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Bond Market Observations

September 2011

“Fools learn from experience. I prefer to learn from the experience of others.”

– Former German Chancellor Otto von Bismarck

- Global financial markets have become increasingly volatile as investors fear a European financial crisis and recession.
- The risk of a near-term Greek default is rising and it appears European policy makers lack the ability to respond quickly.
- The European Central Bank (ECB) will attempt to push off the day of reckoning through its bond purchase program.
- Unfortunately, these measures will only postpone rather than eliminate the need for structural reform in Europe.

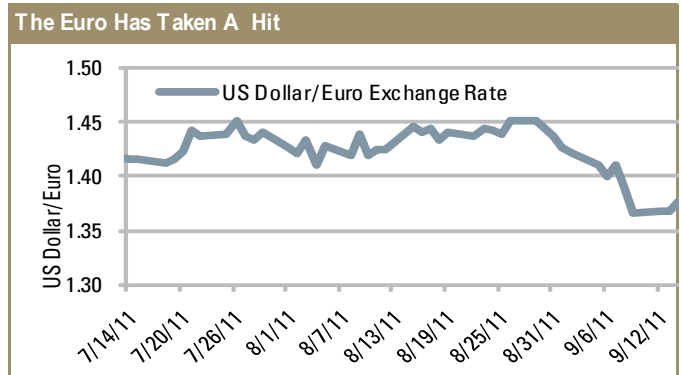
Former German Chancellor Otto von Bismarck (1815-1898) is considered the father of the modern welfare state. He introduced old age pensions, medical care insurance, and unemployment benefits in Germany in the 1880s.¹ Ironically, as today's German Chancellor, Angela Merkel, contemplates the repercussions of a sovereign default by Greece, it is these social programs that are partly to blame for the long-term debt problems that plague the peripheral economies in the eurozone.

Despite repeated bailouts and austerity packages, Greece's debt to GDP ratio will likely breach 150% in 2011.² The success of further spending cuts and tax hikes is questionable given that the economy is already in the midst of a deep recession and there is little support for another large fiscal transfer from the rest of Europe. Consequently, the risk of a near-term Greek default is rising. The European Central Bank (ECB) may push off the day of reckoning by providing unlimited euro loans to regional banks and purchasing the bonds of peripheral European governments to prevent an immediate liquidity crisis. However, these measures can only postpone rather than eliminate the need for structural reform.

Comprehensive solutions to Europe's sovereign debt problem exist, but none are politically viable in the short-term, since the situation outside the peripheral economies has not yet deteriorated sufficiently to warrant joint sacrifice. Even if the political will were there, European leaders lack the ability to respond quickly given the need for national parliamentary approvals to adopt new measures. But when push comes to shove, we believe Europe will do everything in its power to

prevent a disintegration of the euro because the economic costs of not doing so are too great. Yet despite our confidence that European policy makers will eventually take action to prevent a break-up of the euro, we are concerned they will react too late to avoid a European financial crisis and recession.

In our view, this has negative implications for global financial markets, but we do not expect a repeat of the Global Financial Crisis that occurred in 2008. There are fewer channels for direct contagion given that holdings of peripheral European debt outside Europe are smaller and less concentrated, policy makers have already developed facilities to provide liquidity in case of such an event, and there is generally less leverage in the global financial system today. Nevertheless, the world economy would not be immune to a European financial crisis and recession. Heightened financial market volatility and the knock-on effect on confidence have elevated the downside risks at a time when global growth is already slowing.



Source: Bloomberg as of September 14, 2011

Difficulties Predicting Financial Crises

Predicting the timing, nature, and scope of a financial crisis is extremely difficult. Spreads on peripheral European sovereign debt indicate a crisis may be looming, with contagion spreading from the smaller government bond markets in Greece, Ireland and Portugal to the larger bond markets in Spain and Italy. All are trading at or near record spreads to German bunds. For example, two-year Greek government bond yields rose above 75% in mid-September, while comparable German yields were below 0.5%.³

Investors are nervous about Europe for at least three reasons. First, the debt dynamics for some of the peripheral economies,

¹ AJP Taylor, *Bismarck: The Man and the Statesman* (New York: Alfred A. Knopf) 1969. p. 203.

² World Economic Outlook. International Monetary Fund. April 2011.

³ Bloomberg, September 2011

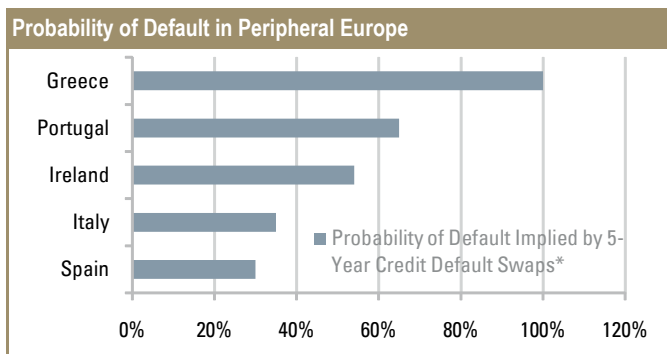
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particularly Greece, appear unsustainable. Second, the European banking system has large cross-holdings of peripheral European debt, which are held in the banking book and so are accounted for at book value.⁴ Yet, the market value of some of these assets may be considerably lower than the accounting value, and the write-down of these holdings could force a recapitalization of the banking system and a sharp contraction in credit. European regulators stress tested 91 of the largest banks in July, but the tests were not deemed credible because they did not include the possibility of a Greek default. Third, the European banking system is heavily dependent on wholesale funding with roughly \$1 trillion in debt coming due in 2012 and \$760 billion maturing in 2013.⁵ The combination of these factors suggests there is a significant risk that Europe's sovereign debt crisis might deteriorate into a banking/financial crisis at some point in the future.

Therefore, we are closely monitoring indicators of stress in sovereign and bank funding markets in Europe. In addition to spreads on peripheral European debt, we are also watching the cost of insuring those bonds against default using credit default swaps (CDS). Five-year CDS on Greek government debt cost more than \$6 million per \$10 million face value on the bond in mid-September.⁶ Strains are also apparent in the banking system where stock prices for the major European banks have tumbled to new lows and hedging exposure to European bank debt has grown prohibitively expensive according to the iTraxx Senior Financials Index.⁷

The cost of bank funding in overnight markets, which is tracked by the Euribor option adjusted spread, has risen from 25 basis points (bps) in early June to more than 85bps in mid-September.⁸ Although this is well off the highs of more than 200bps during the 2008 Global Financial Crisis, it may be artificially suppressed by the ECB's pledge to supply unlimited liquidity to the banking system. Indeed, rather than lend money to one another, European banks are parking their money at the ECB where overnight deposits have reached a high for this year of €182 billion on September 9.⁹ In general, most of the sovereign and bank funding indicators suggest the situation in Europe is deteriorating. Money market funds in the US have responded by reducing their dollar loans to European banks. This prompted a joint announcement from the ECB, the US Federal Reserve and other credit banks to provide unlimited three-month dollar loans from October to bridge them through the year end.



*Assumes a recovery rate of 40%

Source: Bloomberg as of September 2011

Potential Outcomes: The Good, Bad and Ugly

Although there are many potential outcomes for Europe, we highlight three scenarios that we think have the highest probability of occurring over the next year:

1) Base Case Scenario: 65% Probability

A European financial crisis triggered by an event, such as a disorderly Greek default, incites fears about the assets European banks are holding on their books and a bank run ensues similar to what happened to Lehman Brothers due to its exposure to US subprime debt in September 2008. Although the larger banks in Europe appear to be well capitalized and should be able to absorb a shock of this magnitude, over 5% of banks representing 2% of assets had core Tier 1 capital ratios below the Basel III regulatory minimum of 6% at the end of 2010.¹⁰ This figure rises to 30% of banks representing 20% of assets using a core Tier 1 capital ratio of 8% or less. Depending on the size of the write down on peripheral sovereign debt, contagion could spread from the weak tail of banks to this next layer. This scenario would almost certainly be accompanied by a sharp contraction in credit and lead to a European recession. We believe this would eventually force European politicians to adopt a more comprehensive solution to the structural flaws in the common currency (see details of solution below under Best Case).

2) Best Case Scenario: 30% Probability

A managed Greek default combined with a recapitalization of the banking system and an agreement in principal to move toward fiscal union over time. In the interim, the ECB could continue to provide liquidity to the banking system while maintaining its purchases of peripheral European government debt under its Securities Market Program. European leaders would need to agree to reforms such as an expansion of the size and mandate of the European Financial Stabilization Fund (EFSF) or the joint issuance of a Eurobond. The EFSF currently has an effective lending capacity of €440 billion, which was fine when it was just the smaller peripheral economies that were having problems, but this fund would need to be increased to €2 trillion or

⁴ Global Financial Stability Report. International Monetary Fund. April 2011. p.16.

⁵ Moody's Investor Service, May 2011.

⁶ Bloomberg, September 2011.

⁷ The iTraxx Senior Financials Index represents the cost of insuring the senior debt of 25 European financial companies against default.

⁸ Bloomberg, September 2011.

⁹ European Central Bank. Balance Sheets of Monetary Financial Institutions.

¹⁰ Global Financial Stability Report, *Op. cit.*, p.18.

more if Italy gets into trouble. The EFSF would also need to have the ability to recapitalize the European banking system similar to the Troubled Asset Relief Program in the United States. Although the core economies could probably manage without this, the peripheral economies are already too deeply in debt to take on this responsibility. Alternatively, a more fundamental step toward fiscal union would involve joint issuance of a common Eurobond where liability would be shared across the eurozone. Since the eurozone overall has a much lower debt to GDP ratio than any of the peripheral economies, their borrowing costs would likely drop sharply. By contrast, borrowing costs for France and Germany would probably rise. This scenario would almost certainly stop the bleeding in financial markets and could even lead to a rebound in confidence which would lessen the downside risk for both the eurozone and the global economy.

3) Worst Case Scenario: 5% Probability

An abrupt breakup of the euro would throw Europe into complete disarray. The reintroduction of 17 domestic currencies would be costly and time-consuming. It took three years to get the euro up and running. Contracts must be redenominated; computer code must be rewritten; automatic teller machines must be reprogrammed. Even if these logistical problems could be overcome, the currencies of the peripheral European economies would likely experience a sharp and immediate devaluation. This could precipitate a chain of defaults by these governments on their euro-denominated debt, which in turn could undermine the capitalization of banks across Europe.¹¹ The result could be a deep recession or depression in Europe and potentially the global economy.

From our perspective, the cost/benefit analysis suggests that European leaders have an incentive to push off the adoption of a comprehensive solution until the situation deteriorates to the degree where their constituents insist they take action. The risk is that by the time we reach this point, it will probably be too late to avoid a financial crisis and recession in Europe especially since parliamentary approval by all 17 member governments will be necessary in order to implement any substantive reforms. Most of the peripheral economies are already either in or bordering on recession and indicators of manufacturing activity in the core countries, such as France and Germany, have recently taken a turn for the worse.

The Risk of Global Contagion May Be Lower

The implications of our European base case scenario for the global economy are less clear. The good news is that peripheral European sovereign debt is not as broadly held as US subprime debt was in 2008 and the exposure of individual financial institutions is more transparent. There was also less leverage involved in the purchase of peripheral European debt than there was in the case of US subprime. Outside Europe, the global banking system is better capitalized today than it was

in 2008 and would likely be better equipped to absorb the deterioration in asset quality that would likely accompany a European recession.

Equally important, policy makers have or could quickly put into place tools to mitigate the risk of another global liquidity crisis. For example, all the major central banks have swap lines with one another which can be funded immediately. The Fed could also reinstate some of the facilities it implemented in 2008 including the Term Securities Lending Facility, the Commercial Paper Funding Facility, or the Primary Dealer Credit Facility depending where funding pressures arose.

The bad news is that monetary policy makers in the advanced economies are running out of ammunition to combat the downside risks to economic growth and fiscal policy makers seem hell bent on deficit reduction. The same is not true for emerging markets which have been raising interest rates over the past couple years to combat inflation and have room to stimulate aggregate demand using both fiscal and monetary policy. Even so, heightened financial market volatility and the knock-on effect on confidence suggest global growth will likely remain under pressure as we await some resolution in Europe. We expect periodic weakness in the euro currency, government debt markets in peripheral Europe, and European financials given the risks of a disorderly outcome.

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Views expressed are subject to change rapidly as market and economic conditions dictate. Portfolio composition is also subject to change.

¹¹ Barry Eichengreen. "The Breakup of the Euro Area." University of California. October 2008.



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