

INSIGHTS

Special

A Greek Tragedy: Assessment of risks surrounding sovereign stress in Europe

The Greek government's inability to refinance its debt on global capital markets has set off a sovereign debt crisis throughout the peripheral countries of Southern Europe, with yield spreads soaring and credit ratings downgraded. Concern is growing that the crisis could provoke a full-scale global financial dislocation on a par with that of September 2008. While Euro-zone member states and the International Monetary Fund have now agreed on an impressive support package of Eur 750bn, we are sceptical that the crisis is over.

Nevertheless, our base-case scenario is that Greece will not default this year or in 2011. Thereafter, some form of debt restructuring by the Greek government seems difficult to avoid. Importantly the latter is different for the other peripheral countries in Europe, which are able return to a sustainable fiscal path if additional negative shocks are prevented.

Even during the turmoil in the sovereign market, other global macroeconomic and market trends have remained broadly supportive for risky assets. Economic activity has been surprisingly strong in many parts of the world economy. Liquidity and investor inflows have remained strong.

To assess the current situation in more detail, we provide below an overview of the economic situation in Greece and those European economies most likely to experience contagion from the crisis. We detail our base-case scenario as well as downside and upside risks to that view.

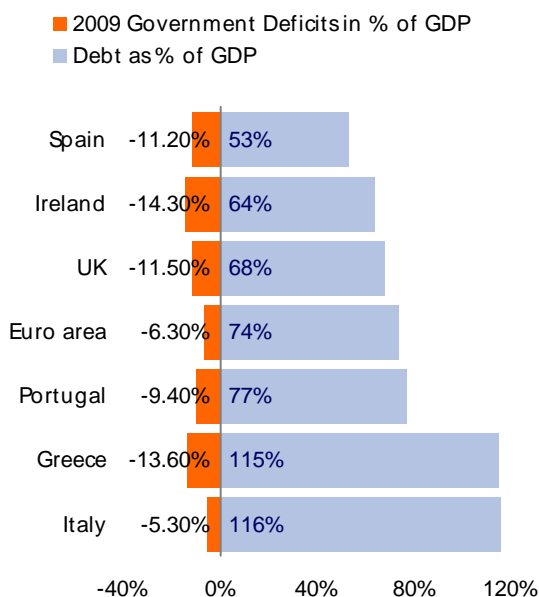
Based on an overview of market behaviour in recent periods of stress, we discuss the implications of these scenarios for macroeconomic conditions and the fixed income, equity, commodity, real estate and foreign exchange markets. Finally, we list potential "macro" tactics investors could use to hedge against downside risks¹.

¹ It is important to note that these tactics are presented for informational purposes only and are not intended to constitute investment advice.

Macroeconomics of the Debt Crisis

As Chart I shows, all peripheral European nations are struggling with some combination of debt and deficit concerns. Greece, however, faces the worst liquidity and solvency problems. Greece must refinance around 50% of its debt in the next five years and will have to come up with between €30 billion and €40 billion per year until 2015 to cover interest and principal payments. The recently announced loan package, large though it is, does not completely provide for these needs.

Chart I: Government Debt and 2009 Deficits as a Share of GDP



Source: Eurostat

In return for financial support from Euro-zone member countries and the IMF, the Greek government has now committed to a fiscal retrenchment estimated at about 12.5% of GDP over the next three years. The program includes higher value added, fuel and alcohol taxes, public sector wage reductions, and pension reforms, and targets reducing the fiscal deficit to 3% of GDP by 2014. Even if the program succeeds as announced, Greece's debt-to-GDP ratio is expected to rise to 140% by 2014.

Yet its success is by no means assured: apart from the fierce resistance previous packages have already met in Greece, the program is likely to lead Greek GDP to contract at a time when the world economy as a whole is still emerging from recession and financial crisis. For all these reasons, it is hardly surprising that investors continue to bet on some form of debt restructuring such as a significant extension of the maturity of Greek debt. We believe that this helps to explain the continued inversion of the two-to-ten year Greek yield curve.

While contagion from Greece's difficulties was limited until recently, there now are distinct signs of spill-over to other countries, most notably Portugal. Portugal has a lower debt-to-GDP ratio than Greece and at current rates only needs a much smaller swing in its primary budget balance — roughly half that of Greece — in order to stabilize it. On the other hand, Portugal's private sector is much more leveraged than that of Greece, implying a greater risk of non-performing loan problems and private sector debt deflation. Greece faces credibility issues due to repeated quality issues with its fiscal statistics; Portugal faces a credibility problem because it has a minority government, which some analysts believe, makes it less able to carry out necessary fiscal retrenchment.

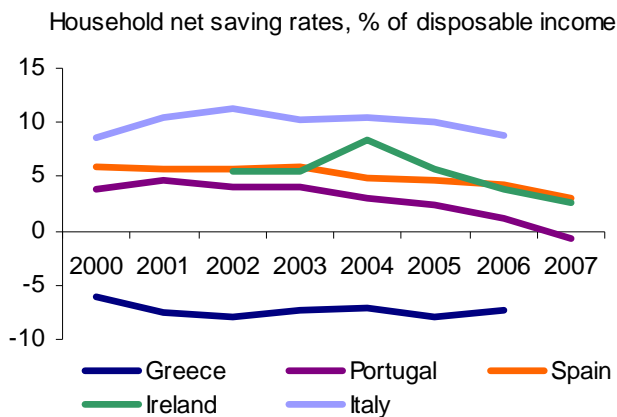
Both Greece and Portugal have been heavily reliant on foreign financing because of low or even negative savings rates. This highlights deeper structural problems in the two economies which have worsened since they joined the common currency.

As Chart II illustrates, Greece's household savings rate has been negative for most of the past decade, while Portugal's fell from 5% of GDP in 2001 to below zero in 2007. On average, the two countries have run current account deficits averaging 9% of GDP over the past ten years.

The unrealistic exchange rate at which both countries adopted the euro made their exports less competitive in world markets, while the lower interest rates enabled by euro membership encouraged debt-financed consumption growth.

As euro members, however, Greece and Portugal no longer have independent monetary or exchange rate policies. They cannot devalue their currencies as they could before adopting the euro. Instead, the only way open to them to improve competitiveness is often painful wage and price adjustment.

Chart II: Household Savings Rates for Peripheral European Economies



Source:OECD

Spain differs from Greece in a few important aspects. Its debt repayments over the next few years are far less onerous. This gives it more time to put its public finances in order. The government has already taken some painful fiscal measures, including a hike in the value-added tax (VAT); while these have shown the market that Madrid is serious about deficit reduction, possible resistance to such measures from Spain's autonomous regions (e.g., Catalonia or the Basque country) remains a risk factor.

Spain also has a significantly higher domestic savings rate than Greece or Portugal, and is therefore less dependent on foreign financing: in 2009, for example, 43.9% of Spanish funding needs came from abroad, compared to 75% for Greece. All this should make Spain less vulnerable to a sharp increase in yields, even though it still needs to make a significant increase in its primary government balance. The adjustment is attainable if the markets give Spain enough time to make it.

The real Achilles heel of the Spanish economy, however, is that the private sector is highly leveraged and that Spain's GDP growth has been dependent upon a huge expansion of the financial sector.

This implies a larger risk of non-performing loan or debt deflation problems, even if this problem is somewhat mitigated by the fact that Spanish home mortgages tend to be financed short-term, which has enabled households to benefit from the sharp decline in short-term interest rates.

Spain should also be able to see a more positive contribution to growth from trade than will Portugal or Greece since the country has been fairly successful in maintaining global market share over the past decade. However, it will still have to increase its global market share going forward, implying that further structural reform and a relative decline in wages and prices may be necessary.

Italy is an outlier on the positive side. Although its debt-to-GDP ratio is higher than that of Portugal or Spain and is comparable to Greece, its debt dynamics seem sustainable — Italy's primary deficit was very small in 2009, making only a minor swing necessary to restore stability.

Due to the long maturity of Italy's debt, it will be a long time before an increase in interest rates materially affects debt servicing costs. Previously enacted reforms also mean that Italy's fiscal accounts are already more transparent than those of other European Union countries.

As Chart II above shows, Italy has the highest household savings rate of the peripheral countries, so that its current account deficit has been small compared to the other peripherals. A smaller portion of Italy's government debt is held outside the country: 40% vs. 60% - 80% for Greece, Portugal and Ireland. Finally, since Italy did not experience a credit-driven boom/bust cycle, the risk of debt deflation is relatively low.

Debt Crisis Endgame: Three Scenarios

We see three possible outcomes for the sovereign debt crisis. The first – “muddling through” is in our view most likely, with a probability of about 70%. It involves an orderly unwinding of the crisis through a loan package and debt restructuring, and results in limited contagion to economies outside Greece.

We assign a probability of about 10% to a downside “blowout” scenario in which Greece defaults in a disorderly manner, speculative attacks frustrate the adjustment process in the other peripheral countries, and a 2008-style global financial dislocation results.

Finally, we assign a 20% probability to a more positive outcome, in which strong global economic momentum boosts economic conditions in Europe and facilitates the adjustment process in Greece and the other peripheral countries.

Scenario I: Muddling Through (Base case, 70% probability)

- Greece receives aid, which helps cover its financing needs for the rest of this and next year.
- The political will to provide more bailout funds wanes next year. Market pressure finally triggers an orderly restructuring of Greek debt.
- Contagion to other economies remains limited as markets continue to take note of differing fundamentals. Markets view the commitment to alleviate liquidity problems as credible, which buys these countries valuable time.
- Euro-zone growth trails that of the other G4 economies due weak nominal growth in the peripheral countries and additional stress on bank balance sheets in the core countries. This keeps private sector credit growth more subdued than it would have been otherwise.

- Due to this and a continued downward trend in core inflation, the European Central Bank lags the U.S. Federal Reserve and the Bank of England in raising short-term interest rates.

Scenario II: Downside Blowout (10% probability)

- Severe market pressure and the refusal of core countries to provide more funds cause a disorderly Greek default.
- Markets launch speculative attacks on Portugal, Spain & Ireland, frustrating their efforts at fiscal adjustment and limiting their ability to roll over debt.
- This in turn sends shock waves throughout the Euro-zone banking system. The value of peripheral country assets held on European bank balance sheets declines dramatically, causing more write-downs and raising risk-rated capital requirements. Funding costs for the peripheral countries also rise due to the increase in government yields and in the risk premium as the implicit value of government guarantees wanes.
- Risk aversion spikes in global financial markets, causing financial conditions to deteriorate sharply across much of the world. International capital flows drop off, impacting trade finance.
- Developed economies are again caught in a downward spiral of deteriorating growth, worsening financial conditions and diminishing private sector confidence. Economic activity contracts significantly, most seriously in Europe.
- Those countries who are able to do so, including many emerging markets and the U.S. (which is likely to see a fall in Treasury yields) once again apply fiscal stimulus. By contrast, Europe has only limited capacity for fiscal stimulus, as its core countries must use their spending to bail out the banking system.

- Global monetary policy is loosened and many developed world central banks expand quantitative easing measures significantly².
- Rising political tensions and the dire state of the economy bring the theme of a euro breakup back to the fore. This is likely to worsen the economic outlook of the peripheral countries, as capital will flee those countries and impair their banks' balance sheets even more.
- These events may ultimately result in a euro break-up, but only after a long period of political and economic uncertainty.
- In such a scenario a double dip in the Euro area seems very likely because of the tightening in financial conditions as well as the fact that renewed balance sheet problems in the banking sector would cause a renewed contraction in credit supply. The concomitant depreciation of the euro would of course help core country exports but this effect will not fully compensate given the high degree of intra-EMU trade which for most countries is something in the region of 45-65% of total exports.
- All of this may be aided by a shift in income distribution toward labour income, which has a higher marginal propensity to spend. Such a shift could provide a substantial boost to global demand, especially if it were to occur in China and other Asian economies.
- Europe benefits disproportionately from this, as the euro embarks on a gradual depreciation over the next few quarters, leaving it considerably lower against both the dollar and emerging market currencies.
- The European peripherals benefit directly and indirectly via higher demand from the core countries (their main export destinations). As a result, private sector and public sector saving in the peripherals can rise while reasonable nominal growth rates are maintained.
- The latter combined with declining spreads enhances their prospects of attaining debt sustainability, thus setting in motion a virtuous cycle of falling rates and improving public finances.

Scenario III: Strong global cyclical momentum (20% probability)

- Currently strong global momentum persists and continues to surprise on the upside. In particular, the cyclical increase in the willingness of corporations to spend turns into a structural trend and reverses conditions of the past 15 years.

² The reaction of the European Central Bank to a situation of this kind is in our view a major question. The ECB's earlier policy of providing unlimited liquidity to the banking system will not help bring peripheral spreads down; it might even achieve the opposite, as banks will invest in core country sovereigns. One way around this would be the outright purchase of peripheral country sovereigns on the secondary market. The ECB strongly resisted this in the past, as it amounts to indirect monetary financing of budget deficits. However, if the future of the euro were at stake, the ECB might change its mind on this.

Investment Strategy Implications

Each of these three scenarios has very different implications for financial markets. We can draw some inferences about likely market reactions to our base case and downside scenarios by considering the behaviour of markets during episodes of stress, such as the aftermath of Lehman Brothers' collapse in the fall of 2008, the period following Dubai World's debt restructuring in late 2009, and the two periods of market stress over Greece this year.

A few observations stand out from these episodes. First, the U.S. dollar has appreciated significantly in all four periods. Second, commodities have posted negative returns, although much less so in the last three corrections than in the fall of 2008. Third, the recent stress triggered by sovereign solvency problems has had a much more negative effect on the performance of European equity markets than on U.S. stocks. Finally, we believe that the relative strength of some risky assets, such as high yield bonds, emerging market debt and real estate during these periods probably reflects the stronger fundamentals underpinning these asset classes at the start of the credit crisis.

Let us now examine each asset class under our three scenarios.

Fixed Income:

Implications for bond markets vary significantly across market sectors. In the base scenario, we expect the EU/IMF support packages to prevent Greek default in 2010 or 2011. For euro denominated government bonds, this implies that significant yield differentials among core and peripheral countries will persist as long-run solvency worries linger and a degree of debt restructuring is priced in for Greece. Spreads might gradually widen but they will not explode.

Peripheral country government bond markets could modestly underperform core markets over the next two years, but fiscal outperformers might surprise on the upside. The euro treasury market will probably trade in a range for most of 2010

and could weaken in 2011 if ECB rate hikes loom on the horizon. If that happened, credit and emerging markets would modestly outperform treasury markets.

Credit spreads still provide a nice yield pick-up and we believe additional spread tightening will generate incremental capital gains for all credit markets. The stronger fundamentals of the corporate and emerging sectors suggest that even with low nominal growth, as we expect for the euro area, these risk factors will be rewarded.

Everything changes in the downside risk scenario. If the Greek government reaches its breaking point this year, it will send shock waves through the peripheral country government bond markets and the European banking sector, which has significant exposure to those markets. For the European fixed income markets this would mean that the core countries will outperform, with German bunds in the lead, as they will benefit from the liquidity that safe haven flows seek. Safe haven flows into U.S. Treasuries will even be stronger, making them the likely strongest performers in this scenario.

Credit markets also will sell off strongly. The relative strength of balance sheets and liquidity provisions among non-financial firms and emerging market economies might cushion the blow, but not enough to prevent sharply negative returns in all credit classes.

Chart III: CDS Spreads for Sovereign European Issuers

European sovereign stress has recently reached record highs

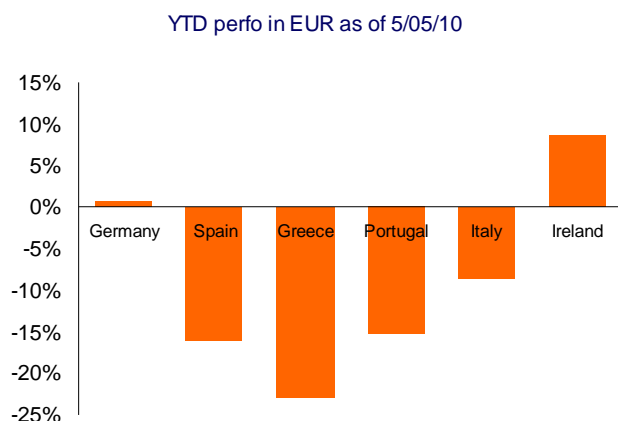


In the upside scenario we believe the underperformers will be the core treasury markets of the Euro zone, as the probability of interest rate hikes in 2010 increases and yield spreads versus the peripheral countries narrow. In our view, credit asset classes will outperform, especially those with limited duration, e.g., asset backed securities, senior bank loans and emerging market local currency funds.

Equities:

Since the start of the year equity markets have made a distinction between the weak (peripheral) countries within and the stronger (core) countries within the Euro-zone. A notable exception is the strong performance of the Irish equity market compared to the other peripheral markets. However, in our view this is mostly due to the high industrial weighting in that market (over 40%).

Chart IV: Diverging equity performances between Euro-peripherals & Germany



Source: Datastream

In the base case, equity markets seem more confident of a positive outcome than fixed income markets. Even in this scenario, we think risks are skewed to the upside. This is why a cautious stance along the lines above seems warranted. This generally corresponds to our current, top-down equity strategy, which favours emerging markets, quality at attractive valuations and large-cap equities.

In the downside scenario, we expect to see an increase in global risk aversion. This will have a

negative impact on equity markets, and we expect to see more divergence as investors focus on sovereign balance sheets, financial sector exposure, export dependence and easy access to external financing. The focus on sovereign balance sheets will cause peripheral countries to underperform core countries.

Portugal seems to be the most vulnerable peripheral, given its debt situation and the performance of its equity market compared to Spain. The Spanish market has a high banking exposure but also has a large emerging market exposure, which may mitigate the risk. Table 1 illustrates the sector exposures of the main European peripheral country stock indices and contrasts them with those of Germany.

Table 1: Sector Exposures for Selected European Stock Markets

Sector composition					
	Greece	Germany	Portugal	Italy	Spain
Materials	2,6%	20,2%	4,6%	2,5%	2,8%
Financials	38,6%	19,7%	17,0%	41,4%	40,3%
Industrials	8,5%	15,5%	13,7%	7,7%	9,7%
Utilities	7,3%	15,1%	24,9%	13,8%	13,2%
Consumer goods	15,9%	12,5%	0,4%	6,4%	0,5%
Technology	0,7%	6,6%	0,4%	1,7%	0,7%
Telecom	7,3%	5,5%	11,4%	5,1%	20,6%
Healthcare	2,3%	3,0%	0,0%	0,6%	0,6%
Services	10,8%	2,1%	12,1%	2,9%	5,6%
Energy	6,1%	0,0%	15,6%	18,0%	6,2%
Defensives	16,9%	23,6%	36,3%	19,5%	34,4%
Cyclicals	11,8%	42,3%	18,7%	11,9%	13,1%
Financials	38,6%	19,7%	17,0%	41,4%	40,3%
Consumer	26,7%	14,6%	12,5%	9,3%	6,0%
EM exposure		5,0%	5,0%	9,0%	17,0%
Domestic exposure		32,0%	27,0%	49,0%	31,0%

Source: Bloomberg

We are likely to see further underperformance of financials as their funding costs rise and balance sheets deteriorate. This sector represents 24% of the EMU equity market, and is thus an underperformance risk for the euro zone versus the rest of the world.

Economic growth and hence earnings growth will come under pressure from fiscal tightening, although euro depreciation could ease the pain. Markets with large international exposure, e.g., the German equity market, are likely to fare better. Large, quoted companies are in better shape than small, unlisted companies.

Corporate balance sheets are strong and companies have excess cash, making them less vulnerable to tighter lending conditions.

The market rally so far has been driven primarily by earnings momentum and not by attractive valuations. This implies that once equity investors start to worry about earnings as a consequence of lower growth expectations, we will see a shift from cyclical earnings driven exposure towards defensive sectors, protected by low valuations and high dividend yields. Domestic financials are likely the most vulnerable.

In the case of a benign outcome, we believe Euro-zone equities will outperform global equities and the market focus will return to high earnings growth and attractive valuations for this year and next. From a sector point of view, however, we remain cautious on financials for regulatory reasons and keep a more constructive view on commodity related sectors and sectors depending on corporate spending (IT, capital goods). Cyclical outperformance may continue despite already high relative valuations.

Foreign Exchange:

The depreciation of the euro is a necessary market adjustment to correct for competitive pressures faced by some members of the monetary union. What causes it — a debt restructuring or an actual or threatened default by some members — is what matters. However, the extent and the speed of the correction in the euro also matters; this depends on the scenario.

In the base case, debt restructuring will continue to drag the euro down, as uncertainty will linger. We would expect the euro/U.S.-dollar exchange rate to go to “undervalued” levels, say 1.15 at end of 2011. In our view, fair value of the euro/dollar exchange is around 1.25, so a level of euro/dollar of 1.15 at end of 2011 is not extreme.

We do not think that a gradual decline of euro/dollar to 1.15 at end 2011 will invoke policy reaction. The last time the ECB and other central banks intervened to stem euro weakness was in fall 2000.

At that time, fair value was 1.15 but the actual level was 0.85, an undervaluation of around 25%. The euro/dollar exchange had declined by around 30% in two years, contributing to inflation, which was running at 2.5%.

If the euro/dollar was 1.15 at the end of 2011, the undervaluation would be 8% and the decline from the peak would be around 25%, while we would expect inflation to be much more contained.

In an environment of ongoing global economic recovery, we expect emerging and commodity currencies to continue performing well.

In the blow-up case we expect a sharp decline in the euro: first because EMU uncertainty will skyrocket, and second because uncertainty about bank exposure to peripheral European sovereigns could result in cash hoarding. We expect that this would be positive for the U.S. dollar.

In the second half of 2008, the euro/U.S. dollar rate declined rapidly from 1.60 to 1.25. This time, the combined forces of euro weakness and U.S. dollar strength might send the euro/ dollar rate to 1.00 at year-end 2010 (from 1.50 at year-end 2009). At that point we might see intervention, as the ECB's main worry is about the speed of currency moves. A 35% decline in one year would be too fast, in our view.

In this risk-averse scenario, we expect emerging and commodity currencies to continue to perform poorly.

In the benign case, the euro/ dollar rate might initially move somewhat higher, as a lot of uncertainty was priced in. Based on current cyclical interest rate levels, we estimate the euro/ dollar exchange would be 1.40 “without Greece.”

Longer term, the euro/ dollar rate depends mostly on future cyclical interest rate levels. Again, this would suggest a modest decline to about 1.30-1.25 by year-end 2011. In this benign scenario, we expect emerging and commodity currencies to continue performing well.

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