

FFTW OUTLOOK

Our Thoughts On European Financial Turmoil

Overview

Our working assumption has been that the euro zone would manage to "muddle along", delivering reforms when government bond markets threatened revolt - implying that peripheral risk could be bought during periods of stress. This strategy has proven correct so far, but this reactive approach to policy making has obvious risks. One risk is that solutions are delivered in a piece-meal way, and that hard choices are merely delayed. The other risk is that solutions are delivered in times of panic, so that measures are not well considered. Nevertheless, we have generally given policy makers the benefit of the doubt, so that our positioning has tended to be overweight peripherals. However, there are growing signs that policy makers either do not comprehend the magnitude of the problem, or are simply not up to the task of delivering solutions. Furthermore, we are unsettled by the ECB's recent decision to raise policy rates (thereby flattening the yield curve and compromising the profitability of banks) in the middle of a sovereign debt crisis.

Correspondingly, we are looking for policy makers to provide something meaningful for Greece in the next few days, in the hope that progress on Greece would ease market pressures on other sovereigns. Should the market lose confidence, we fear that additional, more drastic measures would be needed in quick order, namely : (1) massive purchases of peripheral debt by the ECB (whether immunized or not) or another official institution, perhaps newly created ; or (2) rate cuts by the ECB to allow the euro to weaken, support domestic growth, and allow German economic strength to be set aside in favor of saving peripheral economies. The latter option would essentially be a complete capitulation by the ECB; a huge change in stance. For this to occur it would require a real crisis as well as more time. It may be the eventual story but not in the near term.

Views On Greece, Spain and Italy

Greece

Greece has not been able to deliver on its fiscal consolidation plan agreed with the EU/IMF last May. This is partly a result of the weak growth environment and lack of domestic growth engines, but also because of the lack of political support for fiscal austerity. The PASOK government is weak, only narrowly winning a recent confidence vote, and could fall at any time. This raises execution risks around any fiscal plan that need to be taken into account. A second EU/IMF/EFSF bail-out is likely to be agreed upon soon, but details on private sector involvement need to be agreed before this can be finalized. We believe that the markets and EU policy makers increasingly recognize that Greece's fiscal finances are not on a sustainable path, and that some form of debt relief is required. Although banking contagion risks may make it too dangerous to have a full restructuring now, kicking the can down the road is no longer a credible option. We believe that a partial restructuring would help investor confidence rather than harm it, as markets would see that Greece's fundamental problems were being addressed, even if only partially.

Ultimately market participants, as well as Greek politicians and voters, need to see an end game - i.e. a path to fiscal sustainability that is economically and politically tolerable. True debt relief for Greece means a reduction in the net present value of government obligations, which could be delivered in a number of ways:

- 1) private sector participation, with partial haircuts, or restructuring of coupons and maturities ; or
- 2) extension of repayment terms and / or reduced interest rates on official IMF, EU loans.

Some combination of the above options is inevitable, but the EU / IMF are bargaining to extract the greatest amount of reforms (and potential collateral) from Greece. Partial, "voluntary" rollovers of debt to longer maturities with higher coupons would not meaningfully help Greece. Given all of this, execution risk is extremely elevated.

Spain

The debt-to-GDP ratio for Spain is one of the lowest in the EU, and is by far the lowest of the GIIPS (Greece, Ireland, Italy, Portugal and Spain). Meanwhile, banking sector exposures to commercial and residential real estate actually look manageable and non-performing loan ratios have not deteriorated sharply, though this will clearly be influenced by growth developments. So far, the more extreme estimates of potential banking losses look far-fetched. Furthermore, in contrast to Greece and Italy, Spain is delivering structural reforms. Spain has turned its trade deficit into a surplus, indicating its ability to regain competitiveness. Spreads to Germany are trading at the same levels as in 1996, a time at which Spain's accession to the EMU was far from assured. We believe that these spreads represent attractive medium-term value, although volatility is likely to remain high in the weeks ahead.

Italy

Italy had, until very recently, avoided investor scrutiny as it has had a history of primary government budget surpluses, strong domestic demand for government bond issuance and relatively strong financial sector balance sheets. Private sector indebtedness is also more modest than in Spain and the UK. Italy's Achilles' heel, however, is its low growth outlook which is arguably a result of poor governance. Italy has come under pressure because markets have realized that growth is key, and Italy has had the weakest growth rates in the EU from 2001 to 2010 with the second highest debt levels. In addition to this political instability and the scandals threatening the tenure of the Berlusconi government, the impact of the new fiscal plan was back-loaded to after the next elections raising doubts over the effectiveness of the implementation.

We think that Italy remains vulnerable given that the growth story isn't going away and investors still hold sizable positions, even if positions have been trimmed, so we would expect markets to reduce exposure on any meaningful bounce. The possibility or actuality of official buying could drive spreads tighter quickly, but we think that Italy will remain somewhat tainted in the near future.

Ireland and Portugal

Both Ireland and Portugal have recently been downgraded to below investment grade status by Moody's. Similar ratings actions are likely from the other major ratings agencies, particularly for Portugal. Further ratings downgrades, if they materialize, are likely to lead to Portugal and Ireland dropping out of the major government bond indices, and further technical selling. In the absence of the SMP, or some other form of officially-sponsored purchases, these sales are likely to weigh on the market in the coming weeks. We believe that both Portugal and Ireland are fundamentally cheap at current levels. Both countries have newly elected governments committed to fiscal austerity, are delivering on their fiscal consolidation programs in line with targets agreed with the EU/IMF and have financing programs in place which remove the need to come to the markets until 2013. We believe that both countries have the means and political cohesiveness needed to deliver fiscal consolidation and ultimately return to market issuance. However, recent events have extended the investment horizon on this view from the medium term to the longer term. Given near term event risks, we have decided to trim exposures to Portugal and Ireland. We remain somewhat constructive, particularly in the longer term, and retain small overweight positions where client guidelines and investment horizons allow.



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