

## A Greek Tragedy?

The nearly \$1 trillion aid package announced by the Eurozone policy makers on May 10, 2010 appears to be stabilizing investment grade bond markets in the US and Europe for the moment. The need for extraordinary action was clear. In the past month, concern over the Greek fiscal condition had evolved into fears about that nation's ability to refinance its sovereign debt maturities. The implications of a disorderly Greek debt restructuring (default) are two-fold. Firstly, financial institutions holding Greek sovereign debt (banks/insurers/pensions) would be faced with large write-downs, possibly impacting solvency of some institutions. Second, the evolution of fiscal concerns about Greece into funding concerns served to focus the market's attention on other fiscally challenged sovereigns with large funding needs, including Portugal, Ireland and Spain. The aid package provides a refinancing backstop for the sovereign issuers that were faced with spiking funding costs, if not outright roll-risk on upcoming refinancing of their debt issuances. At the same time, the announcement of extraordinary measures by the European Central Bank, including purchase of public and private debt, as well as reinstating term lending facilities and U.S. Dollar swap lines with the Federal Reserve Bank, should counter rising pressures on European banks that had manifested themselves in the interbank funding markets in the two weeks prior to May 10<sup>th</sup>.

However, the challenges facing the Eurozone remain daunting. While near-term refinancing risks appear to be addressed via the aid package, the persistent fiscal imbalances underlying the recent market fears remain. A number of the Eurozone economies continue to spend in excess of their ability to grow revenue resulting in growing indebtedness. This issue is exacerbated by structural rigidity in certain economies that makes labor market and government spending adjustments challenging, thus further depressing economic growth (particularly in Greece and Spain). While the Maastricht Treaty which formalized the European Monetary Union laid out budget deficit and debt-to-GDP limits, numerous members of the Eurozone have violated these criteria over the years, with several members doing so in an unsustainable manner. Until Greece, Portugal and Spain (and potentially Italy) are able to get control of their persistent budget deficits and stabilize their debt levels, the markets will continue to be cautious of the sovereign debt and the issues of banks domiciled in those countries.

So what are the implications for global bank credit? Given the impediments to successfully addressing the Greek fiscal imbalances, some form of restructuring of Greece's sovereign debt seems likely, as it is hard to see how Greece can "grow into" its current and future projected debt load. Furthermore, other members of the Eurozone may face similar choices if they are unable to overcome their persistent deficits and rising indebtedness. Perhaps the least bad option, a managed restructuring of Greek obligations, might go a long way towards stabilizing the rest of the Euro area and giving countries such as Portugal, Ireland and Spain time to address their own fiscal imbalances. While the likelihood of default appears low, given the support mechanisms put in place this past weekend, individual banks that are exposed to the sovereign debt of Greece would face write-downs in the event of a restructuring. As such, we recommend avoiding banks in the affected countries (Greece, Portugal, Spain, Italy and Ireland) and confining Eurozone bank exposure to national champions in the fiscally stable and supportive Eurozone countries (i.e., France/BNP Paribas, Netherlands/Rabobank). Despite the underlying strong fundamentals at banks such as BBVA and Banco Santander in Spain, the risk-adjusted returns on their bonds are not compelling, given the macro risk facing their sovereign hosts.

However, we are not changing our overweight recommendation on global banks more broadly, despite the challenges facing the southern European banks. We believe the U.S. and global economic recovery continues to take hold and that the fundamental improvement of the bank sector will follow as bank balance sheet quality improves. Furthermore, the global banking system has taken concrete steps to recapitalize and strengthen liquidity over the past two years. While sovereign concerns will continue to cause spread volatility, we believe the fundamentals for banks in the most developed countries justify continued overweight to this sector.

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