CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

European Update: Kicking an Ever Bigger Can

July 2011

Wade O'Brien
Andrew Beatty

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July 2011 European Market Commentary

European Update: Kicking an Ever Bigger Can

Wade O'Brien & Andrew Beatty

While recent efforts by European authorities to expand rescue packages for peripheral countries are a step in the right direction, market volatility is likely to remain elevated until more comprehensive solutions are put on the table.

The Eurozone sovereign debt crisis again came to the brink in July, only to be defused by a last-minute restructuring of existing peripheral aid packages and a re-engineering of the European Financial Stability Facility (EFSF). This followed several fraught weeks in Europe, with the Greek government surviving a confidence vote, its parliament narrowly approving new austerity measures and thus qualifying for more aid, and yields on peripheral sovereign bonds reaching new highs as contagion fears escalated.

While the market breathed a collective sigh of relief after the package was announced, and a variety of asset classes saw sharp surges in prices, we suspect that these measures will simply buy time before the crisis again flares up. Rather than take concrete steps to return countries to sustainable levels of indebtedness, politicians seem content altering the terms of existing debt, thus kicking the can farther down the road. In some respects, their hands are tied—thinly capitalized creditors have little ability to bear haircuts and political support is limited for contributing further resources. Meanwhile, the European Central Bank (ECB) and International Monetary Fund (IMF) have been pushed to the sidelines, though tension simmers as they see standards compromised and the credit quality of their loans deteriorate. Ultimately, a massive reworking of European sovereign bailouts is probably in store, though we suspect the catalyst for this event is more volatility, which may not be anticipated by current market prices.

What Has Gone Wrong

Following the turmoil of last summer and the subsequent aid packages for Ireland and Portugal earlier in 2011, many were hoping European leaders had contained the sovereign debt crisis. New tools such as the €750 billion EFSF were expected to calm market nerves, and the passage of time was supposed to allow aid recipients to enact austerity plans and improve their balance sheets.

Subsequent events demonstrated that these hopes were misplaced for several reasons. For one, it has become clear that peripheral Europe faces a solvency, rather than a liquidity crisis. Therefore, the passage of time, rather than helping, actually seems to be making things worse. Austerity targets have been proven unrealistic given continued deterioration in the underlying economies. Greece was initially expected to grow its GDP at around -0.3% in 2010; the actual number was -4.5%. Unemployment was expected to rise to around 10%; it may reach 15% in 2011. Given these trends, perhaps unsurprisingly, tax revenues have also missed projections and debt/GDP may increase further to 152% by the end of 2011 (Exhibit 1).

Investors may also have overestimated the current ability, putting aside willingness, of the various interested parties to tackle the worsening crisis. For example, take the ECB, which has been central to containing the crisis thus far through its provision of liquidity to a huge swath of the European banking system. The euro system (the ECB together with the various central banks such as the Deutsche Bundesbank) has around €80 billion

of capital, yet has provided funding against approximately €2 trillion of collateral. While haircuts have been taken when extending liquidity, it is clear that were many of these assets (such as residential mortgage–backed securities and peripheral sovereign bonds) marked to market, the system would likely be insolvent. Under any circumstances, the ECB would be reluctant to accept collateral of dubious quality, but now its ability to do so (and thus stave off a liquidity-induced default) is hampered by its weak capitalization.

The position of the various "core" members of the Eurozone is also weaker than is commonly understood. This could have been inferred all along by the contentious political wrangling over topics such as haircuts and forced private sector participation in restructuring, though at the time this discord was easily passed off as political posturing to please uneasy voters back home. In fact, it has become fairly apparent in recent weeks that senior European politicians may not have understood their exposure to the crisis, or contemplated how their banking systems could serve as a channel for contagion.

This lack of knowledge may be partially attributable to the complexities of understanding bank balance sheets and the significant differences between the ways banks report capital for regulatory and accounting purposes. While some German politicians may be emboldened by recent stress test results that imply their banking system has a healthy 9.4% core Tier 1 ratio, they should be frightened that from an accounting perspective, their banking sector has just €300 billion of equity supporting €9 trillion in assets—a 3.5% equity ratio (Exhibit 2). The ability of the banking sector to absorb losses is much lower than is implied by the stress tests. Furthermore, the fairly limited exposure of German publicly traded banks to peripheral debts may also have given some politicians a false sense of confidence. In reality, the German banking system had nearly €400 billion of exposure to Greece, Ireland, Italy, Portugal, and Spain at the end of 2010. Much of this may be held by non-listed banks, such as landesbanks and mutual banks, which typically are not rated by sell-side analysts and thus are out of the spotlight. This is also likely true of other European banking sectors, such as the cajas in Spain. The attention paid to these banks has also been limited because they have not been active in funding markets in recent years, turning instead to domestic central banks.

The ability of the various countries to find lasting solutions has been weakened due to limited public support for making shared sacrifices. When polls showed that the majority of Germans were opposed to enlarging bailout facilities, but the large majority of Greeks were against further austerity measures, it was hard for politicians to strike a deal, particularly because they may not have understood their bargaining power. The good news is that incentives are starting to shift and the level of awareness is rising to the point where at least some agreement can be reached.

Recent Events

With borrowing costs for peripheral countries having risen to record levels (Exhibit 3), and debt crises by nature self-fulfilling as higher borrowing costs further increase debt burdens, it was almost inevitable that policymakers would have to come to some agreement this summer. Indeed, as if just in time to not interfere with the summer holidays, in late July an agreement was reached that reworked aid packages for Greece and other peripherals through several key mechanisms.

The recently announced measures have three key features. First, the cost of borrowing from the EFSF will be lowered and available loans will be lengthened from 7.5 years to a range of 15 to 30 years. Second, and in a nod to German demands,

the private sector will be involved. Though participation is said to be "voluntary," effectively regulators have leaned on banks to take haircuts via tendering existing bond holdings into new instruments. The exchanges can occur in one of several ways, but all involve a reduction in net present value for bondholders. Finally, the role of the EFSF has been expanded—it will now be able to buy peripheral government bonds in the secondary market and help recapitalize European banks.

Where This Leaves Us

While these developments have been cheered by markets, and lower the risks of contagion in the short term, we suspect problems will reappear in the not-too-distant future. Debt burdens are still too high and the discussed haircuts too low to make a meaningful reduction. At least some peripheral countries will have a difficult time outgrowing their debt burdens. For example, even under optimistic scenarios, Greek debt/GDP may only drop to 143% by 2017, according to analysis by Morgan Stanley. The problem is not simply having too much debt, but rather a more fundamental issue of competiveness—peripheral countries are locked into an expensive currency that makes it extremely difficult to compete with more efficient economies. Bridgewater estimates that the peripheral countries would need to devalue their currencies by 15% to 20% just to "get back in the ballpark of being competitive." However, with this option not on the table, governments face the unpalatable mandate of trying to improve competitiveness through reductions in costs such as wages. This suggests that achieving further austerity targets will be difficult, as increasing tax revenues is difficult in a stagnant or shrinking economy.

There are other ways in which peripheral debt burdens could be reduced. The recent rescue package involves private sector creditors taking a haircut, but does not go far enough. One reason is that banks (and other investors) can only sell bonds at low prices (or have positions restructured) if they have marked them to market (so no further loss ensues) or if they hold sufficient capital to absorb losses. Neither of these two events is likely, which explains why most peripheral exposure still sits on the loan books of European banks. These banks are significantly undercapitalized, despite what recent stress tests imply. These tests, which ignore loan books, are far too optimistic about the ability of these banks to generate capital via retained earnings. The stress test's worst-case scenario envisages a 28% drop in financial sector profits in 2011 from 2010 levels, even though 2010 represented a record level of profitability for the sector and one well above profits seen earlier last decade, according to analysis by BofA Merrill Lynch.

One solution is for the EFSF (or another pan-European vehicle) to conduct sizable buybacks of peripheral debt, selling this debt back to issuers at the discounted price and reducing debt burdens. To facilitate sales from European banks, however, it is likely that significant funds would need to be put aside to allow for capital injections. The recent aid package moves in this direction and expands the EFSF's mandate to include both capabilities. However, it somewhat surprisingly did not involve an expansion of the EFSF's size to accompany these new functions. Some regional funds already exist to help recapitalize banks, such as in Ireland and Spain, though their size is thought insufficient to deal with the necessary scale of a pan-European restructuring.

Weighing all this, we suspect that the next step in this crisis will be that more resources are allocated to the EFSF. Where this money will come from is straightforward, as peripheral countries are already tapped out. When this money will come is a more complex question, and highlights some of the potential risks for investors. Political resistance to

allocating more resources to bailouts is high in "core" European economies, and additional aid may require parliamentary or judicial approvals in some countries. Execution risks are therefore high, though politicians can attempt to facilitate the process by having more honest conversations with voters about where the risks lie. Ultimately, however, we suspect that only further turbulence will drive an increased commitment from the "core."

What Markets Seem to Be Saying

Given these dynamics, aside from sovereign bonds, European asset prices seem to suggest investors are relatively sanguine about future events. The euro, for example, has actually appreciated against currencies such as the U.S. dollar and the Japanese yen in 2011 (Exhibit 4), though it has weakened against currencies such as the Swiss franc. While the Federal Reserve has undermined the U.S. dollar with its zero interest rate policy, justified by a mandate that includes raising employment, the ECB has hiked rates twice in 2011 and is more focused on combating inflation. It is unclear if inflation will have staying power in Europe; presumably, consumption will drop in countries implementing austerity programs, and confidence polls have recently plummeted. While the recent flare-up has created speculation about the possibility of a country trying to leave the Eurozone, the benefits and domestic political support for such an attempt are likely overstated.

Local equity markets (Exhibit 5) also have held up surprisingly well. The MSCI Europe ex U.K. Index was essentially flat for the year as of July 25, though it had experienced some volatility prior the recent bailout announcements. Across sectors, financials (Exhibit 6) has been among the most affected by the crisis, confounding many that expected a rebound after an index-worst 12.6% drop in 2010. This sector is most at risk to an escalation of the sovereign debt crisis from several angles. Bank funding costs are directly tied to local sovereign yields; banks are also significant holders of peripheral sovereign and private sector debt. While many of the listed financials in countries such as Germany and France have reduced exposure to countries like Greece, a seizing up of financing markets for Italian and Spanish borrowers would have much more substantial collateral damage.

On the positive side, sectors such as consumer discretionary (5.1%) and health care (7.1%) have led the pack, with the former in particular benefitting from strong emerging markets demand and resurgent core economies. Indeed, while recent economic data have started to disappoint, the recovery in some core countries exceeded expectations during the first half of 2011 (Exhibit 7). Earnings have also been strong, with nearly 60% of European companies exceeding expectations during the first quarter. What remains uncertain, however, is how earnings will hold up given that the debt crisis is likely to trigger a slowdown in activity. The early indications from second quarter earnings announcements do not look promising in this regard; according to Bloomberg, just 42% of European companies reporting through July 28 had beaten expectations. The financial sector, which contributes nearly 20% of the index, is an obvious Achilles heel; news of expected layoffs in the sector may be a sign that profitability is starting to turn.

Finally, the bond markets have given mixed messages in recent weeks as volatility has escalated. Prior to the bailout announcement, sovereign bond yields and credit default swap levels reached record highs for many peripheral countries, though many saw significant tightening once bailout terms were announced. For the time being, the "voluntary" participation of European banks in the rescue plan is not expected to trigger a default for credit default swap purposes, though ultimately the determination would be made by the ISDA committee. Looking ahead, refinancing needs are high for sovereigns

such as Italy and Spain (Exhibit 8), and it remains to be seen what they will be required to pay in upcoming weeks. Corporate bonds, in contrast, have held up surprisingly well, as the yield on the BofA Merrill Lynch EMU Corporate Index is nearly unchanged since the beginning of the year and its option-adjusted spread (OAS) is just 186 basis points (bps) (Exhibit 9). This strength comes even though over 50% of the bonds in the index are financials. While many of these issuers are not from peripheral markets, their balance sheets do have heavy direct and indirect exposure.

What Should Investors Do?

It is always challenging to provide advice to investors in the midst of a volatile market, particularly in circumstances like the present when so many variables, such as political leanings, are difficult to predict. That said, we believe that the recent volatility in the European debt and equity markets may be a recurring phenomenon, at least until more comprehensive measures are taken to contain the crisis. While we do not know what exactly these measures will entail, we do feel like we have a high degree of confidence in several factors, and this influences our investment advice. Current debt burdens for at least some peripheral countries will need to be reduced, contagion implications will force core Europe to increase its level of involvement, and the financial sector is likely to require significant amounts of capital.

Given this situation, we continue to believe that peripheral sovereign debt is too hazardous to invest in, as its underlying value will ultimately be determined not by fundamentals, but by political agreements about burden sharing and signaling effects (if Greek debt is written down, what does this imply for Ireland, Portugal, etc.?), which we have little ability to predict. In terms of core sovereigns, we have considered the asset class overvalued for some time given the asymmetric risk/reward of buying bonds with low yields. In addition, we increasingly believe that a more comprehensive and costly bailout will be required in Europe, which will be funded by core countries and thus may lower their credit quality. Put another way, whether Germany spends its euros directly by transferring money to peripheral countries or indirectly by recapitalizing local banks and allowing them to incur write-downs on their bond portfolios, the result is the same. This suggests to us that ultimately there will be a convergence between the perceived credit quality of core and non-core borrowers. For investors that share these concerns, or are simply concerned about the asymmetric risk/return of low yields, we would consider moving some of their deflation hedges to cash instruments such as Treasury bills from core economies, and potentially adding hedged exposure to global sovereign bonds.

Looking at credit markets, while the OAS on the European corporate bond index is well above its historical average, the yield continues to hover around 4%, a level that appears to offer a low probability of generating an equity-like return and little cushion should conditions deteriorate. Looking at fundamentals, given that over 50% of European corporate bond indices consist of financials, which are most exposed to the sovereign debt crisis, we also see reasons to be cautious.

Our advice on equity markets is more nuanced. We view European equities as fairly valued, as by a variety of metrics their valuations are in line with historical averages. However, we acknowledge that macro risks are much higher than they have been historically, and may worsen in the near term, as the market has a high weighting for financials. On balance, this leaves us neutral on European equities relative to other developed markets, which are generally more expensive. We would not be in a hurry to rebalance if relative performance has resulted in slight market underweights, and are not proponents of simply "buying the dip" if the

crisis drags on in the weeks ahead and the market suffers modest losses. However, we could foresee a scenario where the crisis escalates and indiscriminate selling of high-quality businesses with global exposure causes their valuations to become very attractive. In this instance, we might selectively increase allocations to active managers, though we would continue to be wary of sectors such as financials. To justify a larger overweight at the index level, we would need to see a more significant restructuring (and perhaps a well-funded European TARP-style fund) surface, perhaps pushed by a market sell-off that forces the hands of politicians. Before doing so, however, we would want to be assured that the groundwork had been laid for a sustainable recovery. For offshore investors, we would examine hedging out some of the currency exposure, as current levels seem to leave little room for policy error.

For investment strategies involving less liquid assets, such as distressed investing, we suspect there eventually will be attractive opportunities, but are unsure as to when European financials will have the capital that allows them to sell some of their distressed assets at a discount. In the meantime, there will be occasional opportunities to invest in assets being divested by state-run vehicles, as is the case now in Ireland. Investors looking to allocate to this strategy will need to carefully choose their managers. The reason is that pressure will be enormous on financials to sell assets and shrink balance sheets, but the value proposition is likely to vary tremendously depending on what is sold and at what prices. For example, to the extent that Irish banks are forced to sell U.S. commercial property holdings in prime locations, competition is likely to be intense and the potential for generous returns limited. Conversely, to the extent that U.K. banks are required to sell leveraged loans in mid-market continental European companies, markets may be less efficient. One key trait to look for in some managers will be the ability to handle restructurings and look at multiple asset classes, as debt-for-equity swaps may be required for some over-indebted firms.

Finally, we have discussed the safety of cash proxies such as money market funds in several publications recently. In the United States, there are various types of these funds, but so-called prime funds frequently have significant (up to 50%) exposure to European financials via holdings of their commercial paper and certificates of deposits. While we think it is likely that European central banks would intervene should funding markets freeze up, we do not think the paltry 15 bps or so of yield on offer from these funds compensates for this risk. Investors therefore are probably best off investing in high-quality obligations such as T-bills and government-guaranteed obligations. However, the U.S. debt ceiling debate could introduce further short-term volatility in this market, so investors may want to forgo exposure to funds holding such instruments, and instead place cash required to meet very near-term needs in non-interest bearing transaction accounts[1] or laddered short-term Treasuries with durations that match expected liabilities. For European investors, investing in high-quality T-bills seems reasonable, particularly as short-term core T-bills are made even more attractive due to flatter interest rate curves and relatively higher interest rates than in the United States.

Conclusion

The route is far from predictable, but we believe the crisis in the Eurozone is moving toward an inevitable resolution that involves countries shedding unsustainable debt burdens and a greater commitment from the core to bail out peripheral countries in exchange for greater fiscal union. Investors navigating the crisis should not become

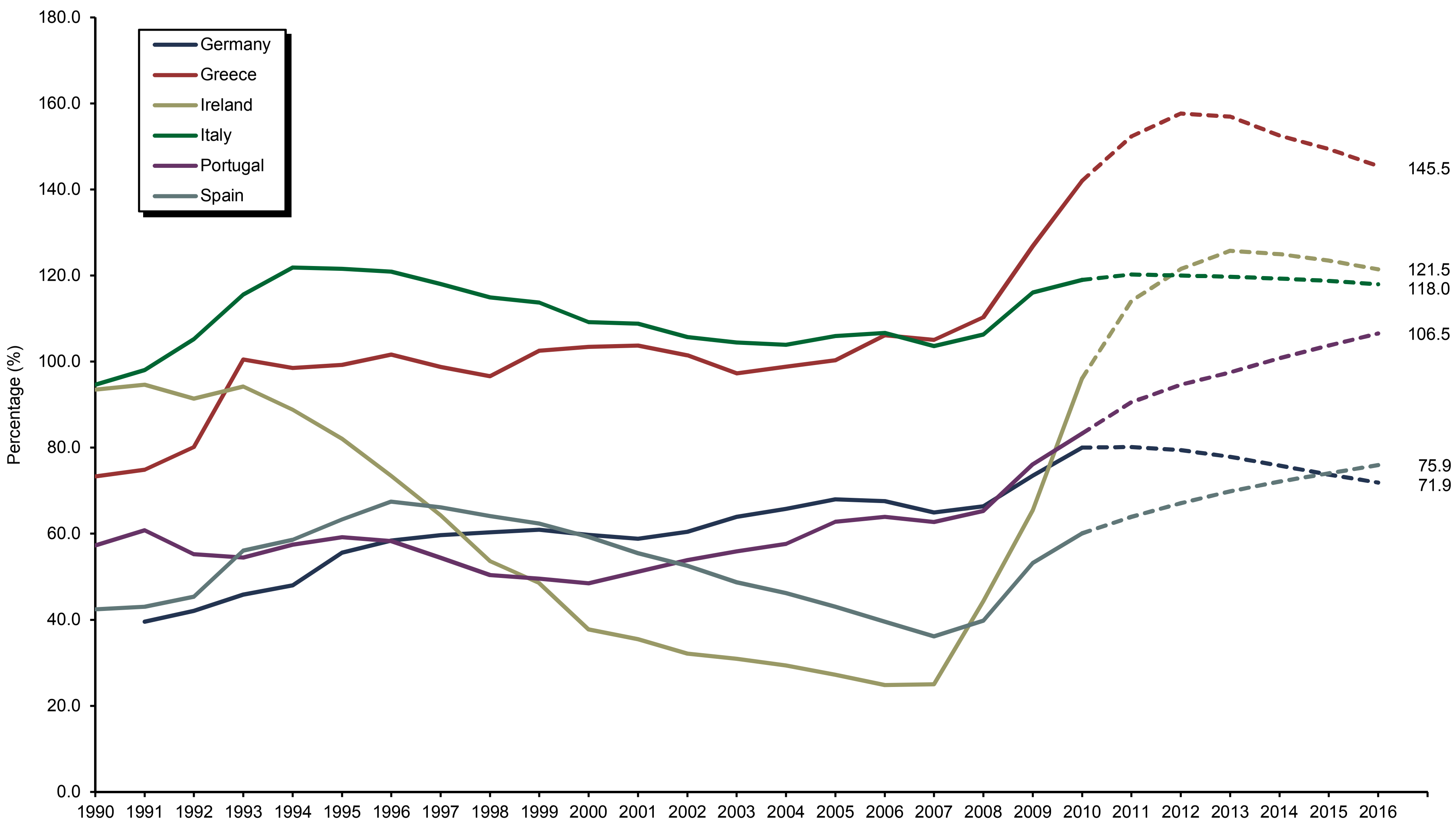
[1] Such accounts currently offer unlimited FDIC protection.

distracted by headlines or short-term fixes—the evaporation of recent market gains suggests attempting to generate short-term profits from such events is increasingly difficult. When concrete steps are taken to put countries on a sustainable financial footing, and comprehensive resources are put behind them, the investment proposition offered by many assets will be better understood. Until then, investments and managers should be selected with great care, and allocations kept to a minimum where fundamentals may not be the ultimate determinant of returns. ■

Exhibit 1

Gross Government Debt to GDP

1990–2016



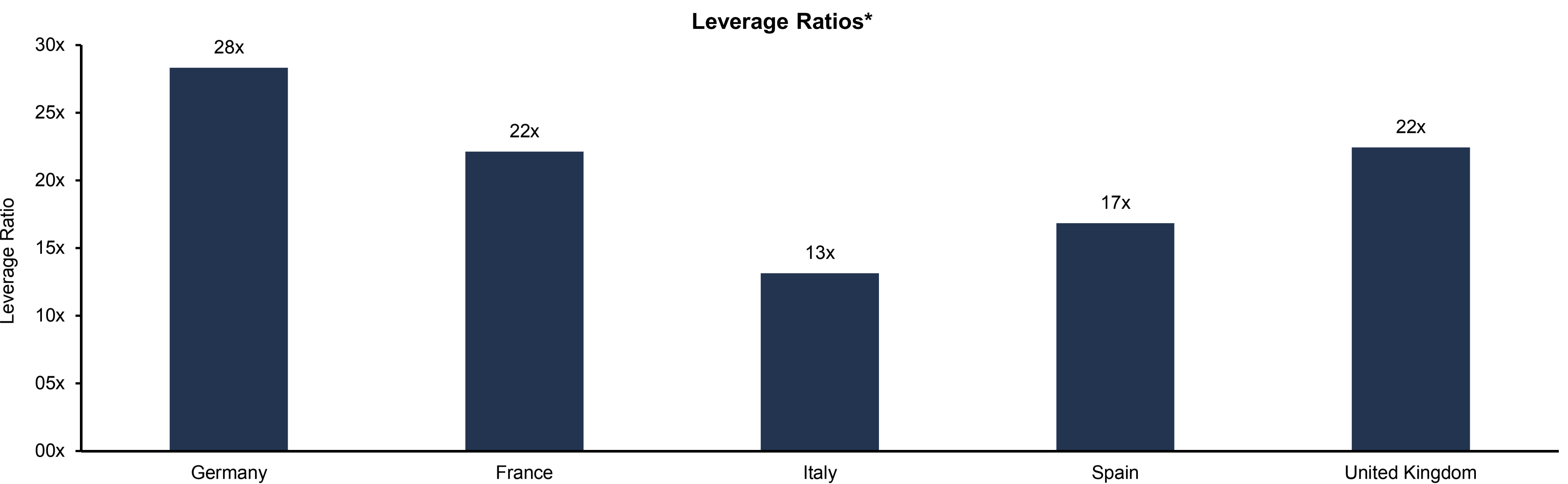
Source: International Monetary Fund - World Economic Outlook Database.
Notes: All data are annual. Data for Germany begin 1991. Projections are represented by dotted lines.

Exhibit 2

Consolidated European Banking Sector Data

As of 31 December 2010 • Euro (millions)

	Equity Capital	Exposures to Peripherals						Peripherals as % Capital	Total Banking Sector Assets
		Greece	Ireland	Italy	Portugal	Spain	Total		
Germany	331,100	25,325	88,073	120,969	27,149	135,586	397,102	120%	9,382,700
France	304,900	42,295	22,081	292,631	20,069	104,826	481,901	158%	6,744,700
Italy	210,300	3,045	10,077	N/A	3,020	22,107	38,249	18%	2,763,900
Spain	230,300	726	7,473	23,276	63,078	N/A	94,553	41%	3,877,000
United Kingdom	497,000	10,480	100,809	49,486	18,146	79,876	258,797	52%	11,155,700

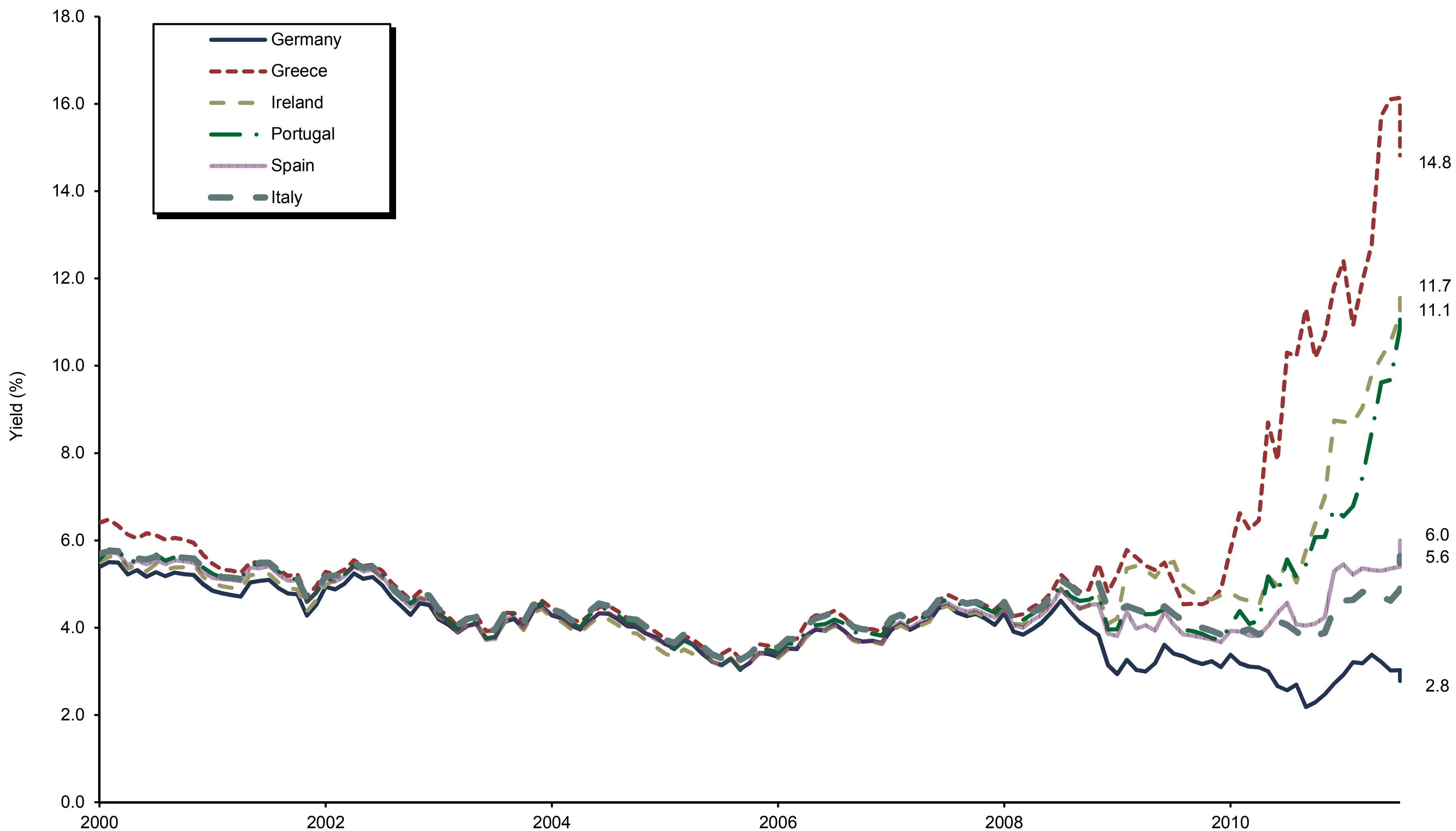


Sources: Bank for International Settlements, Bridgewater Associates, LP, and the European Central Bank.
Notes: Exposures are represented as consolidated foreign claims on an ultimate risk basis. Foreign claims are represented as a total of public sector, banks, and non-bank private sector claims. BIS data are as of 31 December 2010 and converted to euros from U.S. dollars as of 31 December 2010. ECB data are as of 30 June 2010.
* Leverage ratio is calculated as total banking sector assets divided by total bank equity capital.

Exhibit 3

Ten-Year European Government Bond Yields

1 January 2000 – 25 July 2011

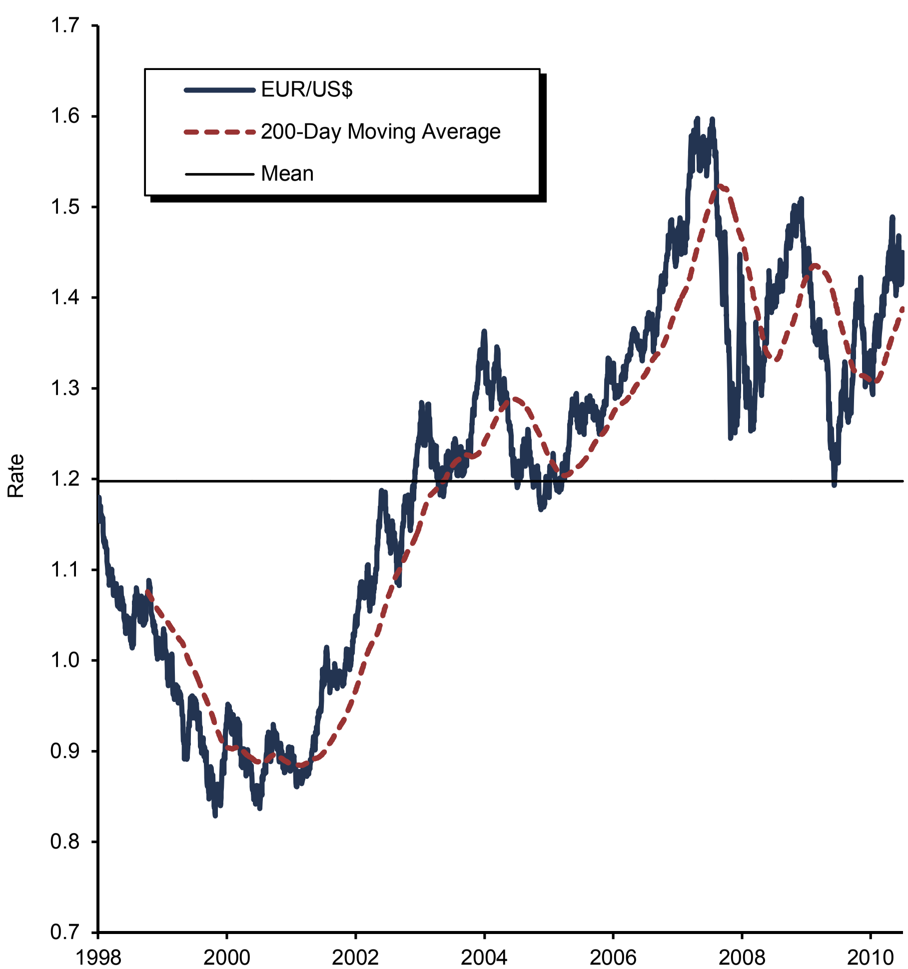


Source: Thomson Datastream.

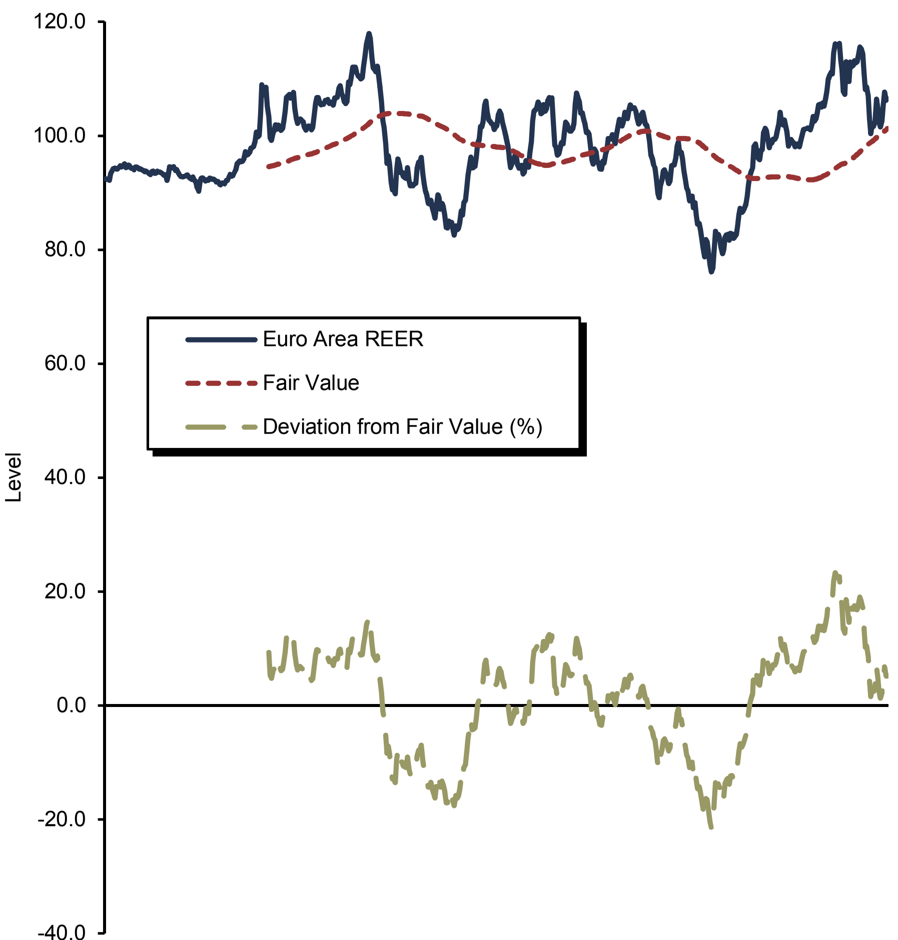
Exhibit 4

Euro Exchange Rates

Euro Real Effective Exchange Rate
31 January 1964 – 30 June 2011



Euro-to-U.S. Dollar Exchange Rate and 200-Day Moving Average
31 December 1998 – 30 June 2011

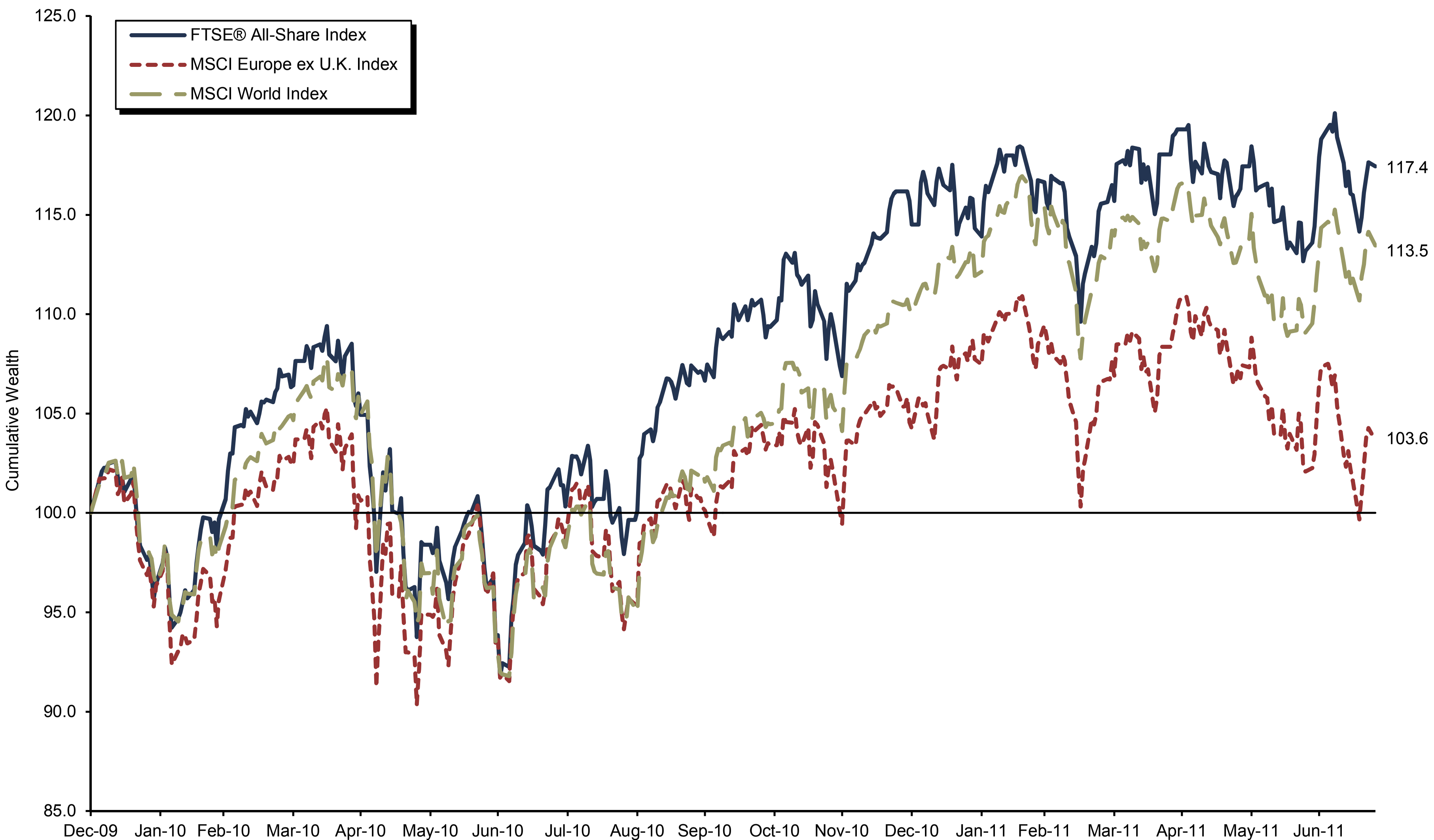


Sources: Bank for International Settlements and Thomson Datastream.
Notes: EUR real effective exchange rate (REER) graph uses monthly data. EUR/US$ graph uses daily data. REER is calculated as geometric-weighted averages of bilateral exchange rates for 27 economies adjusted by relative consumer prices. Fair value represents the REER ten-year moving average.

Exhibit 5

Cumulative Wealth of Various European Equity Indices

31 December 2009 – 25 July 2011 • Local Currency • 31 December 2009 = 100



Sources: FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Data are daily and in local currency.

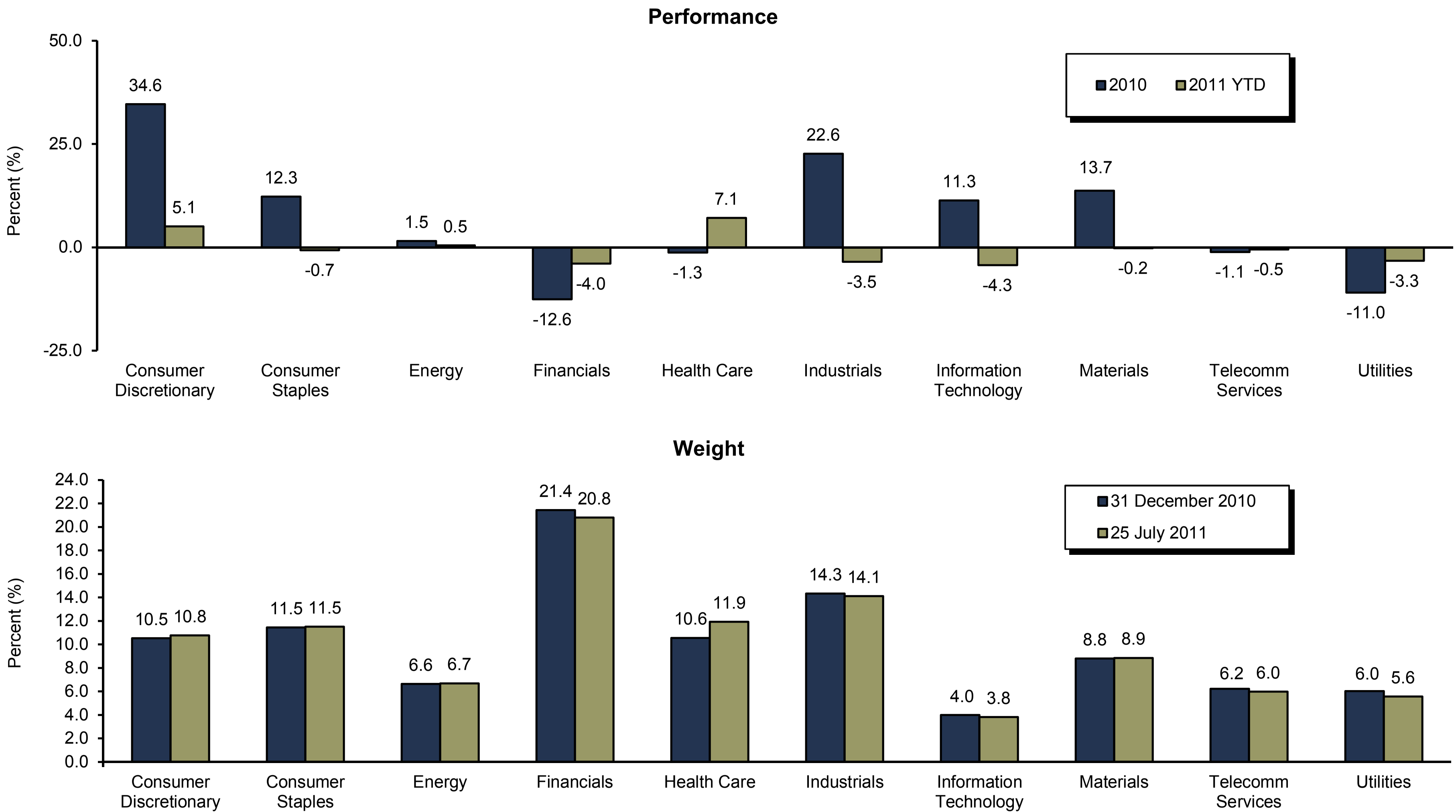
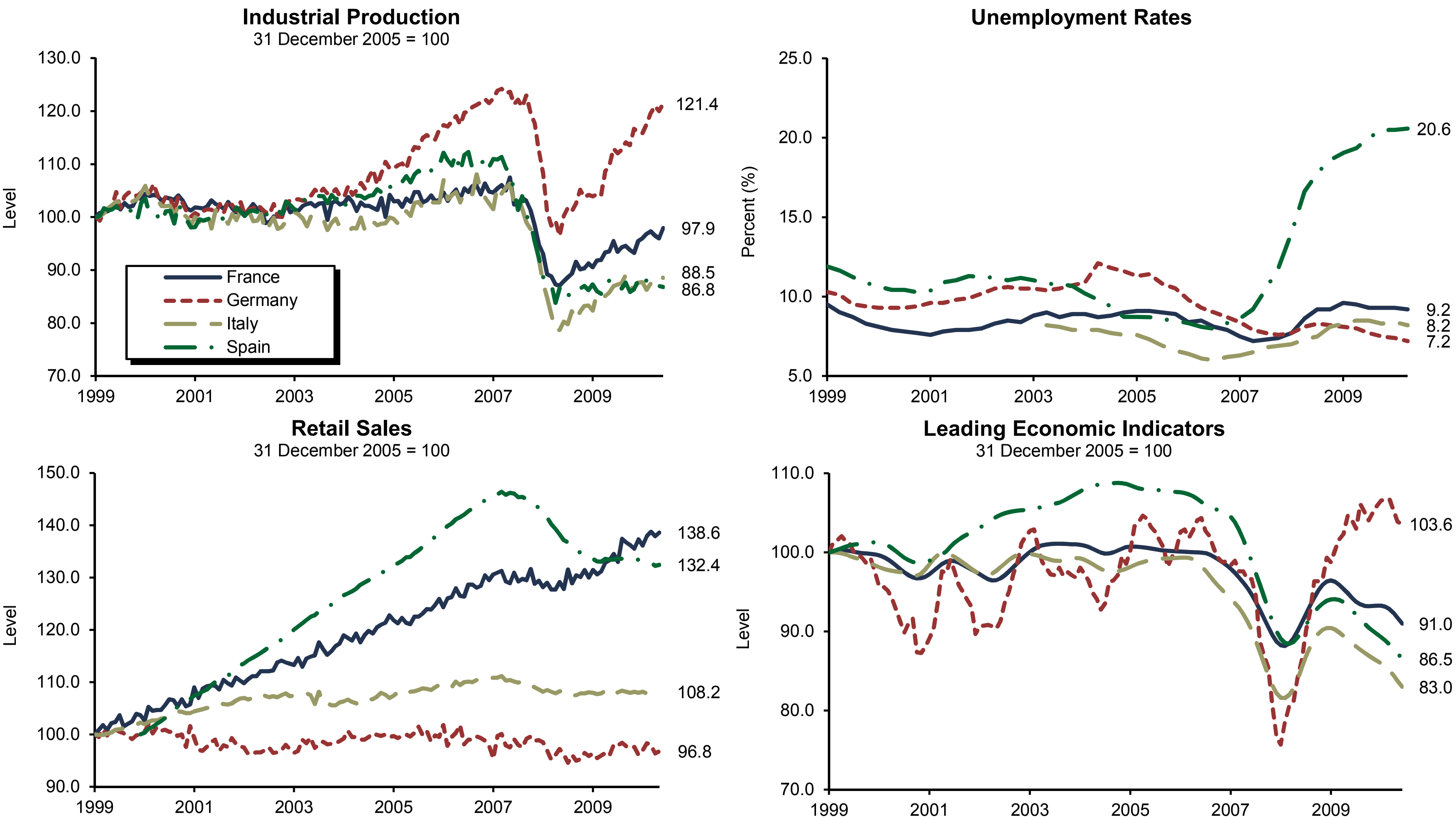


Exhibit 6
MSCI Europe ex U.K. Economic Sector Performance and Weight
As of 25 July 2011 • Local Currency
Performance
Percent (%)
50.0
25.0
0.0
-25.0
2010
2011 YTD
34.6
5.1
12.3
-0.7
1.5
0.5
-12.6
-4.0
-1.3
7.1
22.6
-3.5
11.3
-4.3
13.7
-0.2
-1.1
-0.5
-11.0
-3.3
Consumer Discretionary
Consumer Staples
Energy
Financials
Health Care
Industrials
Information Technology
Materials
Telecomm Services
Utilities
Weight
Percent (%)
24.0
22.0
20.0
18.0
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
31 December 2010
25 July 2011
10.5
10.8
11.5
11.5
6.6
6.7
21.4
20.8
10.6
11.9
14.3
14.1
4.0
3.8
8.8
8.9
6.2
6.0
6.0
5.6
Consumer Discretionary
Consumer Staples
Energy
Financials
Health Care
Industrials
Information Technology
Materials
Telecomm Services
Utilities
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: GICS sector classifications used for MSCI Europe ex U.K. weights may not total to 100% due to rounding. Sector weight calculated in euros.

Exhibit 7

Selected European Macroeconomic Statistics

31 December 1999 – 31 May 2011



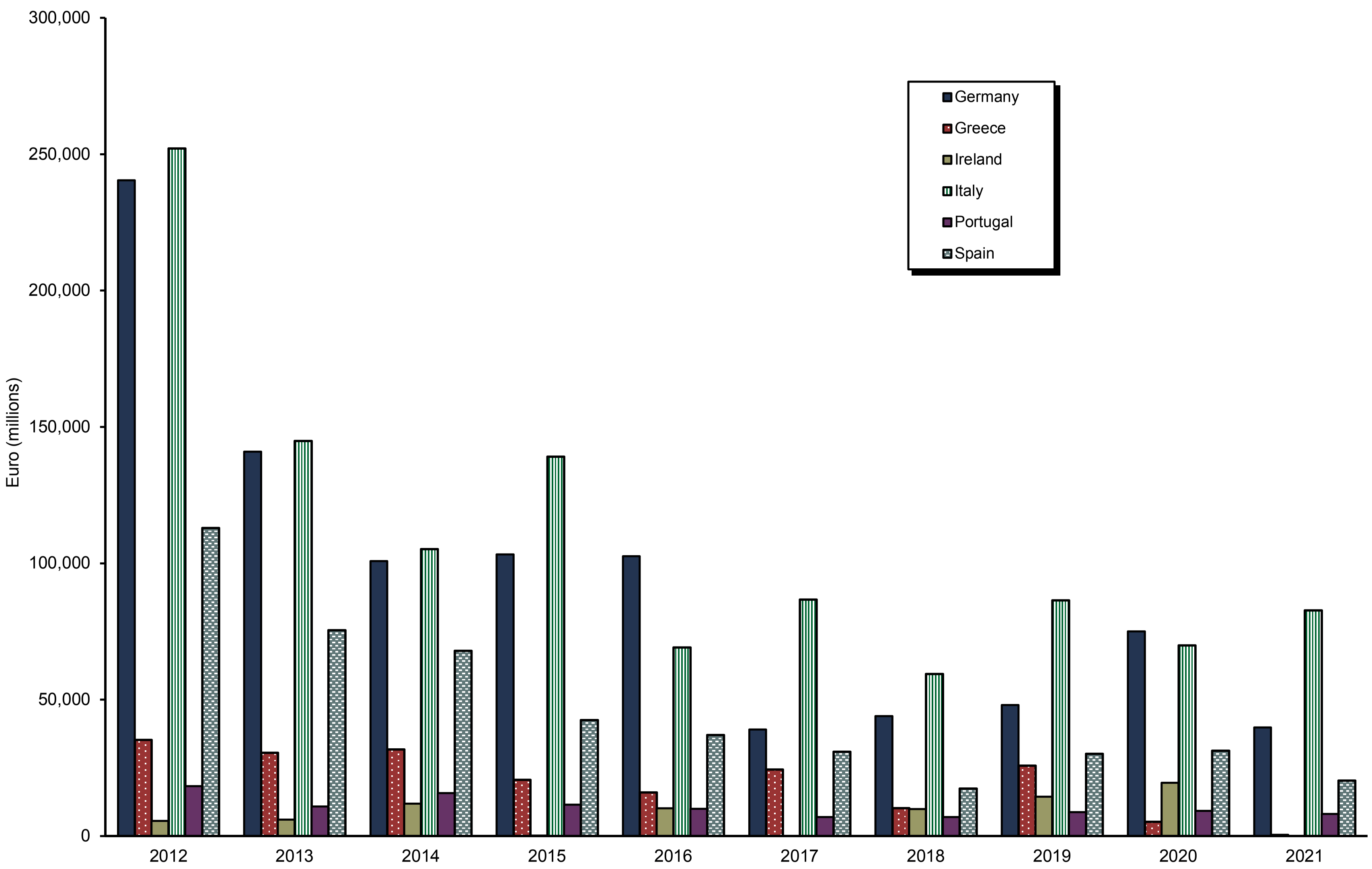
Sources: Deutsche Bundesbank, INSEE (National Institute for Statistics and Economic Studies), Instituto Nazionale di Statistica, Ministerio de Economía y Hacienda, and Thomson Datastream.

Notes: Unemployment data for Italy begin 31 March 2004 and are quarterly. All retail sales data are seasonally adjusted except Spain, which begin 31 December 2000 and are a 12-month rolling average.

Exhibit 8

Sovereign European Debt Maturity Schedule

2012–21 • Euro (millions)

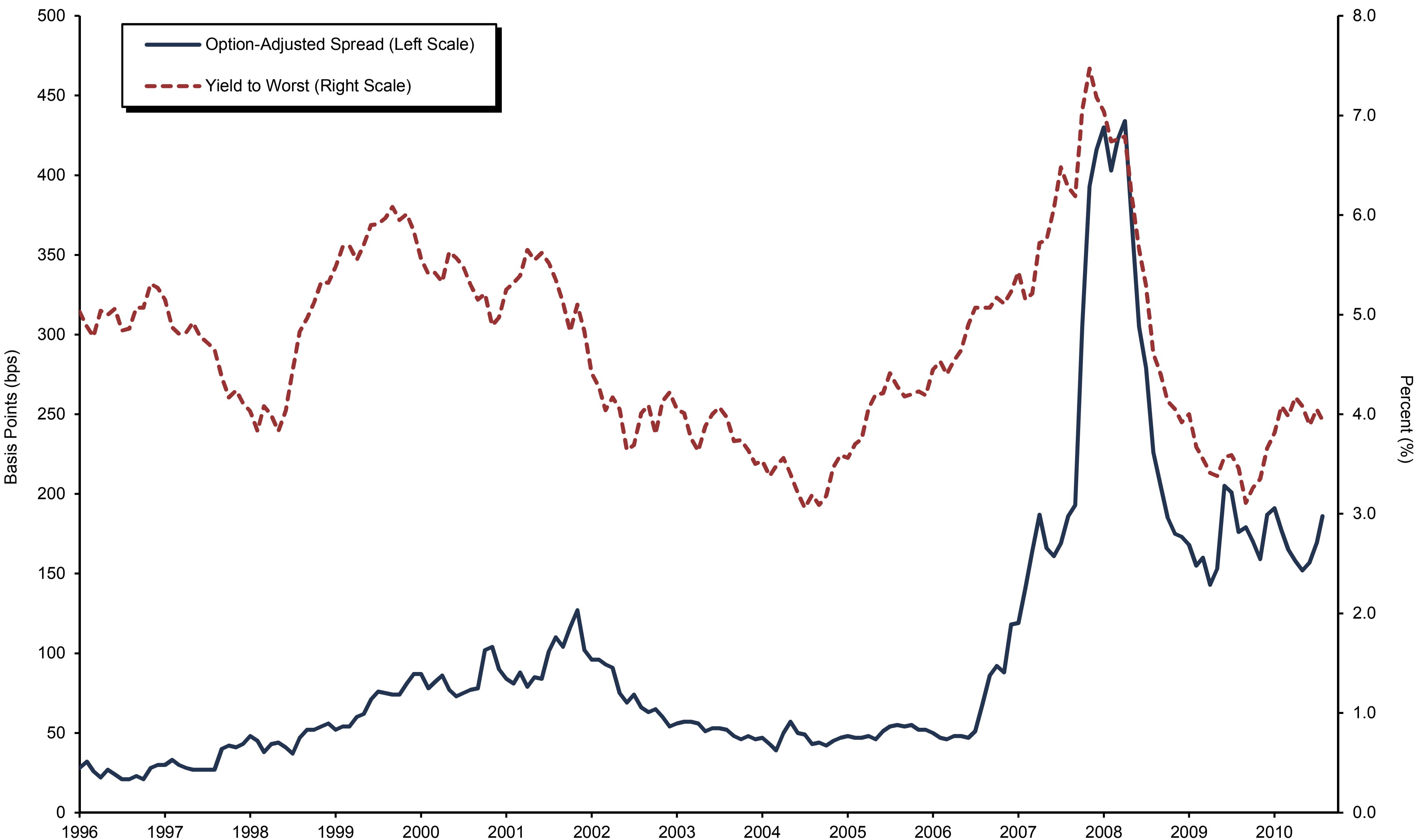


Source: Bloomberg L.P.

Exhibit 9

BofA Merrill Lynch EMU Corporate Index OAS and Yield

31 December 1996 – 25 July 2011



Source: BofA Merrill Lynch.