

We Must All Hang Together, or Assuredly We Shall All Hang Separately – Part 3

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Summary

- Conditions are changing quickly in Europe's sovereign debt crisis. At first, concern was focused mostly on the weaker periphery countries (Greece, Ireland, and Portugal). However, a series of half starts and stops (e.g. EFSF 1.0 and 2.0) and confusion over how the Euro area crisis can be contained has caused investors to pressure the bigger countries such as Italy and even recently, Germany. Due to lack of adequate outside demand, Germany's central bank had to purchase over one third of its monthly Bund auction last week, which pushed rates up over 2 percent.
- Rome owes its creditors € 1.9 trillion, a sum that exceeds the debts of Greece, Portugal, Ireland and Spain combined. Unless Italy's borrowing costs return to below 5.5 percent, even long-term reduction of the debt mountain is unlikely.
- The survival of the European Monetary Union depends on whether Italy can repay its debts and, since the scope of Italian debt is large at 120% debt-to-GDP, Italian solvency is at the mercy of investors worldwide.
- It appears that the best way to contain the crisis would be to have the European Central Bank backstop Italian debt, as yet a position untenable to the ECB and Germany, who fear future inflation. This action would also require a change to the ECB charter. While we think the ultimate solution will involve the ECB, it is hard to predict when that solution might occur, so we expect a high degree of volatility to continue.
- At Cutwater, we have been monitoring the situation closely and have positioned client accounts to weather even the worst-case scenario. Below we outline our understanding of recent events in Europe.

Italy Update

Italy's longstanding Prime Minister, Silvio Berlusconi, lost his majority before stepping down on November 12 amid turmoil as 10-year Italian debt yields surged past the 7 percent mark. Yields of over 7 percent have immediately preceded bailout requests in Greece, Ireland and Portugal and have therefore been seen as the point of no return for sovereigns. Despite ECB purchases, rates remain near euro-era highs, signaling that Italy's finances continue to cause concern among bond investors.

Berlusconi was replaced by former European Union Commissioner Mario Monti, who was sworn in on November 16 amid a sell-off in Italian bonds. With Monti comes a phalanx of bankers, professors, and businessmen seemingly assembled to demonstrate

that Italy takes austerity seriously. After winning a final confidence vote in Parliament on November 18, Prime Minister Monti addressed both houses of Parliament and outlined his government's policies. Monti pledged to make immediate progress on implementing budgetary reform and proposed new austerity measures, including a campaign against tax evasion, elimination of provincial governments, reinstatement of property taxes, sale of government real estate, and an effort to bring more private investment into public-work projects. "This government recognizes that it was born to confront... a situation of serious emergency," the new prime minister said.

Monti and his new government must convince investors of Italy's solvency as they seek to refinance approximately €200 billion of treasury debt that will mature by April. At present, the borrowing cost could be prohibitively high—on November 22, 10-year Italian debt was yielding 6.82 percent, a level we consider to be inconsistent with the capacity for debt reduction, as that rate exceeds Italy's "normalized" GDP of 2%.

Greater Europe

The economic outlook across the continent appears to be darkening. Due to the crisis, most economists now believe Europe will flirt with recession in 2012. Given such, even AAA-rated Germany and France are looking less safe than they had several weeks ago.

Despite being considered the strongest economy in Europe, even Germany's Bundesbank, the Frankfurt-based central bank, cut its 2012 GDP growth forecast to between 0.5 percent and 1 percent, down from a June prediction of 1.8 percent, saying "the German economy faces more difficult terrain in the months ahead" in a statement released November 21. Although they cited "weakening foreign demand" and "financial market nervousness" as reasons for their dimming expectations, their report indicates that Germany's own debt burden is also a "cause of concern." Germany's sovereign debt was €2.03 trillion in 2010, compared with €1.48 trillion in 2005. German investors have now begun to pressure German rates, as well, with a poor auction of Bunds in late November.

Spain has also been drawn into the turmoil. Spanish voters elected Mariano Rajoy as their new prime minister, but the political deck-shuffle did little to

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appease investors worldwide. Spanish 10-year yields hit a euro-era record of 6.78 percent on November 17. And in an auction held on November 22, Spain sold three-month bills at an average yield of 5.11 percent, higher than rates paid by Greece and Portugal and more than twice the rate fetched at auction just one month earlier. As borrowing costs balloon, Spain faces 23 percent unemployment and a budget deficit of more than twice the EU limit. Spain hopes to reduce its government's budgetary shortfall to just 4.4 percent of GDP next year, down from more than 6 percent this year.

Ways Forward

If investors are waiting for Germany to come to the rescue, they may be waiting a long time. German Chancellor Angela Merkel has consistently opposed joint bond issues by Eurozone governments, saying that confidence cannot be restored through “a big bang” and that “only a coherent political response can create this confidence.” In practice, “political response” will likely mean deep austerity across Europe. A spokesperson for the Chancellor has stressed that there is no “new bazooka to pull out of the bag”. Although Chancellor Merkel will be looking at three alternative structures for Euro bonds, she has so far been adamant that the European Central Bank must not become the lender of last resort to financially besieged nations. Perhaps understandably, Chancellor Merkel has been reluctant to have Germany underwrite her stagnant and indebted southern neighbors. The irony of the situation is that these statements by Chancellor Merkel have served to put even more fear in investors' hearts of the potential for a Euro default and / or break-up.

Cutwater's View

As we wrote two years ago in our market commentary, “We Must All Hang Together, or Assuredly We Shall All Hang Separately,” there remain two ways forward for Europe: to rescue or not to rescue the Euro. Europe can either become a true monetary union by collectively guaranteeing the debts of its members, or it can split, suffering the inflation, stagnant growth and market chaos that will likely result.

Conventional wisdom suggests that Italy is too big to bail, but default is not an option (so it is also too big to fail!). We believe that the recent sell-off in Italian debt reflects a crisis of investor confidence, and not a change in the underlying fundamentals. Although Italy briefly exceeded the 7 percent landmark, the

country remains solvent—a status neither Greece nor Portugal could claim.

Investor worries can quickly reverse Italy's fortune, however. If Italy is going to resolve its debt over the long-term, it will need continued access to affordable funds. If its borrowing costs continue to climb upward, Italy could be left unable to cover upcoming maturities. In a liquidity crunch like this, the IMF might provide short-term relief to Italy, but if the markets determine that Monti's new government is not decisively implementing budget-cutting measures, there will be no liquidity provider large enough to save Italy...except perhaps the ECB.

Through corporate and other spread-sectors, we have positioned Cutwater portfolios for continued uncertainty. We expect market volatility to remain elevated but, given large price concessions in certain sectors combined with our sustained growth expectations for the U.S. and global economies, we believe returns will ultimately be constructive for our allocations.

We do not expect Italy to leave the European Monetary Union, and we believe that the net present value of a united Eurozone is greater than a divided Europe. Indeed, a breakup would likely lead to a hard European (and Global) recession with the “core countries” of Europe suffering greatly. After all, Germany's economic strength is derived from its exports, 70% of which are to other European countries! Germany would suffer high unemployment and a devastated banking sector. Conversely, a Euro-centric solution keeps growth positive and the Euro strong. That said, given the political pressures, there is a chance that Italy may choose to selectively default, break treaty with the EMU, and reintroduce the Lira as its domestic currency. We consider this to be the worst-case scenario. A selective default would immediately impair Italy's financial system, because of the €400 billion in government debt held by domestic banks and insurance companies (this will be especially challenging for Italy's banks, since they must refinance €111 billion of their own debt in 2012.). A selective default will require Italy's central bank to print enough Lira to recapitalize their government, exchange privately held Euro, and pay creditors some negotiated balance of the €1.9 trillion outstanding treasury debt. Revisiting Argentina's default as a base scenario, Italy's economy would likely experience stagflation for a decade or longer and again Germany would also fair poorly in this scenario. Ultimately, it

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may take a similar “Lehman Moment” imposed by the markets to force the political will needed to move toward a closer European union. We could envision a scenario where Europe moves toward a collective Eurobond approach with unlimited ECB backstop capacity and help from the IMF for weaker countries. If this did occur, the Euro area debt-to-GDP would stabilize at an acceptable 80% level (well below where the U.S. is headed). It would also solidify the Euro as a rival reserve currency versus the U.S. — we can see through our own declining interest rates how that could benefit all countries in Europe. Indeed, “to bail or not to bail” is a question that will be answered, and we think “to bail” is the better way.

Conditions continue to change rapidly and while we do not expect this worst-case scenario to come about, we are currently ensuring that Cutwater portfolios have appropriate flexibility to address this crisis as it unfolds. To that end, we maintain ample exposure to both U.S. government securities and (where permissible) to the obligations of corporations with strong balance sheets and positive cash flow. U.S. Treasuries have repeatedly proven their merit as safe-haven assets. We anticipate even greater allocations to U.S. government sectors if the debt crisis in Europe continues to worsen.

About the Author



Clifford D. (Cliff) Corso is CEO and CIO of Cutwater Asset Management, a fixed income investment management firm with a distinct focus on the long view.

With over 25 years in the industry, Cliff directs the investment of nearly \$38 billion in assets belonging to state and local governments, sovereign governments, pension funds and large institutional investors. Throughout his career, he has managed a wide array of fixed income products, including corporate, asset-backed, government, mortgage and derivative products. Cliff received his bachelor’s degree from Yale University and a master’s degree from Columbia University. He holds his Series 7, 24, and 63 licenses from the Financial Industry Regulatory Authority (FINRA). For more information, visit www.cutwater.com.

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