



POTOMAC
STRATEGIC INVESTMENT

CAPITOL MARKET REVIEW

In This Issue: Europe Steps-Back From The Edge, Details Remain Sketchy...US GDP In-Line with Wall Street Expectations...

At Mid-Day: SPY 1268 US10Y 2.28% Gold \$1725 Oil \$92.70 Oct. 27, 2011

After months of indecision, European policymakers announced a plan to create a \$1.4Trillion rescue fund designed support Euro denominated sovereign debt, and by extension, European banks. In addition, Greek sovereign debt will be factored into EFSF and ECB calculations at 50%, substantially higher than the initial indications.

Details are not complete. It is not clear exactly how the rescue fund will be financed. Or how European banks, who must now absorb 50% haircuts on their Greek sovereign debt holdings, will raise equity capital.

While fear of a European implosion has been taken off the table, CMR still maintains Europe will experience a recession in 2012. In addition, CMR also remains concerned about the potential for burgeoning Italian sovereign debt to overwhelm the EFSF fund.

In a macro sense, the euro itself should now decline in value. Reacting to this inflationary trend, European rates may well rise to defend the currency. (The ECB does not have a dual mandate.) However, both Spain and Italy require near-zero financing. This is one of several new conundrums awaiting Eurozone monetary leaders.

CMR sides with global strategists and economists who maintain that today's feel-good news flow will hold for about six months when a new dose of economic reality hits. There are too many variables still unsettled. For instance, was today's forced Greek haircut a credit event? Should it not have triggered a CDS event? A legal challenge could emerge. Will the strict austerity measures demanded mostly by Germany be followed? Berlusconi is said to have offered his resignation twice in the past week, will his Administration eventually fail? Assuming that foreign sovereign wealth funds are called upon to provide support, what will they want in exchange? Sarkozy is already on the wires saying he's been in-touch with China.

Global markets are experiencing a euphoric rally. Thus far, stocks are up sharply in short-covering. The definition of a short-covering rally is shares most beaten-down by recent sell-offs recover. On a technical basis a new trading range will form at higher levels. CMR expects twenty point shifts in S&P gyrations and will detail the "new normal" in future posts.

Beyond Europe, US markets would have been higher on news that US 3rd Quarter GDP came in at 2.5%; exactly in-line with Wall Street estimates. In addition, today's corporate earnings news has also been positive. The combination of short-covering and nervous "long-only" and hedge fund portfolio managers who have less than two months to out perform their index measures are also leading to up markets in most risk categories.