A closer look at the Eurozone crisis

August 2011

with the Russell Global Investment Strategist team

The past two weeks have witnessed significant market volatility. Three primary factors are responsible for the current fragile state of the markets: the US credit downgrade, fears of a possible global economic slowdown on the horizon, and further drama in Europe, as the Eurozone crisis refuses to abate. Here, we speak with Russell's global investment strategists team and discuss the most recent developments.

What is the general market outlook?

Recently, the Investment Strategy Team at Russell (our investment manager) has revised its target for the S&P 500 index down to 1300, whereas it had been 1372 since the beginning of the year. This reflects both the slower trajectory of US and global economic growth and the increased (but still low) probability of negative growth in the US by the end of the year. Contributing to our worries, the ongoing stress in Europe, the potential for a renewal of fiscal brinkmanship in the US, and the market dislocations that these situations continue to cause have made our view much more modest than it had been.

We refer readers to the investment manager's long-held view that a "three legged stool" of solutions is required to solve the Eurocrisis. To reiterate, this includes expanding the bailout facilities of the EFSF, possibly to the point of creating a well-funded central fiscal authority in Europe; the recognition that much of the HYPES' debt is ultimately unsustainable and must be written down somehow; and the ongoing reform of the fiscal and competitive environments of the HYPES.

We are slightly encouraged as we read and hear more references to various solutions of these types, but progress in actually creating them is still too slow for our – or the market's – liking. Nevertheless, as we have also said, the mere fact that the alternative – a messy default and/or breakup of the Eurozone – would be so much more costly and disruptive, means that sooner (or more likely) later, these three legs still need to be constructed.

Glossary

Core Countries: Those countries in the Eurozone which are not embroiled in both market and official concerns about their fiscal sustainability.

ECB: European Central Bank.

EFSF: European Fiscal Stability Facility. A special purpose vehicle set up by the Eurozone in May 2010 to fund assistance to the HYPES countries. At present it has a lending capacity €440 billion, made up of contributions from European Union countries.

HYPES: High Yielding Peripheral European States. This refers to Greece, Ireland, Portugal, Spain, and Italy, those countries of the European Monetary Union which have significant fiscal difficulties and have come under severe market pressure, driving their bond yields and borrowing costs much higher than the core countries of the Eurozone.

PSI: Private Sector Involvement. The notion that in addition to national governments, and by implication their taxpayers, that private sector entities (banks, insurance companies, other investors) bear some of the burden of any bailout, default, or resolution.

SMP: Securities Market Programme. A facility set up by the European Central Bank to provide liquidity to banks in the Eurozone who cannot access wholesale markets at acceptable interest rates. In return for this liquidity provision, the ECB demands collateral from the banks involved.

In the short term, we don't expect any quick resolution or scaling back of tension for the rest of the year. We expect rolling crisis and responses, as the slow march to European political consensus for a full resolution continues at a snail's pace.

What has been going on in Europe in the last couple of weeks?

In some ways not much, in other ways a lot. By not much, we mean that outside of a deeper pledge and subsequent commitment to an enlarged and more active role for the ECB, the political landscape has been devoid of any new major policy coordination by European governments. French President Sarkozy and German Chancellor Merkel met on Tuesday the 16th, but the result was lacklustre in the eyes of the market, and in any case did nothing to suggest new solutions to the immediate issues. (See below.)

By a lot, we mean that in the past fortnight, the situation in Europe has rattled investors and contributed greatly to the recent high volatility in global markets. Certainly, Standard and Poors's downgrade of US treasury debt from AAA to AA+ also weighed on investors' minds, but the Eurozone mess is at least as responsible for the market movements, if not even more so.

What is the ECB doing?

After a big drop in markets on Monday the 8th on the heels of the US downgrade and renewed pressure on Spanish and Italian government debt, the ECB announced that they would step into secondary markets and buy Italian and Spanish bonds. In return, the Italians agreed to accelerate their fiscal consolidation efforts. This was despite the initial Italian plan being not welldigested by the markets as it left much of the pain of austerity for the later years of the package. This time around, the Italians have moved budget cuts forward, making the programme more front-loaded than it was initially. Markets rallied on Tuesday the 9th in response.

What/how much has the ECB bought, and has it worked?

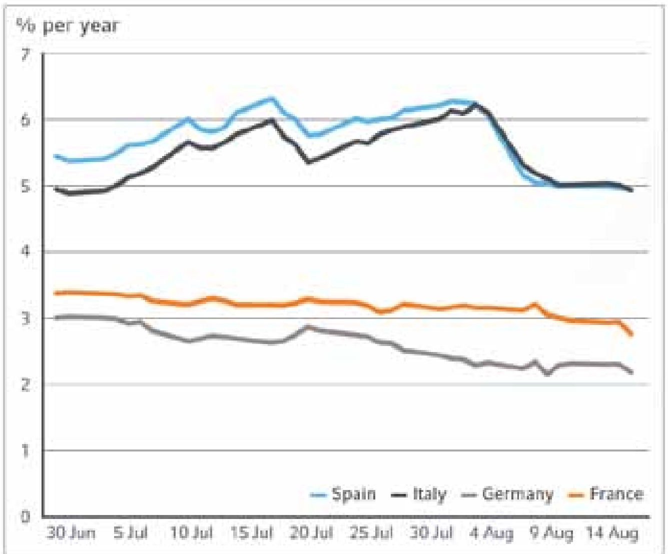
Through its SMP, the ECB has been heavily intervening in peripheral European debt markets, most recently focussed on supporting Italian and Spanish bonds. After the summit agreement on the 21st of July, which dealt mainly with efforts to enlarge the EU's commitment to Greece, including PSI and expanding the remit of the EFSF (subject to national legislative approval), Spanish and Italian bonds came under renewed pressure. In part, this pressure was due to the lack of attention paid at the summit to the fiscal problems in these two important countries.

One feature of the Eurosummit agreement was the expansion of the EFSF's toolkit to allow it to act in secondary bond markets to support treasuries of countries not formally "bailed out" by the EFSF arrangement. This meant that it could then purchase Spanish and Italian bonds. However, to do this the EFSF's expanded remit needs to be approved by national parliaments and this will not happen until sometime in September at the earliest. In the meantime, this meant that the ECB was the only player with sufficient resources and sanction to act.

Until recently, the ECB's most aggressive use of its financial firepower via the SMP took place in May of 2010, after the initial rescue package to bail out Greece was crafted. That month the ECB bought the equivalent of about 9% of the total stock of government debt outstanding of Greece, Ireland and Portugal, for a total of about €40 billion. (Source: ECB). If the ECB were to purchase that much of the far larger Spanish and Italian debt stock, it would amount to around €300 billion, a far larger sum than the May 2010 purchases. So far, since it re-opened the SMP, the ECB has bought €22 billion in the first week of August alone.

The ECB's move has worked so far. On Friday August 5th, Spanish 10-year government bond yields were 6.03%. By the end of the day on Monday the 8th, they had fallen to 5.1% and as of the close of the market on Wednesday the 17th, they have fallen to 4.93% (Source: Factset.). Italian yields have followed a similar path, going from 6.1% to 5.3% between August 5th and August 7th, closing on Wednesday the 17th at 4.92%. See Exhibit 1.

Exhibit 1: Ten Year Government Bond Yields, Selected European Countries



Source: Factset, Data as at 18 Aug 2011

How much more can the ECB buy?

In principle, there is no limit to how much the ECB can purchase, as it is merely an operation that would increase the size of its balance sheet. (See question below on quantitative easing and sterilisation).

The inference is that while the national governments assess and start the approval process for the increase in EFSF powers, the only entity that can stabilise markets until the EFSF is approved is the ECB, via the SMP. Furthermore, unlike the EFSF, which needs to maintain its AAA status by law, the ECB can purchase anything it wants without regard to credit rating or the impact on its aggregate balance sheet.

Furthermore, it appears that the ECB is acting in a quid-pro-quo fashion. By trying to persuade national governments to get their fiscal houses in order, they are rewarding those which do so with support in the secondary markets.

The ECB is uncomfortable with its recent foray into engaging on fiscal policy with national governments. ECB officials have made it clear that their official, legal remit is to ensure price stability. (Source: Interview by ECB President Trichet with Europe Radio 1 this week).

But the ECB also has a looser mandate to ensure orderly functioning of the money market in Europe and it is under this cloak that they see themselves as able to use the SMP. (The explicit ability to do so was conferred upon the ECB at the July 21st summit.). Nevertheless, the ECB is clearly uncomfortable with an open-ended commitment. Four members of the ECB governing council have expressed their opposition to ambitious use of the SMP.

We suspect that the ECB feels it has no choice if it wants to keep the Eurozone functioning somewhat effectively and not risk a major crisis. While it finds this action distasteful, it is necessary in the short term while EFSF approval lingers and in the absence of a long range plan from EU leaders to deal with the crisis.

Isn't what the ECB is doing therefore akin to Quantitative Easing (QE) as has been seen in the US and UK in recent years?

No. QE is an expansion of the central bank's balance sheet via the purchase of securities in exchange for cash. Under QE, a central bank buys government bonds either from commercial banks or directly in the secondary market and in turn issues cash to the marketplace. This increase in the money supply is intended to encourage lending through the credit channel and generate inflation expectations sufficient to get consumers out buying goods and services, thus giving the economy a push.

In the ECB's case, the purchases of bonds are sterilised. The cash that is injected into the market when the ECB buys a security is then re-absorbed by the ECB via the issuance of fixed rate, one week notes issued to banks. This means that in return for these one-week notes, the banks must give cash back to the ECB. At the end of this operation, the amount of money in the economy hasn't changed, just the composition of the assets that back the money supply and who holds which ones.

Furthermore, the ECB has always maintained that it intends to hold to term whatever government bonds it purchases and puts on the asset side of its balance sheet. It does not intend to sell them back into the market. Therefore, the much discussed risk of the ECB becoming a "bad bank" holding severely depreciated government credit, is in the eyes of Frankfurt not a legitimate worry in the short-to medium term. Any impairment it may suffer will be implicitly made up for by a proportional recapitalisation of its balance sheet by member central banks in the Eurosystem of Central Banks. If it ever came to that, then this could be considered an outright increase in the money supply, akin to QE, but this is not an immediate risk as long as the bonds the ECB buys eventually get paid back in full.

What was the much publicised meeting between Nicolas Sarkozy and Angela Merkel all about?

To be blunt, not too much. Going into the meeting many investors had hopes (unrealistic, as it turned out) that some major new initiatives to deal with the crisis would be announced. Besides the standard and emphatic commitment to the integrity and stability of the Eurozone, what was produced was vague and mainly dealt with longer term economic governance issues.

The two leaders called for more coordinated economic governance, and a strengthening of the enforcement mechanisms of the European Growth and Stability Pact, which sets forth targets for government debt and deficits. It is not clear this will ever come about on an EU-wide basis, and even if it does, it won't have any immediate impact.

They also suggested that an EU-wide bank tax on financial transactions be implemented, even in countries which are not part of the EMU. This is probably aimed at raising revenues for the EU to fund future bailouts or even to back an eventual European central fiscal authority. It probably also exerts some punishment on banks PSI has been an important principle, but the precarious capitalisation of many European banks means that a large haircut on peripheral debt holdings would severely impair their balance sheets. By taxing their activities, there is at least a fig leaf that demonstrates that the banks are paying their share for the crisis. This is highly unlikely to be adopted; countries like the UK, which view financial services as a strategically important industry will resist participation, and other countries have already registered their disapproval.

Weren't Sarkozy and Merkel going to address the creation of a Eurobond?

There was some hope that the idea of a commonly issued Eurobond might be addressed at the Franco-German meeting, but this didn't occur. Momentum amongst many commentators and even some officials in the EU has been slowly building for this as a necessary feature of any long term solution to the mess. Such an instrument would draw upon the full faith and credit of the EU as a whole, and therefore be seen as more creditworthy than HYPES bonds issued by individual countries.

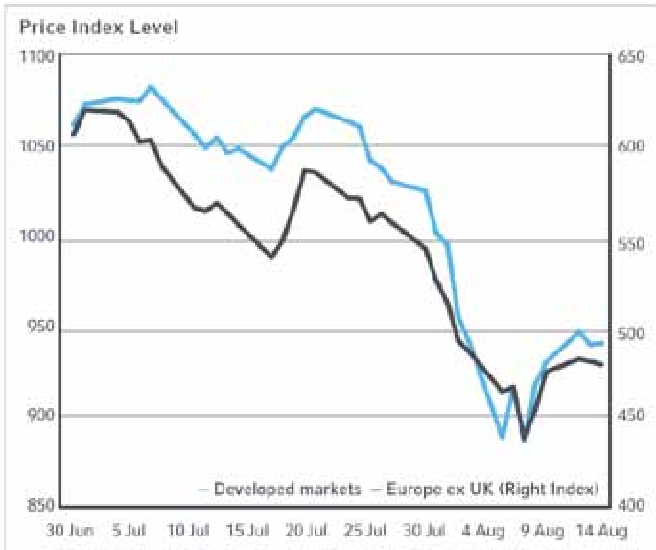
The moies raised by a Eurobond issue could be used to prop up weaker countries' finances and make it easier to transfer funds than through the highly specialised and limited EFSF. It is precisely this notion of "transfer" that continues to thwart movements towards a Eurobond.

National leaders in core countries do not wish to put their taxpayers in the position of funding the profligacy of their neighbours. Until now, the case has not been sufficiently or persuasively made that while undesirable, this is a less costly option than a messy dissolution of the Eurozone, or a banking crisis in the face of a national default. Until that case is made, don't expect the Eurobond to move from being the subject of an intellectual discussion to becoming a practical institution.

European Banks have had a tough run recently. Why is this?

Actually, European financials have had a rough run all year. The Russell Global Europe ex-UK financials index is down 16% in local currency this year. However, the poor run has definitely been more intense recently. Since the beginning of July, the same index is down over 14% and since the beginning of August it has fallen nearly 10%. (See Exhibit 2.)

Exhibit 2: Russell Global Developed Markets and European (ex UK) Financials sector Equity Indexes



Source: Factset, Data as at 18 Aug 2011

It has been pointed out that European banks are heavily exposed to HYPES debt, and their capital bases are highly suspect. Recently however, European banks have been facing great difficulty obtaining short term interbank funding.

A variety of indicators, including short term interbank lending and swap rates have risen, and the ECB reports that European banks are electing to hold cash in the form of overnight deposits at the ECB rather than lend it out. In the first half of this week, they have parked some €80 billion in this facility; last week they deposited a total of €145 bn. Both figures are much higher than they have been in months. This suggests that banks are hoarding cash rather than exchanging it with one another – a sign that liquidity is at a premium. (Source: ECB)

The Financial Times (17th August) cites the ECB in reporting that an unnamed bank has asked for a $500 million credit line in USD, indicating stress in the USD funding market for European banks. Indicators of premia for USD funding versus EUR funding suggest this squeeze as well. The ECB has offered unlimited USD lending to European banks at a one week maturity with an effective interest rate of 1.11%. If they could have obtained one-week dollar funding on standard USD LIBOR markets, they would have had to pay only 0.18%. The fact that banks would borrow dollars from the ECB at a higher interest rate than that offered in LIBOR markets suggests that LIBOR lines are quite restricted.

There have been some noises that after the US downgrade, France was in the rating agencies' crosshairs. Is France becoming a problem?

French banks in particular have had a very tough time. They are amongst the largest holders of Greek debt, and also highly exposed to the Italian market. Last week there were rumblings that due to fears in the French banking sector, French government debt was at risk of a downgrade, the thinking being that the French sovereign would have to bear the costs of any French bank troubles.

In recent days, however, the three main ratings agencies have reaffirmed France's AAA rating, and President Sarkozy has been very vocal in his assurance that France would continue and intensify its fiscal discipline in the medium- to short-term.

What is going on with the European Fiscal Stability Facility (EFSF)?

The EFSF, as we have noted, has had its powers and its reach expanded at the July 21st Eurosummit. However, as we have indicated, this extension is subject to the approval of national parliaments. In Slovenia and more importantly the Netherlands this legislative approval is in some doubt. More worryingly, the free-market FDP party in Germany, a junior, but necessary coalition partner in Chancellor Merkel's government seems to be taking a dim view of the new EFSF. Chancellor Merkel might have to rely on the minority Greens and SDP to pass the EFSF's new powers. Furthermore, there is no plan to increase the EFSF's funding, and this might be necessary should the crisis spread to the point that Italy and Spain, the third and fourth largest economies in Europe respectively, need bail outs. While we wait for the EFSF votes in the EU legislatures, due to take place in September, the ECB, as mentioned, is the only entity that is empowered to stem the tide of the market.

Has the crisis abated in the last two weeks?

To some degree yes, in that Spanish and Italian benchmark yields, the best indicator of investor faith in these two large economies, have fallen since their late-July and early-August levels.

In addition to the positive reaction in secondary markets, both Spain and Italy had relatively successful auctions in primary markets recently. On August 10th, Italy sold €6.5 billion in 1 year notes at a yield of 2.96%. This represents quite a drop in a similar 1-year auction a month ago, when Italy had to pay investors a yield of 3.67%. This past Tuesday, Spain placed 5.7 billion in 12- and 18-month debt at yields of 3.35% and 3.59% respectively, a drop in borrowing costs compared to a similar issue a month ago which fetched 3.7% and 3.91% respectively.

Nonetheless, with interest rates that are above the projected growth rates of the Spanish and Italian economies over the next two years, the eventual sustainability of long term debt is still in question. To offset this difference between the debt service cost and the growth rate of the economy and stabilise debt-to-GDP ratios, both countries would have to run primary surpluses over the next two years, and this is unlikely. We still have to see more work done in individual countries and at the European Union level to stablise the long term outlook for the HYPES.

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