MARKET Commentary

December 2010

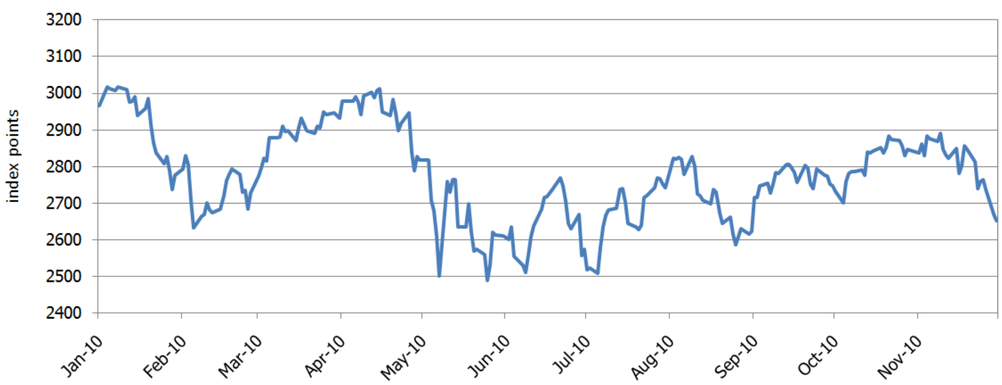
Fall of the Titans

Seven months have passed since the Greek bailout, and the European debt crisis shows no signs of easing. The resolution of the debt woes that plague peripheral Eurozone sovereigns will demand substantial time and resources and likely result in real losses on bank and sovereign debt. Because we anticipate financial conditions in Europe to deteriorate further, we affirm our long-held view that credit risk management should be the primary focus of investors. We encourage investors to review banking relationships, bank deposits, direct security and prime money market holdings for exposure to troubled European sovereigns and credits.

Triumph or Tragedy?

The stakes are high for European policy makers charged with stemming the debt crisis before it results in full-blown contagion. At risk is not only the solvency of any single European sovereign, but also the fate of the common Euro currency. Quelling contagion fears in Europe will require that policy makers restore market confidence in the European banking sector and sovereign efforts to control ballooning budget deficits and legacy debt overhang. Policy makers' ability to do so will determine whether this debt crisis will result in a triumph or a tragedy.

Figure 1: Euro STOXX 50 Index Returns Show Market Skepticism



Source: Bloomberg

The Eurozone comprises sixteen countries that use the Euro as their official currency. These sixteen counties share one central bank which institutes monetary policy for all member states. Members of the Eurozone are monitored in domestic fiscal and regulatory policies in order to keep the integrity and stability of the Euro currency.

From the inception of the Euro in 1995, many economists felt that this collective union subjected member states to a heightened risk of contagion. The common currency created a strong economic link that could accelerate growth in good times and magnify the pain in bad times. This was most recently evidenced by the Greek debt crisis, in which a country that comprised less than 3% of the collective Eurozone GDP effectively brought Europe to its knees.

US Treasuries

As of 30-Nov

Benchmark	Yield
3 Month	0.17%
6 Month	0.20%
1 Year	0.26%
2 Year	0.48%
5 Year	1.47%
10 Year	2.80%
30 Year	4.11%

Merrill Lynch Indexes

29-Oct to 30-Nov

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.20%
1-3 Yr Municipals	-0.26%
1-3 Yr Agencies	-.023%
0-3 Month UST	0.01%
S&P 500	0.01%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist

This collective economic and monetary policy shifts the negative effects of an economic or debt crisis of one member state to all member states. In times of economic distress, sovereign policy makers are unable to undertake conventional measures—such as devaluing the currency or creating aggressive fiscal stimulus—to stimulate their respective economies. The inability of member states to effectively resolve an economic or debt crisis when limited domestic policy tools have been exhausted forces leaders to seek external assistance from other Eurozone members. When several countries are in need of assistance, as in the current environment, the problem can quickly become overwhelming.

Recent rescue packages for Greece and Ireland have recognized the risk of contagion and provided potential assistance to future struggling sovereigns. The €110 billion Greek bailout was accompanied by €750 billion to allow for assistance to other members states. After Ireland was provided €67.5 billion to buoy its teetering finances, attention immediately turned to whether the existing rescue packages would be enough to cover future problems. Germany—the country bearing the bulk of the cost of the rescue packages—is now staunchly opposed to pledging any more aid. Unfortunately, they may not have a choice if the current funds prove to be insufficient to stem the crisis.

Figure 2: Various Institutions Offered Support to Stem the European Debt Crisis

Program	Amount	Contributors	Details
Greece Loan Package	€ 110 billion	16 Eurozone members and the IMF	€ 80 billion by Eurozone and € 30 billion by IMF. Loans specifically for Greece.
European Financial Stability Mechanism (EFSM)	€ 60 billion	27 European Union members	Backed by the EU budget and thus contributions from EU members. Loans are available to any of the 27 EU members.
European Financial Stability Fund (EFSF)	€ 440 billion	16 Eurozone members	SPV created that would issue debt in order to extend loans. Loans are available only to the 16 members of the Eurozone.
International Montetary Fund (IMF)	€ 250 billion	187 member countries	IMF has preferred creditor status where its loans are senior to all other debt. Loans are available to any of the IMF member countries.

Source: IMF, European Commission and EFSF

Banks on the Ropes

The fear of insufficient aid to effectively stem the crisis is exacerbated by the European banking sector's interconnectedness and its size relative to the Eurozone economy. European banks are heavily exposed to the wholesale funding market, a market where banks borrow and lend short-term funds to each other. The wholesale market is a market that is built entirely on trust and confidence. When confidence wavers as it did during the Greek debt crisis, this market essentially shuts down, constricting the flow of credit and leading to further economic contraction.

Recently released Federal Reserve data as part of the Dodd-Frank legislation indicate just how perilous the situation was for European banks during the US credit crisis. European banks were some the largest beneficiaries of U.S. government programs established to restore stability in the credit markets. In one program, the Commercial Paper Funding Facility, which aimed to help banks roll maturing short-term debt at artificially low rates, 6 of the top 11 users were U.S. subsidiaries of foreign banks. These 6 banks sold an astounding $274 billion of short-term debt to the Federal Reserve during the life of the program.

European banks are still reliant on special funding programs in order to meet liquidity needs. The European Central Bank has remained active in extending unlimited short-term loans to troubled banks at artificially low rates. This has benefitted Greek, Irish and Spanish banks that have all but been shut out of the short-term funding markets. The European Central Bank recently announced that these rescue programs will remain in place until greater stability in the credit market returns.

Many people fear that the European banking sector is too big to save relative to the size of member states' economies. These people are probably right. In the case of the Irish bailout, which was largely attributed to the troubled banking sector and the government's inability to support it, we expect senior bondholders will be forced to make concessions, as junior bond holders have already agreed to do, if conditions worsen.

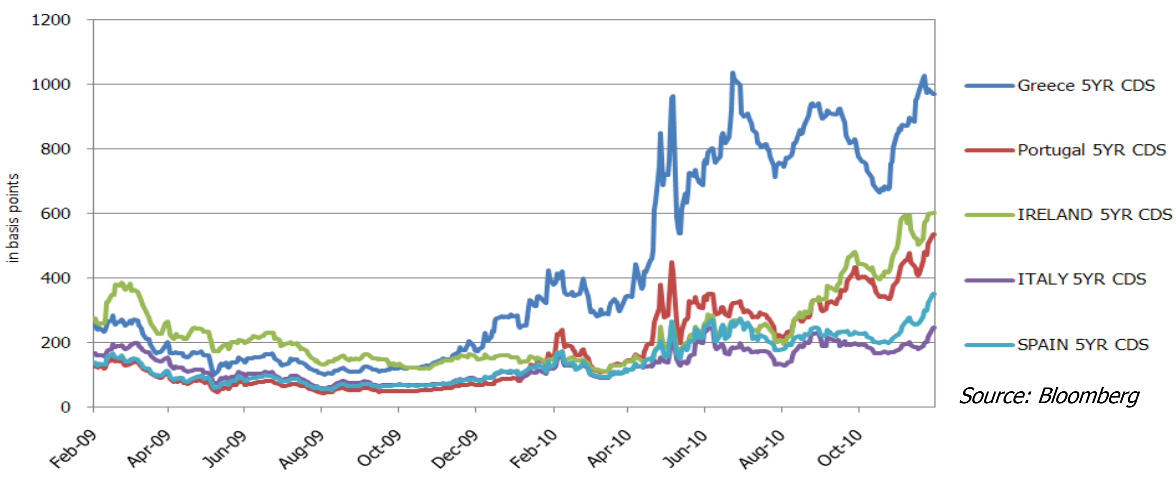
A credible banking sector is crucial to restoring confidence in Europe. European policy makers conducted a bank stress test to restore confidence in European banks, much like the United States had done at the height of the US credit crisis. The results of the European bank stress test released June 2010 lacked serious credibility. Of the 91 European banks tested, only 7 failed the stress test (1 defunct German bank, 5 Spanish savings banks and 1 Greek bank). The fact that no bank from Ireland, widely viewed as a house of cards, made the list was unnerving. It would be only weeks after the results of the test were released until the largest Irish banks required assistance to avoid insolvency. The bank stress test was a missed opportunity by policy makers to make real headway in stemming the crisis.

The Sovereign Hydra

Perhaps the largest contributor to the rapid loss of confidence in Europe is the realization that several larger Eurozone members like Italy and Spain look eerily similar to Greece and Ireland. In the fight to quell fears of contagion, bailing out Greece and Ireland was equivalent to cutting off only two heads of the mythical Hydra. The bailout of Greece and Ireland was a frank admission by policy makers that the situation in Europe was much worse than originally estimated. Estimates to solve the European debt crisis were once as low as €30 billion. The price tag is now €750 billion and climbing.

The market is having a hard time differentiating among peripheral Eurozone sovereigns. The problems that currently plague Portugal, Spain and Italy—high budget deficits, high unemployment, weak real estate markets, high debt levels and troubled banking sectors—are the same problems that plagued Greece and Ireland before they required extraordinary assistance. Rising sovereign yields and widening credit default spreads (CDS) of Portugal, Spain and Italy indicate that the loss of confidence in these peripheral sovereigns is growing exponentially.

Figure 3: Sovereign CDS of European Peripherals Show Evolution of Fears (as of 11/30/10)

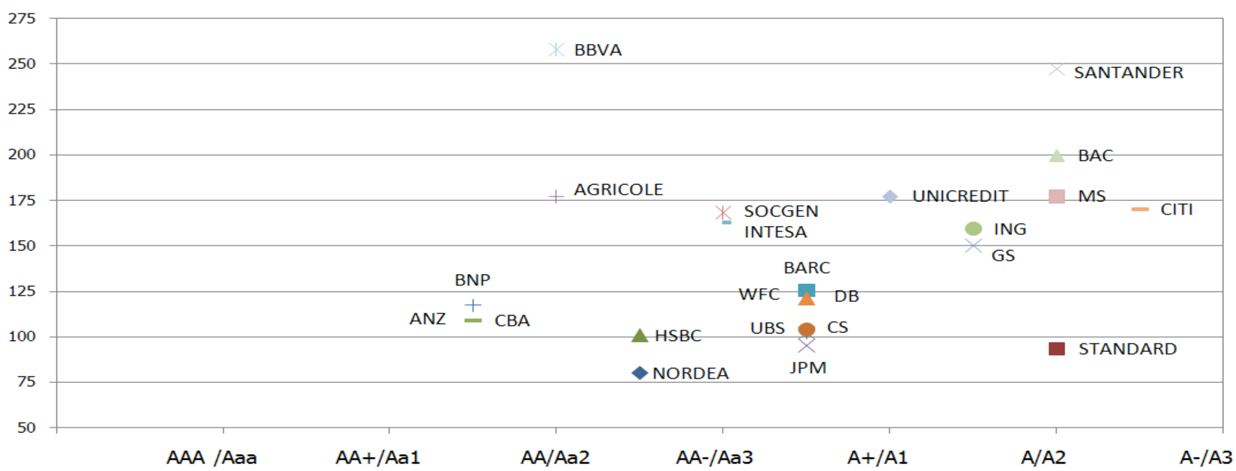


We expect that Portugal, Spain and Italy will require and receive extraordinary assistance in the near future as confidence in Europe continues to waver. These peripheral sovereigns can help restore market confidence by presenting credible plans to control ballooning deficits and to reduce the amount of debt outstanding. Ireland recently announced plans to reduce the deficit by €6 billion in 2011, and Spain and Portugal are likely to follow suit. The big test for these countries will come in 2011 when large debt refinancing will be necessary. Italy will need to refinance €287 billion and Spain €132 billion. Without credible plans to overcome fiscal deficits, a cycle of rising yields and increased borrowing will complicate policy makers' efforts to get financial houses in order.

The Siren's Call

In this low rate environment it may seem tempting to consider the attractive yields that European banks offer in the money market space. Pursuing such a strategy in this environment is like heeding the call of the Siren. The risks—financial and non-financial—inherent in troubled European bank debt are not worth the additional yield. When weighing investment alternatives, investors should consider extending further out the curve into high-grade credits to increase portfolio yield rather than staying short and lowering credit standards in European banks.

Figure 4: Global Bank CDS versus Average of S&P and Moody's Credit Ratings (as of 11/30/10)



Source: Bloomberg

Investors may not be fully aware of their exposure to troubled European credits. An analysis of five of the largest prime money market funds show that the paper of troubled banks like Royal Bank of Scotland, KBC Group, Unicredit, Llyods, Dexia, Natixis and Santander are regular holdings of these funds. We have also observed that the issuer concentration per troubled name is often greater than 3%. These are credits that we would not consider in the current environment, whether in a banking relationship, time deposit, direct holding or holding in a money fund.

Many investors take solace in the fact that several countries have instituted guarantee schemes on bank deposits. While this may be true, we caution that guarantees are only as good as the governments that supply them. A guarantee by Greece or Ireland may not be much of a promise.

Looking Forward

Recognizing a lost opportunity, European policy makers are instituting additional bank stress tests to be released early next year. We feel that credible stress tests with real punishment for failure, like closure or merger, will be crucial to force bank recapitalization and restore confidence in Europe and the banking sector. We are also closely watching comments from European leaders on measures to reduce unsustainable budget deficits and debt levels in an effort to do their part.

We expect that the debt woes that plague European sovereigns will persist for years to come. There is no quick fix to these debt problems. Many politically tough decisions will need to be made in order to prove the rescue packages a long-term success and not a further descent into unsupportable debt.

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