

European sovereign credit risk

Fixed Interest and Credit research

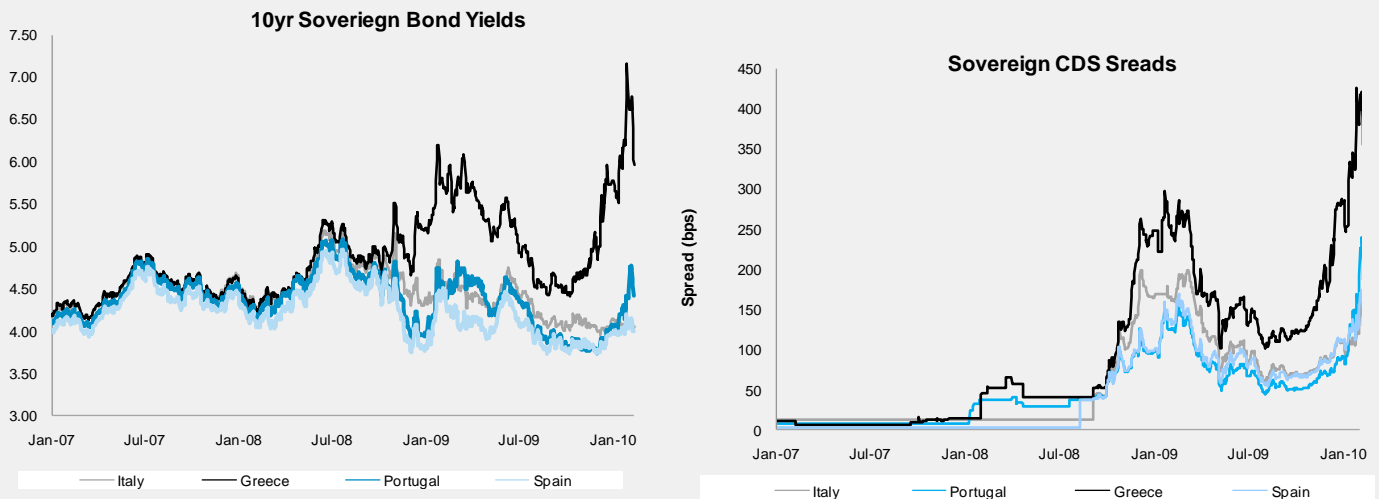
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This paper examines sovereign risks intensifying in Europe and their impact on global bond yields, credit spreads and our strategies and positioning.

PIGS are flying... what is going on?

Greek bond yields flew to dizzy heights in February, triggered by sovereign risk worries intensifying around the world. This was fuelled by speculation about Greece's ability to implement budget reforms or risk defaulting on its debt. Looming fiscal problems have been lingering for a while now in several 'developed' economies, particularly in Europe. The so called PIGS - Portugal, Italy, Greece and Spain, in addition to Ireland, Iceland and the UK are all facing deteriorating public finances.

Chart 1 and 2 – Sovereign bond yields and CDS spreads are elevated in PIGS countries



Source: Bloomberg

Among the biggest problems developed economies are facing are; the aging population with associated pension deficits, enormous debt levels on both consumer and national level, and structural problems that require tough reforms. Inflating asset prices and growing global imbalances are unlikely to provide a quick fix to these problems. Consequently, tight fiscal policy will weigh on growth for years to come

The market is expecting a 'two speed global economy', in which emerging markets grow faster and developed markets lag, with yield convergence between these markets becoming more pronounced. As official interest rates start to rise and sovereign risks get re-priced, yields are expected by many to rise in heavily indebted western markets. In emerging markets, with relatively healthy balance sheets and recovering growth, inflows may push local currency yields lower as markets develop and liquidity improves.

The market remains concerned about the stability of the Eurozone and the increasing fears that member states will struggle to reduce their budget deficits. Under the Maastricht treaty, national budget deficits in the Eurozone are

supposed to be limited to 3% of GDP. Currently, most members are significantly exceeding this limit, primarily due to the Global Financial Crisis (GFC), although some members, such as Greece, went into the crisis with already stretched finances.

Fears of a contagion, and resulting debt market turbulence, have shaped market sentiment in recent weeks. The EU economic summit in February on short-term challenges and structural reforms had the primary focus of preventing market panic and determining what role the IMF should play in supporting Greece. Not only would IMF intervention be an embarrassment to the EU, but it could potentially trigger distressed trading for the euro.

In the worst-case scenario, the potential fallout from Greece's default would be extremely serious for Europe. Greece's economy may be relatively small (2.7% of the USD13tn Eurozone economy), but the contagion risk to other larger members could be catastrophic. Opinions are split between those who argue for an EU bail out, those who suggest IMF intervention, and those who think Greece should be left to default (to teach other fiscally lax economies a lesson). Without drawing any close parallels, it is noted that moral hazard arguments were also fiercely debated prior to the Lehman Brothers collapse in September 2008. A bail out seems inevitable, but the price Greece would have to pay for this support needs to be high enough to prevent other countries contemplating this option.

A default in a Eurozone member country could potentially:

- Derail the global recovery.
- Damage the euro and the Eurozone.
- Threaten the European banking system. European banks have some US\$1.9tr exposures to Greece, Ireland, Portugal and Spain, hence a default and contagion to other markets would wipe out a very large proportion of common equity in the European banking system.
- Trigger another banking crisis. After the massive write downs during the last two years, with tighter regulations on their way and still a subpar growth, the market could fall over and the economy double dip.

Some facts about the figures

Chart 3 –Budget deficits are well above the 3% limit

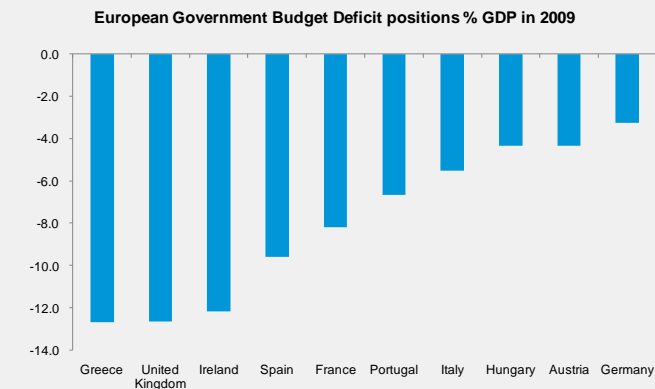
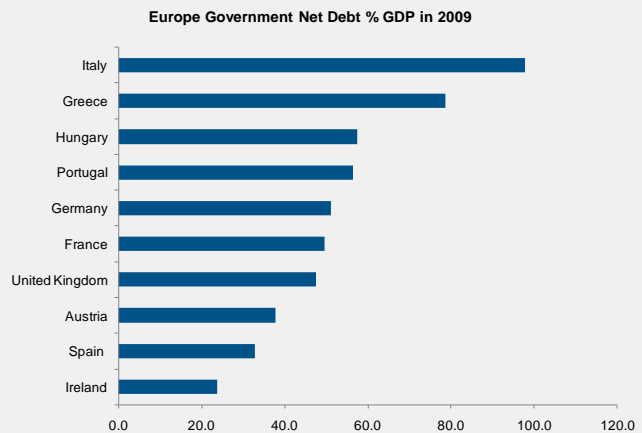


Chart 4 –Net financial liabilities are growing



Source: OECD

Several Eurozone members entered the GFC with already large deficits and faced a situation where public spending had to be increased to counter balance the weakness of the private sector. The public purse was already running on borrowed money. The crisis, therefore, left many countries with a deep deficit that will need to be financed by additional public debt.

In Europe, the situation is most severe in Greece. Greece entered the Eurozone almost a decade ago with relatively healthy public finances, or so the world thought. Due to some banking and accounting rules, there was a small surplus reported. However, this rapidly dipped into deficit shortly after entry, and Greece has been running a deficit ever since, while borrowing relatively cheaply under Eurozone interest rates. It was not preferable but manageable before the crisis. After the GFC hit, however, its budget deficit got out of control and currently stands at four times the Eurozone's 3% limit.

Poor fiscal policy over a number of years has left Greece with a large level of accumulated debt, estimated by the OECD at just under 80% of GDP in 2009. This is the second largest of the main EU nations, just behind Italy at close to

100%. However, Italy's budget deficit is half that of Greece and its bond market is the third largest in the world, making it less vulnerable to speculative attacks.

Greece needs to borrow around EUR 54bn, the equivalent to around 20% of expected annual GDP in 2010. Around EUR 20bn worth of debt is due in April and May, and will be a critical period for Greece's ability to refinance. Greece sold EUR 8bn in 5-year bonds in late January, issuing more than was announced due to stronger than expected demand. This calmed the market a little, however, two days later the yields on Greek government bonds jumped to their highest since 1999, and the interest-rate spread on its 5-year bond widened to a record 4.1 % over German bunds. The sell-off was on the back of rumours that Greece was looking for financial assistance from the EU, and that it had asked China to buy EUR 25bn worth of debt. Investor appetite suffered, breeding uncertainty about demand for Greek debt. Estimates for Q3 2009 show that 77% of Greece's debt is held by foreign investors, hence Greece is dependent on international funding. It seems a lot is hinging on demand for Greek debt at the next auction.

What is Greece doing?

Greece's plans to reduce its current 12.7% of GDP budget deficit towards the EU's limit of 3% of GDP by 2012 have been accepted by the European Commission. New measures to reduce the deficit have been unveiled by the Prime Minister, including significant cuts in public sector wages (-6% in nominal wages) and wage supplements (-10%), along with a 10% reduction in the remuneration for the Prime Minister and other government ministers. In addition, the income threshold for the highest income tax rate of 40% has been cut from EUR 75k to EUR 60k. Partly in response to these measures, Greece's 600,000 public sector employees went on a 24-hour strike last week, closing down schools, hospitals and airports. Opinion polls have suggested, however, that the Greek government has wide support from the population to implement the fiscal and economic steps needed to restore economic prospects.

Eurozone countries must take individual fiscal actions, and are constrained by their common monetary union. This factor puts particular pressure on these countries to address fiscal imbalances with decisive measures, as has been done in Ireland. Greece, to date, has not convinced the market that its plan will be successfully implemented, and that the fiscal measures taken are enough to successfully reduce the fiscal imbalance by 2012.

So what are the options?

There are three main options for Greece. The most likely and least damaging option is a painful and slow fiscal consolidation via reforms from its own strength and/or with external help. The second is to declare default and let the IMF come in and clean up with Greece paying the price for a decade under strict conditions. And the third is to leave the euro and print drachmas again.

Greece and Europe are unlikely to consider the last two options and put the existence of the single currency area in risk. At the February EU Economic Summit, the EU agreed to support Greece in a pledge for solidarity, should it have problems refinancing its debt in the next few months. For now, EU leaders are likely to wait and see how Greece handles its problems. If Greece asks for help, or cannot sell its debt, the EU will have to translate its words of solidarity into action.

So what about the first option? Should Greece fail to raise funds in the bond market, the EU is likely to step in and provide loans to Greece or buy sovereign debt outright. The European Central Bank cannot bail out any member governments under the Maastricht Treaty's 'no bail-out' clause. However, there is a loan backstop facility available to the EU to 'protect the integrity of the euro'. This aid was increased to EUR 50bn in 2009 to help struggling Eastern European countries (like Hungary, Lithuania and Romania) with emergency funds should they have needed them. Also, it was suggested that Greek debt could be bought by the European Investment Bank.

The second option would be for the IMF to step in, but the price tag and stigma attached to the deal would be felt for decades in Greece, notwithstanding the reputational risk the Eurozone would suffer. An IMF paper evaluated four types of cost that may result from an international sovereign default: reputational costs, international trade exclusion costs, costs to the domestic economy through the financial system, and political costs to the authorities. It concluded that the economic costs are generally significant but short-lived, and sometimes do not operate through conventional channels. The political consequences of a debt crisis, by contrast, seem to be particularly dire for incumbent governments and finance ministers, broadly in line with what happens in currency crises. Hence, the most likely outcome will be for the EU to bail out struggling economies.

What is unavoidable, is that Greece will suffer under any of the scenarios and growth will be restrained for several years. This will be the case for many of the troubled countries, as well as the larger and healthier economies that will be dragged down by the weaker ones. Eurozone growth may be sub-par for the next several years and lag the current recovery.

Who is the next weakest link?

After Greece, fiscal consolidation is expected to be the largest in Spain, Portugal and Ireland, creating more downside risks to economic growth in these countries. The Spanish economy, in terms of output, is four times as large as Greece, five times the size of Ireland and six times that of Portugal, posing a much larger threat to stability in the region than smaller members. Spain's fiscal deficit was 11.4% of GDP in 2009 vs the 3% limit. There is scepticism as to whether the Spanish government can perform the necessary cuts to improve their budget, particularly after the government's proposal to increase the retirement age to 67 years from 65 years sparked union outrage. Unions are also unlikely to accept any cuts to wages or social spending. This will put further pressure on unemployment (currently close to 20%) and the associated spending on benefits, increasing Spain's debt problem. Furthermore, Spain is the only major developed economy expected by the IMF to shrink in 2010. On a positive note, Spain entered the GFC with a budget surplus and its financial system is in good health. Its debt is still expected to peak at 74% of GDP in 2012, below the European average. Spain's ability to implement cuts will be very closely followed by the bond market.

Portugal, another Eurozone member struggling with debt issues, announced that its budget deficit was 9.3% of GDP in 2009, higher than previous forecasts. It also said that the deficit would narrow only slightly to 8.3% of GDP this year. Less budget consolidation than other periphery peers and competitiveness issues resulted in Portuguese bonds also selling-off sharply, leaving the level of yields second only to Greece.

Given the stress in Europe, the market's attention was somewhat diverted from the UK and US in recent weeks. Contagion is most prominent in the PIGS, but the US and UK have similar issues to those facing peripheral Europe, an important difference is their flexible currency. Nevertheless, recent rating agencies rhetoric about their dire fiscal situation and risk of being downgraded may come back to haunt them.

For now, questions remain:

- Can contagion be stopped?
- Will several healthier and larger economies share the burden of a Greek bail out?
- Will several economies need to be bailed out by Germany and France?

To be sure, elevated levels of sovereign risk are expected to linger for many years to come in the developed world, until public finances look healthier, structural challenges are addressed and stronger growth returns.

In summary, the biggest risk facing the market today is the risk of contagion. Should sovereign default risk scare the market and irrational behaviour escalate, a large repricing of all asset classes could occur. We are not calling for another 'Lehman' scenario, but the risk of significant market turbulence is not off the charts.

What about yields and credit?

The market is still waiting and weighing these options. Implications for Greek government yields can vary in magnitude, but the trend to higher yields seems to be set for some time to come. The magnitude of rising yields and widening of spreads will largely depend upon Greece's ability to raise funding. If it can convince the market that it can sell its debt, and is committed to fiscal reforms, spreads will tighten from their recent highs. However, if it cannot fulfil its funding requirement, the market will punish Greece and yields may rise further. German yields had been falling of late, as a result of fund flows from peripheries into Bunds, but market volatility has been high, and Bunds could also suffer if Germany is forced to support PIGS. A 'mini crisis' would trigger a global flight to quality and push US yields lower, as Treasuries are still considered a safe heaven.

The danger for risk assets globally is that if higher quality assets get re-priced, it may trigger a larger re-pricing at the riskier end of markets, just as occurred after Lehman's failure. If the contagion is limited in Europe, credit markets may continue healing, although spreads have been tightening at a much slower pace, and mostly moving sideways in recent months. If distress grows, however, any global reduction of risk appetite will impact global markets, making a resolution of this issue an important goal for the global economy.

The issue is a reflection of the pressure on the world economy to reduce debt levels across the board. Consumers and corporations have begun that process, but in order to 'buy time' for the world economy to grow and avoid an economic depression, governments have had to move deeper into debt, increasing borrowing to fund and continue fiscal stimulus measures. This cannot continue forever, but the capacity to keep running deficits is more limited in countries like Greece which was heavily in debt before the GFC.

Our strategies and positioning

Although we do not expect another 'Lehman' scenario, the risks are not negligible. We have been monitoring and analysing these risks, selling out of our Greek exposures in November 2009 in the Colonial First State Wholesale Global Bond Fund. In other PIGS countries we are underweight in Italy, Spain and Portugal relative to the benchmark.

Credit risks have also been rising as sovereign risks intensified; we have a rigorous and in depth credit research process in place to monitor daily developments in all our exposures across all our funds. Sovereign risk issues came to the forefront in November 2009, when Dubai World announced that it will not pay the interest due on some of its debt. The market was reminded that systemic risks are still a concern in this fragile recovery. On 30 November 2009, the United Arab Central Bank announced that it was 'standing behind' the country's local and foreign banks, somewhat calming the market. We did not have direct exposure to Dubai World; our concerns were for a potential default impacting on other banks exposed to Dubai World, Dubai or the Middle East as a whole. Details of known exposures in the region were prepared, and concluded that no individual bank had significant exposure to Dubai World, therefore the reported US \$60bn of Dubai World debt was shown to be well-spread amongst global financial institutions. It did not affect any of our investments.

Our concerns regarding the sovereign risk of Greece intensified following the results of the 2009 elections. The new centre-left government was elected on 4 October 2009 and shortly thereafter released significantly revised estimates for the 2009 deficit. As a result of the revised forecasts, we changed our internal credit rating and downgraded Greece on 16 November from 'a' to 'a-/negative outlook.' At the time, S&P announced that there was no change to their rating of 'A-/stable' following the election announcement and Moody's placed their sovereign rating of A1 on watch negative.

In late December, S&P downgraded the rating on Greece from A- to BBB+, at which time our internal rating was revised again downwards to 'bbb+/negative outlook' due to continuing concern regarding spiralling levels of government debt. Moody's also revised their rating on Greece in January 2010 to 'A2/negative outlook', which remains two notches above our internal rating. Concurrently, we reviewed our only Greek exposure in OTE Plc in the Colonial First State Wholesale Global Credit Income Fund, to make sure the security still compensated us for the risk taken. We concluded that the issuer offered an attractive return per unit of risk. We have since sold this security in February.

In our Colonial First State Wholesale Global Credit Income Fund, we have 1.04% exposure to Italian, 0.25% to Irish, 1.52% to Spanish and no exposure to Greek or Portuguese names as of 31 January 2010. The 1.5% exposure in Spain is made up of 3 larger issuers, Santander, Iberdrola and Telefonica, while our Italian exposure includes Enel, Telecom Italia and Intesa. Our only Irish name is Allied Irish Bank. All of these issuers are investment grade global businesses not totally reliant on their domestic economies, with spreads that we find attractive relative to their credit matrix. Our exposures are based on the credit quality of companies and their diversification benefits for the portfolio, with risks under constant monitoring.

For further information

Adrienn Sarandi Fixed Interest and Credit Investment Analyst +61 2 9303 6130 asarandi@colonialfirststate.com.au

cfsinstitutional@colonialfirststate.com.au

Regional Managing Director, Australia and New Zealand

Joanna Davison +61 2 9303 7007

Institutional Business Development and Consultant Relationships

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Tracey McNaughton +61 2 9303 2695

Institutional Relationship Management

Liz Krajewski +61 2 9303 2927

Daniel Bristow +61 2 9303 6311

Helen Squadrito +61 2 9303 6142

Hugh O'Neill +61 2 9303 6116

Nadene Moore +61 3 8628 5615

Simon Good +61 3 8628 5681

Lucas Rooney +61 7 3328 5875

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