

Has Europe done enough and what does it mean for the world?

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Key points

- > Europe has announced plans to write down more Greek debt, recapitalise banks, expand the firepower of its bailout fund and strengthen fiscal integration.
- > Apart from a lack of details, the latest response suffers from a number of weaknesses and it's doubtful it will mean the end of the European debt crisis. The vicious cycle of fiscal austerity, weaker growth, budget blowouts, ratings downgrades and more fiscal austerity will likely remain. Europe desperately needs easier monetary policy.
- > The latest plan should help avoid a near-term global financial blow-up and it adds to confidence that global growth will remain positive (albeit sub-par) which should offer some support for share markets which have been fretting about a global recession.

Introduction

October has seen a strong rebound in share markets driven by a combination of improved data out of the US and signs Europe is heading towards a “comprehensive” response to its sovereign debt crisis. After some delay, Europe has finally announced a range of measures. Unfortunately much of the details are yet to be worked out so it looks more like a work in progress than the final solution. This is the third attempt by Europe to get its debt problems under control. Will it work and what does it all mean for investment markets?

Debt response 3

The key elements of the latest package are as follows:

- > A 50% haircut for private investors in Greek bonds.
- > A program to recapitalise banks thought to require around €106 billion, with banks given till mid-2012 to get core capital ratios up to 9% (after writing sovereign bond holdings down to market levels), after which they have to rely on their governments or lastly the European Financial Stability Facility (EFSF) for funding.
- > A scaling up in the firepower of the remaining funds in the EFSF (of around €200 billion) to around €1 trillion, by using it to provide first loss insurance on sovereign bonds and associating it with a special purpose investment vehicle which would buy bonds issued by struggling countries such as Spain and Italy, with funding hopefully coming from non-European sovereign wealth funds, the International Monetary Fund (IMF) and private investors.
- > Measures to further integrate fiscal policies.

Will it work?

The latest set of measures goes further than those before and should help to head off a near-term meltdown. Europe has accepted the reality that Greece is insolvent (with its debt to gross domestic product (GDP) ratio projected to grow to 180% of GDP next year), so it has moved to further reduce Greece's debt burden and protect banks as well as other countries in the process.

However, announcing a plan is one thing, but implementing it is another. Europe hasn't done too well on this front over the last 18 months. More broadly, it's doubtful this is the end of the European debt crisis.

Firstly, while the Institute of International Finance has apparently agreed to the ‘voluntary’ 50% write down of Greek debt, actually achieving acceptance from individual banks and financial companies won't be easy. It took two months to reach 90% acceptance to the 21% ‘hair cut’ announced on 21 July 2011. Also, one wonders what the point is of having so-called credit default swap (CDS) insurance on Greek debt if it won't pay out on a 50% loss. Investors might start wondering whether CDS insurance on other investments is equally as useless. Furthermore, the proposed ‘hair cut’ is probably not sufficient as once allowance is made for debt holders who won't participate in the haircut (such as the IMF) it will only amount to a 25% write down to Greek debt.

Secondly, it's doubtful the recapitalisation of European banks thought to cost €110 billion will be enough, with most estimates suggesting the figure should be around €200 billion. Allowing banks until mid-2012 to recapitalise on their own will only allow uncertainty to linger. More importantly, and despite regulatory oversight, many European banks would rather boost their capital ratios by shrinking their balance sheets (ie by cutting lending) than accept government funds. Asset reduction plans already announced add up to around €1 trillion. If banks follow through with this, the impact from such a lending cutback on growth will be significant. The forced recapitalisation approach used by the US Government in late 2008 was arguably more effective in making sure banks maintained lending levels.

Thirdly, numerous uncertainties remain around the enhancement to the firepower of the EFSF:

- > IMF and non-European sovereign are likely to be involved, so this means waiting for the G20 Summit next week and probably beyond. The US already seems to be sceptical of greater IMF involvement as participating in such a fund would go beyond anything the IMF has ever done before, and sovereign wealth funds are likely to be sceptical after the bad experience of helping to recapitalise US banks three years ago. In fact it's hard to see anything beyond token involvement from China.
- > The involvement of sovereign wealth funds would probably entail a cumbersome governance arrangement.
- > Getting private sector involvement may be difficult, without attractive terms.
- > It's doubtful the proposed firepower of €1 trillion will be enough. This would only cover Spain and Italy's gross financing needs over the next two years. To cover Belgium and France will require €1.7 trillion.
- > Whose bonds would be bought? Obviously Spain and Italy are prime candidates, but what about France and Belgium? And if it's not the latter, why won't speculators attack those markets? This already appears to be happening, with a sharp rise in the relative borrowing costs between France and Germany since July.

French bond yield spreads now on the rise too



Source: Bloomberg, AMP Capital Investors

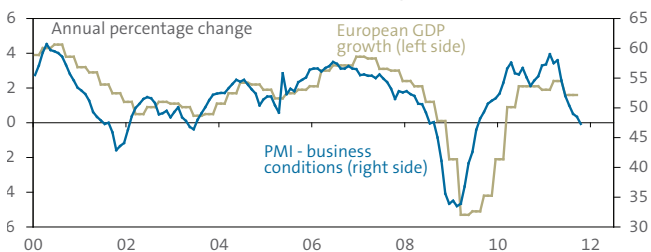
- > If the EFSF is to take first loss on bonds then it entails more risk for countries that guarantee it, because they will potentially take a loss with no chance of recovery. This naturally adds to concerns France will lose its AAA credit rating, which partly explains the recent blow out in French bond yields. And if more countries lose their AAA credit rating, this will threaten the EFSF itself.
- > While the scheme has the approval of the German Parliament it may still be subject to legal challenges.

The limited and restricted buying power of the enhanced EFSF contradicts the first rule of successful market interventions, which is that buying power be unlimited and unpredictable.

What Europe needs is an unlimited buyer of bonds in troubled countries to ward off speculators. Gearing up the EFSF by using money from the European Central Bank (ECB) would have achieved this with less threat to credit ratings. Unfortunately both the ECB & Germany have ruled this out.

Finally, none of this changes the underlying reality that fiscal austerity is causing a vicious cycle where austerity depresses growth, making deficit reductions unachievable, causing more ratings downgrades, more bouts of panic, even more fiscal austerity and even weaker growth. Business conditions indicators already point to a recession for the EU, so clearly a circuit breaker is needed. This normally comes from monetary easing and exchange rate depreciation, but the ECB is still missing in action on this front.

Business conditions in Europe pointing to recession



Source: Bloomberg, AMP Capital Investors

This all suggests that it's doubtful the response put up by Europe will end the debt crisis, nor will it prevent Europe falling into recession. However, it probably will help head off a worst case financial meltdown scenario, therefore avoiding a much deeper recession in Europe. As such, it adds confidence to our view that the global economy won't fall into recession over the year ahead.

What about the world and share markets?

A month ago I set out a list of five measures that would help keep the global recovery going and provide confidence to investors. So where do we stand on this list?

- > **Coordinated global monetary easing:** well it's not quite coordinated but we are seeing global monetary easing with rate cuts in Brazil, Russia, Israel, Turkey and Indonesia, as well as quantitative easing in Switzerland and the UK and China starting to ease at the margin. Obviously there is more to go, with Europe and Australia likely to ease soon.
- > **An increase in the firepower of the European bailout fund:** on the way but not as aggressively as hoped.

- > **Aggressive and unlimited buying of European peripheral country bonds by the ECB/expanded EFSF:** there is still further to go on this front.
- > **Recapitalisation of European banks:** this is set to occur although not optimally.
- > **The passage of President Obama's stimulus plan:** this is yet to occur and looks debatable given the polarised political machinations in the US.

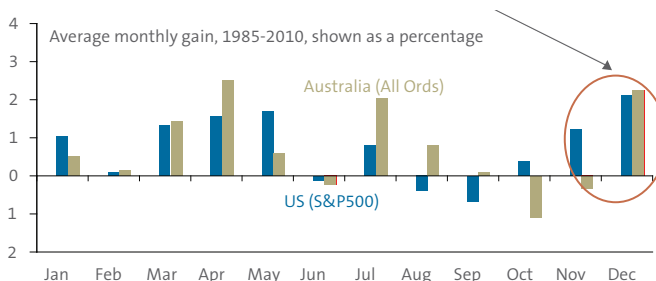
While we are yet to see everything on this list achieved, we are at least moving in the right direction. Furthermore, US economic data has picked up some pace recently, consistent with growth of around 2-2.5%. This is not great, but is also not the recession feared a month ago.

Overall, we have become more confident that the global recovery will continue with around 3% global growth next year, with 1% in advanced countries and 5% in the emerging world. This is sub-par but not a recession.

Since early October share markets are up by around 10 - 12%. A further bout of short-term weakness cannot be ruled out and the ride is likely to remain volatile. But against this:

- > Value is good. This is particularly evident in Australian shares, with grossed up for franking credits, dividend yields still high at 6.7%. For financials and blue chip stocks, dividend yields are even higher than this. This is well above bank term deposit rates and means share values only need to rise by 3% per annum or so to provide pretty attractive returns for long term investors.
- > US economic data has improved with solid September quarter profit results.
- > Europe is far from out of the woods, but is moving to substantially reduce the risk of a rerun of a global financial crisis.
- > After the September quarter, which is normally the weakest quarter of the year, October often marks an important turning point ahead of some strengthening into year-end. So far, it looks to be the same this year.

Shares entering a stronger part of the year



Source: Bloomberg, AMP Capital Investors

All of this suggests there is a good chance that we will see further gains in share markets into year-end.

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