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# MARKET EDGE

EU summit – we can work it out  
28 October 2011



## Key points

Fourteenth euro zone crisis meeting since January 2010 and this will not be the last.

Banks to take a voluntary 50% 'haircut' on Greek sovereign debt.

Euro zone's main bail-out fund could have over a €1trn of firepower at its disposal.

Threat of financial system meltdown and double-dip recession subsides.

Summit deal supports the recovery in risk assets seen during October.

Markets to remain volatile ahead of clarity on the measures decided at the summit.

EU policymakers held two summits between 22nd and 26th October to try and thrash out a solution to the euro zone sovereign debt crisis. While progress was made towards preventing the difficulties in peripheral euro zone bond markets spreading, the debt crisis has some way to run. After eighteen months of mounting pressure in the euro zone debt markets, we look at whether the latest measures will be enough to satisfy investor concerns.

## Background

Euro zone policymakers have been grappling with widening fiscal deficits, anaemic economic growth and soaring sovereign bond yields for over eighteen months. Bail outs for Greece, Portugal and Ireland have been made during that time, along with the introduction of the European Financial Stability Facility (EFSF) as a vehicle to assist with bail-out funding. What started as a minor irritation confined to Greece has developed into something far more costly to fix and with the potential to break up the euro zone, causing havoc across the global financial system.

European policymakers have met in recent days to try and prevent the debt crisis spreading. The summits essentially addressed three issues: the size of 'haircuts' for private investors in Greek sovereign debt, how much euro zone banks need to be recapitalised, and how the EFSF should operate plus the level of firepower needed.

Stewart Robertson, our Senior Economist (UK & Europe), says, "This was the 14th euro zone crisis meeting in the last 21 months and will not be the last. Markets have reacted well initially, but scepticism understandably remains that this is not a detailed blueprint on the resolution of the euro zone's deep-rooted troubles." Dan James, our Head of Global Markets Alpha, adds, "The 'grand plan' is out of the box. Euro zone politicians finally realise they have a problem and that co-ordination is required to deal with it."

## Greek sovereign debt haircut

Private banks holding Greek sovereign debt have agreed to accept a 50% haircut on their holdings. EU policymakers had been holding out for a 60% haircut, which the banks found unacceptable. It is worth remembering that only in July, the banks accepted policymakers' requests for a 21% haircut on Greek debt, illustrating how much the situation has worsened in the interim. The cuts in Greek debt repayments are aimed at reducing the Greek government debt burden to 120% of GDP by 2020, instead of the 180% of GDP it was otherwise predicted to be.

Dan warns, "There are many details still to clarify on the debt restructuring arrangements. Not least the level of private sector involvement in the 'voluntary' restructuring and a potential legal challenge from holders of sovereign debt default protection via credit default swaps." He also notes that the level of participation will determine the ability to lever the euro zone's bail-out fund and the potential for additional external investment.

## Bank recapitalisation

European banks must raise about €106bn in new capital by June 2012, increasing their tier 1 capital ratio to 9% from 6%, to provide more protection against any losses suffered from potential government debt defaults in Italy, Spain or other euro zone economies. Stewart is concerned that banks may bolster their tier 1 assets by "shrinking assets rather than raising capital". This could exacerbate economic weakness across the euro zone during a time when growth has been at best anaemic.

<sup>1</sup>Source: Lipper Hindsight

Pascal Heurtault, our Chief Investment Officer in France, and John Botham, our Head of European Equities, are both optimistic that banks will be able to raise the extra capital required. John says that as retained earnings and convertibles form part of the capital ratio calculations, "few major banks will need to raise significant equity capital".

#### **Bail-out fund firepower increased**

The firepower of the EFSF is expected to be boosted from the €440bn agreed earlier this year to around €1,000bn. After drawings made on the EFSF since its inception, about €250bn is left in the fund. Policymakers suggest the remaining funds could be leveraged four or five times by offering insurance to purchasers of euro zone members' debt and/or setting up a special investment vehicle which private and sovereign investors, such as China and Brazil, could invest.

Stewart believes that operational arrangements for the enlarged EFSF need to be agreed speedily. "Solvency risks in the euro zone remain, public finances are still on unsustainable paths, contagion from Greek default is still an enormous risk and economies in the region are heading back into recession.

"As the European Central Bank (ECB) wants to move into the background, the pressure on the enlarged EFSF will grow swiftly. The ECB has bought €97bn of sovereign bonds in the last 12 weeks. Any new special purpose investment vehicle will struggle to match that pace of purchase."

#### **Outlook**

Risk assets have enjoyed a strong recovery in October ahead of the EU summit. The outcome of the summit should support investor sentiment in the short term.

Ross Junge, our Chief Investment Officer for Fixed Income in the US, believes that the summit will increase investor confidence that a "near-term systemic financial crisis will be avoided and the potential spillover risks for the US economy and banks will be reduced".

The deal brokered at the summit rests on the euro zone hitting growth targets to be successful. Ross says, "As investors gain temporary comfort with political developments, economic and corporate fundamentals will come under greater scrutiny. Any negative development in European economic growth, relative to the seemingly optimistic assumptions embedded in the plan, will further complicate the plan's implementation and effectiveness."

John warns that while the markets seem to have initially reacted well to the summit, "We have often seen post-summit rallies peter out very quickly. Much of the move in the equity markets reflects very low expectations, investor positioning and continued solid macroeconomic and corporate news."

Pascal reiterates the improving underlying corporate fundamentals in the euro zone, "Initial third quarter earnings data for many European companies were better than expected." He also thinks the summit will help improve confidence in the region.

Ross says the summit has important implications for the US credit market. "In the US, the combination of modestly improving post-summer economic data and lower euro zone risks should focus credit investors' minds more heavily on fundamental credit risk. Our outlook for credit is modestly positive. We see more attractive credit spread valuations offering opportunities to exploit. However, we continue to view lower levels of active risk positioning as prudent ahead of further clarity and reduced political uncertainty."

John believes that while there are attractive long-term investment opportunities in European equities, caution is the watchword ahead of further clarity on the measures announced at the summit. He concludes, "Financial markets will remain highly volatile. Relief rallies have faded in the past as it has become apparent that deeds matter far more than words. This crisis will have many more chapters."

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