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Financial botox for Europe

'Plan A never works, plan B almost never works and nobody ever has a plan C'

Financial markets continue to be dominated by the daily shifting of events in Europe. Over the past few months, it's been difficult to form a trading view which could last for more than a few hours before a new headline reversed the prior news. We have given up trying to determine which statements are true and important versus which are unimportant and false. We've been first notified that Greece approved fiscal austerity measures, then rejected austerity measures, the prime minister resigned, then the prime minister didn't resign, then he did resign, there's a vote on staying in the euro, then there's a no vote on the euro. And as the Italian crisis moves into full swing, we learn Germany has endorsed new prospects for country moves out of the euro – a position vehemently denied as a possibility over the past 15+ years. It's no surprise that Peripheral bond yields can move more than 1% per day and global market volatility has again approached record highs.

With new prime ministers in Greece and Italy, adjustments to the European Financial Stabilization Fund (EFSF) and more support from the IMF and ECB, markets have recently reversed their increasing belief in peripheral-wide defaults as the end-scenario for Europe. However, this conviction changes by the minute and no doubt by the time this article reaches press, the mood will have reversed. Over the past few weeks Italian 10-year bond yields rose from 5.5% to an unsustainable 7.25% before recently falling back below 6.5%. Investors appear to be renewing confidence in Italy's ability to contain its debt problems following a leadership change. A non-elected, non-political government led by economists/bureaucrats was the outcome the market was looking for. Recent legislation, including fiscal reforms comprising improved tax collections, pension reform and moderately enhanced competitiveness should sustain Italy over the shorter-run, however the long-run debt burden (with debt at 120% of GDP) remains a key hurdle.

The Greek challenges are even more daunting, beginning with more than €350 billion in outstanding debt at year-end 2011, more than 160% of GDP. Even a 50% haircut on private sector debt and no haircut on preferred creditor debt (IMF at €15 billion, expected to rise to €47 billion by year-end 2012) would still leave Greece at over 100% debt/GDP in a few years. It appears the private sector haircut will eventually be much higher than 50%, in our view in the 70%+ range. Aside from the debt issues, creating and maintaining a stable coalition government is the next challenge. Even this seems unlikely despite the early elections scheduled for February 2012. However, we expect Greece will survive the latest European review and receive the next €8 billion in support and the new government will approve a viable 2012 budget, maybe even with a primary (ex-debt service) surplus. Nonetheless, improvements in tax collection, cuts in public sector employment and negotiation of even higher private sector haircuts on government debt will challenge any new government. Overall, the Greece story remains negative in our view.

We at Kapstream will remain in the pessimistic camp for the long term as the structural problems of the periphery – too much sovereign debt, too high labour costs and a close-to-insolvent banking sector will eventually cause yields to rise as the periphery moves toward default. Global sovereign debt issuance will reach record levels in 2012: the US needs to rollover $2.1 trillion in debt, Japan

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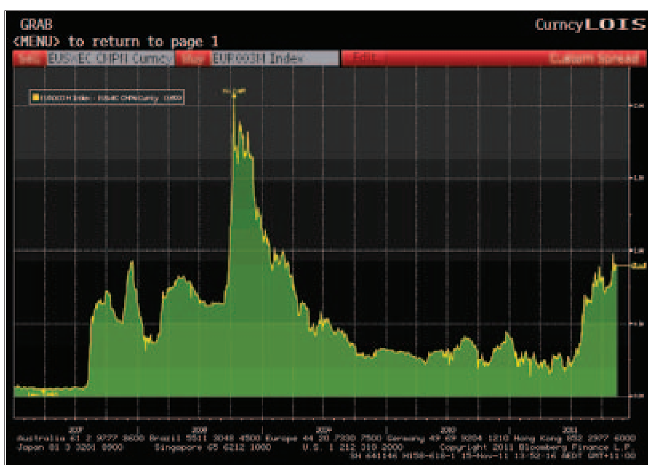
$2.5 trillion and Euroland $1 trillion. While European sovereigns have been able to borrow $1 trillion over the past few years, 2012 will likely prove much more difficult given the deteriorating fiscal story and increasing competition for global investor savings.

The story for the European banking sector is even worse: the IMF estimates the Eurozone crisis has so far cost Eurozone banks, weighed down by their holdings of Greece, Italy, Spain and Portugal, about €300 billion. We estimate European banks must raise another €200 to €300 billion in 2012. European banks have done little-to-nothing over the past four years in terms of raising capital. It is virtually impossible for us to see investor demand for European bank capital, even with bank shares trading at half their book value. Raising new debt and/or rolling over existing debt will also be much more difficult than in the past. In fact European banks are charging more for borrowing from each other: the Euribor-OIS spread – the banks' measure of each others' creditworthiness, has reached its highest levels in almost three years. And the cost of new debt issues is currently about 2% higher than a year ago. And it will likely rise.

Term funding for banks is increasing: 3-month bank borrowing rate less overnight bank borrowing rate



We also worry that similar to the US, European banks will respond to greater capital shortfalls by raising interest rates and restricting credit, which would significantly reduce growth and push the Eurozone into another recession. The cyclical story already appears to be deteriorating, with euro-wide unemployment reaching 10.2%, from 7.4% pre-crisis.

With little positive long-term fundamentals, we expect to see more tweaks to the plans of the EFSF, the ECB, the IMF and the European Stability Mechanism. As it currently stands, the EFSF does not have enough money to solve the peripheral problems, although we expect there will be new proposals to leverage the fund, special investment vehicles to guarantee portions of peripheral debt and adjustments to the size of core Eurozone member commitments. We also expect more support from the ECB and the IMF through direct interventions on secondary market bonds, potentially increasing money supply and direct loans. We believe policymakers will remain behind the curve in terms of the necessary size and scale.

Portfolio Strategy

We expect to maintain risk-averse positions including higher cash allocations and holding credit default protection. We remain reluctant to own most of Europe as the risk relative to return is not warranted. We believe the extent of Australian rate cuts priced into markets is unlikely and will continue to favour floating-rate assets due to more attractive yields in an inverted yield curve environment. We expect the US to keep interests on hold for the remainder of the year and likely through 2013.

We will maintain defensive portfolio positions, with a home country bias (in Australia) given high real rates. We intend to maintain positions in US banks and Asian corporates given their attractive yields and will look to add to positions should opportunities arise. We continue to hold 25 to 30% of our portfolios purely in cash and anxiously await stability in markets to invest in quality assets.

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