private sector deleveraging will end up on the government balance sheets, the government debt to GDP would rise to 147% in Ireland and 155% in Greece, which we would consider unsustainable at current bond yields. The table below shows the amount of fiscal tightening (compared with that announced so far) that is needed to stabilise government debt to GDP - clearly the degree of fiscal tightening required outside of Spain is unsustainable (for example on current bond yields Greece would need to tighten fiscal policy by 26% of GDP to stabilise government debt to GDP).

Figure 10: Fiscal tightening required to stabilize the debt to GDP ratio and haircuts required to take the debt to GDP ratio below 100%

Country	Government debt to GDP			% haircut required to reduce government debt/GDP to 100%	Implied haircut in 5Y CDS	Fiscal tightening required to stabilize government debt to GDP using:		Estimated fiscal tightening 2011-14
	2010E	2014E	2014E (incl. de-leveraging)			Current bond yield	EFSF rate (5.8% for Ireland, Portugal; 4% Greece)	
Ireland	96%	125%	147%	32%	34%	18.3%	10.6%	8.0%
Spain	60%	72%	99%	-1%	14%	9.2%	9.2%	4.2%
Portugal	83%	101%	134%	25%	34%	14.6%	5.7%	5.1%
Greece	142%	152%	155%	36%	63%	26.5%	6.2%	9.3%
				14%				

Source: IMF estimates, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse estimates

The good news is that the market is already pricing in haircuts of 63% and 34% for Greece and Ireland, more than is required to take Greek and Irish debt below 100% of GDP. That is, if anything, the degree of haircuts being priced into markets is now too high, in our view.

We believe peripheral Europe does not pose a systemic risk

Our key view is that the crisis in peripheral Europe is not a systemic risk because:

a) The cost to core Europe of not bailing out peripheral Europe would be greater than the cost of bailing it out

If we assume that Spain recovers even without European support, then the direct cost of not bailing out Europe would be €320bn, rising to c€500bn if Spain can't have European support (if we add the indirect costs, we think the costs can easily be double these figures). This compares with a cost of bailing out Europe of €225bn (we assume a 40% haircut on peripheral European debt and that the cost of bailing them out is the money needed to get the government debt to GDP down to 100%, as shown in Figure 11).

Figure 11: **Breakdown of exposure to the periphery for European banks (4Q2010)**

End of Q4 2010, EUR bn		Bank Nationality				
Exposure to	**Type of exposure**	**Germany**	**France**	**Belgium**	**Netherlands**	**Core Europe**
Greece	Foreign claims	25	42	1	4	**73**
	o/w public sector	17	11			
	Other exposures	4	6			
	Total exposures	**30**	**49**	**1**	**4**	**84**
Ireland	Foreign claims	88	22	19	12	**142**
	o/w public sector	2	3			
	Other exposures	30	20			
	Total exposures	**118**	**42**	**19**	**12**	**192**
Portugal	Foreign claims	27	20	3	5	**55**
	o/w public sector	6	6			
	Other exposures	10	4			
	Total exposures	**37**	**24**	**3**	**5**	**69**
Spain	Foreign claims	136	105	16	58	**315**
	o/w public sector	21	23			
	Other exposures	31	26			
	Total exposures	**167**	**131**	**16**	**58**	**372**
Total Periphery	Foreign claims	277	190	39	79	**584**
	o/w public sector	46	43			
	Other exposures	76	56			
	Total exposures	**353**	**246**	**39**	**79**	**717**
	as % of GDP	*14*	*13*	*11*	*13*	***13***

Source: BIS, Credit Suisse estimates

b) Spain can just survive without a haircut

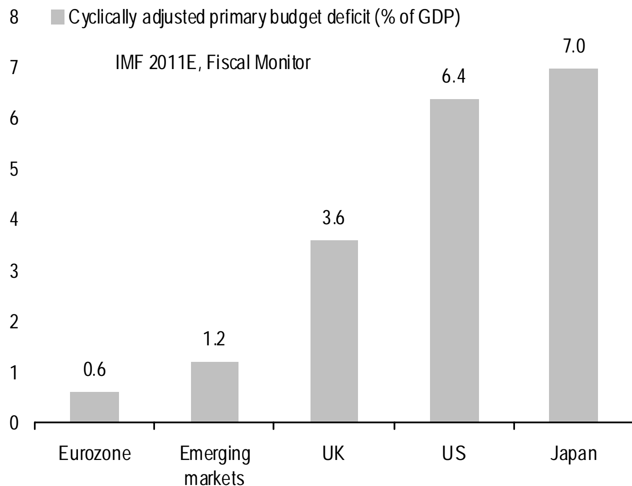
This is the key as Spain, in terms of GDP (€1.1trn or 12% of aggregate Euro-area GDP), is double the size of Portugal (€173bn), Ireland (€147bn) and Greece (€222bn) combined.

Even if the government has to take on board a third of the costs of deleveraging of the private sector (i.e. spend €200bn on recapitalising banks), government debt to GDP peaks at around 100%. This would require an additional fiscal tightening of 5% of GDP to stabilise government debt. This is shown in Figure 10. This is less than the fiscal tightening announced in Ireland and Greece and we think it is politically and economically manageable. It is possible that our assumptions have been too pessimistic, given the counter-cyclicality of the Bank of Spain (our European bank analyst, Dan Davies, highlights that most residential mortgages were taken out at LTVs well below 80%, and that there are still balances of past year countercyclical provisions to be used up).

c) In aggregate, Europe's financial situation does not seem unbalanced

Europe's current account is in balance (at just 0.2% of GDP based on European Commission forecast for 2011E), Europe's aggregate cyclically adjusted primary budget deficit, at 0.6% for 2011E on IMF estimates, is less than that of the UK (3.6%), emerging markets (1.2%) or the US (6.4%), while the total government debt is 83% compared with 98% of GDP in the US and 233% of GDP in Japan, according to the IMF.

Figure 12: The Eurozone has a marginal primary budget deficit – adjusted for the cycle ...



Source: IMF estimates

Figure 13: ... and public debt well below US levels

Source: IMF estimates

d) **We think that over time the ECB will end up repo-ing more and more of peripheral European debt** (as there is more deposit flight from peripheral Europe)

The ECB already repo-ed €250bn of Portuguese, Irish and Greek debt (this rises to c€300bn if we include Spain). The more the ECB repos peripheral debt, the greater the risk that the collateral posted does not hedge against the risk of counterparty default risk and the more peripheral Europe debt *de facto* becomes a pan-European problem, as any potential recapitalisation of the ECB (if there is a loss) has to be funded by all of Europe.

e) **We think the solution is, in part, a boom in Germany and de-regulation in peripheral Europe** – both of which are happening, as shown in Figure 24.

What could turn the current situation into a systemic crisis?

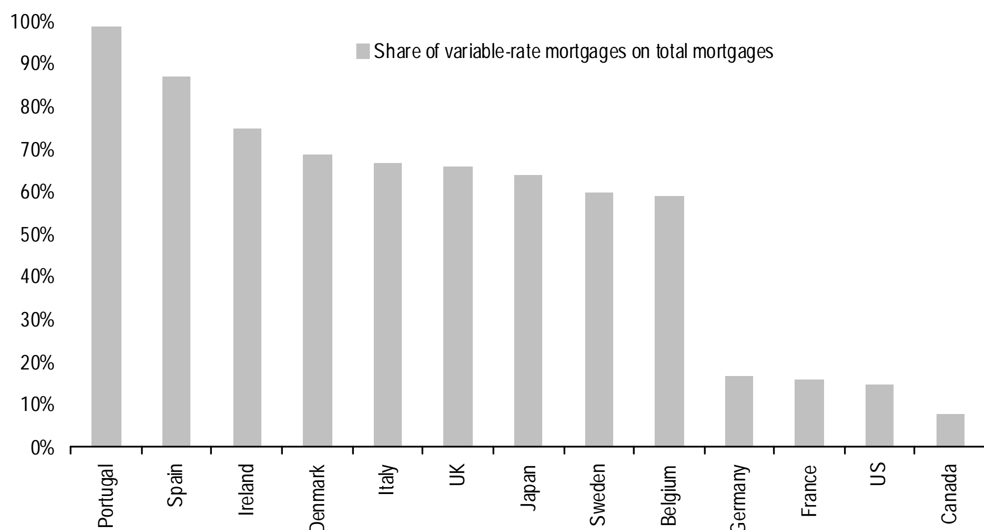
1) ECB over-tightening

Over-tightening would occur if the ECB raises rates too far, tightens repo requirements too much or allows the euro to become too strong.

We think anything more than a marginal rate rise would impose too much pain on peripheral Europe, which has most of Continental Europe's excess leverage, with most of that debt being floating (99% and 87% of mortgage debt is floating in Portugal and Spain, compared with 20% in Germany). The impact on Spain is delayed because mortgages refix once a year. A rise in rates tends to make the Euro stronger and we believe that if the Euro strengthens above €/$1.50-1.60, we would start to worry about the growth prospects of Europe as a whole (according to the OECD, each 10% on the euro takes 1.5% off nominal GDP in Europe).

The provision of liquidity is critical when Ireland, Portugal, Greece and Spain have a loan to deposit ratio of 160%, 150%, 110% and 130%, respectively (which would be aggravated by deposit flight).

Figure 14: More than 80% of Portuguese and Spanish mortgages are at variable rate



Source: European Mortgage Federation (2010)

2) Political fatigue

There is a risk of an 'irrational' political outcome; as such it is hard to predict something that appears irrational. We believe that, because of the issues discussed below, an involuntary default and an exit from the Euro-area would mean a much greater loss in economic growth than staying in the Euro and undergoing the painful, but necessary adjustments. We would expect that, if the political consensus in a country were to swing towards the option of a unilaterally-declared default or a Euro exit, the costs would be made clear and this might be enough to change popular opinion.

The critical risk is that at some point in the future the Greek Parliament votes against the new austerity measures and a general election is called. Then the opposition could campaign on the basis of renegotiating the terms with the IMF and, assuming they win, as suggested by the latest polls, the risk of a unilateral default would increase significantly (PASOK has a majority of just 6 seats, with 2 PASOK MPs announcing they will vote against the new austerity measures and another 17 MPs undecided, according to the FT,

17 June). However, our European economist Giovanni Zanni believes that the opposition party would likely agree on a relatively contained redefinition of the plan rather than asking for a different one and would also support an acceleration of the privatization process.

It would be hard for the IMF, the ECB or Germany to provide help to Greece if the Greeks turn their back on austerity measures.

In core Europe, and Germany in particular, the government has sent conflicting signals, with the German Finance minister Schäuble suggesting a 'soft restructuring' of Greek debt – i.e. an extension of the debt maturity by seven years – being a pre-condition for the release of additional support, while Chancellor Angela Merkel suggested on 17 June after a meeting with the French president, Nicolas Sarkozy, that Germany would agree on a voluntary roll-over of debt, leaving the details of any private sector involvement – likely to be rather symbolic – until September.

In our opinion, Portugal would be at severe risk, simply because there has been no growth dividend from the Euro membership, even though at the recent general elections 80% of voters supported one of the three parties that have backed the IMF/EU bailout conditions.

What is the impact of imposing a default of senior debtors of Irish banks?

There is some €250bn of senior European bank debt rolling over each year in both 2011 and 2012. Clearly the issue is whether this debt can be rolled over if the Irish decide to impose a haircut on holders of senior Anglo Irish and Irish Nationwide debt (the proposal affects €3.5bn of senior debtors). We tend not to be as worried about the impact of this as our credit strategist, William Porter, because:

- Eamon Gilmore, the Irish deputy PM, told parliament that "the matter would be discussed with the ECB in particular and the European commission", suggesting that they would only do this with the ECB's agreement. The ECB clearly has leverage in Ireland owing to its provision of €100bn of liquidity;
- The two banks (Anglo Irish and Irish Nationwide Building Society) involved are in wind-down mode and therefore the situation is a relatively special case;
- We have already seen a default on senior bank debt in Europe this year (Amagerbanken in Denmark, with a 41% haircut) without any contagion to other countries.

An exit of Greece from the Euro looks counterproductive and unlikely

We strongly believe that an exit of Greece from the Euro-area would be counter-productive for the following reasons:

- *If Greece were to leave the Euro-area, it would have to default,* we assume that the new Greek currency would fall by 40% (during an emerging market crisis REER fall by c50%, compared with only 2% in Greece so far – see Appendix 1) – and with foreign debt being 88% of GDP, foreign debt would rise to 147% and this would necessitate a 43% default (to bring the foreign debt to GDP ratio back to 100%). This is why we agree with William Porter that leaving the Euro is an expensive way to default.
- *The cost to Greece would be a 20% hit to GDP,* as there would likely be a 30% fall in Greek loans, given that the loan to deposit ratio is already at 110%, Greek deposits are falling at a rate of c15% a year and borrowing from the ECB already amounts to 33% of loans. The alternative would be for Greek banks to raise deposit rates sharply to attract in deposits, but clearly a sharp rise in interest rates is hardly a desirable remedy, given the lack of growth.
- Greece does not yet run a primary budget surplus (and will not before 2012 at the earliest, on IMF forecasts). Therefore, even in the case of a default, it would have to continue tightening fiscal policy by 3% of GDP just to balance its budget (as clearly post a default Greece would be unable to borrow from international markets).
- *Greece would be frozen out of international capital markets for years*. In the case of Russia, it took Gazprom four years after the Russian default before it borrowed again. (The Russian government did not borrow again until 2010 as the rise in the oil price limited its need to borrow. Credit Suisse emerging market economist, Kasper Bartholdy, believes that if Gazprom was able to borrow in 2002, the government also would have been able to.) This means that deposit shortfalls would have to be made good for by asset reductions or deposit rate hikes, as described above.
- *Leaving the Euro would mean leaving the EU, w*ith Greece losing c4% of GDP a year of EU 'structural' funds and all the other advantages of the common market.
- *An exit from the euro would leave Greek policymakers without the political cover to implement the necessary structural reforms.*

Thus, we believe an exit from the Euro-area is not in Greece's interest. Furthermore, we believe that it is also not in the interest of core Europe:

- *It would make little sense for core Europe to withdraw support for Greece now* (it has spent €53bn supporting Greece directly; the ECB has bought c€60bn of GGBs and lent c€90bn to Greek banks).
- *Contagion risk would be extremely high*: there would be deposit flight from Greece and other peripheral European countries (Irish deposits fell 10% prior to Irish the bailout), either causing more acute deflation or the ECB would have to repo lower-quality assets in these countries to offset the deposit shortfall.

Credit Suisse's head of European credit, William Porter, believes that leaving the EMU is exceptionally difficult and is an expensive way to default (see his note, *Leaving EMU is just an expensive way to default*, 15 March 2010).

What are the possible scenarios?

Below we show an overview of the possible scenarios for the outcome of the Greek sovereign crisis.

Figure 15: Greek debt crisis – scenarios and probabilities

Stage 1			Stage 2			
Description	Trigger/rationale	Probability	Description	Trigger/rationale	Probability	Market impact
No Greek default within 6 months - "Muddle-through"	Austerity measures approved by Greek Parliament	75%	Austerity & EU/IMF support continue, voluntary roll-over of debt, restructuring postponed until 2013	"Buying time" to allow Greece to run primary surplus, banks to build up capital, acceptable to core European electorate, ECB preferred option	75%	Markets rise
Greek unilateral default within 6 months	Austerity measures rejected by Greek Parliament	20%	Quick policy response	Ring-fence Spain, ESM/EFSF extended, ECB accelerating purchases of peripheral bonds, agreed restructuring of Portuguese and Irish debt, IMF helps to recapitalize banks	15%	Markets fall c10% then rally
			Poor policy response	Governments cannot act quickly for the opposition of the electorate in core Europe and fail to stop contagion - resulting in disorderly default in Greece, Portugal and Ireland	5%	Markets fall 20%
Core Europe stops supporting Greece	German Parliament rejects new bailout funds or German Constitutional Court rules against them	5%	All emergency support stops, triggering sovereign defaults	Without German support, all EU/IMF plans cannot be implemented.	5%	Markets fall 20%

Source: Credit Suisse research

'Muddle-through' scenario – 75% probability

Under this scenario, the Greek Parliament approves the new austerity measures by the end of the month, the IMF/EU disburses the 5th tranche of the bailout package in July (€12bn) and the Euro countries find a compromise on a voluntary roll-over of Greek debt along the lines of the 'Vienna initiative'.

Under this scenario, a restructuring will eventually take place in 2012 or 2013 (with the new permanent bailout mechanism, ESM, being operative from July 2013) and the ECB will keep providing unlimited liquidity to the Greek banks and accept Greek bonds as collateral. This would involve the ECB repo-ing more and more ECB bonds (as deposit flight continues).

We believe that there will be a form of debt roll-over that will not be considered a default. For example, Fitch has already suggested it would not count the issuance of new securities to replace existing ones as a default, as a coupon payment would not have been missed (in a way that Greece would keep its CCC rating and the ECB would keep on accepting GGBs as repo collateral). A seven-year extension of a two-year Greek bond would result in the NPV falling by 20-30% on our calculations (assuming bond yields post-restructuring fall 200-400 bps) and yet banks may be able to mark their assets at par value on their banking book.

Figure 16: NPV reduction of an extension of maturity of a two-year Greek bond

	NPV % change for a Greek 2-year bond				
Extension of:	**Current Bond yields**	**-100bps**	**-200bps**	**-300bps**	**-400bps**
3 years	-20%	-17%	-13%	-10%	-7%
7 years	-37%	-33%	-29%	-25%	-20%

Source: Thomson Reuters, Credit Suisse research

Therefore, the 'muddle-through' scenario continues until it is less risky to have a complete restructuring of Greek debt which is when:

a) There is sufficient liquidity set up in the bailout funds to ring-fence Spain, which unlike Ireland and Portugal, does not have a solvency problem. In other words, the financing of the ESM as been agreed and both the ESM and EFSF have been extended.

b) Banks are better capitalised (via retained earnings).

c) The counterparty risk of banks is known after the results of the European stress test are complete.

The main incentives for the major players in a 'muddle-though' scenario are:

a) Greece does not achieve a primary budget surplus until 2012 at the earliest, according to the IMF. Only at that point will Greece be in a good negotiating position.

b) Each year the ECB makes c€10bn on its holdings of peripheral European debt.

c) Each year Greek banks' pre-provisioning profits are equivalent to almost 20% of shareholders' equity, while European banks overall earn pre-provisioning profits equivalent to around a quarter of equity every year, thus allowing the banks sector to recapitalise through retained earnings.

d) The French and Germans do not want a default before the other countries in the European periphery – and especially Spain – are ring-fenced to ensure a Greek default does not lead to speculative attacks on these. *While critically the issue in Greece, Portugal and Ireland is one of solvency, not liquidity - in Spain we think that there is not a solvency issue and thus extending the ESFS and ESM would help to ring-fence Spain, which as we have highlighted above is the critical country, in our view.*

e) The ECB ends up owning or repo-ing more and more peripheral Europe debt (owing to deposit flight) and since the recap of the ECB has to be all of Europe, this, de facto, passes the burden of peripheral Europe onto core Europe (which would be the only region able to afford the recapitalisation of the ECB).

We think that if the austerity measures are passed, then there will quite quickly be a voluntary debt roll-over and maybe some improvements in the conditions attached to the bailout funds (extension of maturity, lower interest rate but also the front-loading of EU structural funds). This should buy the required time (a couple of years as above).

If the austerity measures are passed but then only partially implemented then we will return to today's situation in 6 to 12 months' time (although hopefully the problems would not be so acute as by that stage the ESM should have been passed and results of the banks' stress test should be clear).

What are the key dates?

- The financing of the ESM – to be operative in mid-2013 – with the issue of the initial financing that has not yet been agreed.

- The result of the stress test of European banks so that potential counterparty risks are known. This is due in mid-July.

Below we show a detailed political calendar that highlights the critical events in Europe over the next two years (see Niall O'Connor's note, *Greece and Greece Macro*, 16 June, for more details).

Figure 17: Detailed European political calendar

Date	Event
27-28 June 2011	Greek parliament to review new fiscal plan
30 June 2011	Greek parliament to vote on new fiscal plan
03 July 2011	Eurogroup meeting to discuss Greece
mid-July	EZ/IMF due to disburse €12bn tranche 5
11 July 2011	Eurogroup/Ecofin meeting (last before summer break)
13 July 2011	EBA banks' stress tests published?
15 July 2011	Coupon payments of €3.1bn due, as well as bills of €4bn
August	we expect Bailout 2.0 to be in final discussion
20th August	€6.8bn bond maturity
30th August	IMF 5th review due; €8bn to be disbursed by EZ/IMF around 2 weeks later
October	Trichet leaves
November	independent review of Greek banks loan books due
19-Dec	€1.2bn bond maturity
29-Dec	€4.6bn bond maturity
May, June 2012	French Presidential and parliamentary elections due
Apr-13	Greek parliamentary elections due

Source: Credit Suisse European Banks team

Who owns Greek debt and how much money does Greece need?

Currently, the ECB is the major owner of Greek government bonds, followed by Greek banks, as shown below.

Figure 18: The ECB is now the biggest owner of Greek government bonds

Nominal, €bn	Q4 2010
IMF/EZ	38
ECB	60
Greek pension funds	8
Greek banks	59
Other european banks from CEBS	40
Other european banks not reporting in CEBS	9
Swiss banks, major	0
European insurers	11
US banks	very low
Remainder	102
Total	**327**

Source: IMF, Credit Suisse European Banks team estimates

In the short term, the risk is that Greece may not have enough money to meet debt repayments, with €6.8bn due on 20 August.

Our European banking team highlights that the additional funding required by Greece to meet its payment obligations until the start of the ESM in July 2013 is about €163bn.

Figure 19: **Details of borrowing needs of the Greek government until 2014**

Time	Gross borrowing needs	Maturing bonds		Privatization (max)
		Total	held by Greek banks	
2011	59	28	7	6
2012	67	31	6	6
2013	61	26	5	6
2014	78	32		na
Remaining 2011 (as at 16/6/11)	35	13	3	6
2013 to start of ESM (end July)	42	20	3	3
Cumulative from now to...				
... start of 2014	163	70	14	17
... start of 2013	102	44	9	12
... start of ESM	144	63	12	15

Gross borrowing needs = primary deficit + coupons + maturities

Source: IMF, Credit Suisse European Banks team estimates

Of this, €57bn would be covered by the remaining funds of the IMF/EZ bail-out package, bringing the financing requirement down to €87bn. This falls to €73bn once we include proceeds from possible privatization and to €51bn if we assume that debt held by European banks and maturing between now and July 2013 will be rolled over, according to our European bank analyst Niall O'Connor.

Figure 20: **So far, €53bn of the €110bn IMF/EZ money has been disbursed. Assuming the remaining €57bn will be paid out, the funding shortfall between now and the start of the ESM will fall to €87bn**

Funding needs from now to start of...	... 2013	... 2014	... ESM	... ESM + Vienna initiative	... ESM + general maturity extension
GFN	102	163	144	123	81
IMF/EZ	57	57	57	57	57
Shortfall	45	106	87	66	24
...including privatization	*34*	*89*	*73*	*51*	*9*

Source: IMF, Credit Suisse European Banks team estimates

Greek unilateral default – 20% probability

In this scenario, the Greek Parliament refuses to vote through the austerity measures. Under such circumstances, it is very hard to see the IMF, ECB or any European countries agreeing to supply more money to Greece. With no access to markets, a primary budget deficit and €35bn and €67bn financing needs for the rest of this year and 2012E, Greece would then announce a moratorium on interest and principal payments – a technical default.

We think that if default leads to Greece leaving the Euro it would face potentially a decline in GDP of 20% to 30%.

In a unilateral default scenario, we see two options:

i) Unilateral default with poor European policy response (5% likelihood); the ECB stops repo-ing Greek government bonds and European governments are constrained from acting quickly by fears of a backlash from their local electorates.

This forces a steep decline (30% plus) in Greek bank assets (given the loan to deposit ratio of 110%) – maybe leading to a 20-30% fall in GDP in Greece.

We only put a 20% likelihood on this scenario because the ECB has shown itself to be able, when pushed, to act aggressively (buying peripheral European debt directly, easing of collateral rating requirements, unlimited liquidity provisions) and the core Europe leaders (Merkel and Sarkozy) have again been willing to come up with substantial support packages. The politics would become harder (because German banks and the ECB would have lost money supporting Greece, ultimately in vain) yet the signs of the obvious consequences of not acting rapidly become clearer. For example, a potential break-up of the Euro would lead to a strong appreciation of a new Deutsche Mark, the 20% to 30% decline in peripheral European GDP, trade tensions as well as losses of c€120bn to French and German banks (assuming a 40% haircut on all peripheral European debt excluding Spain), compared with an aggregate book value of only €270bn for the quoted sector and €880bn of total capital for the banking system overall, according to central bank data.

If there is no quick reaction by the European governments and the ECB, then we would expect exceptionally large deposit flight into Germany and a break up of the Euro with an establishment of a new core Europe. Into such a scenario it would be quite easy to see European GDP falling 5%-10% as capital markets cease to function. There is a likely seizing up of the inter-bank market, and potentially a problem with money market funds, with our head of the US interest rate team highlighting that 43% of US mutual funds' holdings are in European bank assets in the form of CDs, CP, repo and notes (*US Interest Rate Strategy Weekly*, 17 June 2011). This would likely lead to a contraction in the availability of working capital (to finance inventory, creditors etc) as well as a significant loss of confidence. Any vaguely threatened currency would see a huge capital flight which the ECB would be unable to offset and, in turn, that could lead to a steep decline in bank assets.

Clearly, a unilateral Greek default could trigger a speculative attack on peripheral Europe, especially that part of peripheral Europe which has unsustainable fiscal positions, mainly Portugal and Ireland. The funding still available under the EFSF (and ESM) and IMF amount to c€800bn – this would cover the financing needs of the periphery only until 2013 – and this is excluding Italy.

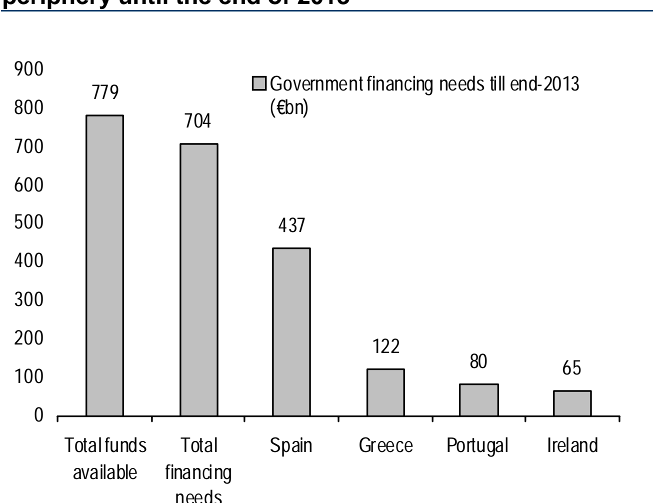
However, the problem is that no amount of liquidity can solve an insolvency problem.

Figure 21: Bailout funds available for the periphery are still c€800bn ...

Total additional effective lending capacity (€bn)	
EFSF (ESM after mid-2013)	440
EU - EFSM	60
IMF (50% of EFSF/EFSM combined)	250
Greek bailout	110
Total	860
minus Greek bailout funds already disbursed	53
minus Irish bailout (total €85bn) already disbursed	22
minus Portuguese bailout (total €78bn) already disbursed	6.5
Total	**779**
% Peripheral Europe GDP	48%
% Peripheral Europe government debt (2014E)	40%
% Peripheral Europe financing needs till end-1013	**111%**
% Euro-area GDP	8%

Source: Thomson Reuters, Credit Suisse European Economics team

Figure 22: ... this would cover the financing needs of the periphery until the end of 2013



Source: Thomson Reuters, Credit Suisse European Economics team

We think this would lead to only one conclusion: any company or country requiring capital would trade down significantly: illiquidity would become synonymous with insolvency. Markets could easily fall up to 20% under this scenario.

Meanwhile there would be a significant re-rating of the 'safe' European countries. Germany, Switzerland and Sweden all rank in the top seven of our global country risk table (see Appendix 2). We remind investors that into a default with a poor policy response scenario certain equities are likely to have a better credit rating than their governments and we believe that governments would struggle to raise corporation taxes (as corporates are likely to move to avoid higher tax rates). Appendix 3 highlights those stocks that have a better credit rating and higher yield than their respective governments.

ii) Unilateral default with quick policy response (15% likelihood):

The markets have been through the Lehman Brothers bankruptcy and this will very quickly remind central bankers and politicians of the dangers of not acting – in the case of Lehman, obscure money markets breaking the buck caused the CP market and corporate funding market to dry up. This is why we believe that within a few days there would be a very aggressive response from both the ECB and core Europe. Clearly the fear is that only financial market meltdown (equities down c10% and interbank markets temporarily seizing up) would force the ECB and the German government to respond quickly.

We suspect that the ECB would initially take the brunt of the policy response – after all, if it did not, then the Euro and ECB would in all probability cease to exist. It is quite possible that the smaller members of the ECB (Malta, Slovenia, Slovakia, Estonia and Cyprus), fearing the obvious consequences of the break up of the Euro, would give their critical support in the governing council to force the ECB into some form of QE. We note the periphery have 6 seats on the ECB, out of a total 23 and if combined with these smaller countries that count would rise to 11 seats out of 23.

The ECB has shown that it can move quickly. It could commit to target a certain bond yield if various fiscal criteria were met (and in extremis the German government could agree to underwrite Spanish bond yields at a certain level if Spain kept to strict fiscal criteria). Indeed, once Greece defaulted, the cost in a worst-case scenario of getting Portuguese and Ireland government debt to GDP down to sustainable levels (100%) would be €110bn and we think some form of debt extension would occur to move balances back to sustainable levels (eg, extending the maturity of the debt by a few years, allowing the banks not take any impairments on bonds held in their banking books).

Under extreme circumstances, we believe the ECB would be willing to repo so-called defaulted bonds or buy them directly. We think that ESM, EFSF and other facilities would, with the help of the IMF, be extended very quickly to provide sufficient support to ring-fence Spain. The IMF could lend money to banks indirectly to help with their recapitalisation.

Under this scenario, a unilateral Greek default would not lead to an exit of Greece from the Euro.

Clearly the Euro would weaken significantly, as would equities initially (10-15% down). But as the policy response unfolds (i.e. the ECB participating in QE), there could be an attractive buying opportunity depending on the shape and size of the response, with the Portuguese and Irish debt, post-restructuring, put on a sustainable footing. In effect, the ECB along with the Fed and the BoE (and if necessary the BoJ) would likely be willing to debase their currency. This would force investors to seek 'real' assets (of which arguably the cheapest is equities). This scenario this would also likely be positive for gold (possibly rising to c$2,000 per oz).

Core Europe stops supporting Greece – 5% probability

This is a low-probability scenario (as we argue above, it is in the interest of core Europe to avoid a collapse in peripheral Europe) but it is not unthinkable that the German Parliament will stop supporting the Greek bailout. According to the FT (20 June), dissident MPs of the ruling coalition said that the acceptance of a roll-over of debt instead of a formal restructuring may not be enough to win a majority in parliament, with even the opposition SPD now suggesting a withdrawal of support in which case the ruling coalition would not be able to reach a majority on its own. We think the outcome of this scenario is the same as that of a unilateral default with a poor policy response.

What would happen if the Euro were to break apart?

As we highlighted on page 8 above, we believe that if the peripheral European countries left the monetary union, they would likely be forced to default, causing losses of around €500bn to core Europe. In particular, we think there would be c€290bn hit to banks in core Europe (given that German, French, Dutch and Belgian banks have around €720bn of total exposure to the periphery, according to BIS data). This compares with total core Tier 1 capital in the quoted core European banking system of €220bn, according to our banks team, and €1,040bn of total capital and reserves for their banking system, according to central bank data (though our banks team highlights that the latter number might overstate the sector's actual capital, given that it is based on non-consolidated figures and does not adjust for provisions).

A back-of-the envelope calculation based on these figures suggests that in the case of a Euro-area break-up, the core European banking system would require recapitalisations of around €170bn (currently the tier 1 capital position of the European banking system is around 9%; that means that, using the central bank figures on capital and assuming a target ratio of 8%, there is currently around €120bn of excess capital – which would turn into a €170bn shortfall in the default scenario we are envisaging).

We also highlight that our European Credit Team has in a recent note (*A Nash equilibrium for Greece*, 15 June 2011) analysed the Greek debt situation within a game theory framework and found that – in a multi-step game – the only Nash equilibrium would imply the following:

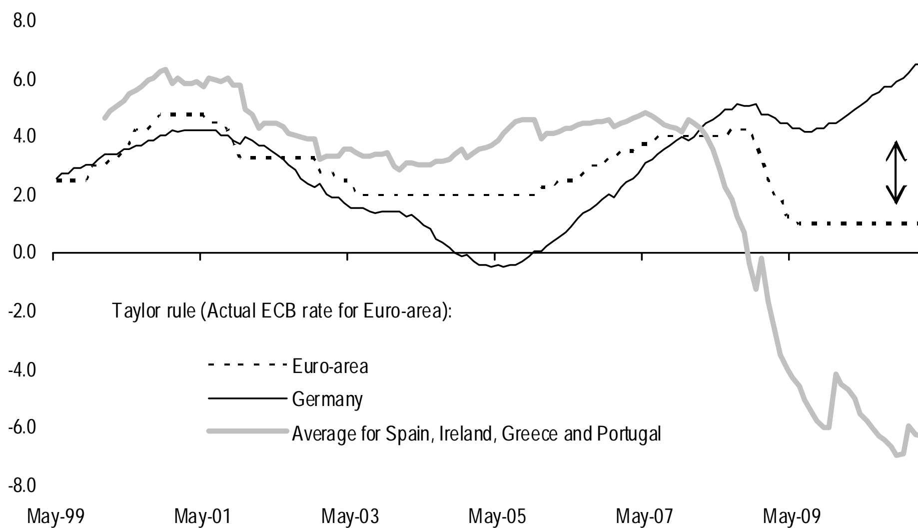
- ECB continuing to accept Greek collateral despite being downgraded to default
- A private sector participation in loss-sharing, more additional bailout funds
- Further austerity measures taken by Greece

Investment conclusions under the 'muddle-through' scenario

1) Buy plays on Germany

We believe Germany will likely continue to see a monetary policy that is too loose – and thus we continue to buy domestic Germany. Our models, based on a simple Taylor rule (inflation and unemployment rate), indicate peripheral Europe needs a policy rate of *minus* 6.5%, while Germany needs policy rates of 6%. Rates at current levels (1.25%) are equivalent to a 2pp boost to German GDP growth, on the OECD Interlink model.

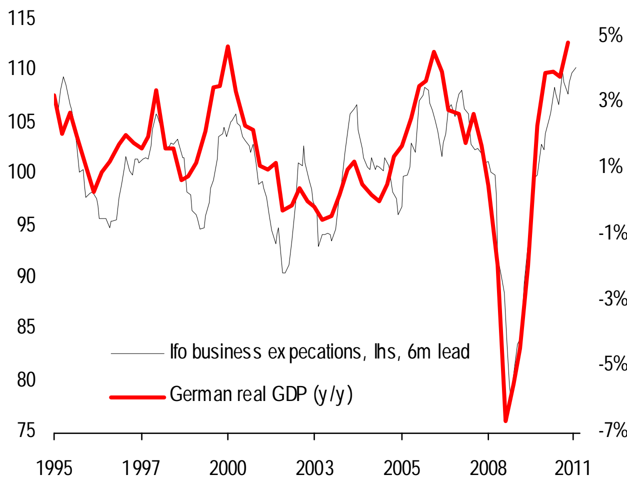
Figure 23: **The Taylor rule suggests a 6% short rate in Germany and *minus* 6% in peripheral Europe**



Source: Thomson Reuters, Credit Suisse research

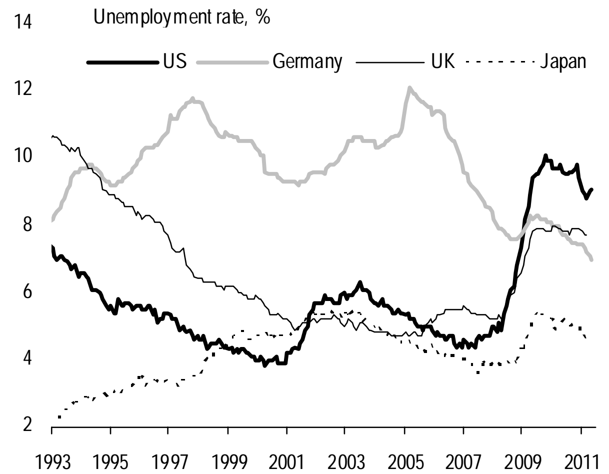
Additionally, Germany is underleveraged: it has a cyclically-adjusted budget deficit of just 0.8% this year (with government debt to GDP at 75%, i.e. 20pp below that of the US), the third most undervalued housing market globally, unit labour costs that appear highly competitive, unemployment at a 20-year low and high pent-up demand with a savings ratio of 12%. The two new catalysts for growth are: a) negative real rates (forcing consumers to spend) and b) immigration, which could lead to an influx of up to 800,000 people, on the back of the recent ending of the work restrictions for immigrants from the Eastern European countries that joined in the European Union in 2004.

Figure 24: **The IFO index is consistent with c5% real GDP growth**



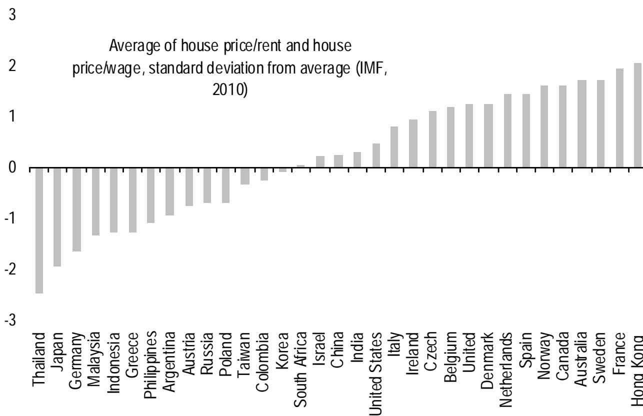
Source: Thomson Reuters, Credit Suisse research

Figure 25: **German unemployment is at a 20-year low**



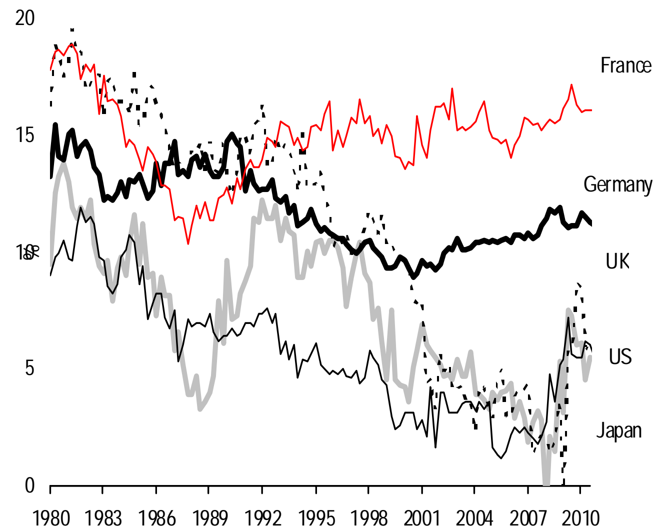
Source: Thomson Reuters, Credit Suisse research

Figure 26: **Housing is undervalued in Germany**



Source: IMF estimates

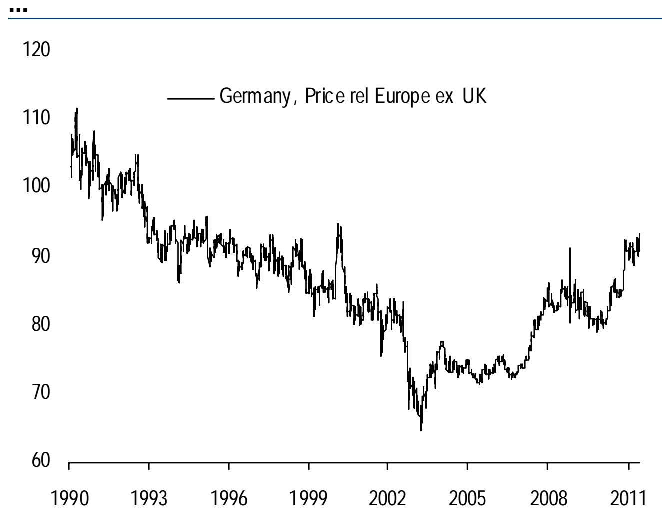
Figure 27: **Savings ratio still high in Germany**



Source: Thomson Reuters, Credit Suisse research

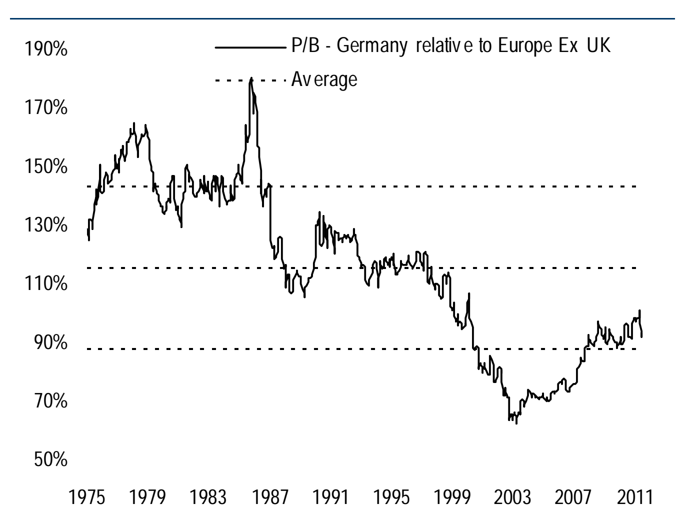
We find it interesting that Germany, even after an outperformance of 18% since November 2009, still trades at a 6% discount to Europe on price to book compared with an average premium of 16% (on consensus P/E, Germany trades at a 1% discount compared with an average premium of 8%).

Figure 28: Germany is outperforming Continental Europe ...



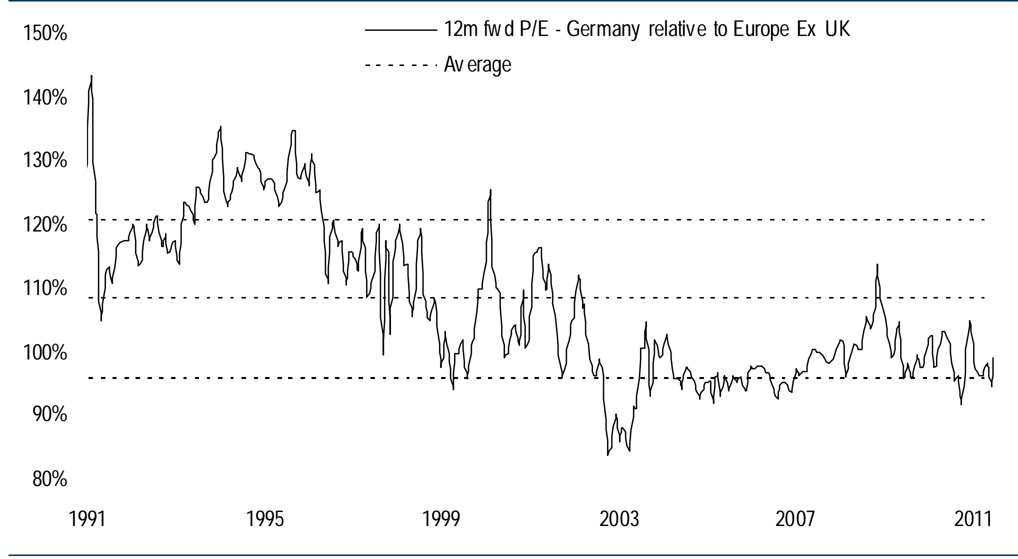
Source: Thomson Reuters, Credit Suisse research

Figure 29: ... but it is still cheap on PB



Source: Thomson Reuters, Credit Suisse research

Figure 30: Germany is also cheap on consensus P/E



Source: Thomson Reuters, Credit Suisse research

We would focus on the following domestic German names: Deutsche Wohnen, Commerzbank and Euroshop—all of which are Outperform-rated by Credit Suisse.

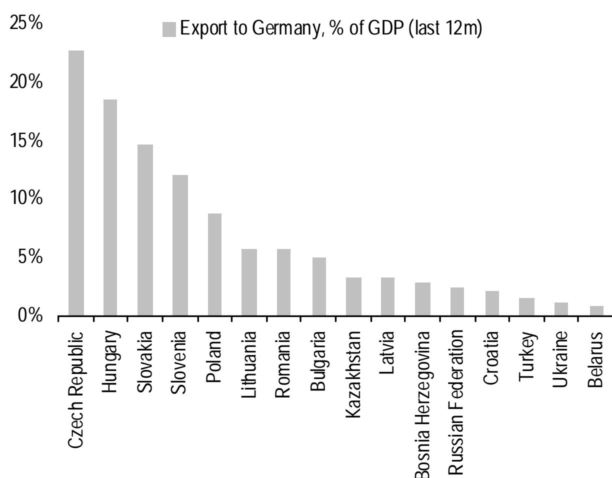
Figure 31: German domestic plays

Name	Domestic Sales Exposure (%)	P/E (12m fwd) Abs	P/E (12m fwd) rel to Industry	P/E (12m fwd) rel to mkt % above/below average	P/B Abs	P/B rel to mkt % above/below average	Yield (2011e) FCY	Yield (2011e) DY	HOLT Price, % change to best	Momentum 3m EPS	Momentum 3m Sales	Consensus (buy less holds & sells)	Credit Suisse rating
Deutsche Wohnen Ag	100%	21.5	132%	n/a	1.0	n/a	n/m	2.2%	-50.9	-3.1	4.5	6.7	Outperform
Commerzbank Ag	93%	6.8	72%	-21%	0.2	-77%	n/m	0.0%	-1.2	-3.9	1.7	-24.1	Outperform
Deutsche Euroshop	83%	17.7	109%	n/a	1.2	n/a	n/m	4.0%	-20.4	-0.3	5.5	-47.8	Outperform
Fielmann Ag	81%	22.3	158%	55%	5.7	101%	4.0%	3.5%	-43.5	0.1	-0.3	-33.3	NR
Axel Springer Ag	79%	11.1	85%	-26%	2.1	-36%	5.4%	4.9%	-5.3	-3.3	1.1	42.9	NR
Douglas Hldg Ag	66%	14.4	102%	14%	1.9	-8%	5.5%	3.2%	-2.3	-3.1	-0.3	-30.0	NR
Metro Ag	39%	11.1	84%	-4%	2.4	7%	2.1%	3.3%	-14.1	-0.9	-1.2	7.3	Neutral

Source: IBES, MSCI, Thomson Reuters, Factset, Credit Suisse HOLT®, Credit Suisse research

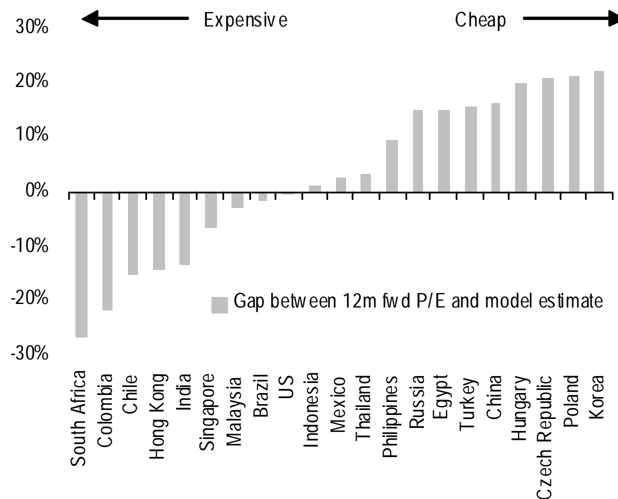
As likely beneficiaries on a boom in Germany, we would also focus on those countries where export exposure to Germany is most significant. This highlights the Czech Republic and Hungary. Interestingly, on our GEM model, Poland, Czech Republic and Hungary also appear undervalued. We would focus on domestic plays in parts of Eastern Europe.

Figure 32: Czech Republic and Hungary have the biggest exposure to Germany



Source: Thomson Reuters, Credit Suisse research

Figure 33: Poland, Czech Republic and Hungary look cheap on our models



Source: Thomson Reuters, Credit Suisse research. The P/E model is based on total debt, budget balance, current account, gross savings ratio, potential GDP growth and inflation.

Our EMEA strategist, Alex Redman, highlights OTP in Hungary and PKO BP and TVN in Poland as attractive plays on German growth.

We also note that the following US companies have high exposure to Germany (>15% of total sales).

Figure 34: US companies with high exposure to Germany

Name	Germany Sales Exposure %	-----P/E (12m fwd) ------ Abs	rel to Industry	rel to mkt % above/below average	------ P/B ------- Abs	rel to mkt % above/below average	Yield (2011e) FCY	DY	HOLT Price, % change to best	Momentum 3m EPS	3m Sales	Consensus (buy less holds & sells)	Credit Suisse rating
First Solar Inc	74%	11.6	101%	n/a	2.8	n/a	2.6%	n/a	49.8	-0.7	-0.6	7.0	Neutral
Harman International	42%	15.2	95%	46%	2.3	-29%	3.7%	n/a	23.6	NM	NM	n/a	Neutral
Rockwood Holdings Inc	41%	12.5	95%	n/a	2.8	n/a	8.1%	0.0%	-5.0	29.5	6.0	11.1	Outperform
Borgwarner Inc	37%	14.4	121%	n/a	3.2	n/a	4.9%	0.0%	3.6	-2.0	2.4	-10.0	Neutral
Celanese Corp	36%	10.2	77%	n/a	6.6	n/a	8.0%	0.5%	-28.7	9.2	3.1	63.6	Outperform
Wabco Holdings Inc	32%	12.9	93%	n/a	7.8	n/a	6.0%	n/a	39.8	11.1	4.5	42.9	Outperform
Dentsply Internatl Inc	21%	18.0	117%	34%	2.7	-4%	4.6%	n/a	-16.9	-5.3	-1.5	-9.1	Neutral
Sirona Dental Systems	20%	15.8	103%	n/a	3.3	n/a	7.0%	0.0%	13.3	1.0	4.1	62.5	Outperform
Kennametal Inc	19%	11.2	81%	n/a	2.1	n/a	7.5%	1.3%	31.0	7.9	1.6	16.7	Outperform
Trw Automotive	19%	7.3	62%	n/a	2.7	n/a	13.0%	n/a	21.3	9.3	2.5	80.0	Outperform

Source: IBES, MSCI, Thomson Reuters, Factset, Credit Suisse HOLT, Credit Suisse research

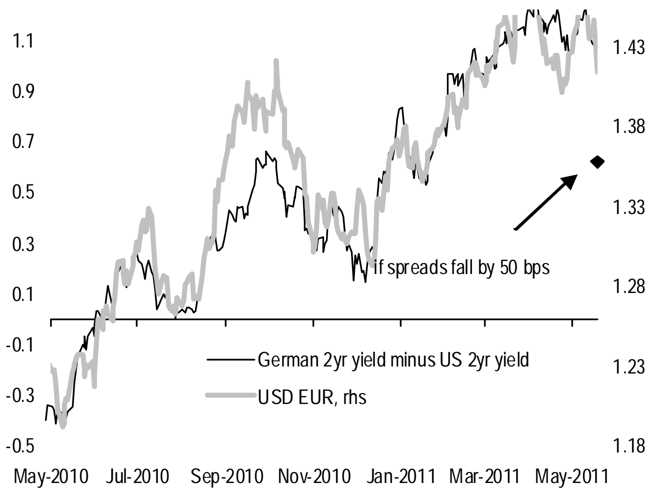
2) The Euro should weaken slightly (maybe to €/$1.35)

We think the ECB will end up pursuing a looser policy than is generally expected in terms of rates (see above) – but more importantly in terms of quality of its balance sheet. On rates, we think that with wage growth of only 1.4% there is unlikely to be an inflation problem, and the combination of exchange rates, fiscal policy and the Euro has taken nearly 1% off GDP growth.

Additionally, as mentioned above, the excess leverage in peripheral Europe and the prevalence of variable rates on mortgages is a constraint on the degree to which the ECB can raise rates.

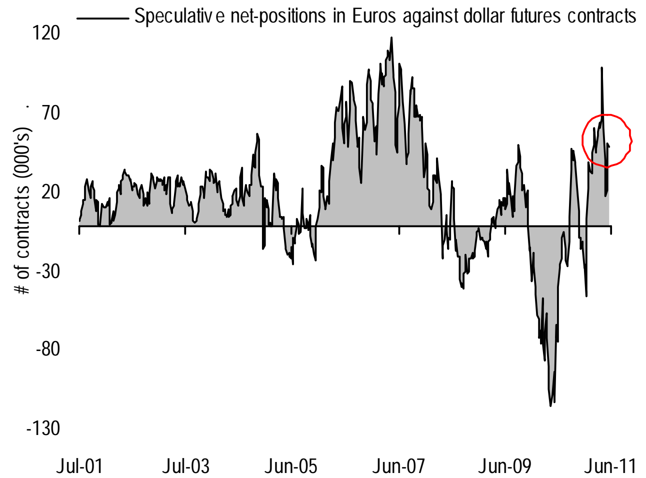
A looser monetary policy will likely lead to a compression of the interest spread between European and US short-term rates – and there is a close relationship between the relative two-year note yields and the Euro/$. We also note that the net long speculative positions on the Euro are still significant.

Figure 35: **The Euro/$ is strongly correlated with the interest rate differential**



Source: Thomson Reuters, Credit Suisse research

Figure 36: **The net long speculative positions on the Euro are significant**



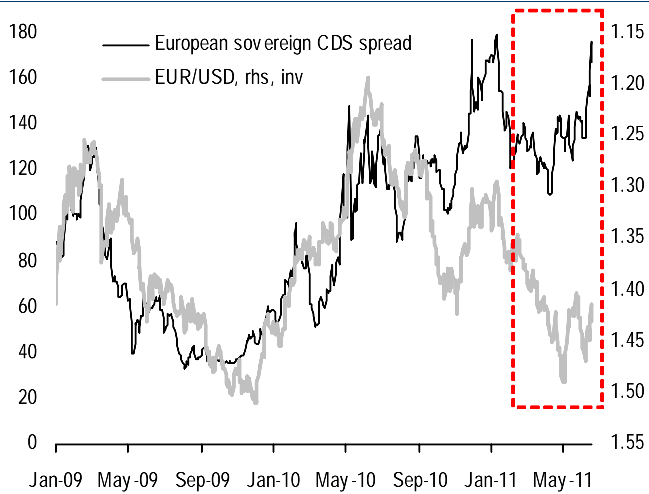
Source: Thomson Reuters, Credit Suisse research

The deterioration in the balance sheet is potentially even more interesting. Currently the ECB balance sheet is €1.9trn, or 20% of GDP, with about €100bn of Greek bonds and c€300bn of other peripheral bonds accepted as collateral in repo operations, according to our European interest rate team.

We think that the ending of the Greek crisis will inevitably be the ECB owning directly or indirectly an ever larger share of Greek public debt. There will continue to be deposit flight in peripheral Europe, leading to a fall in bank assets, and only the ECB could step in to stop this. This will continue to increase the exposure of the ECB's balance sheet to peripheral European debt. Clearly, the counterparty risk could be high, given that around 70% of all repo operations are to banks in peripheral Europe, according to our economists. Thus, the quality of the balance sheet is likely to deteriorate. Indeed, the market might worry that, if there is a default, the ECB might have to do some form of QE to recapitalise itself (currently the ECB has only €81bn in capital and reserves).

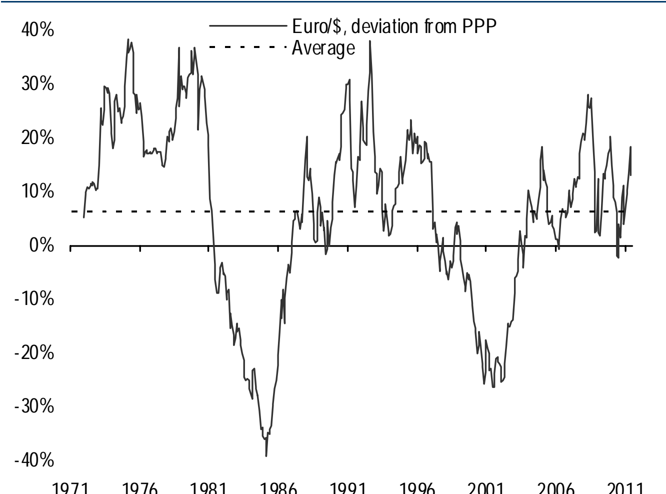
European sovereign CDS spreads are consistent with the Euro falling to €/$1.20 to 1.15 and the Euro still trades 13% above the PPP rate (€/$1.25 on OECD estimates).

Figure 37: The sovereign credit spread would suggest a weaker Euro ..



Source: Thomson Reuters, Credit Suisse research

Figure 38: ... and the Euro is still 13% expensive vs the US$ on a PPP basis



Source: Thomson Reuters, Credit Suisse research

We note that our view on the Euro is more pessimistic than our FX team, which forecasts €/$1.52 on both a 3-month and 12-month basis.

3) Stay underweight domestic peripheral stocks

We believe that there will be more wage deflation required outside of Ireland – and this sits uncomfortably with consensus nominal GDP forecasts, as shown on page 4 above, which are optimistic in our view.

In particular, we are very cautious on Spain for the following reasons:

i) Wage growth is still running at 2.8% a year (and on our estimates wages need to fall by 5% to bring relative competitiveness back to historical average levels) and core inflation is 2.1% year (against 1.5% in the Euro area as a whole), suggesting there has not been a large gain in competitiveness so far. Furthermore, Spain has yet to turn a current account deficit of 4.6% of GDP into a surplus.

ii) We note that real retail sales growth is minus 2% and the unemployment rate – above 21% – is still rising.

iii) Private sector leverage needs to fall by as much as c70% of GDP, we believe (given the experience of other banking crises), but so far only 1.4% has occurred.

iv) We think that in order to stabilise government debt-to-GDP Spain needs to implement fiscal tightening of 9.2% of GDP by 2014E, compared with 4.2% announced so far. While we think this is achievable it will clearly have a negative impact on growth.

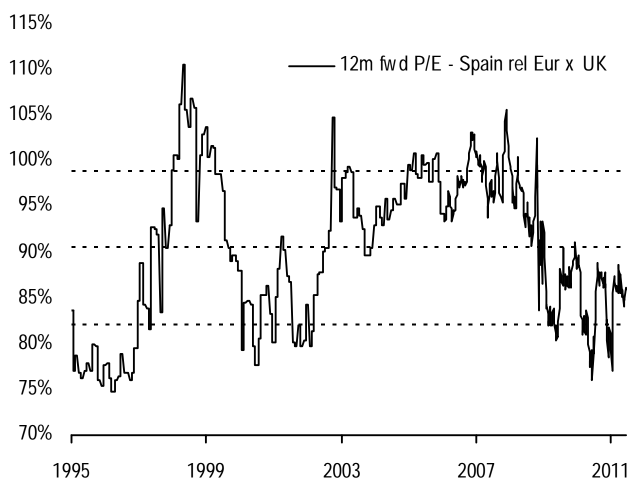
v) House prices are down only 15% since 1Q2008, but back in 2007 the housing boom (in terms of excess housing construction) and the housing price bubble looked worse than Ireland, where prices are down c40%.

vi) There is political risk in Spain, with the largely autonomous regions accounting for about a third of the public debt and having less of an incentive to meet the fiscal targets assigned to them by the central government.

vii) Valuations are still not cheap enough (Spain trades roughly in line with its historical discount relative to continental Europe).

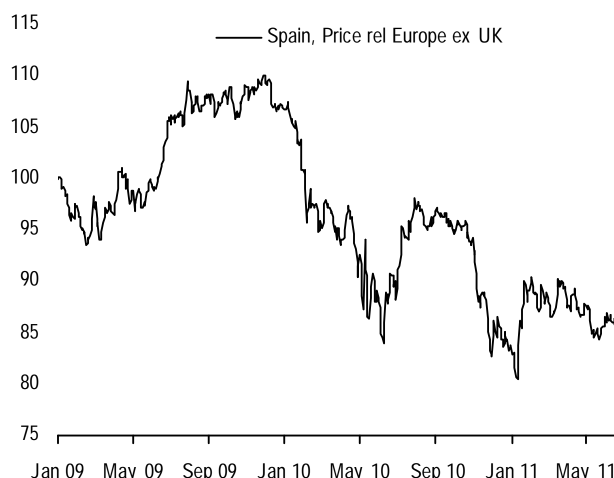
viii) 29% of earnings for the Spanish market come from Latin America – and we remain concerned about Brazil (where the consumer debt service ratio is a very high 25% due to average interest rates charged by banks being 46%; with an average maturity of the debt of 1½ years, the debt service charge rises as rates rise).

Figure 39: Spain is not cheap on 12m forward P/E relative to Continental Europe



Source: Thomson Reuters, Credit Suisse research

Figure 40: Spain relative performance



Source: Thomson Reuters, Credit Suisse research

Below we show domestic peripheral stocks that look expensive on our screens.

Figure 41: Peripheral European stocks with more than 70% domestic sales exposure and look expensive on HOLT

		-----P/E (12m fwd) ------			------ P/B -------		Yield (2011e)		HOLT	Momentum			
Name	Domestic Sales (%)	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus (buy less holds & sells)	Credit Suisse rating
Brisa(Auto-Estrada	100%	20.0	91%	29%	1.4	-47%	12.0%	7.0%	-29.0	-8.3	-0.3	-4.8	Underperform
Sonaecom Sgps Sa	100%	12.6	90%	n/a	0.5	n/a	6.9%	3.4%	-30.2	15.0	-0.1	40.0	NR
Red Electrica Corp	100%	11.8	80%	n/a	3.5	n/a	-0.4%	5.1%	-7.0	0.5	0.9	18.5	NR
Enagas Sa	100%	10.4	68%	-15%	2.2	3%	-2.4%	5.6%	-38.5	-0.2	0.4	42.9	NR
Logistic Hidrocarb	100%	n/a	n/a	n/a	9.2	n/a	-3.4%	n/a	-12.1	n/a	@NA	n/a	NR
Tt Hellenic Postba	100%	9.9	106%	n/a	0.9	n/a	n/m	0.0%	-37.1	3.4	1.4	-84.6	Underperform
Emporiki Bank	100%	13.5	n/a	71%	0.9	-57%	5.6%	n/a	-7.7	NM	NM	n/a	Underperform
Cimpor Cimentos De	100%	12.6	85%	30%	1.7	-1%	6.7%	3.9%	-19.0	-1.3	-1.5	42.9	NR
Criteria Caixacorp	99%	10.2	118%	n/a	1.3	n/a	n/m	5.2%	-19.5	0.0	NM	-33.3	NR
Bco De Sabadell	96%	11.3	121%	15%	0.7	-52%	n/m	3.8%	-4.4	-6.5	3.8	-100.0	NR
Zardoya-Otis	95%	20.0	144%	21%	16.8	22%	5.0%	4.8%	-61.2	-2.5	-2.7	-84.6	NR
Sonae Sgps Sa	92%	8.8	70%	-30%	1.0	-22%	-3.1%	4.0%	-5.8	-10.3	-1.9	11.1	NR
Fom Const Y Contra	91%	10.1	73%	9%	0.9	-57%	15.4%	6.5%	-48.9	-6.9	-2.1	-18.2	Underperform
Vivartia Hldg Sa	84%	n/a	n/a	n/a	2.2	n/a	-3.8%	n/a	-82.9	n/a	@NA	n/a	NR
Promotora De Info	78%	6.8	52%	-51%	0.4	-85%	9.0%	0.0%	-24.8	-17.5	-0.7	29.4	NR
Sol Melia Sa	73%	26.5	159%	n/a	1.5	n/a	-0.2%	0.7%	-54.2	1.4	2.7	0.0	NR

Source: IBES, MSCI, Thomson Reuters, Factset, Credit Suisse HOLT, Credit Suisse research

We stress that we do not think Spanish government bonds will need a haircut – but this outcome will be avoided only at the expense of greater deflation, in our view.

4) European banks need to be trading on 0.8x TB to be considered a buy

Banks do not look an attractive investment proposition, in our opinion, until they trade down to around 0.8x to 0.9x tangible book (against 1x currently in Continental Europe). On our calculation the cost of Tier 1 debt is 7.5% and thus the cost of equity is 10.5% and hence banks require a 10.5% long term RoTE to offer value.

Between 1960 and 1990 US banks returned a 11% RoTE (the UK was lower because of the building societies which were not profit-maximising, being mutually owned). We believe that banks ought to trade around 20% to 30% below their long term fair value to reflect many different risks to their business models: excessive regulation (because bank assets as a proportion of GDP are over 200% in five European countries and hence regulators tend to want banks to be smaller); dis-intermediation (86% of lending to corporates in Europe is done by banks, double the proportion of the US); a change in the bail-in clause (that could increase the cost of debt as debt becomes riskier); a rise in cost of liquidity (with a loan deposit ratio of 145%, our banks team points out that a 10bp rise in wholesale funding costs for Lloyds would hit 2012E attributable profits by 3.4%).

Our Greek banks analyst, Niall O'Connor, highlights that Greek bank shares appear to be pricing in a 35% haircut and a recapitalisation to 9% core Tier 1.

Our favourite bank in the region is Bank of Cyprus (Outperform) which is a beneficiary of better credit ratings than its peers, and now has a 29% market share of deposits in Cyprus, up from 25% at the end of 2009.

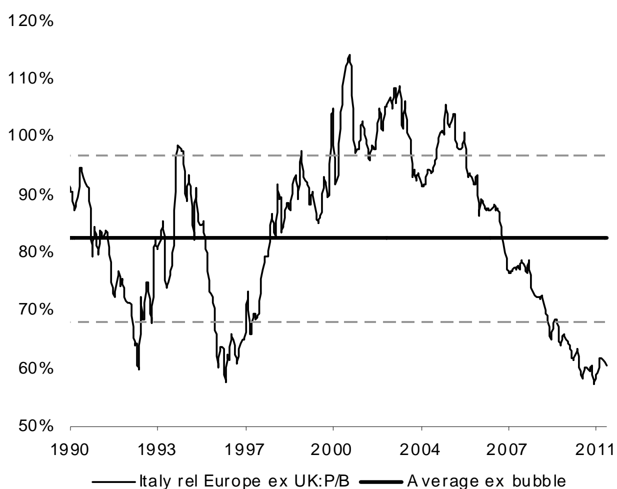
5) Buy cheap Italian domestic stocks

From a macro point of view, Italy has five advantages:

- A primary budget surplus (0.2% of GDP this year on IMF estimates, 1.7% on a cyclically-adjusted basis). Even at current bond yields (4.7% on a 10-year maturity), not much above the long-term nominal GDP growth, the fiscal position in Italy looks sustainable and does not require any additional fiscal tightening;
- A current account deficit of just 2.7% of GDP;
- Net foreign debt of only 21% of GDP;
- A relatively low loan-to-deposit ratio and relatively low bank leverage;
- No housing bubble in the last decade.

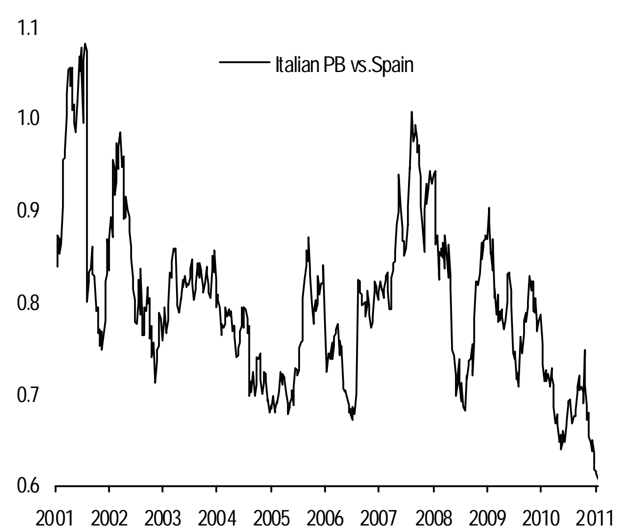
Additionally, valuations look very attractive – Italy trades at a 40% discount to Continental Europe on price to book (and at a record discount to Spain).

Figure 42: **Italy is cheap relative to Continental Europe ...**



Source: Thomson Reuters, Credit Suisse research

Figure 43: **... and Spain**



Source: Thomson Reuters, Credit Suisse research

Italy's equities performance relative to the Euro-area is at an all-time low.

Figure 44: Italian equities' relative price performance is at a record low

Source: Thomson Reuters, Credit Suisse research

Therefore, we look to buy Italian domestic plays, especially those that look cheap on HOLT, including Enel and Snam Rete Gas.

Figure 45: Italian domestic plays

		-----P/E (12m fwd) -----			------ P/B -------		Yield (2011e)		HOLT	Momentum			
Name	Domestic Sales, %	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus (buy less holds & sells)	Credit Suisse rating
Snam Rete Gas	100	12.9	84%	7%	2.2	66%	0.3%	5.8%	2.9	0.8	-0.6	-28.0	Outperform
Azimut Hldg S.P.A	100	8.5	88%	n/a	2.4	n/a	n/m	3.4%	71.1	0.1	2.2	42.9	Outperform
Atlantia Spa	98	12.5	57%	n/a	3.0	n/a	-4.4%	4.8%	-48.1	1.1	0.7	85.7	Outperform
Lottomatica Spa	55	15.1	91%	-8%	1.3	-40%	7.3%	3.0%	-53.2	8.8	10.0	-5.9	Outperform
Enel	43	9.4	63%	-18%	1.1	-27%	6.9%	6.2%	60.4	3.8	1.9	35.1	Outperform

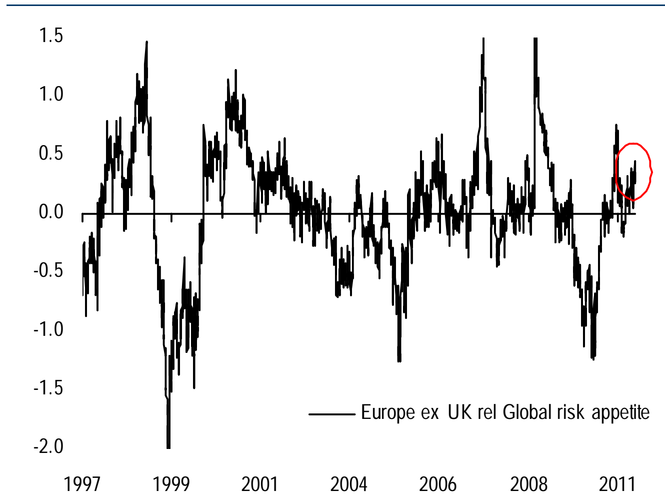
Source: IBES, MSCI, Thomson Reuters, Factset, Credit Suisse HOLT, Credit Suisse research

6) It's too early to be overweight Continental Europe

The negatives for Continental Europe are the following:

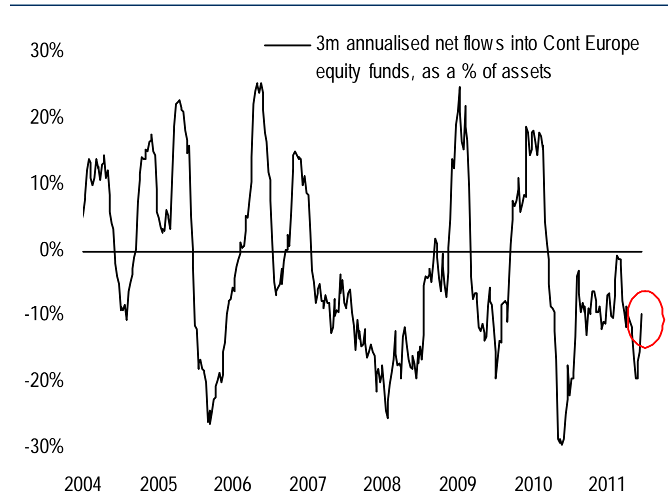
a) There are still no clear signs of investors' capitulation when we look at relative risk appetite and mutual fund flows.

Figure 46: **European relative risk appetite is neutral**



Source: Thomson Reuters, Credit Suisse research

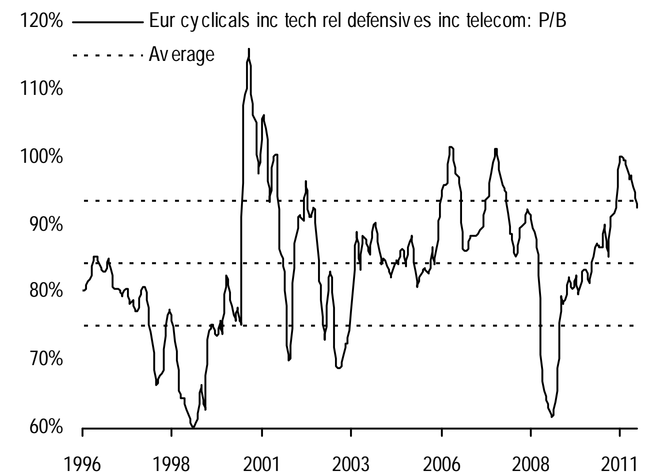
Figure 47: **... and mutual fund flows are above previous lows**



Source: EPFR

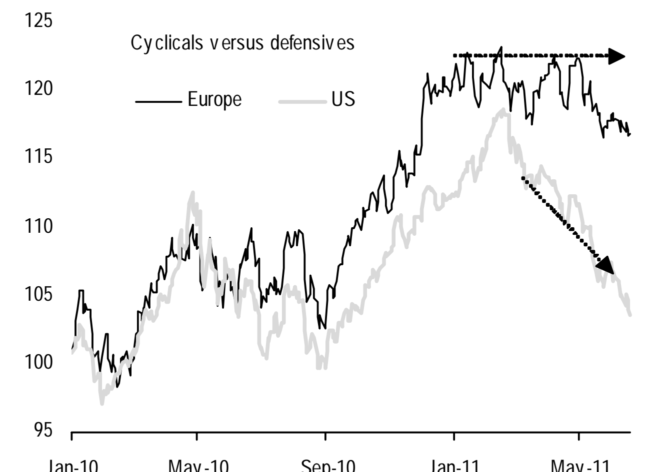
The same point is highlighted by the performance of European cyclicals versus defensives or their price relative (especially when compared with the same ratio in the US).

Figure 48: **European cyclicals are expensive ....**



Source: Thomson Reuters, Credit Suisse research

Figure 49: **... and have underperformed US cyclicals**



Source: Thomson Reuters, Credit Suisse research

b) Continental Europe has the second worst earnings momentum of any region (with margins being the highest relative to history – see our note, *Margins: higher for longer*, 6 May, for details).

Figure 50: Continental Europe has poor relative earnings momentum

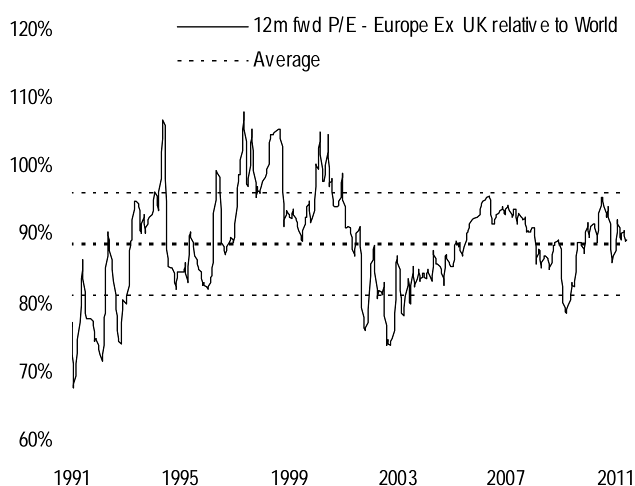
	Net Upgrades (% tot. revisions)			12m EPS change			2011 EPS change			Total score
	1m	3m	z-score	1m	3m	z-score	1m	3m	z-score	(50% upgrades, 50% EPS change)
US	12%	26%	1.4	0.1%	2.0%	0.6	0.1%	2.1%	0.8	1.0
UK	-1%	0%	0.3	0.5%	0.6%	0.7	0.5%	0.8%	0.8	0.5
GEM	-8%	-2%	0.0	0.0%	0.7%	0.4	0.1%	0.7%	0.2	0.2
Europe ex UK	-23%	-11%	-0.7	-0.6%	-0.9%	-0.1	-0.6%	-1.2%	-1.5	-0.7
Japan	-18%	-38%	-1.1	-1.4%	-12.7%	-1.6	0.0%	0.0%	-0.2	-1.0
Global	**-9%**	**2%**		**-0.1%**	**-0.1%**		**-0.1%**	**-0.5%**		

Source: Thomson Reuters, Credit Suisse research

c) The ECB has the greatest chance of making a policy mistake, in our view; we note a new ECB President takes over in November.

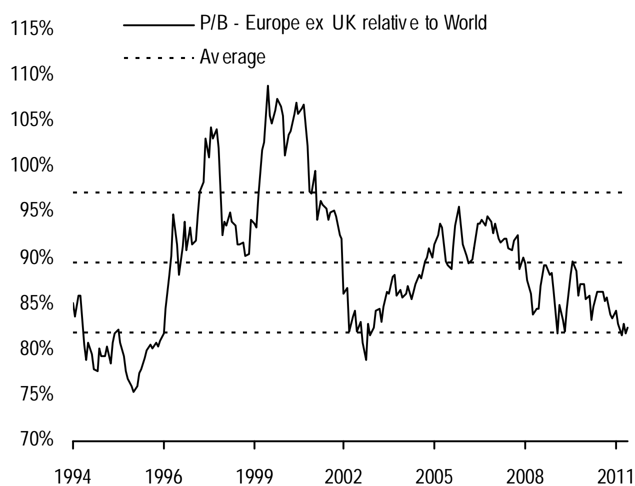
d) Continental Europe might look cheap on a P/B relative, but that is because it is a market that is particularly overweight banks and diversified financials (16% versus global weightings of 12%). On relative P/E, Continental Europe appears neutrally valued.

Figure 51: 12m fwd P/E Eur x UK rel to global at average levels



Source: Thomson Reuters, Credit Suisse research

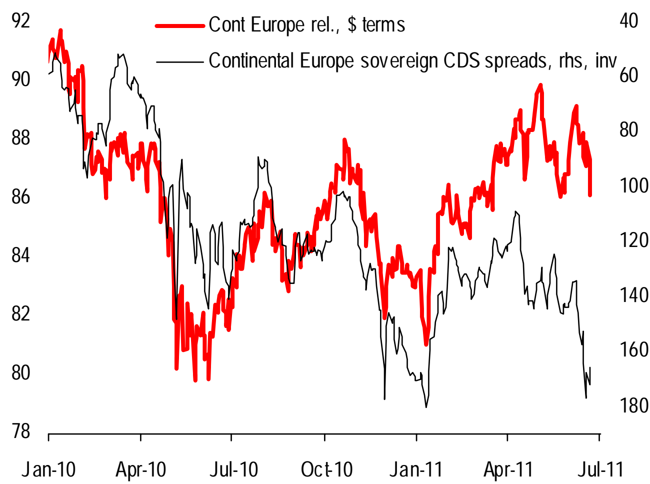
Figure 52: Continental Europe looks cheap on price to book



Source: Thomson Reuters, Credit Suisse research

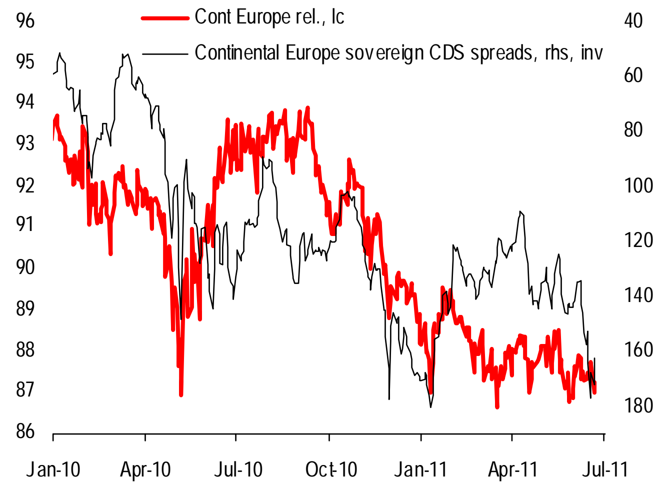
e) Europe has performed better than suggested by European sovereign CDS spreads (in dollar terms, in local currency the gap gas closed recently).

Figure 53: Cont. Europe has performed better than suggested by sovereign CDS in dollar terms ...



Source: Thomson Reuters, Credit Suisse research

Figure 54: ... but not in local currency

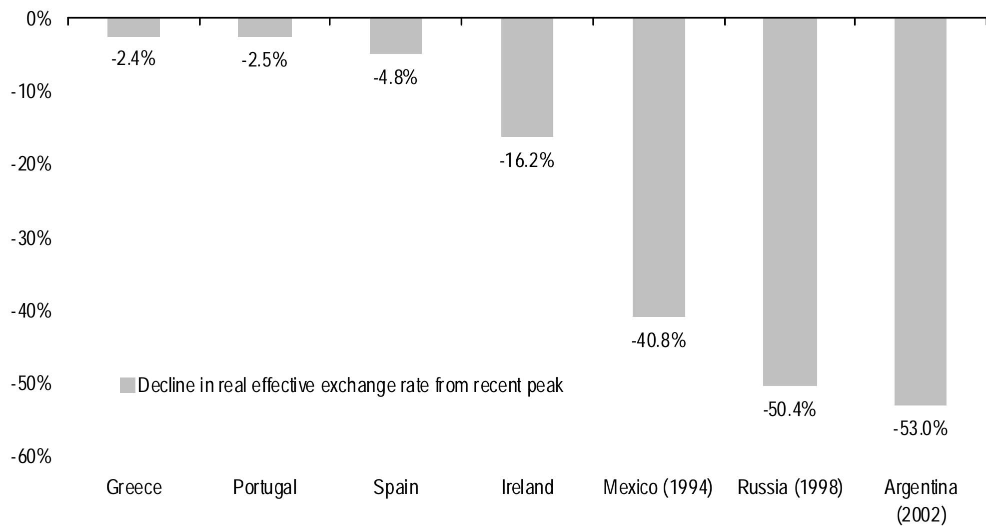


Source: Thomson Reuters, Credit Suisse research

Appendices

Appendix 1: REER after sovereign defaults

Figure 55: **Average decline in REER after sovereign defaults has been 50%**



Source: Thomson Reuters, Credit Suisse research

Appendix 2: Country risk table

Figure 56: **Country risk table**

	Country	Economic indicators						Ratings & CDS		Overall score
		2011 Current account balance	2011 Government budget balance	2011 Government debt	Private sector credit	Net external assets	Potential GDP growth (2014-2016)	CDS spreads	Credit Ratings	
		as % of GDP								
	Weighting	*11%*	*11%*	*11%*	*11%*	*21%*	*5%*	*11%*	*21%*	
1	Portugal	-6.9%	-6.5%	111%	228%	-113%	1.1%	713	BBB-	53.8
2	Greece	-4.5%	-8.4%	157%	116%	-88%	2.6%	1,590	CCC	53.4
3	Iceland	0.8%	-5.4%	121%	490%	-700%	2.9%	292	BBB-	49.6
4	Ireland	3.2%	-11.4%	120%	311%	-102%	3.2%	708	BBB+	47.1
5	Hungary	0.5%	-2.9%	75%	145%	-129%	3.1%	270	BBB-	44.2
6	Spain	-4.0%	-6.8%	74%	223%	-94%	1.8%	223	AA	44.2
7	Latvia	-0.9%	-5.5%	37%	104%	-86%	4.0%	na	BB+	41.1
8	Egypt	-3.9%	-9.6%	79%	34%	-16%	6.2%	312	BB	40.9
9	Italy	-3.1%	-4.0%	129%	125%	-21%	1.4%	135	A+	38.3
10	Ukraine	-2.7%	-3.5%	41%	76%	-34%	4.1%	na	BB-	38.1
11	Poland	-4.0%	-5.7%	59%	53%	-65%	3.8%	150	A	37.9
12	Romania	-4.0%	-4.5%	37%	37%	-64%	4.1%	239	BBB-	37.6
13	Turkey	-7.0%	-2.1%	41%	47%	-45%	4.0%	169	BB+	37.5
14	Lithuania	-0.6%	-5.8%	30%	64%	-62%	3.6%	198	BBB	36.2
15	Bulgaria	-2.1%	-2.9%	15%	53%	-107%	4.0%	207	BBB	36.0
16	India	-2.7%	-7.6%	70%	65%	-9%	8.1%	na	BBB-	35.1
17	Brazil	-3.1%	-2.6%	59%	59%	-38%	4.2%	113	BBB+	32.8
18	New Zealand	0.6%	-8.2%	46%	152%	-100%	2.6%	64	AAA	32.8
19	United Kingdom	-2.1%	-9.0%	89%	207%	-23%	2.5%	60	AAA	32.3
20	Czech Republic	-3.1%	-4.5%	41%	47%	-47%	3.1%	77	A+	32.3
21	United States	-3.9%	-9.1%	101%	162%	-19%	2.7%	34	AAA	32.1
22	South Africa	-4.3%	-4.6%	39%	82%	-14%	4.5%	123	A	31.5
23	Colombia	-2.5%	-3.6%	45%	28%	-25%	4.5%	108	BBB+	30.2
24	Japan	2.5%	-8.0%	213%	142%	57%	1.3%	56	AA-	29.5
25	Indonesia	1.2%	-1.0%	31%	29%	-40%	7.0%	na	BB+	29.1
26	France	-2.4%	-5.8%	97%	137%	-12%	2.1%	52	AAA	28.4
27	Argentina	1.0%	-1.4%	44%	14%	18%	4.0%	600	B	28.3
28	Mexico	-0.8%	-2.6%	37%	26%	-40%	3.2%	109	A	27.9
29	Estonia	1.7%	-1.3%	7%	94%	-84%	3.6%	78	A	27.8
30	Australia	-2.6%	-2.5%	29%	253%	-71%	3.2%	52	AAA	27.8
31	Philippines	4.9%	-3.4%	54%	24%	-10%	5.0%	134	BB+	27.7
32	Belgium	1.2%	-3.8%	101%	122%	45%	1.9%	121	AA+	26.7
33	Israel	1.8%	-2.9%	77%	88%	-3%	3.5%	142	AA-	26.1
34	Thailand	2.3%	-3.7%	44%	98%	-2%	4.9%	123	A-	26.0
35	Canada	-1.8%	-3.4%	86%	142%	-9%	2.0%	16	AAA	23.7
36	Austria	0.8%	-3.3%	80%	105%	-14%	2.0%	39	AAA	23.5
37	Korea	1.0%	0.8%	34%	110%	-12%	4.0%	99	A+	22.8
38	Malaysia	10.6%	-5.4%	51%	113%	18%	5.0%	82	A+	22.8
39	Kazakhstan	5.0%	3.3%	18%	38%	-39%	6.3%	na	BBB+	22.6
40	Finland	1.0%	-1.2%	63%	139%	-4%	2.1%	na	AAA	21.7
41	The Netherlands	5.6%	-4.2%	74%	219%	18%	1.7%	33	AAA	21.6
42	Denmark	6.2%	-3.8%	57%	252%	4%	1.9%	23	AAA	20.6
43	Chile	-1.8%	-0.3%	10%	73%	-12%	4.3%	72	AA	19.8
44	Russia	7.1%	-0.7%	8%	42%	10%	4.1%	142	BBB+	19.2
45	Sweden	6.1%	0.1%	45%	219%	-15%	3.4%	18	AAA	18.2
46	China	4.2%	-2.0%	18%	131%	36%	9.5%	79	AA-	17.9
47	Germany	4.9%	-1.6%	87%	130%	38%	1.5%	27	AAA	17.8
48	Switzerland	10.9%	-0.2%	39%	198%	150%	1.8%	35	AAA	13.1
49	Singapore	23.8%	0.0%	106%	102%	239%	4.1%	48	AAA	12.3
50	Norway	12.7%	10.6%	56%	128%	86%	2.1%	20	AAA	11.7
51	Hong Kong	4.3%	0.2%	2%	199%	344%	4.3%	48	AAA	9.9
		1.0%	**-3.6%**	**62%**	**123%**	**-26%**	**4%**	**179**		

Source: Thomson Reuters, IMF estimates, OECD estimates, Credit Suisse research

Appendix 3: European and US companies with better credit ratings than their governments

Figure 57: European companies that have CDS below the government and offer higher yields – the average sovereign CDS of the G7 is 54 and the average government bond yield is 3.0%

		-----P/E (12m fwd) ------			------ P/B ------		Yield (2011e)		HOLT	Momentum			
Name	CDS spreads	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus (buy less holds & sells)	Credit Suisse rating
Swisscom Ag	54	10.3	91%	-1%	3.2	6%	9.1%	5.6%	9.1	0.4	0.5	-21.4	Neutral
Sanofi	53	8.0	73%	-36%	1.3	-29%	17.2%	4.9%	55.6	2.1	7.3	27.3	Outperform
Compass Group	52	14.0	84%	21%	3.6	38%	5.9%	3.2%	7.0	-0.2	1.4	50.0	Outperform
Atlas Copco Ab	50	14.4	104%	49%	7.6	242%	6.2%	3.0%	3.3	4.9	1.4	-9.7	Neutral
Glaxosmithkline	50	11.0	100%	-9%	7.6	-1%	9.2%	5.3%	7.3	-0.4	-0.9	-2.6	Neutral
Basf Se	49	9.4	71%	1%	2.6	117%	10.4%	3.8%	44.9	10.4	3.5	38.5	Outperform
Nestle Sa	40	15.5	101%	38%	3.0	14%	4.9%	3.7%	-20.0	-3.0	-10.7	7.3	Neutral
Roche Hldgs Ag	39	10.5	95%	-24%	13.1	355%	8.8%	4.8%	53.4	-3.0	-3.7	11.8	Neutral
Novartis Ag	31	10.9	98%	-19%	1.9	-33%	8.3%	4.0%	59.8	5.0	1.1	38.9	Outperform

Source: IBES, MSCI, Thomson Reuters, Factset, Credit Suisse HOLT, Credit Suisse research

Figure 58: US companies that have better credit ratings than the US government (AAA) and offer higher yields – the average sovereign CDS of the G7 is 54 and the average government bond yield is 3.0%

		-----P/E (12m fwd) ------			------ P/B ------		Yield (2011e)		HOLT	Momentum			
Name	CDS spreads	Abs	rel to Industry	rel to mkt % above/below average	Abs	rel to mkt % above/below average	FCY	DY	Price, % change to best	3m EPS	3m Sales	Consensus (buy less holds & sells)	Credit Suisse rating
Progress Energy Inc	48	14.8	100%	56%	1.4	8%	0.8%	5.4%	-27.3	-0.4	-1.4	-88.9	Neutral
Raytheon Co	46	9.3	74%	-9%	1.7	17%	10.0%	3.3%	38.1	-2.0	-0.1	-13.0	Outperform
Duke Energy Corp	46	13.2	89%	27%	1.1	-18%	1.5%	5.4%	-11.3	0.7	0.6	-100.0	Neutral
Consolidated Edison Inc	44	14.4	116%	53%	1.4	27%	5.1%	4.6%	-14.2	0.4	-1.4	-87.5	Neutral
Conocophillips	44	8.3	83%	-8%	1.5	-14%	8.9%	3.7%	31.0	20.2	11.8	-21.7	Outperform
Procter & Gamble Co	41	15.2	101%	9%	2.8	-41%	5.8%	3.0%	-37.7	-1.0	0.4	58.3	Outperform
Abbott Laboratories	41	10.7	97%	-20%	3.4	-37%	10.0%	3.9%	36.6	0.2	1.1	14.3	Neutral
Lockheed Martin Corp	40	9.7	77%	-6%	7.1	206%	10.7%	4.0%	0.5	4.0	0.2	-38.5	Neutral
Bristol-Myers Squibb Co	40	13.2	119%	5%	3.0	-38%	8.2%	4.7%	38.1	1.1	1.0	-20.0	Neutral
Mcdonald'S Corp	40	15.2	91%	24%	5.8	103%	4.8%	3.1%	-24.2	1.6	2.4	28.0	Outperform
Chevron Corp	34	7.7	77%	-23%	1.8	4%	7.9%	3.1%	55.1	21.7	4.4	45.5	Outperform
Merck & Co	23	9.4	85%	-40%	2.0	-64%	14.3%	4.3%	82.9	1.1	1.0	39.1	Outperform

Source: IBES, MSCI, Thomson Reuters, Factset, Credit Suisse HOLT, Credit Suisse research

Companies Mentioned (Price as of 20 Jun 11)
Abbott Laboratories (ABT, $51.38, NEUTRAL, TP $47.00)
Allied Irish Banks (ALBK.I, Eu.18, OUTPERFORM [V], TP Eu1.30, OVERWEIGHT)
Alpha Bank (ACBr.AT, Eu3.34, RESTRICTED [V])
Antena 3 (A3TV.MC, Eu5.54, NEUTRAL [V], TP Eu7.40, OVERWEIGHT)
Atlantia (ATL.MI, Eu15.40, OUTPERFORM, TP Eu25.00, OVERWEIGHT)
Atlas Copco (ATCOa.ST, SKr160.20, NEUTRAL, TP SKr170.00, MARKET WEIGHT)
Azimut (AZMT.MI, Eu7.12, OUTPERFORM, TP Eu9.00, MARKET WEIGHT)
Bank of Cyprus (BOCr.AT, Eu2.04, OUTPERFORM [V], TP Eu2.90, OVERWEIGHT)
BASF (BASF.DE, Eu62.60, OUTPERFORM, TP Eu84.00, MARKET WEIGHT)
Bolsas Y Mercados Espanoles (BME.MC, Eu20.83, NEUTRAL, TP Eu23.00, MARKET WEIGHT)
BorgWarner, Inc. (BWA, $67.94, NEUTRAL, TP $82.00)
Brisa (BRIS.LS, Eu4.43, UNDERPERFORM, TP Eu5.30, OVERWEIGHT)
Bristol-Myers Squibb (BMY, $27.99, NEUTRAL, TP $28.00)
Celanese Corporation (CE, $47.95, OUTPERFORM, TP $65.00)
Chevron Corp. (CVX, $99.47, OUTPERFORM, TP $130.00)
Commerzbank (CBKG.F, Eu3.25, OUTPERFORM, TP Eu4.66, OVERWEIGHT)
Compass (CPG.L, 591.00 p, OUTPERFORM, TP 657.00 p, MARKET WEIGHT)
Con Edison (ED, $52.30, NEUTRAL, TP $48.00)
ConocoPhillips (COP, $70.87, OUTPERFORM, TP $93.00)
DENTSPLY International Inc. (XRAY, $37.06, NEUTRAL, TP $40.00)
Deutsche Euroshop (DEQGn.DE, Eu28.73, OUTPERFORM, TP Eu27.00, MARKET WEIGHT)
Deutsche Wohnen (DWNG.DE, Eu10.81, OUTPERFORM, TP Eu12.00, MARKET WEIGHT)
DryShips (DRYS, $3.86, RESTRICTED [V])
Duke Energy (DUK, $18.38, NEUTRAL, TP $17.00)
EFG Eurobank Ergasias (EFGr.AT, Eu3.18, NEUTRAL [V], TP Eu4.40, OVERWEIGHT)
Emporiki Bank (CBGr.AT, Eu1.70, UNDERPERFORM [V], TP Eu1.60, OVERWEIGHT)
Enel (ENEI.MI, Eu4.62, OUTPERFORM, TP Eu5.00, MARKET WEIGHT)
First Solar (FSLR, $117.87, NEUTRAL [V], TP $100.00)
Fomento de Construcciones (FCC.MC, Eu20.57, UNDERPERFORM, TP Eu21.00, OVERWEIGHT)
Galp Energia SGPS (GALP.LS, Eu14.57, OUTPERFORM, TP Eu16.40, MARKET WEIGHT)
GlaxoSmithKline (GSK.L, 1305.50 p, NEUTRAL, TP 1310.00 p, MARKET WEIGHT)
Harman International Industries (HAR, $44.92, NEUTRAL [V], TP $58.00)
Kennametal Inc. (KMT, $38.91, OUTPERFORM, TP $49.00)
Lloyds Banking Group (LLOY.L, 47.31 p, NEUTRAL, TP 55.00 p)
Lockheed Martin (LMT, $77.29, NEUTRAL, TP $84.00)
Lottomatica (LTO.MI, Eu13.49, OUTPERFORM, TP Eu16.50, MARKET WEIGHT)
McDonald's Corp (MCD, $81.14, OUTPERFORM, TP $92.00)
Mediaset Espana Comunicacion (TL5.MC, Eu6.11, NEUTRAL [V], TP Eu8.60, OVERWEIGHT)
Merck & Co. (MRK, $35.57, OUTPERFORM, TP $44.00)
Metro (MEOG.F, Eu45.63, NEUTRAL, TP Eu50.00, OVERWEIGHT)
National Bank of Greece (NBGr.AT, Eu4.91, RESTRICTED [V])
Nestle (NESN.VX, SFr53.50, NEUTRAL, TP SFr55.00, OVERWEIGHT)
Novartis (NOVN.VX, SFr52.90, OUTPERFORM, TP SFr63.00, MARKET WEIGHT)
OPAP (OPAr.AT, Eu11.93, OUTPERFORM, TP Eu17.50, MARKET WEIGHT)
OTP (OTPB.BU, HUF5700.00, OUTPERFORM, TP HUF7400.00)
Piraeus Bank (BOPr.AT, Eu1.05, UNDERPERFORM [V], TP Eu.70, OVERWEIGHT)
PKO BP (PKOB.WA, PLN42.00, OUTPERFORM, TP PLN53.40)
Procter & Gamble Co. (PG, $65.06, OUTPERFORM, TP $70.00)
Progress Energy (PGN, $46.64, NEUTRAL, TP $40.00)
Raytheon Company (RTN, $48.58, OUTPERFORM, TP $58.00)
Roche (ROG.VX, SFr145.20, NEUTRAL, TP SFr150.00, MARKET WEIGHT)
Rockwood Holdings Inc. (ROC, $48.48, OUTPERFORM, TP $70.00)
Sanofi (SASY.PA, Eu52.42, OUTPERFORM, TP Eu60.00, MARKET WEIGHT)
Sirona Dental Systems (SIRO, $50.41, OUTPERFORM, TP $63.00)
Snam Rete Gas (SRG.MI, Eu4.09, OUTPERFORM, TP Eu3.82, MARKET WEIGHT)
Swisscom (SCMN.VX, SFr389.60, NEUTRAL, TP SFr400.00, MARKET WEIGHT)
TRW Automotive Holdings Corp. (TRW, $52.93, OUTPERFORM [V], TP $74.00)
TT Hellenic Postbank (GPSr.AT, Eu2.93, UNDERPERFORM [V], TP Eu2.80, OVERWEIGHT)
TVN S.A. (TVNN.WA, PLN16.48, OUTPERFORM, TP PLN23.50)
Wabco Holdings (WBC, $65.01, OUTPERFORM, TP $89.00)
Zon Multimedia Services (ZON.LS, Eu3.57, OUTPERFORM, TP Eu4.50, MARKET WEIGHT)

Disclosure Appendix

Important Global Disclosures

The analysts identified in this report each certify, with respect to the companies or securities that the individual analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors including Credit Suisse's total revenues, a portion of which are generated by Credit Suisse's investment banking activities.

Analysts' stock ratings are defined as follows:

Outperform (O): The stock's total return is expected to outperform the relevant benchmark* by at least 10-15% (or more, depending on perceived risk) over the next 12 months.

Neutral (N): The stock's total return is expected to be in line with the relevant benchmark* (range of ±10-15%) over the next 12 months.

Underperform (U): The stock's total return is expected to underperform the relevant benchmark* by 10-15% or more over the next 12 months.

Relevant benchmark by region: As of 29th May 2009, Australia, New Zealand, U.S. and Canadian ratings are based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. Some U.S. and Canadian ratings may fall outside the absolute total return ranges defined above, depending on market conditions and industry factors. For Latin American, Japanese, and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; for European stocks, ratings are based on a stock's total return relative to the analyst's coverage universe**. For Australian and New Zealand stocks a 22% and a 12% threshold replace the 10-15% level in the Outperform and Underperform stock rating definitions, respectively, subject to analysts' perceived risk. The 22% and 12% thresholds replace the +10-15% and -10-15% levels in the Neutral stock rating definition, respectively, subject to analysts' perceived risk.*

***An analyst's coverage universe consists of all companies covered by the analyst within the relevant sector.*

Restricted (R): In certain circumstances, Credit Suisse policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.

Volatility Indicator [V]: A stock is defined as volatile if the stock price has moved up or down by 20% or more in a month in at least 8 of the past 24 months or the analyst expects significant volatility going forward.

Analysts' coverage universe weightings are distinct from analysts' stock ratings and are based on the expected performance of an analyst's coverage universe* versus the relevant broad market benchmark**:

Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

**An analyst's coverage universe consists of all companies covered by the analyst within the relevant sector.*

***The broad market benchmark is based on the expected return of the local market index (e.g., the S&P 500 in the U.S.) over the next 12 months.*

Credit Suisse's distribution of stock ratings (and banking clients) is:

	Global Ratings Distribution	
Outperform/Buy*	47%	(62% banking clients)
Neutral/Hold*	40%	(56% banking clients)
Underperform/Sell*	10%	(50% banking clients)
Restricted	3%	

**For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.*

Credit Suisse's policy is to update research reports as it deems appropriate, based on developments with the subject company, the sector or the market that may have a material impact on the research views or opinions stated herein.

Credit Suisse's policy is only to publish investment research that is impartial, independent, clear, fair and not misleading. For more detail please refer to Credit Suisse's Policies for Managing Conflicts of Interest in connection with Investment Research: http://www.csfb.com/research-and-analytics/disclaimer/managing_conflicts_disclaimer.html

Credit Suisse does not provide any tax advice. Any statement herein regarding any US federal tax is not intended or written to be used, and cannot be used, by any taxpayer for the purposes of avoiding any penalties.

Important Regional Disclosures

Singapore recipients should contact a Singapore financial adviser for any matters arising from this research report.

Restrictions on certain Canadian securities are indicated by the following abbreviations: NVS--Non-Voting shares; RVS--Restricted Voting Shares; SVS--Subordinate Voting Shares.

Individuals receiving this report from a Canadian investment dealer that is not affiliated with Credit Suisse should be advised that this report may not contain regulatory disclosures the non-affiliated Canadian investment dealer would be required to make if this were its own report.

For Credit Suisse Securities (Canada), Inc.'s policies and procedures regarding the dissemination of equity research, please visit http://www.csfb.com/legal_terms/canada_research_policy.shtml.

As of the date of this report, Credit Suisse acts as a market maker or liquidity provider in the equities securities that are the subject of this report.

Principal is not guaranteed in the case of equities because equity prices are variable.

Commission is the commission rate or the amount agreed with a customer when setting up an account or at anytime after that.

To the extent this is a report authored in whole or in part by a non-U.S. analyst and is made available in the U.S., the following are important disclosures regarding any non-U.S. analyst contributors:
The non-U.S. research analysts listed below (if any) are not registered/qualified as research analysts with FINRA. The non-U.S. research analysts listed below may not be associated persons of CSSU and therefore may not be subject to the NASD Rule 2711 and NYSE Rule 472 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

- Andrew Garthwaite, non-U.S. analyst, is a research analyst employed by Credit Suisse Securities (Europe) Limited.
- Luca Paolini, non-U.S. analyst, is a research analyst employed by Credit Suisse Securities (Europe) Limited.
- Marina Pronina, non-U.S. analyst, is a research analyst employed by Credit Suisse Securities (Europe) Limited.
- Mark Richards, non-U.S. analyst, is a research analyst employed by Credit Suisse Securities (Europe) Limited.
- Sebastian Raedler, non-U.S. analyst, is a research analyst employed by Credit Suisse Securities (Europe) Limited.
- Niall O'Connor, non-U.S. analyst, is a research analyst employed by Credit Suisse Securities (Europe) Limited.

Taiwanese Disclosures: Reports written by Taiwan-based analysts on non-Taiwan listed companies are not considered recommendations to buy or sell securities under Taiwan Stock Exchange Operational Regulations Governing Securities Firms Recommending Trades in Securities to Customers.

Important Credit Suisse HOLT Disclosures

With respect to the analysis in this report based on the Credit Suisse HOLT methodology, Credit Suisse certifies that (1) the views expressed in this report accurately reflect the Credit Suisse HOLT methodology and (2) no part of the Firm's compensation was, is, or will be directly related to the specific views disclosed in this report.

The Credit Suisse HOLT methodology does not assign ratings to a security. It is an analytical tool that involves use of a set of proprietary quantitative algorithms and warranted value calculations, collectively called the Credit Suisse HOLT valuation model, that are consistently applied to all the companies included in its database. Third-party data (including consensus earnings estimates) are systematically translated into a number of default variables and incorporated into the algorithms available in the Credit Suisse HOLT valuation model. The source financial statement, pricing, and earnings data provided by outside data vendors are subject to quality control and may also be adjusted to more closely measure the underlying economics of firm performance. These adjustments provide consistency when analyzing a single company across time, or analyzing multiple companies across industries or national borders. The default scenario that is produced by the Credit Suisse HOLT valuation model establishes the baseline valuation for a security, and a user then may adjust the default variables to produce alternative scenarios, any of which could occur. Additional information about the Credit Suisse HOLT methodology is available on request.

The Credit Suisse HOLT methodology does not assign a price target to a security. The default scenario that is produced by the Credit Suisse HOLT valuation model establishes a warranted price for a security, and as the third-party data are updated, the warranted price may also change. The default variables may also be adjusted to produce alternative warranted prices, any of which could occur.

CFROI®, HOLT, HOLTfolio, HOLTSelect, ValueSearch, AggreGator, Signal Flag and "Powered by HOLT" are trademarks or service marks or registered trademarks or registered service marks of Credit Suisse or its affiliates in the United States and other countries. HOLT is a corporate performance and valuation advisory service of Credit Suisse.

Additional information about the Credit Suisse HOLT methodology is available on request.

Important MSCI Disclosures

The MSCI sourced information is the exclusive property of Morgan Stanley Capital International Inc. (MSCI). Without prior written permission of MSCI, this information and any other MSCI intellectual property may not be reproduced, re-disseminated or used to create any financial products, including any indices. This information is provided on an "as is" basis. The user assumes the entire risk of any use made of this information. MSCI, its affiliates and any third party involved in, or related to, computing or compiling the information hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. MSCI, Morgan Stanley Capital International and the MSCI indexes are services marks of MSCI and its affiliates.

The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of Morgan Stanley Capital International Inc. and Standard & Poor's. GICS is a service mark of MSCI and S&P and has been licensed for use by Credit Suisse.

For Credit Suisse disclosure information on other companies mentioned in this report, please visit the website at www.credit-suisse.com/researchdisclosures or call +1 (877) 291-2683.

Disclaimers continue on next page.

CREDIT SUISSE

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Credit Suisse AG, the Swiss bank, or its subsidiaries or its affiliates ("CS") to any registration or licensing requirement within such jurisdiction. All material presented in this report, unless specifically indicated otherwise, is under copyright to CS. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of CS. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of CS or its affiliates.

The information, tools and material presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. CS may not have taken any steps to ensure that the securities referred to in this report are suitable for any particular investor. CS will not treat recipients as its customers by virtue of their receiving the report. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about such investments or investment services. Nothing in this report constitutes investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable or appropriate to your individual circumstances or otherwise constitutes a personal recommendation to you. CS does not offer advice on the tax consequences of investment and you are advised to contact an independent tax adviser. Please note in particular that the bases and levels of taxation may change.

CS believes the information and opinions in the Disclosure Appendix of this report are accurate and complete. Information and opinions presented in the other sections of the report were obtained or derived from sources CS believes are reliable, but CS makes no representations as to their accuracy or completeness. Additional information is available upon request. CS accepts no liability for loss arising from the use of the material presented in this report, except that this exclusion of liability does not apply to the extent that liability arises under specific statutes or regulations applicable to CS. This report is not to be relied upon in substitution for the exercise of independent judgment. CS may have issued, and may in the future issue, a trading call regarding this security. Trading calls are short term trading opportunities based on market events and catalysts, while stock ratings reflect investment recommendations based on expected total return over a 12-month period as defined in the disclosure section. Because trading calls and stock ratings reflect different assumptions and analytical methods, trading calls may differ directionally from the stock rating. In addition, CS may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and CS is under no obligation to ensure that such other reports are brought to the attention of any recipient of this report. CS is involved in many businesses that relate to companies mentioned in this report. These businesses include specialized trading, risk arbitrage, market making, and other proprietary trading.

Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this report reflect a judgement at its original date of publication by CS and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as well as rise. The value of securities and financial instruments is subject to exchange rate fluctuation that may have a positive or adverse effect on the price or income of such securities or financial instruments. Investors in securities such as ADR's, the values of which are influenced by currency volatility, effectively assume this risk.

Structured securities are complex instruments, typically involve a high degree of risk and are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. The market value of any structured security may be affected by changes in economic, financial and political factors (including, but not limited to, spot and forward interest and exchange rates), time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Any investor interested in purchasing a structured product should conduct their own investigation and analysis of the product and consult with their own professional advisers as to the risks involved in making such a purchase.

Some investments discussed in this report have a high level of volatility. High volatility investments may experience sudden and large falls in their value causing losses when that investment is realised. Those losses may equal your original investment. Indeed, in the case of some investments the potential losses may exceed the amount of initial investment, in such circumstances you may be required to pay more money to support those losses. Income yields from investments may fluctuate and, in consequence, initial capital paid to make the investment may be used as part of that income yield. Some investments may not be readily realisable and it may be difficult to sell or realise those investments, similarly it may prove difficult for you to obtain reliable information about the value, or risks, to which such an investment is exposed.

This report may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the report refers to website material of CS, CS has not reviewed the linked site and takes no responsibility for the content contained therein. Such address or hyperlink (including addresses or hyperlinks to CS's own website material) is provided solely for your convenience and information and the content of the linked site does not in any way form part of this document. Accessing such website or following such link through this report or CS's website shall be at your own risk.

This report is issued and distributed in Europe (except Switzerland) by Credit Suisse Securities (Europe) Limited, One Cabot Square, London E14 4QJ, England, which is regulated in the United Kingdom by The Financial Services Authority ("FSA"). This report is being distributed in Germany by Credit Suisse Securities (Europe) Limited Niederlassung Frankfurt am Main regulated by the Bundesanstalt fuer Finanzdienstleistungsaufsicht ("BaFin"). This report is being distributed in the United States by Credit Suisse Securities (USA) LLC ; in Switzerland by Credit Suisse AG; in Canada by Credit Suisse Securities (Canada), Inc.; in Brazil by Banco de Investimentos Credit Suisse (Brasil) S.A. or its affiliates; in Mexico by Banco Credit Suisse (México), S.A. (transactions related to the securities mentioned in this report will only be effected in compliance with applicable regulation); in Japan by Credit Suisse Securities (Japan) Limited, Financial Instrument Firm, Director-General of Kanto Local Finance Bureau (Kinsho) No. 66, a member of Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Securities Investment Advisers Association; elsewhere in Asia/Pacific by whichever of the following is the appropriately authorised entity in the relevant jurisdiction: Credit Suisse (Hong Kong) Limited, Credit Suisse Equities (Australia) Limited , Credit Suisse Securities (Thailand) Limited, Credit Suisse Securities (Malaysia) Sdn Bhd, Credit Suisse AG, Singapore Branch, Credit Suisse Securities (India) Private Limited regulated by the Securities and Exchange Board of India (registration Nos. INB230970637; INF230970637; INB010970631; INF010970631), having registered address at 9th Floor, Ceejay House,Dr.A.B. Road, Worli, Mumbai - 18, India, T- +91-22 6777 3777, Credit Suisse Securities (Europe) Limited, Seoul Branch, Credit Suisse AG, Taipei Securities Branch, PT Credit Suisse Securities Indonesia, and elsewhere in the world by the relevant authorised affiliate of the above. Research on Taiwanese securities produced by Credit Suisse AG, Taipei Securities Branch has been prepared by a registered Senior Business Person. Research provided to residents of Malaysia is authorised by the Head of Research for Credit Suisse Securities (Malaysia) Sdn. Bhd., to whom they should direct any queries on +603 2723 2020.

In jurisdictions where CS is not already registered or licensed to trade in securities, transactions will only be effected in accordance with applicable securities legislation, which will vary from jurisdiction to jurisdiction and may require that the trade be made in accordance with applicable exemptions from registration or licensing requirements. Non-U.S. customers wishing to effect a transaction should contact a CS entity in their local jurisdiction unless governing law permits otherwise. U.S. customers wishing to effect a transaction should do so only by contacting a representative at Credit Suisse Securities (USA) LLC in the U.S.

Please note that this report was originally prepared and issued by CS for distribution to their market professional and institutional investor customers. Recipients who are not market professional or institutional investor customers of CS should seek the advice of their independent financial advisor prior to taking any investment decision based on this report or for any necessary explanation of its contents. This research may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA or in respect of which the protections of the FSA for private customers and/or the UK compensation scheme may not be available, and further details as to where this may be the case are available upon request in respect of this report.

Any Nielsen Media Research material contained in this report represents Nielsen Media Research's estimates and does not represent facts. NMR has neither reviewed nor approved this report and/or any of the statements made herein.

If this report is being distributed by a financial institution other than Credit Suisse AG, or its affiliates, that financial institution is solely responsible for distribution. Clients of that institution should contact that institution to effect a transaction in the securities mentioned in this report or require further information. This report does not constitute investment advice by Credit Suisse to the clients of the distributing financial institution, and neither Credit Suisse AG, its affiliates, and their respective officers, directors and employees accept any liability whatsoever for any direct or consequential loss arising from their use of this report or its content.

Copyright 2011 CREDIT SUISSE AG and/or its affiliates. All rights reserved.

CREDIT SUISSE SECURITIES (Europe) Limited
Europe: +44 (20) 7888-8888