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# MARKET Commentary

## *Contagion*

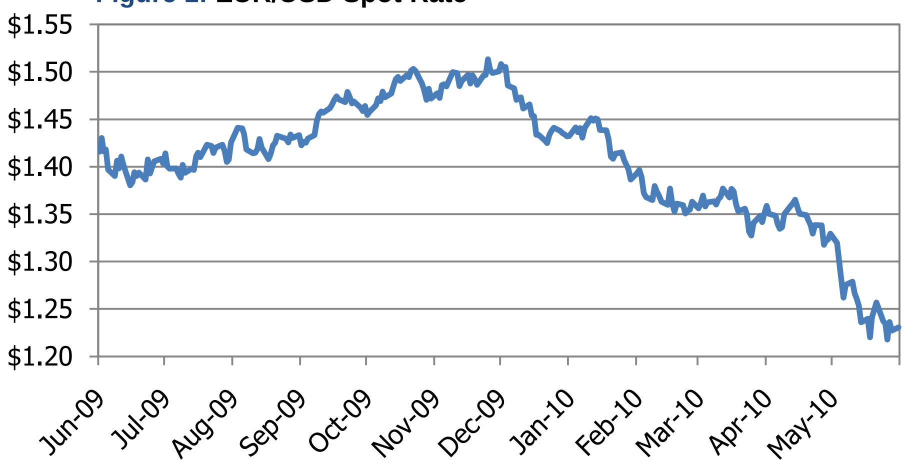
*June 2010*

Investors are not sleeping well, weighed down by thoughts of Europe and the threat of contagion stalling the global economic recovery. The recent market volatility, reminiscent of 2008, is driven by European sovereign debt concerns combined with undercapitalized European banks. We reiterate our view that in the current environment prudent credit risk management should be the primary focus of investors, which should include a thorough analysis of money market fund holdings. The potential effect of deteriorating fundamentals in Europe on the already fragile U.S. economy leads us to push our target for an interest rate hike by the Federal Reserve well into the first quarter of 2011 at the earliest.

### Follow the Euro

Investors need look no further than the EUR/USD spot rate to see the extent of the problems in Europe. Since hitting a relative peak of $1.5134 on November 25, 2009, the currency has declined 18.69 percent to $1.2306. In the month of May alone, the Euro fell 7.43 percent.

**Figure 1: EUR/USD Spot Rate**




*Source: Bloomberg*

The decline in the Euro and widening credit spreads reflect (1) the stressed financial and changing political environment in Europe, (2) uncertainty surrounding the details and the effectiveness of the €750 billion rescue package of Eurozone countries, and (3) deteriorating sentiment and loss of confidence in the European banking sector.

### Sovereigns

Sovereigns are suffering from debt overload, decreased tax revenue, widening budget deficits, and public backlash against government bailouts and budget cuts. This has led to a lack of confidence in the fiscal ability and political will of sovereign

### US Treasuries

**As of 31-May**

| Benchmark | Yield |
|---|---|
| 3 Month | 0.16% |
| 6 Month | 0.22% |
| 2 Yr | 0.77% |
| 5 Yr | 2.09% |
| 10 Yr | 3.29% |
| 30 Yr | 4.21% |

### Merrill Lynch Indexes

**30-Apr to 28-May**

| Index | Return |
|---|---|
| 1-3 Yr Gov/Corp ≥ A | 0.27% |
| 1-3 Yr Municipals | 0.34% |
| 1-3 Yr Agencies | 0.31% |
| 0-3 Month UST | 0.01% |
| S&P 500 | -7.98% |

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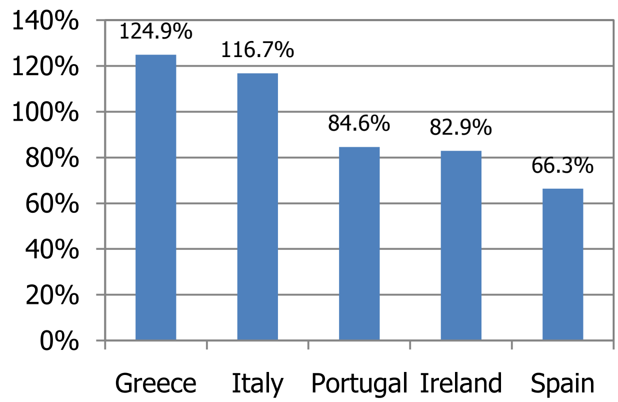
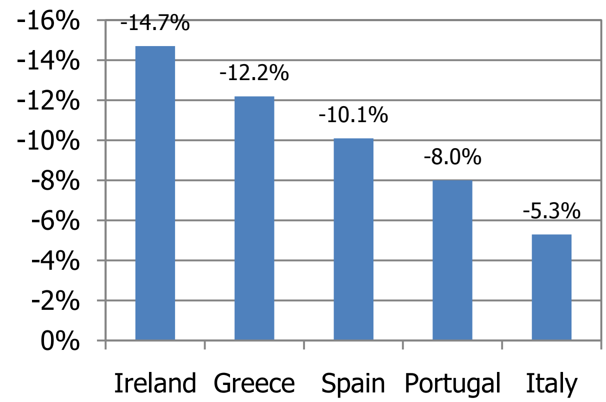
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan nations, such as Portugal, Ireland, Italy, Greece, and Spain (a.k.a., the P.I.I.G.S.) to refinance their debt obligations and undertake unpopular austerity measures in order to close widening budget deficits. For some of these countries, the only viable option leading to a lasting recovery requires restructuring their debt, or strategically defaulting.

**Figure 2: Public Debt: Forecast for 2010 as % of GDP**




*Source: European Commission*

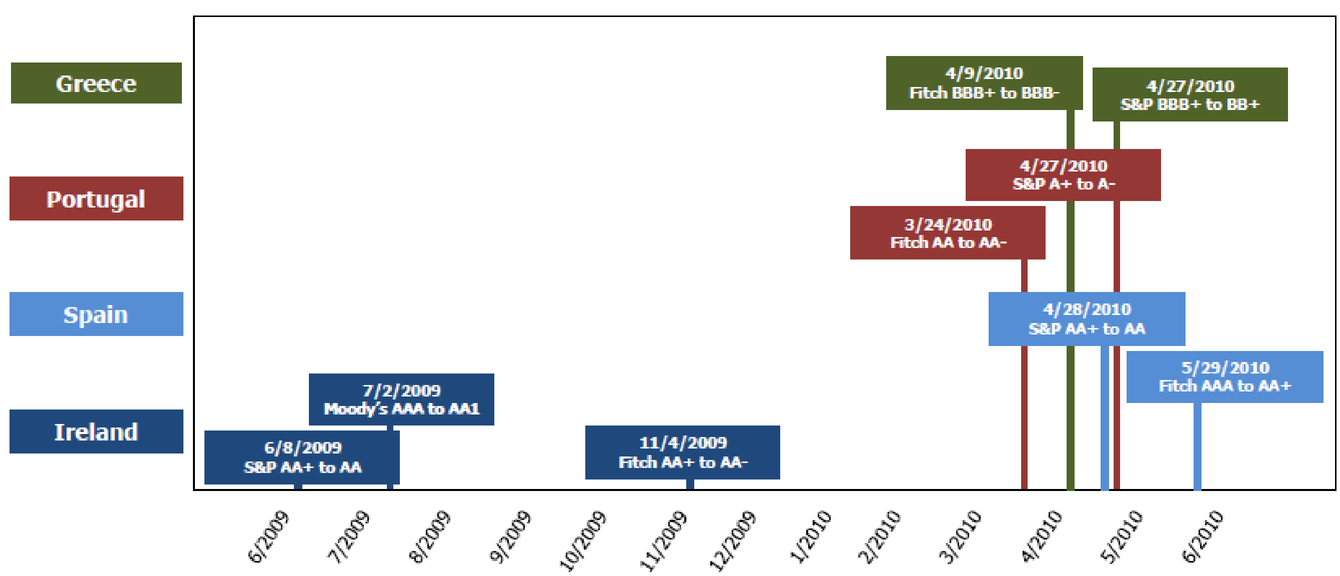
**Figure 3: Budget Deficit: Forecast for 2010 as % of GDP**




*Source: European Commission*

The United States is an example of a country that has been less willing and able to support the banking sector and has created a model of increasing regulation that we believe the Europeans will adopt as they address their own financial crisis. After injecting more than $700 billion to buoy up the U.S. financial system, public backlash has led Congress to press forward with financial regulation aimed at eliminating the "too big to fail" doctrine. Both the House and Senate have passed bills that would limit the idiosyncratic support that the government can offer a failing institution while increasing risk to bondholders. This legislation has negative implications for U.S. banks and, if implemented overseas, similar regulations and restrictions would be worse for relatively weaker European banks and their debt holders.

**Figure 4: Timeline of Sovereign Downgrades**




*Source: S&P, Moody's, Bloomberg*

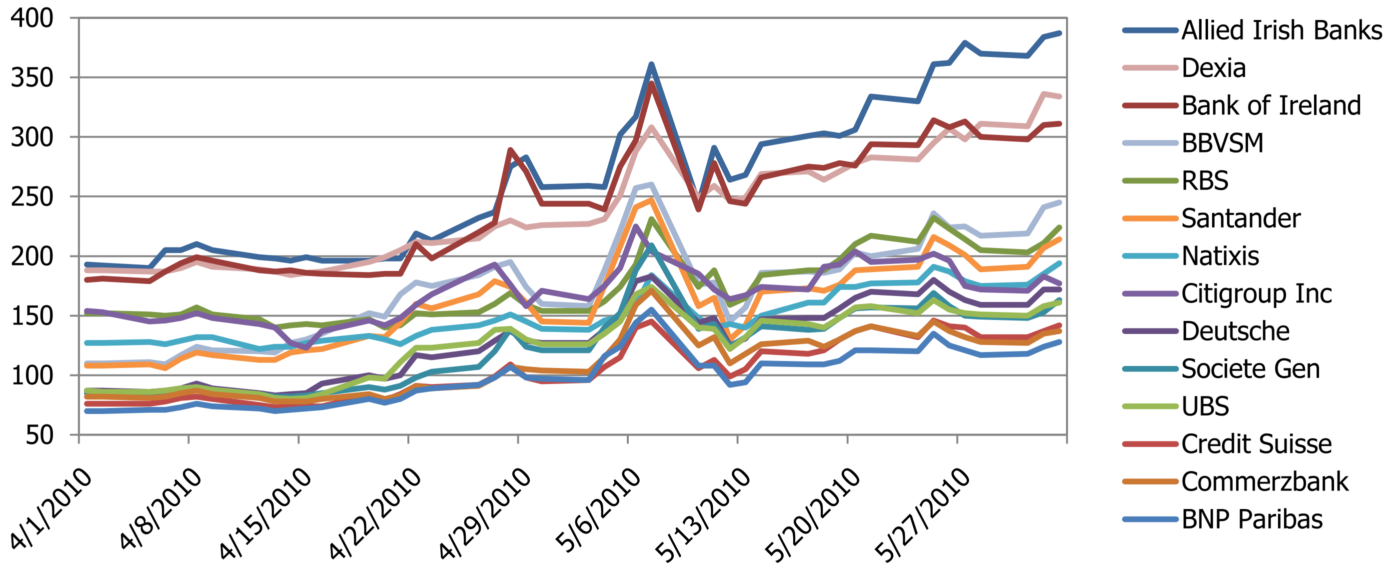
## European Bailout

In a broad attempt to stabilize the international markets and avoid contagion resulting from a possible sovereign default, the IMF, European Union, and Eurozone (member countries that have adopted the Euro as their official currency) have collectively structured a €750 billion package to assist weaker countries that were facing difficulties refinancing future obligations in the public markets. The European Central Bank also began the process of quantitative easing (i.e., buying government securities in the market) in an attempt to lower borrowing costs and provide greater liquidity to the financial system. Many details and mechanics of the program are still unknown and the ultimate efficacy of the package will not be known for years. We do not have confidence that the European bailout will accomplish the needed reform as we believe the problems that exist are structural (e.g., high unemployment rates, low retirement ages, and various unsustainable entitlements).

## European Banks

The European banks are struggling to weather a turbulent market in the face of a weaker economic outlook and large quantities of sovereign debt and troubled assets on their books. They have significant exposure to commercial and residential real estate and rely heavily on wholesale funding sources. In the coming months we expect to see these banks use the time provided by the €750 bailout attempt to raise capital and increase liquidity to bolster their balance sheets. They will also take advantage of quantitative easing to reduce their exposure to sovereign debt.

**Figure 5: 5-yr Bank CDS**




*Source: Bloomberg*

The magnitude of toxic assets still on banks' balance sheets has been masked by the principle of mark-to-market accounting being effectively put on hold in Europe. According to a recent CNBC article, Spanish banks still have over €300 billion of unrealized mortgage-related losses on their balance sheets. Spain was recently forced to inject €500 million to save the large regional savings bank, CajaSur, from failing. Risk of additional failures or bailouts exists as the global capital deficit is estimated to be more than $1.5 trillion by Independent Credit View, a Swiss rating company. Specific European banks referenced in the study as having the greatest capital needs include Allied Irish Banks Plc, Commerzbank AG, Bank of Ireland Plc, and Royal Bank of Scotland.

## Money Funds Exposed

The crisis in Europe continues to impact U.S. money market funds. Our analysis of prime funds shows a large allocation to troubled banks. Some prime funds we have looked into had 30-60% exposure to these banks as of early May. Money funds have been cited recently saying that they were getting very nervous as bank spreads widened significantly in the face of the quickly deteriorating situation in Europe. This is a reminder of the flaws in the money fund model. While funds do attempt to pare back exposure in response to negative news, they seem to be the ones stuck holding the problem assets. Investors should be motivated to apply the lessons of 2008 and be aware of their funds' holdings. As we have mentioned in past commentaries, high-yielding funds most likely hold high-yielding (high-risk) assets.

## Looking Forward

We were hoping for a mild summer in the markets, but unfortunately it does not seem likely this year as individual countries in Europe attempt to put unprecedented austerity measures into place and secure funding ahead of coming debt maturities. Meanwhile, European banks are scrambling to address the market's concerns surrounding sovereign exposure, troubled assets, and reliance on wholesale funding. The challenges and uncertainty in Europe present headwinds for investors here in the United States as well. As such, investors need to be extra vigilant in their attempts to avoid credit issues by conducting thorough research and analysis and utilizing the resources available through their investment managers.

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