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Securinvest News

A modern day Greek tragedy!

For only 3% of the eurozone economy and just under 0.5% of the world economy, Greece has caused big trouble around the world lately. The question is whether steps by authorities to counter the Greek-inspired turmoil will be enough to calm investors over the longer term and leave in place any global economic and sharemarket recoveries.

The larger-than-expected 110 billion euros (A$160 billion) package for Greece, the eurozone bailout package of more than a $1 trillion and a commitment by the European Central Bank (ECB) to buy European sovereign bonds certainly reduce the danger for now. But investors are still concerned about other eurozone economies under similar fiscal pressures to Greece.

On balance, they probably shouldn't fret so much. When you look at the 16 EU countries, they are home to about 330 million people - Greece is a country of only 11 million. The problem's Greece have encountered are due to its own structural weaknesses, ie antiquated (lazy) working practices, retirement laws, political stability and the size of the State. And while there were clarifications on how large the Government debt of Greece is, there has been little new information on Government finances in peripheral European economies which helped explain the market action leading up to the bailout package.

The upward pressure on Irish government bond yields and cash spreads before the package was announced (to above 250 basis points in early May from about 150 basis points in January) is particularly interesting. This is because Ireland was widely applauded by bond investors for tackling its deficit and outlining a credible restructuring plan. This suggests the market behaviour before the latest rescue package was more sentiment driven.

The fact that increases in Greek, Portugese and Irish credit-default swap spreads, (which represent the cost of insuring against default in the underlying bonds) exceeded jumps in corresponding bond yields suggests speculative money was behind much of the recent market action before the eurozone package was announced.

However, investors are right to be cautious. Many commentators suggest the whole eurozone experiment is still shaky longer term and another country could become unstuck.

Might we see a domino effect?

But while the most likely sources of trouble, namely Portugal, Ireland or Spain, have problems, none are as sick as Greece.

Spain certainly doesn't appear to be. While the economy suffers from high unemployment and the Government needs to undertake monetary tightening, a recovery is emerging. The bleak debt environment seems to have been priced into stock markets; however Spain's potential to gain from the rapid growth of Latin America appears to have been underestimated on the basis of current valuations.

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A modern day Greek tragedy! (continued)

Portugal, at first glance, has similarities with Greece. The European Commission believes Government assumptions of positive growth this year and next are over-optimistic. But like Spain, Portugal is not Greece. Its 9.4% 2009 budget deficit is more than 3 percentage points lower than Greece's 13.6% shortfall and, crucially, the country has successfully cut its debt before.

Ireland's 2009 budget deficit is actually higher than Greece's. In terms of the total stock of public debt, however, Ireland's is estimated to be a manageable 65% of output while Greece's is a ruinous 110%.

No banking crisis appears imminent. European banks, overall, have a limited exposure to this potential crisis in comparison with sub-prime mortgages. The Bank of International Settlements estimates that European banks' exposure to Greek, Spanish and Portuguese debt represents only 5% of total bank assets. So, the idea of persistent contagion seems unlikely given the relatively better economic and corporate situation in the other peripheral economies, the better credibility of their Governments and the lack of exposure among the European banking sector in general.

Changed days call for changed tactics

Still, financial markets wanted swift, decisive, and aggressive action from the eurozone authorities to ease their concerns about Greece and other countries. And, they got it. Markets rallied strongly as details of the eurozone rescue package emerged, and it became clear to investors that the eurozone and global financial authorities were prepared to pull out all the stops to avoid any escalation of the Greek debt crisis.

The immediate reaction saw equity markets surge and risk spreads tighten, while the gold price fell and the euro strengthened. Unfortunately we have seen this wain in recent weeks. But the success of the rescue measures will be judged over longer time horizons. Professional investors must assess the short, medium and long-term impact of the overall package, its durability and the potential for unintended consequences.

The package makes an individual country issue into a European issue, and it gives the pressurised economies space to get their finances in shape. What is most clear is that European policymakers have risen to the challenge set by the markets, broken with tradition and boldly expanded the limits of their policy response. The market and the authorities are now in agreement: uncharted waters call for uncharted policies. As a result, investors did have more confidence the turmoil can be navigated.

The European Commission has historically taken a hard line on inflation, with little or no consideration given to economic growth. The commitment to buy sovereign bonds is therefore something of a watershed moment for a central bank that has been reluctant to consider anything but inflation targeting policies. While the markets have welcomed the new flexibility, inflation remains the enemy above all others and it should be noted that the monetary impacts of bond purchases will be sterilised or, in other words, offset via liquidity operations to avoid inflation risks.

Still, the fact is that a two-tier eurozone economy appears to be developing, as high debt levels and austerity measures make growth prospects gloomy for peripheral Europe. This is a big concern because of the implications for monetary union.

Recovery still intact

So what else can we say of the future? Global economic growth remains robust. Corporate earnings are healthy. The recovery in stock and credit markets is unlikely to be materially derailed by the recent events in Greece, which was always going to need a bail-out. That is not to say that other countries such as Spain, Portugal and the UK do not have tough choices to make. It's just that they have more scope to make them.

We know there are pockets of slower growth in the eurozone, but the area will benefit from healthy global and emerging-market growth. Developing economies are contributing significantly to global growth and the eurozone is one of their key sources of machine goods, commodities, services and finished products.

A modern day Greek tragedy! (continued)

In this light, European stock markets could offer excellent opportunities for investors looking for relative value. Another net positive for many European companies is that the weakness in the euro makes their products more competitive. With a well diversified portfolio offered by Securinvest and via a number of International funds available within your portfolio, you would be getting exposure to some of these European stocks.

Source: Fidelity Insights—May 2010

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