October 2011

Outlook on **European Fixed Income**

Judging from news headlines, market rumors, and press articles, the European debt crisis appears to be approaching a climax. The key obstacle continues to be a lack of investor confidence that European Union (EU) decision makers will reach consensus any time soon. Still, it is worth acknowledging that the 17 states comprising the Eurozone have made progress over the last few months, despite the requirement of unanimous decisions and the potential need for constitutional amendments.

A number of measures have been taken on this front:

- The European Financial Stability Facility (EFSF) has been expanded and redesigned, and will soon be operational for potential secondary market purchases after the last round of national ratifications. Most countries vote through October 7, 2011, with the exception of Slovakia, from which political disagreement and extensive approval processes have delayed a decision.
- A permanent European Stability Mechanism (ESM) is expected to be ratified as a replacement for the EFSF in 2013 (European Union treaty amendments have been initiated).
- The European Central Bank (ECB) has embarked on purchasing sovereign debt in secondary markets under its Securities Market Program (SMP).
- Fiscal and economic adjustments have been made. For example, several European countries have implemented further austerity measures.
- So-called "debt-brakes" (constitutional limits on new debt) have been implemented by several countries.
- Germany and France have pledged to harmonize their tax regimes beginning in 2013.
- The European Union Commission has suggested amendments to the Stability and Growth Pact, and member states have embarked on a new initiative, the Euro Plus Pact, which advocates political reform to strengthen the fiscal standing and competitiveness of countries in the EU.

European Union member governments have stated at various junctures that there is no alternative to a political, economic, and fiscal integration of Europe and the Eurozone. We support this view. Our analysis suggests that the economic costs of dismantling the Eurozone would far exceed the cost of bailing out weaker member countries. We believe that should a weaker country exit the Eurozone, it would likely trigger public and private sector debt default and a collapse of banks and foreign trade in that country. Should a core country choose to exit, we would expect to see significant currency appreciation and a distortion to trade and the financial sector. In addition, the political costs might include the sacrifice of a common European (goods) market, and loss of international influence and reputation.

The current lack of confidence of capital markets partly reflects the unusually protracted nature of the Eurozone sovereign debt crisis. This has led investors to overemphasize default risks in some European countries, in our view, particularly those countries in the European periphery. For example, default protection premia for Spain and Italy (as measured by five-year credit default swap spreads) rose to more than 4% and 5% each year, respectively.

Conversely, the International Monetary Fund (IMF) forecasts that in 2011, Germany will have a primary surplus of 0.4%, while, interestingly, Italy should have a surplus of 0.5%. The Eurozone is expected to record a deficit of 1.5%, on average. This figure measures well relative to the United States, the United Kingdom, and Japan, which have projected deficits of 8%, 5.6%, and 8.9%, respectively.

In our view, Europe needs to buy time via loans for weaker countries, while at the same time, build a framework for further integration and a fiscal austerity policy. Still, significant risks remain. In September, the Purchasing Managers Index readings for various Eurozone countries fell further than expected, which may be a sign of a possible recession in the second half of 2011. However, other economic surveys are not yet in recessionary territory. In addition, the ECB has indicated its willingness to respond if macro data worsens.

One might ask, "what else could go wrong?" To start, Greece's fundamentals will not change quickly. We believe that the quarterly "Troika" reviews will continue to pose a risk to the market and its solvency. The European banking sector is in the midst of a recapitalization process. The Private Sector Involvement (PSI) in the voluntary Greek debt restructuring aims for a participation rate of 90% (if lower, Greece could withdraw from the restructuring plan). The details on the new €109 billion loan program for Greece need to be finalized, as well as the passing of the country's budget for 2012.

The Greek privatization program has frustrated its European partners. In addition, we believe Italy needs to progress with structural reforms despite continued government instability, while a new pan-European financial transaction tax promoted by Germany and France might upset financial markets.

What's next for the Eurozone? The October tranche of €8 billion for Greece should be released as soon as the required austerity measures are enacted and the redesigned EFSF is ratified. This should provide Europe with more time. An EU decision is now expected in the second half of October. If the October loan is released, the next obstacle will be a bond redemption in December. We believe that insolvency with unknown consequences for the European banking sector, and the European economy in general, poses risks big enough to keep the pressure on Greece to implement reforms, and to also release new loans in sync with austerity measures.

In addition, the ECB needs to stay the course and continue its SMP program, despite policy disagreements. Jürgen Stark, the ECB's chief economist and one of the most prominent opponents of the SMP program, declared his resignation at year-end. At its September meeting, the ECB reduced its 2012 growth estimate from 1.7% to just 1.3%, and abandoned its tightening bias, focusing instead on downside risks for the European economy. On October 6, 2011, ECB President Jean-Claude Trichet chaired his last council meeting before Mario Draghi succeeds him in November. The meeting resulted in additional non-standard measures, such as a €40 billion covered bond purchase program in the primary and secondary markets that is intended to help spreads stabilize and enable European banks to fund via the covered bond market. Further, the ECB will again provide European banks with long-term repo facilities; in one case, going as far as January 2013 at a fixed rate and full allotment. The ECB chose to postpone a rate cut but, in our view, the non-standard measure will prove more effective.

Italy, Spain, Portugal, and Ireland possess different fundamentals relative to Greece. Italy proceeded with severe budget cuts, after pressure from the ECB, Spain privatized some of its banks in a difficult environment, and Ireland has proven its ability to exceed expectations around austerity measures and growth. These measures have been rewarded by the strongest bond market performance in years for these countries. Since its low in mid July, the market for Irish government bonds has risen close to 48%.[1] Portugal returned approximately 15% for the same period, making some fiscal progress, despite disclosing that the 2011 budget deficit of 5.9% will be exceeded. European sovereign yields should continue to reflect the ongoing uncertainty surrounding Greece's default risk, Italy's re-funding needs, and Spain's general election on November 20, 2011. In our view, ten-year Bund yields are not sustainable at their current levels of close to 1.80%. Short-term Euribor contracts currently imply a rate cut by the ECB in November and potentially another cut by March. With two-year German government bond yields now at 0.60%, bond market expectations appear to support a dovish monetary policy outlook and low yields in core Europe for a prolonged period. Even without quantitative easing, core European government bond yields are low, which is mainly a reflection of investors seeking a safe haven in Bunds and other AAA-rated European countries, such as the Netherlands, Austria, or Finland.

In our view, although the crisis is far from resolved, the market has not yet rewarded the progress made in resolving Eurozone troubles. However, we believe that investors will ultimately be convinced. Thus, we are optimistic and expect further progress in the region.

Notes

1 As measured by the J.P. Morgan Irish Government Bond Index as of September 30, 2011.

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