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THE EUROPEAN UNION DEBT CRISIS

In June this year, I attended an investment strategy conference in London which, in part, focused on the European debt crisis. With the torrent of newsflow daily on the subject, there is no doubt that this has been dominating market movements due to the uncertainty it has created.

While many of the peripheral Eurozone countries are facing fiscal woes, it is important to note that these are for very different reasons. For instance, in Portugal and Ireland the crisis is due to the government guaranteeing their respective country's bank debts; whereas in Greece it is much more of a typical fiscal crisis that is the result of excessive spending.

With Greece being the proverbial weakest link in the chain, the possibility of the beleaguered nation exiting the European Union (EU) is often spoken of. It should be noted, however, that an exit of the EU by any member country was never envisioned. There are no provisions for such a scenario, and no process has been defined for how this would be accomplished. Of course this does not make it impossible, but it does make it a last resort, and justifiably so. Such an outcome is hardly likely to be good for Greece, as its borrowing costs would increase tremendously, making the fiscal situation worse. Nor would it be beneficial for the remaining EU countries as the euro would, no doubt, strengthen significantly which would be to the detriment of the export-fuelled economic recovery.

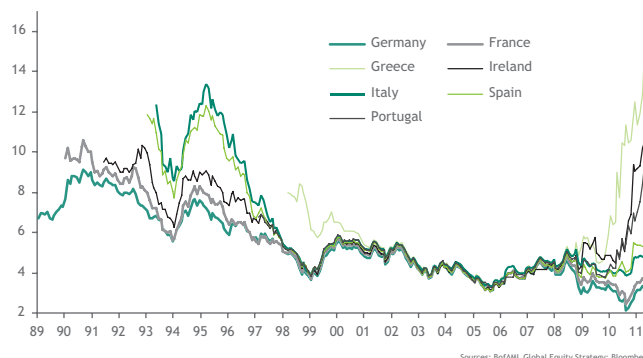
Potential outcomes

There are myriad possibilities ranging from the calamitous to the more optimistic. The worst potential outcome for all parties is a disorderly and messy default by Greece on all outstanding debt. The biggest risk here would be the contagion it would unleash into the European and, most likely, global banking systems.

The latest solution to Greece's debt woes has taken the immediate pressure off Greece. Importantly, for the politicians in Europe's creditor countries, it included fairly substantial 'haircuts' for the holders of Greek debt - so these governments were not bailing out investors completely at the expense of their tax paying public. For the stability of the financial system, the restructuring was "voluntary" and therefore avoided a complete technical default. While the package improved the sustainability of Greek's long-term debt in the market's opinion (as can be seen by the recent fall in the Greek 10-year yield), the 10-year yields of Italy and Spain continue to climb. This continues to be a risk to the European financial system.

A haircut is when the value of a creditor's debt is reduced by a certain percentage.

European government bond yields since 1990



In addition, other risks are likely to continue creating volatility: Ireland may choose to walk away from the bank debt it has chosen to guarantee; the threat of political backlash in both borrower and lender EU countries; and the ECB hiking interest rates may put further pressure on house prices and, hence, the banking system.

Investing through uncertainty

With so many potential outcomes, and still so much that could go wrong, it is not easy to see how one should invest. With all the noise, it is important to stand back and look at the longer-term consequences. The Macro Strategy Investments (MSI) framework of 'Theme and Price' helps us do this.

We have spoken about our theme of Big Government for a while. In short, the spiralling deficits of many EU economies have resulted in a severely deteriorating environment for bonds issued by these governments. As can be seen from the above graph, going into the Credit Crisis, yields were close to multi-decade lows, placing these bonds clearly in the Expensive, and hence SELL ALL quadrant.* Our portfolios have therefore had little or no exposure to these bonds.

The situation in the Eurozone is expected to take several years to resolve, and during this period the countries within the Euro region on average will likely face higher borrowing costs. Without being able to borrow as cheaply as they once did, there will be a need to spend less or tax more. This will act as a drag on economic growth, and therefore our global equity portfolios are underweight the euro region as well.

There will no doubt be bouts of risk aversion which will cause certain parts of the bond market to do well as safe havens. However, these would likely be only short-term rallies in a longer-term trend of weakness. This is why investing with the correct perspective of the larger secular trends, like we do at MSI, is crucial for investing in such uncertain times. Our clients get the benefit of this longer-term view in the multi-asset class portfolios we manage.

*Refer to our June 2010 newsletter on www.omigsa.com/MSI

For more information, visit www.omigsa.com/msi

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