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Our Current Perspective on the European Debt Crisis

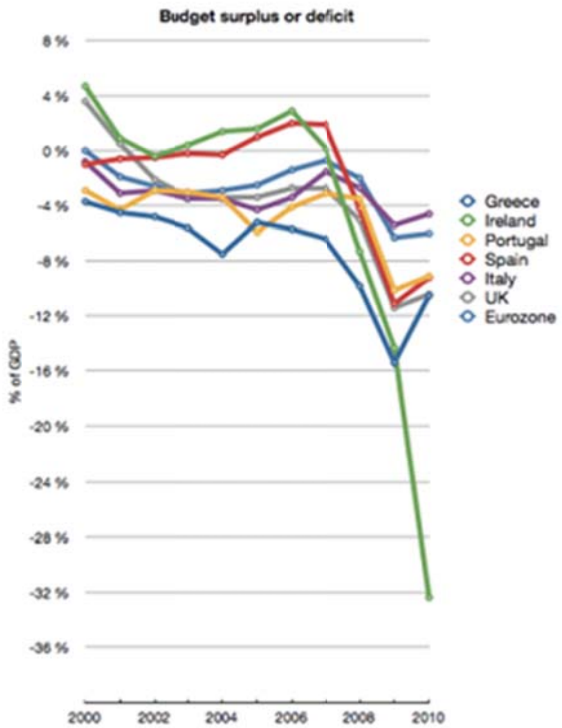
Turmoil in the Eurozone has been plaguing investors for nearly two years now, with Greece, Ireland, and Portugal all needing bailout packages to avoid default. More recently, investors have grown worried about the fate of Italy, the third-largest economy in Europe. And as growth has slowed throughout the 17-country union, some are questioning whether the Euro will even continue to exist in its current form. The unfolding drama has kept investors in suspense, hitting European investment values widely and driving fear and volatility in stock markets domestically and abroad.

In light of this ongoing issue, we think now is a good time to answer some important questions.

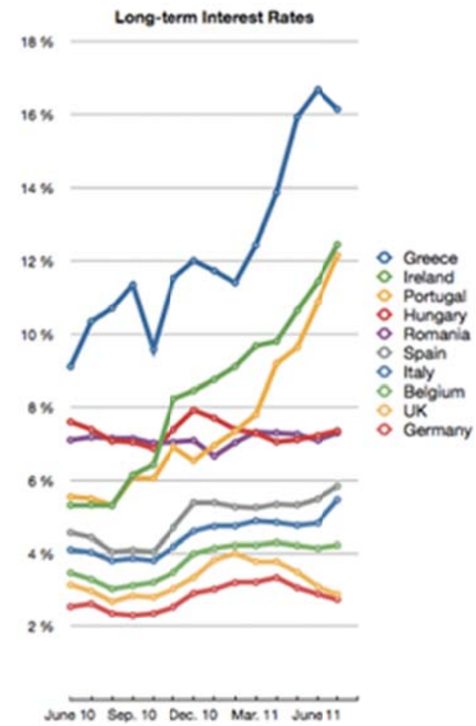
How did we get here?

Interestingly, there are a number of similarities to Europe's debt problems and the subprime crisis we experienced here in 2008. These similarities result in large part from the role played by government policy mistakes. In the U.S., politicians leveraged subsidies and regulations to boost homeownership to record highs, thus setting the stage for a perfect-storm of overinvestment and leveraged debt. In Europe, policymakers tried to buy a way of life they couldn't afford. By striving to provide citizens with low-stress jobs, 4-day workweeks, long vacations, free healthcare, and early retirements, they simply overspent.*

As you can see from the charts below, as budget deficits increased, long-term interest rates on government debt went up, thus exacerbating the problem.



Source: ECB and European Commission



Source: ECB

Gradually, it became apparent that while several of the Eurozone countries had unsustainable budget deficits, Greece was most at risk of imminent default. Awareness of this problem led the Greek parliament to pass the Economy Protection Bill on March 5, 2010, expected to save €4.8 billion through a number of measures. Shortly thereafter, the European Commission, the International Monetary Fund (IMF), and the European Central Bank (ECB) set up a committee to negotiate a loan agreement between Greece, the other Eurozone countries, and the IMF. The deal consisted of an immediate €45 billion in loans to be provided in 2010, with more funds available later.[1] In spite of these efforts, worries that Greece will default on the terms of its agreement have continued to destabilize the region.

In short order, both Ireland and Portugal likewise needed bailout packages, and the troubles have continued to spread into additional countries, including Italy. Italy, which is largely considered "too big to fail," currently has debts equal to 120% of its gross domestic product.[2] At the same time, their decade-long economic slump is not expected to end soon, thus making it more difficult to pay off debts. While lawmakers have proposed several austerity measures aimed at reducing its debt burden, investors remain concerned.

Where are we now?

Financial disorder and slow economic growth are taking a toll both in the United States and Europe. Europe's sovereign debt crisis is causing banks to reduce lending and hold on to cash, thereby reducing the spending ability of consumers and businesses. A common side-effect of decreased spending is slowed growth.

This slower growth is making it harder for stressed nations to get their debt under control, which is one of the reasons the IMF downgraded its outlook for the 17 countries that use the euro, predicting 1.6% growth this year and 1.1% next year, down from 2% and 1.7% respectively.[3]

On September 20, Standard and Poor's rocked the euro and bond markets with a one-notch cut in Italy's credit rating that added pressure on the debt-stressed region. S&P cut its ratings to A/A-1 from A+/A-1+, and kept its outlook on negative, warning of a deteriorating growth outlook and damaging political uncertainty.[4]

In its latest World Economic Outlook released on September 20, the IMF warned that "policy indecision has exacerbated uncertainty and added to financial strains, feeding back into the real economy." The message to policymakers was that they need to do whatever it takes to preserve confidence in national policies and work to tackle economic problems as quickly as possible.[5]

What steps are being taken to resolve this problem?

In July, European political leaders announced a set of proposals designed to address the fiscal crisis and introduced a second bailout for Greece, which was on the verge of default. One key aspect of the July 21 agreement involved the expansion of the European Financial Stability Facility. The EFSF was set up in mid-2010 to facilitate low-cost loans for struggling European Union (EU) members. Under the proposed changes, the fund would be able to buy government bonds directly from banks and investors. The goal of this action is to lessen the burden of nervous investors who have driven borrowing costs for EU members to record highs. These proposed reforms need to be ratified by the governments of all 17 nations that use the Euro as their currency, and will be voted on in the coming weeks.[6]

Meanwhile, the leaders of Europe's two most important economies, German Chancellor Angela Merkel and French President Nicolas Sarkozy, met on August 16th to discuss requiring all EU area nations to commit to balanced budgets.[7] They also discussed greater coordination on corporate tax rates and the creation of a so-called Eurobond which would be backed by all 17 EU nations.

The notion of creating a "Eurobond" has been growing in popularity. Many economists believe that issuing a common form of debt would lower borrowing costs for weaker members of the union (though it would also increase borrowing costs for stronger members). Jose Manuel Barrios, president of the European Commission, recently disclosed that officials are working on different Eurobond proposals.[8] We would not be surprised if this is part of a solution that member nations agree on at some time in the future.

As the crisis progresses, economic leaders from around the world are looking for ways to offer their support to Europe as well. On September 15, the U.S. Federal Reserve moved to help European banks by offering easier access to dollar loans.

That move, combined with comments from French and German leaders expressing confidence in Greece's place in the Eurozone, helped propel U.S. markets to their best five-day move in two years.[9]

Even China, the world's fastest growing major economy [10] has pledged its support to Europe. In a statement released September 20, China's Commerce Ministry spokesman Shen Danyang stressed that "everyone can work hard together to turn the crisis into an opportunity." And in a commentary released the same day, the government's Xinhua News Agency encouraged Europe to "open their arms to Chinese investments, allowing China to make the most of its rich foreign exchange reserves." As China's largest export market, they have a special interest in helping Europe with this crisis.[11]

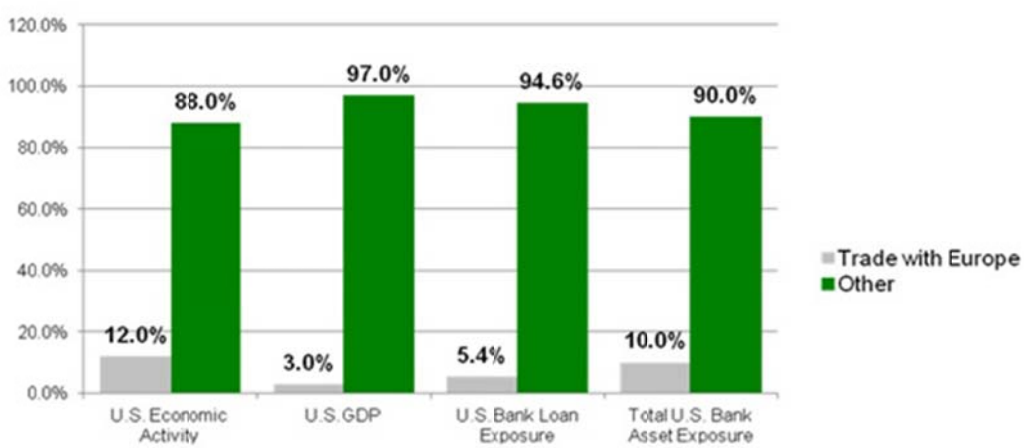
Expressing confidence in the tough choices being made by European policymakers, U.S. Treasury Secretary Timothy Geithner predicted that Europe will adopt some of the same measures the U.S. took to battle its own financial crisis. He urged European leaders to set aside their differences to eliminate "catastrophic risks" from the markets. Europeans "have a lot of work to do," Geithner said. "They recognize that more than anybody."[12]

What does the future hold?

No one can answer that question with certainty. One thing, however, is certain: Europe is headed for change. Whether it will emerge from this crisis with more or less fiscal unity and prosperity remains to be seen. Either way, the Eurozone that exists today will be different from the one we see 10 years from now.

Granted, there is a possibility that troubles in Europe could gradually spread, thus putting further strain on the global economy, but we believe the combined support of world economic leaders will prove to pull Europe out of this crisis.

While some financial institutions may face losses in the process, the minimal level of European exposure U.S. banks have, makes them well equipped to face this challenge. Our research tells us the odds of significant damage to the U.S. economic system resulting from European debt failures are very low. Trade between the U.S. and Europe is relatively small. Exports account for only about 12% of U.S. economic activity and 3% of GDP[13] (See chart below).



While U.S. banks lend to their European counterparts and hold billions in investments, analysts agree that American banks have enough capital to withstand losses from the European crisis. U.S. banks' exposure to the PIIGS (Portugal, Italy, Ireland, Greece, Spain) amounts to only 5.4% of loans, and U.S. lending to Europe accounts for only 10% of total U.S. bank assets.[14]

What about investing in European Companies?

Where some people see tremendous opportunity in Europe, others only see tremendous risk. Regardless of your perspective, overinvestment in Europe offers the potential for both large wins and sizable losses.** An added risk is that a possible devaluing of the Euro vs. the Dollar could affect the returns of European investments. Because a clear path to fiscal austerity has not been defined for the region, we do not believe that being overly weighted in Europe is prudent at this time.

International investing involves special risks not present with U.S. investments due to factors such as increased volatility, currency fluctuation, and differences in auditing and other financial standards. These risks can be accentuated in emerging markets

While our balanced approach to investing may not provide the best (or worst) returns, in environments like we are currently facing, we still believe it is important to diversify.# This is why we work very hard to help our clients select a mix of asset classes that will be right for them personally, but that will also help them achieve their financial goals.

Diversification does not guarantee against a loss. Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values.

In Summary:

We understand that it is hard to have peace of mind about investing when the world is facing challenges like these. If you are uncomfortable with any of your current investments or have questions about how you are allocated, we are always happy to discuss your personal situation. Simultaneously, we also want to assure you that we are diligent about making investment decisions that we discern to be in your best interests - both in the short-term and the long-term. If you have questions about anything you've read in this paper, please don't hesitate to give us a call. It is a pleasure serving you!

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We love being introduced!

Footnotes, disclosures and sources:

*The Irish sovereign debt crisis was not based on government over-spending, but from the state guaranteeing the six main Irish-based banks who had financed a property bubble.

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Sources:

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