Market Comment

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Special Update

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Opa! The Greek Debt Crisis: Implications for investors

European credit spreads, particularly those for Greece, began to rise late last year, following the revelation by the new Greek government that its deficit would amount to more than 12% of 2009 GDP. The previous estimate was under 4%. That prompted the European Commission, the executive body of the European Union, to question the accuracy of the data and demand immediate action from the Greek government to cut its deficit over the next three years. It also resulted in credit ratings downgrades from Fitch, Moody's, and Standard & Poor's. The issue is not so much Greece's ability to make interest payments, but rather its ability to access the bond markets to refinance its debts which, if not addressed, suggest an increasing likelihood of default as it faces significant debt maturities in the year ahead.

It has also prompted a re-evaluation of what a country's membership in the European Union does and does not imply for bond holders and has spread to encompass other weaker European economies with deteriorating government finances, which have become collectively known as the PIIGS (Portugal, Ireland, Italy, Greece, and Spain).

This has raised the level of uncertainty regarding the economic recovery across the euro zone and also for the still-fragile state of the European banking system, which is a large holder of these bonds. Not surprisingly, equity markets around the world have responded by falling some 5-10% from their January highs, but appear to have stabilized as policymakers have turned their attention to this matter.

HOW DID WE FIND OURSELVES IN THIS SITUATION?

The ratification of the Maastricht treaty in 1993, and the formal adoption of the euro as a single currency at the turn of the century marked a new political and economic relationship between Europe's members. In exchange for ceding certain sovereign rights to a central European entity, member states received access to a unified common market alongside other benefits. For many of the economically weaker states, these included significant transfers of financial wealth and, most importantly, the benefits of improved credit ratings and lower borrowing costs that come from being associated with the likes of Germany and France.

For perspective, prior to the Maastricht treaty, Greek government bonds traded at a yield premium of some 16% above German government bond yields, while Spanish, Portuguese and Italian bonds traded at a spread of between 4% and 7%. Not long after the euro was adopted, spreads had collapsed to less than a half-percent, a level at which they remained until the financial crisis in 2008. This new reality afforded these governments financing terms of which they could not previously have dreamed.

The cost of joining included an agreement to meet certain benchmarks with respect to government deficits and debts. However, the treaty was lacking in any overt enforcement mechanisms and thus many members freely ignored the restrictions, as the penalties for non-compliance were deemed remote. In good times, non-compliance was a mere annoyance; however, the credit crisis has resulted in the exponential compounding of the other major cost of EU membership – the ceding of sovereign control over monetary policy and currency.

Were Greece not an EU member, the textbook outcome of such a crisis would include the rapid devaluation of the currency. This would provide an edge to exports and tourism, and thereby leverage stronger growth in other countries as a means of economic resuscitation. In addition, the Greek central bank would be free to pursue whatever monetary policies it required to meet its objectives. As a member of the EU, however, the Greeks are stuck with a strong Euro and conservative euro zone monetary policy (official short-term rates at 1% are low, but much higher than the U.S. fed funds rate and Canada's Bank Rate). This leaves only one avenue for addressing their profligate ways: intense reductions in state budgets and painful economic contraction at a time when economies around the globe are still reliant upon government stimulus in the aftermath of the deepest recession in 70 years.

Recently, efforts by the Greek government to rein in its deficit have been met by challenges from unions and other entrenched interests, raising the spectre of significant social unrest, and increasing doubts about the ability of the government of Greece, or the governments of any other PIIGS members, to take effective action.

HOW MIGHT THE SITUATION BE RESOLVED?

The most expedient solution would be some form of bailout. Typically, such a bailout would be the role of the International Monetary Fund (IMF), which has both the resources and expertise in economic restructuring, and which played a similar role in many of the Emerging European economies as little as a year ago. For the EU, however, the idea of having a member state bailed out by the IMF would be a blow to the credibility of 60 years of political efforts.

The EU constitution itself prohibits a centralized bailout or assumption of debt by the European Central Bank (ECB), although there is room for individual nations to take action of their own. Just how willing they will be to do so is in question given that all EU nations are busy focusing on their own economies, and the majority of them have exceeded the EU deficit thresholds. Moreover, such a bailout raises the risk of moral hazard; i.e. it reduces the incentive for governments facing such circumstances to take decisive action as they will be bailed out by their rich cousins. For those rich cousins, primarily Germany and France, this also raises the prospects of writing blank cheques to the rest of their newly extended family.

The risk of not bailing out Greece is also stark. A default by Greece would undermine the credibility of the EU and could spark a dangerous process of speculation over the next state to default, dramatically raising borrowing costs for many and threatening the economic recovery. In addition, the still-recovering European banking system remains a large holder of peripheral European government debt, suggesting that the broader EU already has skin in the game.

Stuck between a rock and a hard place, the apparent strategy appears to be one of voicing solidarity and providing moral support for Greece, while refraining from offering any concrete help for as long as possible. In our view, the most likely outcome, and the one that appears to be discounted by the market, is an eventual bailout, but with significant IMF-style conditions attached, so as to discourage others from lining up too quickly.

At this point, the timing of such an outcome is unclear; however, there are some milestones ahead. These include an ECB assessment in March of the Greek government's progress in implementing its austerity plan, a March 10 Greek interest payment of €1.7 billion, and the rolling of debt maturities of €8.5 billion on April 10, and €10.8 billion on May 10. Should the Greek government be unable to pre-finance some of its upcoming debt repayments, the most likely timing of any state-to-state assistance is towards the April and May debt maturities.

POTENTIAL IMPLICATIONS

› **Potential for a cascade effect** – At this point, the situation in Greece is still some ways from an actual liquidity crisis, as defined by an inability to refinance its debt. There remains ample time and we suspect that the stakes are high enough to overcome political gridlock and create a positive outcome through a combination of Greek fiscal austerity and some help from their friends. A favorable resolution would prompt a return to broader economic fundamentals as a driver of asset markets, and those fundamentals remain both sound and improving. At the other extreme, were an actual event of default to occur, it might trigger a game of "find the debt-holders" leading investors to flee risky assets until the full scale of the damage is known. In such an event, we would point out that there are several reasons why any such crisis would be much more contained than the subprime crisis:

- While a government debt default presents challenges, it is unlikely that the debt would come to be regarded as completely worthless, as was the case with several hundreds of billions of dollars of exotic securities related to subprime mortgages.
- The extreme leverage within the banking system and hedge fund community prevalent before the subprime crisis has been dramatically reduced, while lending standards, management and regulatory oversight have all significantly increased.
- Financial institutions and policymakers have a much greater awareness of the how the failure of a financial institution can be transmitted via the derivatives market, and are more likely to implement risk-mitigating measures at an earlier stage.
- What matters to equity markets is that the global economy, driven largely by China and the U.S., is now on a growth footing (China's economy has gone so far as to be at risk of overheating).

› **Lower for longer?** Increasing fiscal austerity on the part of some of the peripheral EU states likely sets back the timetable for any ECB rate hikes as the EU economic recovery, which has already begun to lag recoveries in Asia and North America, takes longer to unfold.

› **The Euro's long-term future** – Investors who had written off the U.S. dollar's role as global reserve currency now have fresh reasons to consider challenges faced by the EU in maintaining the integrity of its single currency. Would Greece or any other country leave the EU? We believe the costs would outweigh the benefits as Greece would suddenly find itself with substantial Euro-denominated debt which would be very expensive, given the likely steep devaluation of any future Greek currency. Moreover, switching currencies is no quick or simple feat – it took 10 years to usher in the euro. Finally, for the euro zone itself, the departure of a member state has very costly implications for the remaining states as the market prices in relative degrees of "exit risk".

That said, as noted by Russell Jones, RBC Capital Markets' Chief Fixed Income and Currency Strategist, even if the euro zone survives this crisis, a much bigger and more fundamental fiscal crisis is looming on the longer-term horizon. Within 10 years, European populations will be in decline and dependency ratios (the ratio of the population aged 0-16 and 65+ to those aged between 16 and 65) will shift dramatically. Through 2050, the OECD estimates outlays on health care, long-term care and pensions will increase by roughly 7% of GDP in Germany and France, 15.5% in Portugal, and 16.8% in Greece, representing huge additional burdens on the public finances. In such circumstances, the willingness of those populations at the core of Europe to subsidize those in the periphery is likely to be a lot less than it is now.

› **Implications for other sovereign debt issuers –** Is the U.S. following close behind? In our view, that is unlikely for the simple reason that the government debt burden in the U.S. (and for good measure, Germany, France, and Canada) is well below that of the PIIGS and other offenders. There are also other factors to consider. Japan has the highest ratio of government debt to economic output of almost all nations; however, because it is financed almost entirely by domestic savings, it is not at the mercy of foreign bond investors. This cannot be said for the U.S. or Canada; however, the U.S. status as world reserve currency and pre-eminent export market leaves a large audience of buyers for the greenback. Canada, meanwhile, has the benefit of one of the lowest debt burdens amongst developed nations, and RBC's currency research team recently noted that the Canadian dollar has appreciated against most other currencies over the past month due to a perceived status as a safe haven. That said, unless current fiscal excesses are brought to heel, sovereign debt issues are likely to result in chronic headwinds for some time amongst all the western developed nations, particularly amongst the PIIGS and some other others, notably the UK.

IMPLICATIONS FOR ASSET ALLOCATION AND PORTFOLIO STRATEGY

Most important for investors is the question of managing a portfolio around a risk that it is difficult to quantify. While we suspect that the stakes are high enough to force players to a positive outcome, this is neither the first nor the last time that the markets have been faced by events for which the ability of investors, analysts, and investment strategists to accurately predict the outcome is limited.

This leaves us to ponder the importance of having an investment process that accounts for these kinds of events; in particular, the role of asset allocation. In our view, asset allocation implies a process by which investors, during saner and less emotional periods, make a personal decision about the appropriate trade-off between the amount of near-term volatility that may be experienced in a portfolio and the longer-term expectations for returns. This is perhaps different from what many may view as the definition; that being a process of avoiding risk when stock markets fall and increasing risk when stock markets rise, thereby assuring a smooth and linear growth in wealth. In our view, incorporating the latter definition into an investment plan increases the probabilities of failure for the simple reason that few, if any, can successfully do it.

In our mind, the application of asset allocation in this environment is to ensure that a portfolio contains a suitable mix of non-correlated assets as a means of dampening volatility and hedging your bets. For many, this means avoiding the doubling up of equity risk that comes from too high a concentration in corporate exposure within the fixed-income allocation of a portfolio. This can be done by ensuring a proper amount of high-quality government bonds. Another is to ensure that equity holdings include a representation amongst high-quality names with defensive characteristics, and high and dependable dividends.