



Eurozone 2012 – assessing the unknowns

1. Overview

Assessing the market impact of the eurozone's problems – and potential solutions – is difficult when there are so many unknowns. The challenges are manifold, reflecting the difficult macroeconomic environment, the financial crisis and issues of governance. Asset managers are having to move from market forecasting based on criteria such as economic fundamentals and company profits to include assessing the probability and timing of a range of policy decisions. The task is a very difficult one indeed.

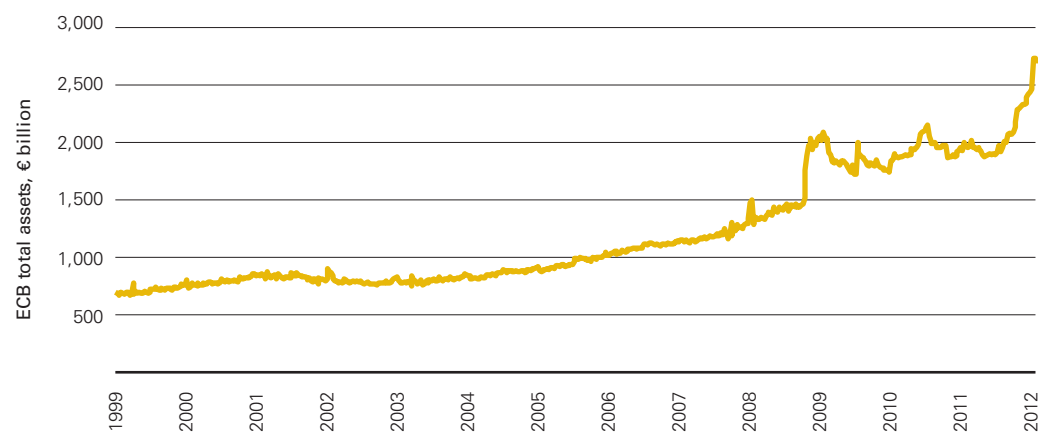
This paper looks at the positive impact of LTRO within the context of the longer-term issues of excessive government debt and the austerity measures being adopted to tackle the problem, when ultimately growth is needed to get economies back in the black. We highlight several key steps that need to be taken to resolve the problems in the eurozone successfully. Finally, we assess the market impact of the different eurozone outcomes.

2. LTRO – some respite for the banking system

In an effort to aid the ailing eurozone, the authorities took measures, just before Christmas 2011, to enable banks to prop up the eurozone financial system. The risks of a liquidity crisis in the financial system were effectively removed by the introduction of the Long Term Refinancing Operation (LTRO), which saw the provision of €489 billion of low cost 3-year money to the European banking sector.

Recognising the dire potential consequences of a liquidity crisis, Mario Draghi, the new President of the ECB, introduced the LTRO to overcome the problem, and to remove the stigma of using central bank funding. The banks were able to borrow at around 1% for three years, either using the money as a substitute for borrowing or to purchase assets, such as peripheral government bonds. The liquidity problem was solved, and in a roundabout way, so were the solvency issues. Banks won't fail if they have a constant supply of low cost money.

The ballooning of the ECB's balance sheet



Source: ECB, Bloomberg.

Does LTRO solve the problems of the euro?

The introduction of LTRO in Europe has had a significant effect on markets. Concerns about liquidity with regard to the banking sector have been substantially alleviated, with a second round of LTRO funding to follow in February. The LTRO has boosted confidence and allowed funding markets to reopen, leading to a significant amount of debt issuance by both banks and sovereigns in the first weeks of 2012. The LTRO has dramatically reduced the tail risk of bank failure and is thus a significant positive step. However, it does not resolve the many problems of the European system.

- The ballooning of the ECB's balance sheet is a reflection of how bad the situation is – the banking sector has become very dependent on the ECB and will stay this way for a long time.
- Europe's fundamental problem is a lack of growth and competitiveness – this provision of liquidity is likely to exacerbate the problem. If banks lend more to governments through bond purchases, they are likely to withdraw further from lending to the economy, undermining recovery. This is classic crowding-out.
- Increased austerity measures will continue to provide a very significant headwind to growth and, until we see fundamental restructuring in Europe and the accompanying supply side reforms, the current environment of heightened volatility and continual flirting with recession is here to stay for a very long time.
- Excessive government debt remains a significant and long-lasting issue that can only be resolved through growth, inflation or money printing.

There is a long way to go.

3. The economic impact of deleveraging – the debt dilemma

The shrinking of the financial sector

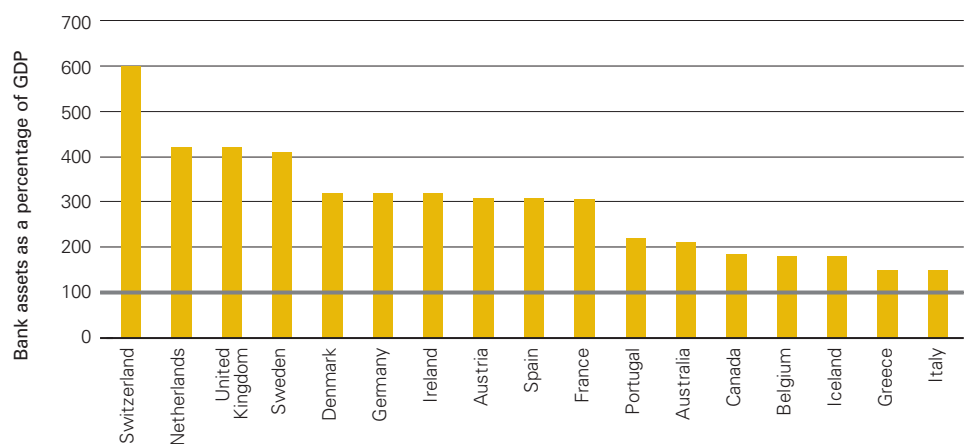
In late 2011 the European Banking Authority (EBA) made compulsory demands for higher capital ratios in an effort to defuse Europe's two-year financial crisis. The crisis, stemming largely from doubts about the abilities of some countries to repay their debts, has engulfed the banking industry, because many lenders are holding billions of euros of such assets. The potential capital shortfalls are spread across more than 30 banks in 12 countries. Anxiety over banks' financial health resulted in them being largely locked out of normal funding markets, forcing many lenders to lean on the European Central Bank (ECB) as their lender of last resort. The LTRO has now provided a credible backstop.

The demands of the European authorities will by and large be met through shrinking bank balance sheets. In the current environment banks cannot raise capital easily (investors are wary of money being soaked up by sovereign debt writedowns) and there is little inclination to do so at depressed share prices – currently trading at about 60% of book value. Improving solvency through shedding loans appears the most viable choice for banks. But while this action may be good for the individual bank, the economy as a whole will pay, as shrinkage has a recessionary impact and will jeopardise any fragile recovery, adding further difficulties to an environment of fiscal austerity.

The vicious circle of sovereign and bank debt

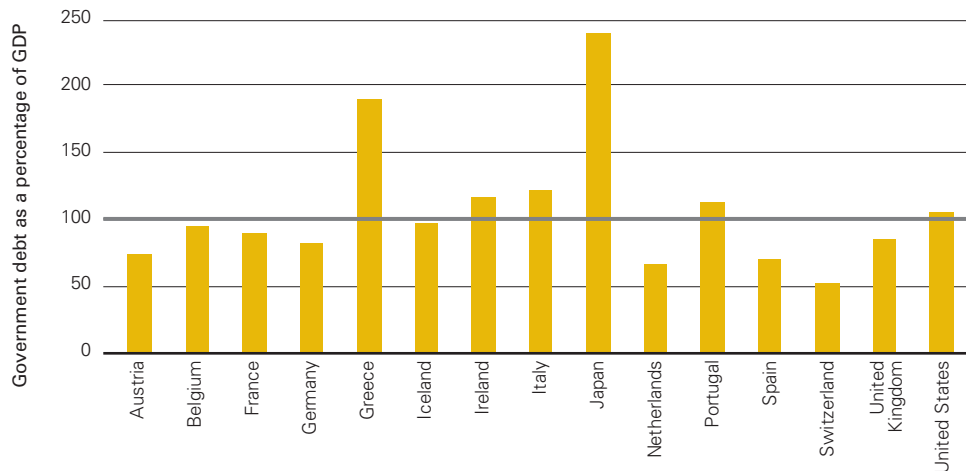
Banks are too big to fail and too big to bail. At an individual bank level, the figures are extraordinary. Many individual banks have balance sheets larger than their country's GDP.

Bank assets are well over 100% of GDP in Europe



Source: ECB.

Sovereign debt holdings are high in many advanced countries



Note: Chart shows IMF forecasts for 2012.
Source: IMF, WEO database, September 2011.

Governments too, are in a precarious state. With high levels of sovereign debt and a Teutonic insistence on austerity as the panacea, there is a legitimate fear that many countries will not be able to grow their way out of public debt. This gives rise to a vicious circle, where governments can lose market access with no ability to raise funds due to the high yields they would be forced to pay. Sovereign insolvency is the outcome. There is already little room to manoeuvre.

Tackling the extent of sovereign and bank debt is critical and scarcely subject to debate. How the debt crisis is addressed is of fundamental importance – an uncoordinated and inconclusive approach, let alone policy errors, can doom the project to failure. The crisis in Europe reflects the lack of recognition of the imbalances within Europe and is therefore as much a crisis of policymaking as it is a debt crisis.

4. A checklist to end the crisis

Markets need to lower their expectations – the principal policy focus in the eurozone continues to be on avoiding catastrophe, buying time and allowing austerity to work. Still, growth in the eurozone is going to be undermined for a long time, with deleveraging measures making problems in the eurozone worse. We believe that there are several key steps towards ensuring the successful resolution of the eurozone's problems. Some combination of these events remains highly likely in the coming months but we will remain vigilant as, in the absence of such developments, the crisis will escalate.

- **A lender of last resort to troubled sovereigns** – The ECB is acting as lender of last resort to the banking system, but not yet doing the same for sovereign nations. Such action may take the form of quantitative easing, or it may be through forcing the banking system to purchase government bonds. Some type of open-ended commitment to purchase government bonds is essential to solving the eurozone crisis.
- **Disinflation** – Deflationary forces are a necessary prerequisite to rapid monetary expansion and/or quantitative easing. Fading price pressures, in the face of economic distress, will open up a new array of policy measures for the region that appear less palatable at present.
- **Some degree of fiscal coordination across the eurozone**
- **Forced bank recapitalisation** – The scale of balance sheet reduction in the absence of equity raising and the removal of bank credit from the economy is too severe for the eurozone economy to withstand. A retreat from this stance is necessary to preclude the recession from becoming a self-reinforcing downturn.

5. Assessing the impact of eurozone outcomes on portfolios

There are still several potential conclusions to the eurozone crisis, and each of them has different implications for markets and investment strategy. It is difficult to conceive of the more severe outcomes below unfolding without losses to all risky assets, including property, equity and corporate credit. Nonetheless, equity and fixed income markets have already factored in a slow-growth environment, and are certainly including some risk premium around the further risk of a eurozone meltdown. Thus, these scenarios may not take the markets completely by surprise.

Scenario 1 – the eurozone survives intact – Equities should rally 10-20% under this scenario, as fear abates and earnings push higher. Peripheral government bond yields should fall, but most developed market yields will rise. Decelerating inflation, slow growth and anchored short rates should prevent a steep sell-off in gilts, limiting the rise in rates to no more than 50 -100 bps over 2012. Gilts would be expected to produce returns of around -2% to -7%. High quality corporate bonds would post an expected return of roughly 0%.

Scenario 2 – some countries exit the eurozone – If policymakers are able to control market contagion, this event may lead to short-term losses but market moves would be somewhat limited given the extent to which this risk is recognised. We believe that interest rates/bond yields and equities would remain range bound around current levels.

Scenario 3 – Full scale eurozone break-up – This is a small probability (less than 10%), but would produce catastrophic outcomes. UK interest rates would fall but gilts would struggle to produce returns greater than 5%. Equities would fall very sharply and predicting the chain reaction of events that might ensue is difficult. Even with aggressive policy action, a global recession would be a near-certainty and risk premiums would rapidly escalate.

More Threadneedle thinks to follow

For a further exploration of these issues concerning the eurozone, please refer to Threadneedle's thought leadership paper to be published in March 2012.



Find out more

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