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OVERVIEW

Investors remain confused when it comes to the European sovereign debt crisis, which has emerged as the *pre-eminent tail risk* confronting global financial markets. The confusion arises because of the cast of characters involved, from politicians to central bankers to the IMF (International Monetary Fund), and their somewhat unpredictable actions. There is also confusion surrounding the very nature of the problem and the degree to which the problem is fiscal or monetary. In terms of the potential for an extreme outcome (tail risk is defined as a 3+ standard deviation move in prices), it is looming large because there is the potential for another global financial crisis and/or global recession if things are not handled effectively.

While European governments are facing many fiscal challenges, we believe the crisis is by and large a monetary one that is essentially a function of European Union political arrangements (treaties). The introduction of the Euro in 1999 linked a number of European nations into a monetary union, but not a fiscal union, and was augmented with a number of treaty rigidities that appear to have inadvertently turned an attempt at monetary harmonization into a sort of monetary doomsday machine. In essence, the monetary union had the unintended consequence of injecting a large amount of credit risk into regional sovereign bonds that have a common currency. For example, the reason Japanese government bonds trade at 1% is not because Japan has angelic credit metrics (Japan actually has more debt per capita than Greece), it is because Japan has a central bank that is willing and able to print an unlimited amount of Yen to satisfy their payment obligations. This is not the case in the Eurozone. The European Central Bank (ECB) is prohibited from taking such action.

However, while Japanese and other sovereign bonds denominated in domestic currencies (such as the US, UK, Canada, etc.) have only small and varying degrees of credit risk, they do have inflation risk. Investors in European bonds are faced with the worst of both worlds because they can lose their purchasing power slowly through inflation or quickly through restructuring (credit default). Importantly, inflation risk should be thought of as a counter-cyclical phenomenon, and credit risk thought of as a pro-cyclical phenomenon. This distinction is significant and is probably best illustrated by the following example:

Counter-cyclical (traditional scenario)

When the Canadian economy goes into recession the following is the normal sequence of events:

- The central bank lowers interest rates while growth and inflation expectations fall.
- Government yields fall across the yield curve.
- Private sector credit quality deteriorates and risk assets get re-rated (lower equity prices and wider corporate spreads).
- The private sector attempts to deleverage which acts as a drag on national income.
- The public sector offsets some of this deleveraging with stimulative policy initiatives by taking advantage of lower interest rates which acts as a boost to national income.
- As the value of the currency falls, making exports more competitive, an increase in the foreign sector provides a boost to income.
- Banks tighten lending but can maintain balance sheet size and stabilize capital ratios by increasing holdings of government bonds against deposits (a net positive because there is no capital charge and a steep yield curve).
- Money growth remains positive, but in the event it doesn't, the central bank can take other measures to stabilize it, such as buying government bonds.
- The system rights itself.

Pro-cyclical (current Eurozone scenario)

This is what happens when an overly indebted European nation, such as Italy, goes into recession:

- The ECB lowers interest rates, provided it is a European recession, while Italian growth and inflation expectations fall.
- But Italian government bond yields rise because a recession raises the risk that Italy won't be able to meet its future obligations.
- Private sector credit quality deteriorates and risk assets get re-rated (lower equity prices and wider corporate spreads).
- The private sector attempts to deleverage which acts as a drag on national income.
- The public sector cannot leverage-up but rather attempts to deleverage by engaging in austerity programs to avoid a rating downgrade and a further widening of credit spreads which act as a drag on national income.
- The foreign sector cannot help because there is no opportunity for a domestic currency adjustment.
- European banks tighten lending standards to both the public and private sector as both asset types are falling in value and being re-rated.

- Every sector of the domestic economy is attempting to deleverage simultaneously sending growth even lower and pushing all Italian asset prices down, accentuating the downward spiral.
- European bank balance sheets start to contract quickly and the money supply contracts.
- The ECB is restricted from engaging in direct unsterilized monetary interventions and can only attempt stabilization through the very banking system that is attempting to deleverage.
- This produces a negative feedback loop which has to be broken otherwise the system cannot right itself.

The difference between the traditional and current Eurozone scenarios noted above comes down to the simple concept of credit risk which is the result of a central bank that is restricted from being a lender of last resort due to the lack of a fiscal union. This is not really about fiscal discipline, it is about monetary policy. In fact, in Italy's case the country currently runs a primary surplus, and if it wasn't for the run on its bond market, it would be very close to being in a position of long-run balance sheet stability, something Japan, the US and the UK can only dream of.

It is pretty clear that the solution to the European sovereign debt crisis is some form of fiscal union and a rewrite of the ECB charter that would exorcise the credit risk out of the European bond markets and lead to a more permanent solution. To this end, European leaders have met and pledged to create a "fiscal compact" by March 2012. This is a step in the right direction, but it is not a fiscal union, which will probably take a couple of years to establish. On the monetary front, the ECB has been very aggressive and lowered interest rates by 50 basis points to 1.00%, agreed to provide European banks unlimited access to 3-year term funding and relaxed the type of collateral that banks can pledge with the central bank to gain access to cheap financing (increased liquidity). In addition, Eurozone countries have pledged to provide up to 200 billion Euros to the IMF to assist the European Financial Stability Fund (EFSF) which in turn will be used to support periphery European countries. Also, the European Union has promised to establish, by mid 2012, a permanent funding vehicle, the European Stability Mechanism (ESM), with fire power up to 500 billion Euros. While this all helps and significantly reduces the risk of a Lehman-like global financial crisis, in the short to medium term further action is needed to make more permanent improvements including:

- Recapitalizing European banks and eliminating bank mark-to-market rules for sovereign debt to ensure they remain healthy buyers of European government debt. Without this, bank deleveraging will continue pushing up sovereign debt yields and entrenching a negative feedback loop within the economy.
- A quantum leap in Eurozone governance and eventual treaty changes so that the ECB doesn't view the buying of sovereign bonds as creating a moral hazard that delays regional governments in working towards structural solutions.
- A move towards the mutualization of debt (Euro bonds).

- Expansion of the ECB's balance sheet (quantitative easing) and a stepped up Securities Market Program (SMP) so as to fight a contraction in the money supply and deflation risks.

To solve the crisis two key factors have to be addressed: Growth and/or some type of consolidation of Eurozone government debt. An unlimited and pre-committed expansion of the ECB's balance sheet could achieve both through a devaluation of the Euro and a consolidation of the debt. However, in the near term the conditions that the ECB is looking for are not being adequately met for the bank to pre-commit to all-out, large-scale asset purchases. As such, the ECB's partial containment approach will continue until the right conditions are in place, which, as noted above, is starting to unfold. We think there is finally some meaningful progress being made with respect to fiscal integration, and if there is follow-through combined with a deterioration in the Eurozone economy, it will be enough to spur the ECB into further action. The combination of recent fiscal and monetary policy actions should be enough to reduce the Eurozone risk premium significantly.

CAPITAL MARKETS

Financial markets will remain volatile and range bound with European events calling the shots until the European sovereign crisis is seen to be abating. North American equity markets will remain tethered to Europe in terms of price volatility and direction. If the news out of Europe is poor and European markets are declining, North American markets will follow (there is now an 80% correlation between markets). Stock markets in North America will have an upward bias because domestic economic releases have continued to surprise on the upside. Positive economic surprises normally encourage investors to take on more risk and in turn push up prices. As noted in previous issues of *Outlook*, the economic environment has been improving in the US, and if things settle down in Europe, we can expect much better returns from stocks.

PORTFOLIO STRATEGY

Although the level of uncertainty remains high and restructuring of the Eurozone will take much perseverance and time, we should not lose sight of how much progress European politicians have made nor how much monetary accommodation has been injected into the global financial system from central banks. In addition, away from the crisis, leading economic indicators have bottomed and look to be heading higher, inflation risks are retreating and global liquidity has continued to improve. We are encouraged by these developments because they have to a large extent eliminated most of the tail risk confronting global financial markets. However, these developments have not removed the potential for further price declines in equity markets because, as noted above, more concrete steps need to be taken in the Eurozone on both the fiscal and monetary front. Being mindful of the risks, we believe a cautious approach is warranted. As such, we have reduced the equity weights in balanced portfolios, bringing stock and fixed income weightings in line with their respective benchmarks. We will continue to monitor the situation closely.