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Euro-Zone Debt and Worldwide Markets

World markets continue to weaken as recovery prospects from the cyclical lows of 2008 look more doubtful and as longer term fears related to the euro-zone debt issues remain front and center in terms of threats to economic stability. This amounts to the “imperfect storm” for investors – increasing the likelihood of developed countries slipping back into negative growth, while circumstances in Europe look more and more dire and available solutions look more and more suspect.

Debt overhang – sovereign debt, central bank debt as well as corporate and individual debt in much of the developed world, including the U.S.- has been classic “kick the can down the road,” and unfortunately, much of the world is now down the road. Governments have piled up debt for decades to satisfy promises made to future generations to provide for the “cocoon” (healthcare, education and retirement), to pay for wars, and for other services that willing populations thought were needs rather than wants. After the introduction of the Euro in 1999, Europe’s mostly small economies participated in the borrowing boom with a view that all euro debt became magically “equal”, and somehow less likely to fall into financial disrepair when economic circumstances faltered.

Today that world is teetering on the edge of serious problems as some of those nations cannot afford to honor their debt and, in order to face those consequences, must address a reordering of debt by lenders, face extreme austerity measures, long periods of reduction of services, and perhaps even default. Again, all of these outcomes are very unattractive and fraught with all manner of side effects that have left policy makers literally with almost no palatable solutions. Remember, these are complicated issues of economics, nationalism, politics and markets, and by no means in that order in terms of importance and complexity. In the end, the world is waiting to see if essentially the “haves” in the euro zone will step up and bail out the “have-nots.” Again, there are lots of reasons that this task still faces an enormous uphill battle, and for some time has seemed close to impossible.

The issue that remains is the sheer size of sovereign debt by many countries in the EU and all the problems that go with those levels and the resulting vulnerability of financial institutions in Europe. The choices for an eventual solution to this very long term problem have come down to either the creation of a euro-bond to facilitate the borrowing and rescue needs, and/or having the European Central Bank (ECB) simply print money and monetize the debt. Neither of these solutions has generated a lot of traction because both have their own negatives and until the last few weeks, solutions seemed out of reach.

However, during the last few months, some new life has been pumped into the European Financial Stability Facility (EFSF), created in May of 2010 but then underfunded in terms of needed size. The EFSF was envisioned as a vehicle to issue bonds or other debt instruments to raise the funds needed to provide loans to euro zone countries in financial trouble, or recapitalize banks, and, if needed, buy sovereign debt. The bonds would be backed by guarantees given by the euro area member states in proportion to their share in the paid-up capital of the European Central Bank. Over the past six months or so, support for a larger EFSF had been lacking, especially in Germany, but this has changed over recent days.

Now it appears that Germany, Europe's largest economy and the biggest country contributor to bailouts for Greece, Ireland and Portugal, will agree to an expanded EFSF which might well begin the process of creating a path for financing the deleveraging process and thereby reducing some of the economic strain for Europe, and the rest of the world. Perhaps the operative word is might – there are still hurdles and significant issues to be resolved.

The importance of fiscal health for Europe is unquestioned. Europe accounts for about 22% of U.S. exports, and provides as much as 15 to 20% of the foreign profits of major U.S. multinational companies. U.S. bank exposure on European loans and investments remains substantial as U.S. money-market funds have lent upwards of \$600 billion to European banks as well. This same sort of exposure exists around the world, and anything that approached a default on debt would have a significant impact on world-wide growth.

There is also the issue of relief occurring now, because the developed world is still suffering with a cyclical recovery, which is tenuous at best. In short, some solution or at least the road to a solution would go a long way to some restoration of confidence for business, hopefully having a much needed domino effect in those countries still struggling with cyclical problems. Strength in worldwide markets over the past week or so would suggest that investors are returning to markets and are a little more optimistic that success is closer than it was a few weeks ago – let's hope so.

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