

The Eurozone: The crisis continues



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Overview: The crisis continues

This section outlines some of the most recent events in the eurozone.

Greece continues to soak up funds with no sign of recovery

Never a suitable candidate to join the EMU and admitted only on the basis of falsified accounts, Greece has pushed the euro to the brink of destruction. The €110 billion bail-out package in 2010 proved inadequate. Then the need for a second bail-out sent markets into panic, while the relief that followed Greece's austerity plan in June 2011 proved fleeting.

In late July 2011, at yet another summit with the EU crisis on the agenda, eurozone leaders agreed a number of points in principle:

- A complicated €109 billion second bail-out of Greece, aimed at keeping Greece solvent through to 2014 and incorporating private sector involvement (PSI) for the first time. The summit agreed to a NPV reduction of private holdings by about 20%. Through a set of four complex options for exchange or rollover of private sector held bonds, private creditors will initially supply a third (€37 billion) of the bail-out package.
- The European Financial Stability Facility (EFSF) is to provide loans to Greece, Ireland and Portugal at a preferential rate of 3.5% for extended maturities of 15 to 30 years.
- The EFSF/European Stabilisation Mechanism (ESM) is able to purchase Spanish and Italian bonds in the secondary market in order to help stabilise prices. Ten-year yields had approached euro-era highs in early July, reaching 6.45% in Spain and 6.25% in Italy.

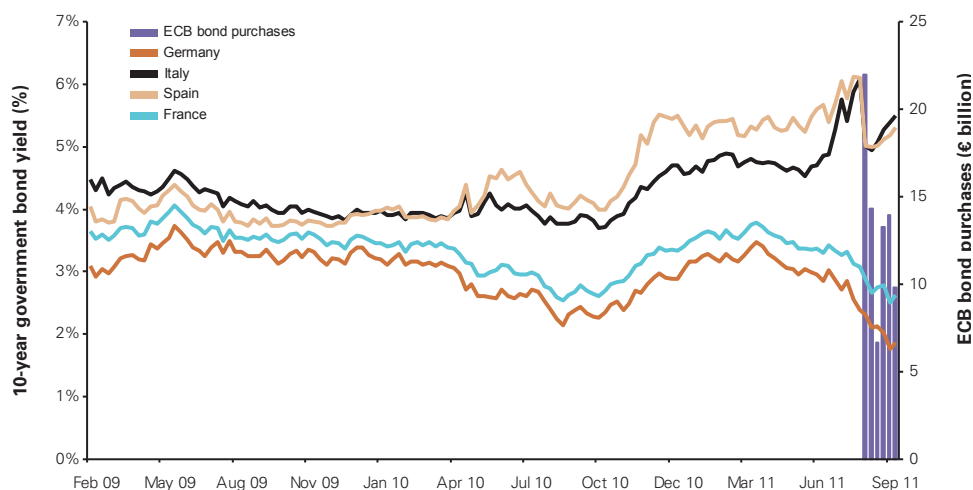
The ECB has conducted open market bond buybacks to quell markets

As the Greek situation became more explosive, the view that Europe was 15 separate bond markets, rather than one solid one, rapidly gained credence. Credit spreads in Spain and Italy, in particular, widened repeatedly from March 2011 onwards as member states hesitated and debated over the second Greek bail-out. Unlike Greece, neither Spain nor Italy has solvency problems but rather, liquidity problems. While solvency problems cannot be settled by central bank intervention, liquidity problems can.

In August 2011 the European Central Bank (ECB) boosted confidence by resorting to the extraordinary measure of buying billions of euros of Italian and Spanish bonds in the secondary market.² Each time Italian and Spanish yields rose, significant intervention by the ECB temporarily calmed markets and yields dropped closer to a more sustainable 5% (although the ECB is no longer focusing on this target). The quid pro quo was that Italy and Spain needed to conduct economic reform, cut their budget deficits and manage their debt.

“Policy actions taken in Europe since the emergence of the sovereign debt turmoil helped to contain the crisis, but not sufficiently to decisively put it behind us. Bold steps are needed to assuage market concerns about sovereign and financial risks and to tackle the underlying root causes of the crisis. Ultimately, more rather than less economic and financial integration will be key to the region's success...”¹

10-Year Government bond yields have widened in Europe over the last 18 months



Source: Datastream, Bloomberg.

European stability funds may be inadequate if contagion is not curbed

The ECB wishes to stop buying bonds in the secondary market once the EFSF is in a position to take over. Capitalised at €255 billion this temporary fund, to help indebted eurozone members excluded from markets by punitive borrowing costs, is due to increase in size to €440 billion later this year. In 2013, it is scheduled to be replaced by a permanent successor, the €500 billion ESM. With much of the €440 billion already committed to Greece, Ireland and Portugal, observers including European Commission chairman José Manuel Barroso, fear the size of the EFSF should be reassessed because it may not be adequate to contain the potential scale of the crisis. Should it come to it, the EFSF may have the resources to save Spain – but not Italy. Since the burden of a further increase in the size of the EFSF would fall principally on Germany's and, to a lesser extent, France's shoulders, not surprisingly Angela Merkel and Nicolas Sarkozy rejected the idea at their mid-August meeting.

There have been appeals for the issue of eurobonds

With the EFSF, each country guarantees its allocated portion – not the full amount. Commonly issued eurobonds, to be backed collectively by all members, are increasingly being proposed to reduce funding costs for participants. These bonds would be issued by an agency and cut the link between a country's borrowing costs and its creditworthiness. However, in mid-August, Chancellor Merkel and President Sarkozy opposed any pending issue. "We could imagine this, but at the end of the process of integration of the eurozone, not at the beginning," said Sarkozy, while Angela Merkel agreed that it would be a last resort, requiring changes to the constitution. Germany would only consider guaranteeing borrowing for other eurozone states with much greater economic and fiscal harmonisation and coordination.

The ECB has misguidedly increased interest rates - twice

The ECB has demonstrated a number of positive initiatives in recent months including buying bonds aggressively in the secondary market and pledging unlimited liquidity to the financial sector until early 2012. The latter was followed, in mid-September, by five central banks³ unexpectedly and jointly providing European banks with dollar liquidity, in three-month tranches, to protect them against a liquidity crisis, particularly around year-end.

However, raising interest rates by 0.25% in April and again in July, to 1.5%, is not among the ECB's credible initiatives. Maintaining price stability is the ECB's primary monetary objective and one which the ECB has pursued very successfully: the eurozone has enjoyed unprecedented price stability since the euro was introduced, "below, but close to, 2% over the medium term". Unlike the US Federal Reserve, mandated since 1977 with the wider goals of promoting maximum employment, stable prices and moderate long-term interest rates, the common monetary policy of the ECB, dedicated to low inflation, is independent of the fiscal needs of EMU members.

Following eurozone inflation of 2.7% in June and determined to boost its inflation-fighting credibility despite the burgeoning eurozone debt crisis, the ECB followed its April interest rate increase with yet another, in July. For a number of reasons, this was incorrect, ill-considered and unnecessary:

- Inflation was being driven by temporary external factors, including rising commodity prices, making interest rates a rather blunt policy instrument.
- Upward risks have since abated – inflation in the eurozone slipped to 2.5% in August.
- The authorities should have given themselves a few more months to assess the impact of austerity measures on the growth outlook – which has since deteriorated.
- Higher growth is critical to resolving the eurozone debt crisis; by its actions, the ECB served to inhibit growth and transparency.
- Rate hikes will hurt the weak peripheral economies more than the stronger, core eurozone economies.
- Jean-Claude Trichet, outgoing ECB President, might argue that with poorer growth prospects, they now have the flexibility to lower rates and, should they do so over the next six months, the potential stimulatory effect would vindicate the earlier rises – but that hardly justifies their earlier actions.

As growth indicators have slowed – both in the eurozone and globally – in early September Trichet appeared to make a U-turn on his hawkish interest rate strategy, with the result that markets are now pricing in a 0.5% cut by year-end.

The crisis of management in Europe is impeding its outlook

Throughout the euro crisis EU leaders have never missed an opportunity to miss an opportunity.⁴

In the minds of Trichet, Merkel and Sarkozy, they've taken bold steps, in recent months, to avert the eurozone debt crisis. In general, however, they're bold only in so far as they would have been inconceivable two years ago but desperate times call for far-reaching measures. Policy responses to date have been ad hoc and palliative – deferring difficult decisions to enable longer-term solutions. Despite the IMF repeatedly demanding quick, decisive action to end damaging uncertainty, responses have repeatedly been too little, too late. What we've seen is a series of last-minute, fire-fighting initiatives, offering temporary respite until the next crisis looms, each having a shorter half-life of success as the markets realise that things on a large enough scale are effected only when there are no other options.

Debt, contagion and slower growth caused the eurozone crisis. Stronger growth is the natural solution to the debt crisis but recent trends have disappointed. Not confined to countries at the periphery, core eurozone countries have also been experiencing a slowdown. GDP growth in Germany rose to 1.3% in Q1 but fell to 0.1% in Q2; up until

then, German companies had enjoyed a bumper year with a depressed currency boosting competitiveness. Economic growth in France fell to 0% in Q2; the eurozone grew by only 0.2% in Q2, after 0.8% in Q1. Naturally, slower economic growth compounds the difficulties for governments in reaching their deficit targets. However, the deceleration in Q2 growth should not be exaggerated because:

- Mild weather in Europe meant Q1 was stronger than usual, making for a tougher than usual Q2 comparison;
- The adverse effects on the global supply chain of the Japanese tsunami hit in Q2;
- France and Germany grew relatively steadily over the first half of 2011.

“Policy responses, in as much as they are responsive, not proactive, mean they are a reaction to things that are going wrong. Consequently, the effect on capital markets, while they remain reactive, will continue to be negative.”

William Davies,
Head of European Equities,
Threadneedle.

In terms of prospects, the IMF is now looking for eurozone real GDP growth of 1.6% in 2011 and 1.1% in 2012. At Threadneedle, we have revised down our expectations for 2011 to 1.8% with activity slowing, especially towards year-end, and 1.1% GDP growth next year.

Rapid deleveraging is the main risk to growth

Looking at the larger eurozone economies, private sector lending numbers in France and Italy have remained particularly robust, with domestic loans to households and companies growing around 6%-7%. In Spain, however, the banks have been excluded from the funding markets for a while, with the result that loans to corporates and households have remained at or below 0%, illustrating the deleveraging of the banking system.

If we were to be pushed to a systematic risk situation in the coming months, this could be the cause. In particular, if loan figures in Italy and France were to turn around, with rapid deleveraging in the eurozone as a whole over the next few months, this would give us cause for significant concern

The IMF is putting together an extensive rescue package to help avoid global meltdown

At the time of going to press, the IMF is putting together an extensive rescue package. It is difficult to know, at this stage, what is fact and what is conjecture. But it is clear that new plans frequently get mooted and we do not know which combination will actually get followed. But for now the plan reportedly has three important dimensions:

- A 50% write-down of Greece's sovereign debt, with private investors in Greek debt also having to accept a 50% reduction in what they are owed.
- An increase in the size of the eurozone bailout fund to €2 trillion. This would be achieved by allowing the ECB to lend alongside the EFSF.
- A strengthening of big eurozone banks, which are still thought to be undercapitalised.

Although the plan is apparently to be put into action within six weeks, it will not be easy. Markets have generally been unimpressed with the speed at which policymakers have dealt with the eurozone debt crisis, and more than ever, actions are needed over words. And we should not forget that the price of failure is high.

Some key questions still dominate the eurozone

If monetary policy has failed, is fiscal policy the solution for Europe?

The primary problem in the eurozone appears to be that the monetary union lacks a fiscal foundation. Many observers now question whether it is possible, or desirable, to have a single currency in the absence of common fiscal policy. Recent experience has proven it's not viable to have monetary union without greater financial integration, or some form of transfer union.

Widening growth discrepancies have resulted in the ECB, at times, having simultaneously to set interest rates to accommodate economies registering positive and negative growth. In the place of asymmetric shocks, one-size-fits-all monetary policy has been tested to the maximum. In the absence of similar business cycles, optimal monetary policy diverges.

The stage has now been reached where the options appear to be closer fiscal union or dissolution of the eurozone. With the former, peripheral countries should have access to subsidised borrowing, ideally through the issue of jointly and severally underwritten eurobonds. Ultimately, fiscal transfers between member states would reduce the impact of asymmetric shocks while, at the same time, strengthening the entire eurozone.

Could the euro ever be abandoned or Greece leave the eurozone?

Over the past two years, the euro, the 'jewel in the crown' of post-war politics and economic integration has been tested to near-destruction. While the Maastricht Treaty has no exit or default clause (which doesn't mean this couldn't happen) and costs attendant on the exit of a country or countries would be huge, we are increasingly of the view that Greece will exit the euro. With Europe in crisis, the issue is really to determine the least damaging outcome. Peripheral Europe, particularly Greece, has excessive debt, recession and an uncompetitive exchange rate and faces a potential range of extremely unattractive outcomes. Even if the German public were somehow persuaded to foot the bill, it is not obvious that Greek citizens would be persuaded to accept it and pay the economic consequences in terms of the imposition of fiscal rules upon them. Moreover, it would not address the problem of competitiveness which could only be improved by a very significant fall in Greek living standards – amounting to a prolonged recession there.

Greece exiting the euro would be a traumatic event for the European financial system. The key issue is whether it will be carried out in a coordinated or an uncoordinated manner. If coordinated, accompanied by a state-funded recapitalisation of the banking system, a cut in rates and a massive liquidity injection, this would potentially be a positive event, enabling markets ultimately to move beyond the recurring crisis. Moreover, it would act as a catalyst for Italy and Spain to address their deficits. For Greece it would be extremely unpleasant and traumatic but, if well-planned and implemented would, at least, give Greece the opportunity to move beyond its vicious cycle of insolvency, low competitiveness and ever-deepening depression.

"We are challenged by the markets concerning the discrepancy between the perceived weak degree of fiscal policy integration and the high level of monetary/financial interdependence..."

Herman Van Rompuy,
President European Council,
7 September 2011.

Are guaranteed eurobonds the solution?

The purchasing of Spanish and Italian bonds by the ECB can only be a temporary solution. Increasing the size of the EFSF beyond €440 billion or the issue of eurobonds, collectively backed by all members and jointly guaranteed providing 'cheap' funding to members experiencing borrowing difficulties, are more permanent solutions. The latter would provide the eurozone with a fiscal foundation. Current ECB rules prohibit the monetisation of members' debts; the ECB would issue its own bonds to 'sterilise' the potential inflationary impact of the money printed to buy government debt. With a 4% of GDP deficit for the entire eurozone (significantly below levels in the US and Japan, both of which are able to borrow very cheaply), commonly issued eurobonds would be well received by the markets. Pooling of debt, enabling low-cost borrowing across the eurozone, could resolve the crisis. This represents the 'ultimate' solution and does not appear imminent.

A framework of fiscal integration and coordination with cooperation between eurozone states, as Angela Merkel proposes, is a pre-requisite for eurozone guaranteed bonds which would require members to put aside overriding self-interest and concerns over loss of sovereignty in a 'United States of Europe'. Moreover, structural reform, harmonisation of rules to encourage greater pan-eurozone integration and mobility of labour, capital and enterprise are additional pre-requisites.

Can Spain and Italy be protected from rampant contagion?

With peripheral countries significantly in debt to each other and to core members, euro contagion can spread frighteningly easily and quickly. Loss of confidence in a member country leads to bond yields rising to unsustainable levels, the problem mounts and an almost self-fulfilling vicious circle develops. Greece, unfit to join the eurozone and entering on fabricated accounts, is the paradigm. Contagion to the core euro area, through lack of confidence, remains a significant risk. Italy and Spain are not strong enough to resist contagion but are much stronger than Greece, Ireland and Portugal. With appropriate policy measures, both should be able to withstand the crisis – although volatility will remain high.

"Whether we get that economic rebalancing away from the core and towards the periphery over the next few years, as more and more structural reforms are introduced, will be the defining long-term factor for the eurozone."

Martin Harvey,
Fund Manager, Fixed Income,
Threadneedle

"We have discovered that three countries, representing about 6% of the GDP of the euro area, could threaten the financial stability of the eurozone... Lack of financial oversight played its role. But clearly, the financial and monetary interdependence had been hugely underestimated."

Herman Van Rompuy,
President European Council,
7 September 2011.

With crisis comes opportunity – how Threadneedle views investment prospects

European equities have some compelling valuations

In general, European equities are fundamentally strong, highly liquid and trade on low valuations. To look at the valuation of the equity market on a price-to-book basis (currently a more accurate valuation measure than price-earnings ratio), with the exception of Q1 2009, the market is as low as it has been for the past 30 years. Even with financials stripped out, the market looks as cheap as it has for the last 20 years, notwithstanding Q1 2009, as can be seen in the chart below. This implies a really sharp downturn, although it's uncertain how sharp any downturn could be. Whether we get a sharp downgrade in growth depends on a number of factors, including:

- a seminal event in Europe that leads to a break-up of the euro;
- a belief that one of the large countries will have to exit the euro;
- Greece will exit or default.

Price-book ratios for non-financial sectors, Europe ex-UK, 1980



Source: Datastream.

Threadneedle - an equities investment perspective

- In an environment such as this, we look for steady growth companies which are not particularly dependent on the strength of the economy.
- Our focus on companies that do well in a tough environment includes: healthcare equipment, steady-growth food manufacturers and software companies with sustainable top-line growth.
- We are also looking at companies on extremely low valuations.
- We focus on companies whose valuations are discounting an environment worse than any we've seen over the past 30 years.
- We are underweight financials in our portfolios.
- The companies we focus on have quite high margins; their balance sheets are very strong and they seem well-positioned to cope with a downturn.
- Lowly-leveraged companies can borrow cheaply and can use the low cost of debt to invest in themselves and to make acquisitions.
- With returns on cash very low, the opportunity cost for cash-rich companies of investing is low, as are the returns required to beat the cost of capital.
- We expect M&A activity to accelerate over the next 12 months.

“The balance sheets of large firms in the core economies are generally in good shape, allowing them to self-finance their expansion projects...”

IMF Regional Economic Outlook, 'Europe Strengthening the Recovery', May 2011.

We do not believe that the eurozone countries will be proactive enough to come up with a lasting solution, without experiencing further pain. Indeed, pain creates weakness, forcing countries to accept what is imposed upon them. Equity valuations are currently factoring in a great deal of pain. We expect it to remain a very volatile period in the markets but know from experience that patient stock pickers enjoy the opportunities of lowest share prices at times of maximum uncertainty. There are good opportunities there for the taking.

Caution remains the key word in fixed income

Scenario 1: Effective monetisation due to weak growth and a negative feedback loop

If there is a very weak growth environment going forward, with a negative feedback loop from lack of confidence in policy credibility, we could end up with ECB monetisation as the only possible outcome. That would be positive for risk assets, not only in Europe but globally, since much of the global financial system is being undermined by concerns over the eurozone.

Sovereign bonds

Over the past 18 months, the key decision has been one of allocation between core and peripheral credit. Mostly it has been right to be cautious. Were there to be a credible solution, or a significant step forwards concerning eurobonds or monetisation, which increased confidence that the likelihood of default was substantially reduced, that would be a positive environment for peripheral bond markets. Obviously there is a great deal of yield to be reaped in those markets. Whether this can be done without a 'haircut' to Greece in the next two years, the market obviously doubts, which is why these assets have continued to underperform.

Scenario 2: Keep kicking the can down the road

If events simply grind on, with no agreement over the issue of eurobonds, the likely outcome is less clear.

Sovereign bonds

If the authorities keep kicking the can down the road, the bund market remains very attractive. Italian bonds are tricky. We await the EFSF's ability to purchase bonds in the secondary market but do not know how aggressive they will be. Attempts to increase the firepower of the EFSF could potentially soothe markets' immediate fears. This is likely to require cooperation with the ECB, further prolonging their involvement. Their method of operation has not inspired confidence in bond investors thus far due its sporadic nature, so a more concrete commitment would be a positive development. However, institutional and political stumbling blocks will continue to bring this commitment into question. Consequently, we are still cautious on Italian bonds – our favoured peripheral market over the past few years. We believe it is a case of playing it safe and remaining cautious on Italy and Spain. Until recently, there was a good tactical trading environment for Italian bonds, but that changed in July when spreads broke through 200 basis points and we fear the liquidity lost in that market will not return anytime soon, again supporting our cautious stance.

Covered bonds

Secured against pools of loans with a bank guarantee, covered bonds remain attractive. In the medium-term, they have the regulatory structure which makes them very safe and the fact that the ECB bought €60 billion of covered bonds in 2008-2009 shows them to be an asset class supported by the central political authority (and indeed, the ECB is discussing reinitiating these bond purchases). We would be comfortable holding them as yields decline.

More Threadneedle thinks to follow

Ongoing volatility in financial markets will continue over matters of sovereign debt and potential problems with continental banks. Both these factors will give rise to a range of investment opportunities which Threadneedle will continue to evaluate. Watch out for regular 'Threadneedle Thinks' market commentaries over the next 12 months.

References

- ¹ IMF, Regional Economic Outlook 'Europe Strengthening the Recovery'. May 2011
- ² The ECB has bought €143 billion of eurozone government bonds since May 2010. Nearly 50% of purchases have been since the second week of August 2011.
- ³ The ECB, Federal Reserve, Bank of England, Swiss National Bank and Bank of Japan.
- ⁴ Megan Greene. Noch eine verpasste Chance für den Euro. Die Zeit. 17 August 2011.



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