

INVESTMENT STRATEGY
COMMENTARY

EURO DEBT CRISIS: MERKOZY DELIVERS

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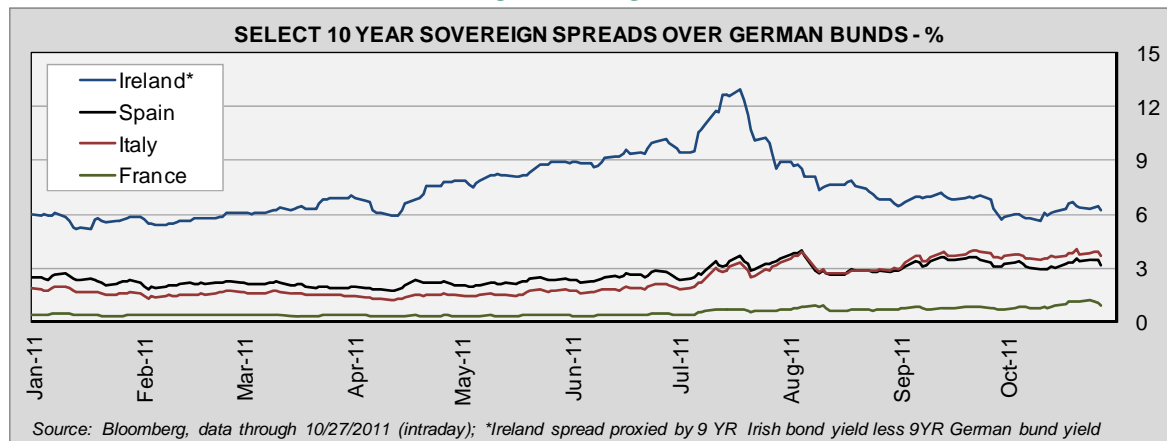
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European leaders, led by Germany's Angela Merkel and France's Nicolas Sarkozy, appear to have outperformed market expectations with the rescue package announced overnight. Global stock markets are rallying, yields on European bonds are falling and safe havens like gold and the U.S. dollar are lagging. We have been of the view that the European leaders understood the dire implications of not addressing this problem; therefore, they would grudgingly provide the necessary support and we would avoid a repeat of the Lehman Brothers-induced financial system meltdown of 2008 – 2009. The package announced last night, while still needing much greater transparency, is a step in the right direction and we believe supports our modest tactical overweight to risk assets. With European and U.S. shares now having rallied 16% – 17% over the last four weeks, the market may be due for a breather. October has historically been a volatile month and has produced some of the biggest market drops (such as in 1929, 1987 and 1997). Yet October is also called a “bear killer” by “The Stock Trader's Almanac,” which cites 11 bear markets in the post-WWII period that were ended by October rallies.

EXHIBIT 1: MORTARING THE FIREWALL



The Terms of the Deal

Political leaders have apparently agreed with bondholders for a 50% haircut of Greek debt in a voluntary restructuring. This apparently doesn't apply to holdings of Greek bonds at the European Central Bank (ECB) and was engineered to avoid triggering credit default swap payments (and the unknown consequences of that event). The details are to be worked through the remainder of this year, with implementation in early 2012. Various press reports indicate that Greece's next tranche of bailout money has been approved by the International Monetary Fund (IMF). The agreed debt reduction, which is forecasted to reduce Greek debt/gross domestic product (GDP) to 120% by 2020, will still leave the country's debt burden very high. A further reduction, which would have helped Greece's long-term sustainability, was probably too much for bondholders to “voluntarily” accept.

A recapitalization plan for Euro-area banks was agreed, using a 9% Tier One capital ratio on Basel “2.5” guidelines. All bank sovereign debt holdings are to be marked-to-market as of September 30, 2011. Regulators are expected to receive the plans by year-end, with implementation by June 2012.



Of the €106 billion in total capital needs identified, approximately 28% is for Greek banks, 25% for Spanish, 14% for Italian and the rest spread among remaining countries. An analysis by Barclays estimates that the capital shortfall for the top 15 debt-issuing European banks is €25 billion, as compared with normalized quarterly earnings of €14 billion. Therefore, we don't expect significant capital raises to rapidly ensue. The overall package was being positively received by the markets, with European bank shares up over 8% intra-day today (while still down more than 18% year-to-date).

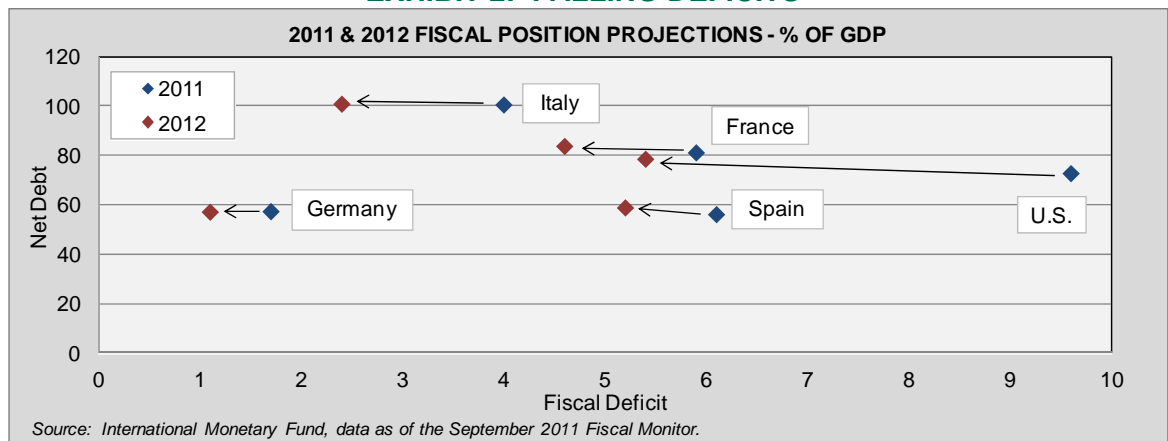
Agreement has apparently been reached to leverage the European Financial Stability Facility (EFSF) to increase its impact. Press reports indicate leveraging by a factor of four or five times, but details are lacking so this can't be considered a done deal yet. The concepts include increasing the credit quality of new bonds issued by partial guarantees by the EFSF, which could be purchased at the buyer's option. An additional possible path to boost the firepower of the EFSF is the introduction of additional outside funds, from both private and public sources, into special purpose vehicles that could help extend loans, recapitalize banks and/or buy government bonds in either the primary or secondary market.

What the Program Addresses

Our view has been that a successful program will firewall off the "too-large-to-rescue" markets of Italy and Spain from the troubled peripheral countries. This package is a positive step in that direction, and the haircuts on Greek debt help diffuse some criticism about further "kicking the can down the road." As evidence of successful fiscal progress (see Exhibit 1), yields on Irish 10-year debt have rallied to 8% (after surging from 10% in March this year to 14% in July) as investors have increased confidence in the country's outlook.

Last night's announcement has also led to improvement in spreads in both Italy and Spain. At a conference this week in New York, Raghuram Rajan (former chief economist at the IMF) shared his view that that neither Spain nor Italy is a true solvency problem today and that if the liquidity risk can be addressed, they will have time to address the solvency challenges. Spain's net debt to GDP of 56% is not onerous, and Italy's fiscal deficit in 2012 is projected to be around 2.4% of GDP.

EXHIBIT 2: FALLING DEFICITS



Additionally, press reports indicate that the ECB stands ready to continue to intervene if needed, despite German legislation that says ECB action is "unnecessary" if the EFSF is active. The Europeans seem to be walking a careful political line of not supporting monetization of debt but also respecting the independence of the central bank. We think that commentary from Mario Draghi, the ECB's new head, is constructive about the ECB's interest and willingness to be part of a liquidity solution, if needed, in Europe.

What the Europeans Haven't Addressed Yet

While the outlines of the package so far are constructive, there is still much detail to be determined and communicated. The adequacy of the bank recaps will be scrutinized, and investor sentiment toward Italy and Spain is most critical. Merkel and Sarkozy apparently demanded that Italy produce additional economic reform proposals before the announcement, and press reports speculate that Italian Prime Minister Berlusconi had to exchange an offer to resign early next year in return for support from the opposition Northern League for the proposed reforms. While his resignation could be positive for medium- to longer-term development, the turbulence in the short-term may not help. Italy needs to implement its reform programs, and last night's statement asks urgently for details on a timetable for reform.

Governance and growth challenges for the European Union remain after this deal. There is nothing like a crisis to concentrate one's mind, but the potential easing of pressures from the market may cause some leaders to lose some of their commitment in coming months. The statement does contain language discussing the enactment of balanced budget legislation in national constitutions, and work is apparently ongoing on common corporate and transaction taxation policy. More importantly, the transition to an economic union on par with the monetary union is critical – and was highlighted in the statement as necessary to support the Euro currency.

Longer-term, economic growth must be reinvigorated to help service the high debt loads not just in Europe but in the United States as well. Rajan, in his presentation earlier this week, shared his view that the United States can "grow its way out of its debt problems." If the United States can tackle its entitlement time bomb, the dynamism of its economy and more favorable demographics work strongly in its favor. While it may seem odd to speak of the dynamism of an economy that has a 9.1% unemployment rate and where a 2.5% economic growth rate is met by investor applause, private sector economic performance has been stellar in this recovery. Corporate balance sheets and profits are in excellent shape, and Standard & Poor's 500 revenue growth has been in the low double digits this year. Private sector job growth has actually matched the pace of the 1991 recovery and exceeded the 2001 recovery pace. Much of the weak overall job growth can be attributed to downsizing of governmental employees, a long-term trend necessary for budgetary reasons.

Europe doesn't have the economic dynamism of the United States (outside of certain pockets like Germany). For example, returns on equity across public European companies average 12.6%, compared with 14.6% in the United States (and 14.9% in emerging markets). Additionally, Europe's demographic outlook is significantly worse. This puts a greater burden on them to make their labor markets more competitive, and their social state less expensive. Like Rajan, we are more optimistic about the ability of the United States to handle this challenge than Europe.



Tactical Asset Allocation Outlook

With our base case scenario that Europe was going to muddle through their problems, and that the United States wasn't going into a double-dip recession, we have stuck with our moderate overweight to risk this year. Our most recent move, in the midst of the August market turmoil, was to increase exposure to high yield bonds at the expense of investment-grade fixed income. As markets have moved toward our view that we were avoiding recession, and that "Lehman 2.0" was not likely, risk assets have rallied strongly and high yield bonds have regained some favor. The market has come a long way in a very short period of time. Some consolidation of these gains would be unsurprising. Our tactical investment policy remains levered toward rising stock markets and an improving economy, topics we will again debate at our next Tactical Asset Allocation meeting.

Input from our partners in London, particularly David Blake and Wayne Bowers, has been critical in both today's analysis and all of our work leading up to this point.

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