"The Past is Prologue"

The Tempest, *Act 2, Scene 1...spoken by Antonio*

The British Prime Minister, David Cameron, wasn't the only politician forced to cut short his summer vacation, as the on-going European sovereign debt crisis caused many of the Euro political elite to remain close to home during the traditional holiday month of August. Despite numerous presidential summits, finance minister meetings and central banker conventions, as of now the markets remain distinctly unimpressed with what has thus far been agreed, believing that the politicians have consistently failed to deliver on markets' expectations. This has led to continued weakness in Southern European bond markets, widening credit spreads and falling equity markets. And now, adding fuel to an already-blazing bonfire is the real prospect of a stagnation in European economic activity, as the German economy grinds to a halt.

How Did We Get Here?

To recap, Greece was the first Eurozone country to apply for €110bn bail-out package from the EU/IMF/ECB troika in the spring of 2010. At the time, the hope was that the package would prevent the sovereign debt crisis from spreading to the wider Eurozone. Unfortunately, it wasn't to be. With markets focussing on Ireland, unhelpful comments from German Chancellor Angela Merkel about private investors having to take "haircuts" post-2013 saw international investors shun Irish debt and the Irish government was also forced to apply for a €85bn bail-out in November 2010. This was quickly followed in May 2011 by Portugal, who sought an aid package of €78bn. Whilst each of these bail-outs individually and collectively calmed markets for a short period of time, a pattern was emerging – a short rally in bond prices and risky assets, followed by a resumption of the sell-off as investors realised that these measures addressed the liquidity of the three countries but not their solvency.

Additional Initiatives were put into Play.

In May 2010, the ECB announced a Securities Market Programme (SMP) that would allow it to purchase sovereign bonds in the secondary market but used it sparingly at first and then not at all for a considerable period. A special purpose funding vehicle called the European Financial Stability Facility also was created in May 2010 to preserve the financial stability of Europe's monetary union by providing temporary financial assistance to Euro area member states in difficulty. Although initially announced as being €440bn in size, the EFSF's effective lending capacity is actually only €255bn, reflecting a complicated system of over-guarantees and cash reserve buffers from member countries. None of the above measures were sufficient to calm market fears and the crisis reached a new level in July 2011 when markets became concerned about Italy's ability to fund itself.

With the world's 3rd largest debt market and a debt / GDP ratio of 120%, Italy needs to issue approximately €325bn in 2012 and €196bn in 2013 to replace existing debt, an ambitious target at the best of times. In early July 2011, investors took fright at the prospects for Italian debt and significant liquidation took place, driving yields to a high of 6.20% and spreads against German Bunds out to almost 400bps. With the bonfire now threatening to engulf Spain and Italy, it was time for another round of crisis meetings and another emergency leader's summit.

"Let's hope I have to work less hard in the next few months than I had to during my supposed vacation - I spent more time on the phone than on the beach".

Jean-Claude Juncker – Prime Minister of Luxembourg

Summer Summit "Solutions" not Optimal

To be fair, what was agreed at the end-July EU emergency summit exceeded market expectations, but crucially fell short of a comprehensive solution. Two main areas were addressed – first, a new loan package for Greece with longer loans at lower rates and importantly, voluntary debt restructuring options that could shave up to 20% off Greece's 150% debt / GDP ratio. Second, an increase in the size of the EFSF to €440bn, allowing it to buy bonds in the secondary market and re-capitalise financial institutions. Backing up these announcements, the ECB also announced a re-activation of its SMP and immediately started buying Spanish and Italian debt, driving 10 year yields down by over 100bps to 5% in both countries.

But the ink had hardly dried on the press release when disagreements amongst the politicians began to surface and markets reacted with predictable dismay, as it became evident that a larger EFSF needed parliamentary approval in many countries, a process that could take months. Recently the Finnish government demanded collateral against its loans to Greece, a move that sparked outrage from other countries, annoyed that they hadn't thought of the move first. And Greece has demanded a 90% take-up of its "voluntary" debt restructuring option; otherwise it won't proceed, meaning the bail-out package may have to be increased. At the moment, it's hard to see any light at the end of the Euro sovereign debt crisis tunnel.

Death Knell for Euro Premature

Our base case remains that the Euro will survive intact. People outside the Eurozone tend to underestimate the amount of political capital that has been invested in the single currency, the desire of the ordinary citizen to keep the currency, the tangible benefits that have accrued from the Euro and the huge financial costs of the Euro breaking up. Virtually no one blames the Euro per se for the troubles that Europe is facing today, hence the lack of a movement to return to national currencies. However, that's not to say we haven't considered the likelihood of the Euro breaking up, or some members leaving. Although this is a possibility, a number of factors persuaded us that a continuation of the status quo is most likely:

1. Any country leaving the Euro would have to revert to a domestic free-floating currency, which would immediately depreciate considerably against the Euro. This would decimate the local banking sector and domestic savings and require huge injections of capital to keep the system afloat.
2. Any country leaving the Euro would most likely default on existing Euro-denominated debt, and lose access to international capital markets. Therefore, such a country would need to run a budget surplus, which no country in Europe is presently doing.
3. History shows that any political party undertaking such actions in the past has been unelected for a subsequent 25 years on average, thus it's a form of political suicide.
4. There is no legal framework or process in the current European Treaty to allow a country to leave the Euro – it's a bit like the Eagle's "Hotel California" – you can check out any time you like, but you can never leave.
5. Lastly, the costs to the core countries of supporting Greece within the Euro are probably less than the damage that would be inflicted on European banks were Greece to exit and contagion spread to Portugal, Ireland, Spain and Italy.

From a purely pragmatic view, we also believe that no politician wants to be remembered as being responsible for the break-up of the Euro. That is why our consistent view has been that politicians will always sort out their differences and come to an agreement, even if it happens at the very last minute.

It's also likely that the recent concerns about collateral and political opposition to the upsizing of the EFSF will be addressed. Although the Finnish demand for collateral appears to be non-negotiable from a domestic political consideration, ways are already being discussed to get around this issue, (transferring soon-to-be-privatised Greek assets into a Luxembourg holding company or pledging Greek bank shares as collateral). Likewise, there are press reports that up to 23 deputies from Chancellor Merkel's own party will vote against EFSF enlargement in late September. Indeed, it now looks like it could be mid-to-late October before all European parliaments get to vote on the EFSF changes but ultimately, the deal is expected to be ratified, allowing the new EFSF to be up and running by early November.

No Easy Solution for Greece

We also believe that current negotiations between the troika (ECB/EU/IMF) and the Greek government around the disbursement of Greece's sixth tranche of aid will be successful, despite Greece failing to meet the targets set by the troika, allowing the funds to be disbursed in September.

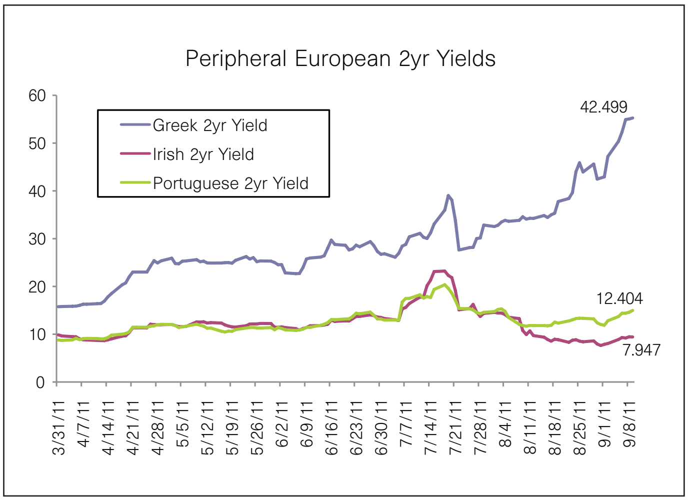
However, with current 1-year Greek yields north of 60%, markets are telling us that a Greek default is not a matter of "if" but rather "when" and the real debate should be around the recovery rate. As we noted above, even with a 90% take-up of the "voluntary" restructuring of Greek government debt, the debt/ GDP ratio is only likely to shrink from it's current 150% level to 140% by end-2011 (20% benefit from debt restructuring is offset by another 10% increase in debt/GDP ratio due to 2011 budget deficit).

That's simply unsustainable and with the current growth outlook in Greece decidedly negative, any hopes of growing their way out of their problems will not happen over the medium-term (i.e. next 3 years). So the choice becomes one of either kicking the can further down the road by continually increasing the size of Greece's bail-out package and extending the timeframe for meeting fiscal targets or accepting a much larger haircut in the near future that allows a return to some semblance of economic growth and the possibility of achieving a balanced budget.

In our opinion, the latter option will become a reality to officials and market participants in the next 12 months, with the size of the haircut probably settling around the 50% level. Although this will impact many European banks' earnings, most banks should be sufficiently well capitalised that such a haircut should not be a major concern. How to ring-fence Greece and prevent hair-cut fever from spreading to Portugal, Ireland and even Spain and Italy will be a much more important task for European officials.

Situation in Ireland and Portugal Still Dicey

Ireland's problems were mainly caused by an insolvent banking system, which has been addressed by a restructuring and recapitalising of the sector. Whilst on-going deleveraging challenges remain, Ireland is heavily dependent on its export sector and the recent slowdown in global growth could have knock-on effects on Irish growth and, by implication, budget deficit and debt/GDP targets. Markets are currently giving Ireland the benefit of the doubt, as evidenced by the fall in Irish 2-year bond yields (see following chart). Portugal's problems stem from a chronic lack of competitiveness and large-scale foreign financing of credit / investment in Portugal, which may not be rolled over. Although nowhere as bad as Greece, it is noticeable that Portuguese 2-year bond yields have not kept pace with Ireland's. Our view is that both Ireland and Portugal should escape debt restructuring (although both may need second bail-out packages), assuming that current official support for both countries remains in place, but the period around a Greek debt restructuring will be a difficult and volatile period for both countries' bond markets.



Source: Bloomberg

The Safety Net Only Stretches So Far

But in some respects what happens in Ireland and Portugal is not where the real concerns lie. Spain and Italy are already receiving support from the ECB's Security Market Programme, without which, yields in both countries' bond markets would be substantially higher than they are today. However, the ECB has been adamant that their actions are only a stop-gap measure until the EFSF is operational. Even then, the ECB's actions have not received unanimous approval from its governing council, as evidenced by the recent resignations of council members Weber and Stark. The dispute centres on whether recent bond purchases are regarded as quasi-quantitative easing, which is something that's illegal for the ECB to conduct. And why it matters is this: with a current operational size of €440bn, the EFSF might just about be able to fund bail-out packages for Greece, Portugal, Ireland and, at a push, Spain (which has €310bn of bonds maturing by end-2015). But there's no way it could cover Italy's funding needs if Italy gets frozen out of international capital markets. Over the next four years to end-2015, Italy needs to issue an average of €215bn each year to fund maturing bonds and with the ECB the only buyer of Italian bonds at current yield levels, the scale of the problem quickly becomes apparent.

With Italian debt being held widely in an international context, any haircut or default by Italy would blow huge holes in bank balance sheets worldwide, leading to forced bank recapitalisations by governments who in turn would have to borrow from international markets to supply the recapitalisation funds. A vicious circle then develops. So it becomes vital to support Spain and Italy while both countries attempt to bring their budget deficits down to more manageable levels. The ECB will continue to buy both Spanish and Italian debt until the EFSF becomes operational in Q4 2011 but we're wondering how effective the EFSF can really be, especially if most investors know that it doesn't have the ammunition to support both Spain and Italy much longer than 18 months or so.

The Lady or the Tiger?

That leaves Europe with two stark options – either the EFSF is again significantly increased to something like €2trn, or some form of common Eurobond needs to be issued. A recent German constitutional court ruling appeared to rule against Eurobonds but a common theme in this crisis has been the ability of politicians to circumvent legal strictures. An EFSF enlargement will be hugely controversial from a political aspect. Many northern European politicians have pledged to their local electorates that there will be no further bail-outs of profligate states and to renege on those promises could be risking the wrath of voters at the next set of elections. There's also the question of whether individual state's credit rating might be endangered by the scale of their contributions to a bigger EFSF – France's "AAA" rating would be primarily at risk here and that could jeopardise the overall mooted "AAA" rating of the EFSF. One suggestion is that the EFSF could leverage its current €440bn size (perhaps by being incorporated as a bank) and use those proceeds to recapitalise the European banking system, thus severing the corrosive link between sovereign and bank creditworthiness.

What We Think

Ultimately Europe will be left with no choice but to enlarge the EFSF until such time as Eurobonds can be introduced. It's also likely that the ECB will have to continue to purchase bonds under its SMP programme even after the introduction and enlargement of the EFSF, despite its obvious distaste for doing so. The issuance of "jointly and severally liable" Eurobonds will require considerable legislative work – the European Treaty will have to be amended and many countries will have to hold referenda to approve such issues. Some commentators have suggested it could take years to introduce Eurobonds – we prefer to believe that when politicians are in a tight corner, they can move pretty quickly. Hence our view that a larger EFSF and continued ECB buying are needed but that these will only be forms of bridging finance until the advent of common Eurobonds.

The fiscally-stronger states in the Euro monetary union will demand certain conditions for effectively lending their credit rating to a Eurobond - we suspect we will see things such as constitutional debt brake clauses introduced across Europe, oversight of national budgetary policies by a European committee, perhaps even a common Eurozone Finance Ministry that would determine fiscal targets for each country but leave the manner of achieving those targets to be decided by individual national governments. Not dissimilar to the United States of America, but with one major difference – the issue of default will most likely never arise with the US, because the US authorities can simply crank up the printing presses and churn out dollars to pay their debts. That's what would have happened too in the pre-Euro days in Europe when currency devaluations were commonplace. And it might also explain why the Euro has remained so resilient against the US dollar in this crisis…printing dollars tends to devalue the worth of the world's reserve currency, and international investors have already experienced two bouts of US quantitative easing.

It has long been a contention of many in Europe that fiscal union cannot be achieved without political union – we may be putting the cart before the horse in how we get there, but it looks ever more likely that Europe will see increased political union in the coming years.

About the Author

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Disclosures