

What the Greek debt problem means for investors

Commentary by Eric Bushell, Chief Investment Officer

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I traveled to London, Athens and Madrid this month to test a theory. I felt that the combination of sharp government spending cuts and financial sector and household de-leveraging could mire Euroland in an extended period of subpar growth.

What I found confirmed this view. Outright deflationary pressures may yet emerge in smaller peripheral Eurozone countries, triggering falling incomes and asset values. This would have pernicious consequences for the banking sector. Hasn't that already happened in Spain, Ireland and the U.K.? Yes, insofar as their governments have nationalized much of the banking sector, but further adjustments lie ahead, particularly in the public sector.

This is what Europe faces over the next five years: fiscal retrenchment, slower growth, lower interest rates and a weaker euro, as well as the potential for political and social upheaval. The synchronized global rebound taking place is masking these longer-term challenges.

Central to this discussion is the political stress in the Eurozone over providing a bailout for Greece. Even though Greece represents just 2% of European GDP, its problems have significant implications for both Europe and the global economy. I believe that the market has mistakenly characterized this as a liquidity problem when it is, in fact, a solvency problem that is unlikely to be solved by the measures authorities are now introducing.

How did we get here? – the Greek problem

In December 2009, the new Greek government announced a budget deficit that amounted to 12.7% of GDP – thanks to the combination of its existing deficit, election year spending and a stimulus plan created in response to the financial crisis. In response, Greek government bond yields jumped from 3.5% to 8% within months. Even though the Greek government has wisely financed its debt over longer terms, it still has to roll over US\$30 billion in debt maturities and finance a \$30 billion deficit – for a total of \$60 billion annually in funding requirements.

The Greek government Stability and Growth Program – which won't deliver either goal in my view – calls for higher taxes and spending cuts. If we test this program with an interest rate shock of 2%, we find that the resulting higher interest rate costs would offset one-third of the permanent revenue gains; after three years, the higher interest costs would offset all of the tax increases.

This illustrates two important factors about the liquidity facility being provided by the European Union and the International Monetary Fund: the cost is critical, and at \$45 billion, it's inappropriately small – enough for just nine months in the absence of private market funding.

Why do we see this as a solvency problem? With a fixed currency, 120% ratio of debt to GDP, a culture of tax evasion and a weak bureaucracy, Greece's options to solve its debt problems without resorting to a restructuring or default are limited. An IMF-

rising unemployment and a protracted downturn, further hampering the country's ability to finance its debt.

Adding to the country's woes is the government fiscal crisis which is destabilizing the country's banking system. The Greek banks, despite their prudent management, have gradually lost their sources of funding, and deposits are beginning to erode. The ECB has become their lender of last resort.

How did we get here? – Flaws in the European monetary union

With their adoption of the euro, the continent's economically weaker countries like Greece, Spain, Portugal, Italy and Ireland saw their interest rates converge with the rest of the Eurozone, falling from double to single digits. This interest rate decline triggered housing booms, leading to rising employment, growth, wage inflation, bigger government and more generous pensions and entitlements. This debt-financed growth was funded by financial institutions in the core countries of France and Germany, which enjoyed strong exports.

In a relationship akin to the U.S. and China, Germany and France ran current account surpluses while the countries on the periphery ran huge deficits. The surplus countries funded the property booms in the periphery. These imbalances were masked by the single currency, because the Eurozone as a whole was running current account surpluses. Now, access to funds for the most profligate borrowers is being cut off. The periphery needs to re-establish its competitiveness vis-a-vis Germany, but they lack the option of currency devaluation. As a result, wages and asset values in these countries need to fall, and this will be accompanied by government cutbacks and lower growth.

This relationship presents a challenge for the European Central Bank. As the German economy recovers, the case is made for higher interest rates to ensure price stability. But the southern Eurozone countries, with their fragile government and household finances, want interest rates to be kept low. Our view is that if rates can be kept lower for a longer period, then a gradual consumer deleveraging can take place, putting these economies on a better footing.

What's the plan?

The EU's spastic response to the Greek crisis has damaged confidence in the concept of Europe as a political and fiscal union, and calls into question the viability of the euro. We think that the future of the union is uncertain, with the possibility of it emerging stronger from this crisis, or disintegrating.

The EU is scrambling because it lacks the tools to deal with this crisis. We expect that European nations will attempt to provide bridge financing to Greece as they develop, over the next two years, mechanisms that will allow them to enforce fiscal rules. These could include the proposed European Monetary Fund, or a protocol to eject rulebreakers. (Only once in the past 18 years did Greece post a deficit of less than 3% of GDP, the ostensible requirement of the monetary union.)

However, investors should not take a bailout as a given. There are legal and political

hurdles to consider. Many point with confidence to the \$250 billion in Greek government bonds held by European financial institutions. The systemic – too big to fail – risk may hold Europeans hostage, but in time, they will devise a resolution authority to administer an orderly default.

Global implications

The Greek crisis highlights several important global trends. First, investors are now more attuned to sovereign credit risk, especially for countries with more generous social welfare schemes. The financial crisis resulted in a double hit to government finances through lower revenues and costly stimulus schemes, with the result that debt-to-GDP ratios have soared by 20% across the board.

In the same vein, differentials in the credit risk between countries are now becoming more pronounced. For example, Canada is perceived to have kept its fiscal house in relatively good order, so Canadian government bond yields are 30 basis points less than their U.S. equivalents. These shifts will continue.

The recovery has a structural weakness that poses a potential risk for investors. Government authorities have fired both fiscal and monetary bullets at the financial crisis. They appeared to have hit their mark, but there are no bullets left.

Investment implications

- Europe and the U.K. will be slower to recover than the U.S., with its national institutions that are better equipped for problem solving. Asia, lacking these debt and deficit issues, is well on its way to recovery.
- Signature's holdings, with a bias towards regions other than Europe, reflect this view. This applies to equities and bonds.
- We are hedging our euro exposure.
- We are avoiding European financial institutions. In addition to the region's economic problems, these institutions will be affected by financial re-regulation and the new capital requirements much more than their global counterparts.
- We feel that the risk of widespread "contagion" is not high. Though Portugal is vulnerable, the problems of Spain and Ireland appear to be manageable.