CIBC Asset Management

Market Insight

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EUROPHORIA: EUROPEAN DEBT CRISIS AVERTED -- FOR NOW

In a significant move toward resolving the euro zone financial crisis, European leaders won an agreement from the world's banks to reduce the face value of their Greek debt. The move was crucial in calming the jittery financial markets which had been on edge about the viability of the euro in the face of several member countries' fiscal woes. The leaders had been trying to restore market confidence in the euro and in the creditworthiness of the 17 countries that use it.

In view of the significance of the events, we feel it is worth providing some thoughts on the proposed deal. The proposal is light on details that are to be worked out over the next several weeks. While particulars remain sketchy, here are some brief details:

- The banks have voluntarily agreed to take a 50% reduction in the par value of their Greek bonds (a haircut);
- Europe's largest banks will be required to raise their Tier 1 capital ratios to 9% by June 2012, estimated to require injections totaling €106 billion;
- The European Financial Stability Facility (EFSF), currently pegged at €440 billion, will be leveraged to provide guarantees for €1 trillion of sovereign debt, should it be required;
- The International Monetary Fund (IMF) will provide a further €100 billion in loans to Greece.

The plan is to set Greece in a direction that will see its debt decline to 120% of GDP by 2020 from the current path that was expected to see Greece's debt to GDP ratio increase to 180%. That is a long way off, and a lot can go wrong in the meantime. But the debt figure, while still huge, is more sustainable for an economy driven into recession by austerity measures. We still don't know whether the European Central Bank (ECB) and the IMF will be writing down their holdings of Greek bonds.

Questions remain, however, over whether the package is large enough to ring-fence Greece and to stop bond investors from shifting their focus to Italy and Spain. The boost in the EFSF facility is designed to take care of that happening, but it has been estimated that it would require €2 trillion to €3 trillion, well above the proposed €1 trillion. The pumped-up EFSF would provide loss guarantees to Italy and Spain should defaults occur. This could mean that there will be two types of sovereign bonds: old ones with no EFSF guarantee and new ones with the guarantee.

Also, the banks may still be short of capital, given that the €106 billion figure was derived from tests undertaken during the summer to assess balance sheet strength. But those tests didn't factor in a haircut on sovereign debt holdings. We should also ask where banks will get the €106 billion, and the EFSF the more than €500 billion to bolster the EFSF.

Depending on how the details work out, France's triple-A rating could be in jeopardy, and other European jurisdictions in financial trouble, like Ireland and Portugal, could call for a 50% haircut on their debt as well.

THE FIXED INCOME IMPACT

With regard to fixed income markets, there is less reason for long-term interest rates to decline further, bolstering the CIBC Global Asset Management view that we are in a long-term sideways trading range for government bond yields. Corporate bonds, including investment grade and high yield, could be the beneficiaries as investors move towards riskier assets. Our portfolios are well-positioned to benefit from this eventuality.

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THE EQUITY IMPACT

The equity markets rallied strongly when the news was announced. Stocks surged at the opening bell and the euro climbed. Stock markets are rejoicing that a major uncertainty has been lifted. Even though North American earnings continued to meet or exceed estimates, the lack of confidence in the global situation had led to a fall in price to earnings ratios over the past few months. We expect equity valuations to recover to a more normal level as details of the European agreement get worked out.

This agreement should benefit the energy and materials sectors as commodity prices firm up. It may also benefit specific holdings in our portfolios, such as Royal Bank of Canada and Magna International, which have exposure to Europe. Our stance however has not changed – we expect a slow recovery and so we generally favor stocks with solid dividend yields.

To be sure, initial market reaction is positive, but the proposed measures don't resolve the core flaw in the original structure of the Euro: Europe has a common currency without fiscal union. This shortcoming leaves countries with no ability to devalue their currency to correct imbalances, and, like now, little control over fiscal policy when they need to stimulate their economies.

The recent measures buy time for leaders to decide how they will achieve greater fiscal union or some other option that will resolve the union's structural flaws. If they don't, investors will continue to question the long-term viability of the euro.

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