



# Weekly Market Commentary



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### Highlights

Europe's Greece fire has been burning for well over a year despite attempts by the ECB and IMF to put it out. Investors are feeling the heat of the Greece fire, as it has added to the pressures on markets in recent weeks. However, after having spilled over into some European banks, it is highly unlikely to spread to the rest of the world in a dangerous fashion and trigger another global financial crisis.

While the events of 2008 are fresh in market participants' minds, and it is often easy to draw comparisons to that financial crisis, there are other historical parallels—such as Argentina's default in late 2001—that present much less dire comparisons.

Many factors are likely to avoid a financial crisis stemming from Greece's financial problems. European banks have already cut their exposure to the troubled peripheral European nations in half, a rescue package is emerging that avoids restructuring until banks are further braced for it, and money market funds are insignificantly exposed to European lenders most at risk of losses on Greek debt.

## Greece Fire

Grease fires are dangerous because they are hard to put out, burn very hot, and are easily spread. Europe's Greece fire has been burning for well over a year, despite attempts by the ECB and IMF to put it out. Last week, Greece's financial crisis intensified as debate continued over efforts intended to avoid the Eurozone's first sovereign default. This intensification was signaled by a plunge in the value of the debt of peripheral European countries. And it has spread to other nations as seen in last week's announcement from ratings agency Moody's that it is putting three of France's biggest banks on review for a possible downgrade due to their high exposure to Greece's debt. However, we think the Greece fire is not likely to be all that dangerous to most U.S. investors.

## The Next Lehman Brothers?

The Bank for International Settlements collects data from banks around the world and provides data on foreign banks' lending to the Greek government, Greek banks and the private sector combined. Fortunately, U.S. banks hold an insignificant amount of Greek debt relative to their total assets. However, this is not true for European banks. As of year-end 2010, German lenders are the biggest foreign owners of Greek government bonds with \$23 billion in holdings last year. While French banks have less Greek government debt, with holdings of \$15 billion, they lead the group of Greek creditors with overall lending that includes companies and individuals amounting to \$57 billion. These are not insignificant sums.

The fear among some market participants is that the default or restructuring of Greece's debt will trigger a series of financial institution defaults and a financial crisis throughout Europe and beyond. This potential path echoes the chain reaction that followed the bankruptcy of Lehman Brothers in September 2008 that led to a global financial crisis.

Under current rules, most banks do not have to hold capital against losses on sovereign bonds because they are considered to be very safe. A default, where the bondholders would suffer a loss on their Greek bonds, may trigger a capital squeeze for some European banks already struggling to meet the new, tougher "Basel III" capital requirements that were enacted to build up a buffer to avoid just such an outcome. This risk increased with rioting and political instability in Athens last week when Greek Prime Minister George Papandreou offered to resign leaving questions as to who may have the



authority to agree to the terms of any bailout that may lack popular support. These events prompted Moody's Investor Services to announce the review of three major French banks for a credit rating downgrade, and Greek bond yields soared as did the cost to insure against a Greek default.

While the exposure to Greece is not that big by itself, by adding the other troubled peripheral European countries debt, namely Portugal and Ireland, on to it the numbers become significant. Although these countries have very different probabilities of default, they all tend to move together. A default for Greece would likely lead to the same for Ireland and Portugal.

In addition, a way that a Greek default could affect U.S. investors is through the impact on money market funds. Many large money market funds around the world hold certificates of deposit, commercial paper, and other short-term obligations of the European banks with exposure to Greek debt. This is raising worries that a Greek default might trigger many money funds to "break the buck," or fall below \$1, as happened in September 2008 after the failure of Lehman Brothers triggered losses on assets held by many money market funds.

### The Next Argentina

If Greece was to default, and there are a number of reasons why that may not happen, the impact may be more akin to Argentina than Lehman Brothers. In December 2001, the government of Argentina initiated the largest government debt default on record, suspending interest payments and principal repayments on bond issues with a face value of more than \$81 billion. Many large global financial institutions that held Argentinean debt were still undercapitalized following the 2001 recession and took substantial losses, yet a global financial crisis did not take place and the global recovery continued.

While the events of 2008 are fresh in everyone's minds and it is often easy to draw comparisons to that financial crisis, there are other historical parallels—such as Argentina's default—that present much less dire comparisons.

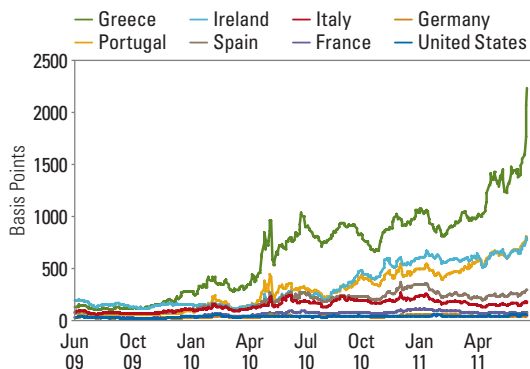
### Avoiding a Financial Crisis

But more importantly, there are many factors that are likely to avoid a financial crisis stemming from Greece's financial problems.

- First, the European Central Bank (ECB), the International Monetary Fund (IMF) and the largest and most financially stable European country, Germany, have been engaged in a debate regarding the best way to avoid a European financial crisis. They appear to be nearing an agreement on Greece, with Germany backing down last week from demands that bondholders, including banks, share in the cost of the rescue by suffering losses on Greek debt. The IMF and ECB have already bailed out Ireland and Portugal and are in the process of extending the remainder of the original Greek bailout of about \$160 billion. The ECB has purchased nearly \$104 billion worth of peripheral debt since May 2010. Greece is funded by a bailout from the European Union and the IMF until about the middle

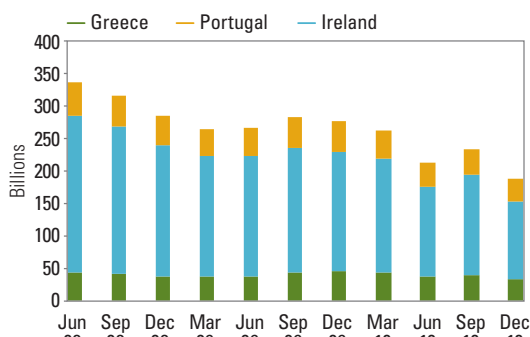


### 1 Credit Default Swap Spreads Show Relative Default Risks



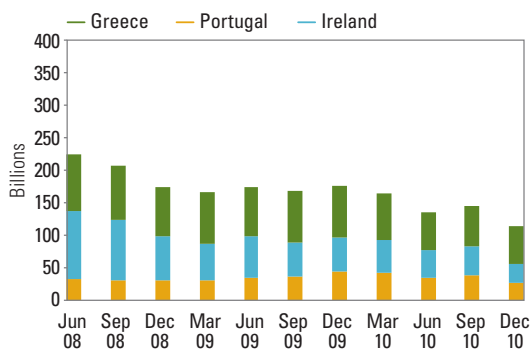
Source: LPL Financial, Bloomberg Data 06/17/11

### 2 German Bank Exposure to Peripheral European Debt



Source: LPL Financial, Bank for International Settlements 06/17/11

### 3 French Bank Exposure to Peripheral European Debt



Source: LPL Financial, Bank for International Settlements 06/17/11

of 2012 even as the next bailout package is being formulated. The bailout packages are intended to buy time to avoid a Eurozone financial crisis and to allow Greece to restructure its debts in an orderly fashion as the European banks are fully prepared for such an event.

- Second, rather than a sudden shock to the system, the possibility of a Greek default has been common knowledge for at least a year and financial markets have reflected this fact. A main indicator that this risk has been well known has been the rising cost of insuring Greek debt. Credit default swaps (essentially an insurance policy that pays off in the event of a default) for Greece are currently the costliest in the world – almost twice as expensive as those for Pakistan. Five-year credit default swaps for Greece are trading at 22% for Greece and 8% for Ireland and Portugal. Notably, Italy and Spain have shown improvement this year and are no longer tracking the more troubled nations as the market is assessing the risks individually.
- Third, kicking the can down the road actually helped. By conducting the Greek rescue in tranches and dragging it out, it actually bought time for financial institutions in Europe to divest themselves of risky assets from the troubled European peripheral countries—Greece, Portugal, and Ireland—over the past couple of years. As you can see in [Charts 2 and 3](#), French and German banks have roughly cut in half their exposure to assets in these three countries between mid-2007 and December 2010. That exposure is likely even lower today. In total, German banks exposure to Greek debt is about 1.2% of consolidated cross-border debt holdings and for France it is 1.8%. Total exposure of German banks to the three troubled Eurozone nations (Greece, Portugal, and Ireland) is less than 7% and for French banks it is under 5%.
- Fourth, overall, money market funds have insignificant exposure to Portuguese, Irish and Greek banks at less than 2% of total assets. However, they do have exposure to European banks that own Greek bonds. The top 10 money market funds by assets hold commercial paper or certificates of deposit from the European banks most at risk of a credit downgrade by Moody's related to their holdings of Greek debt totaling only 2.6% of total assets. While the European banks may have to raise some reserve capital, they are able to meet their money market obligations and those money market funds appear to be well diversified enough to avoid "breaking the buck" in the event of any flow though of losses on Greek debt to the European banks' obligations.

### Austerity Ahead

There is no easy solution for Greece. Greece does not have much choice when it comes to austerity; the country is likely to face years of recession whether they default, opt for aid, or any other outcome. Greece's public debts amounted to 142% of its gross domestic product (GDP) at the end of 2010, and interest payments are approaching 20% of government revenue. Borrowing rates are over 20%, the economy is in recession, and its currency (the Euro) is overvalued relative to Greece's prospects and unable



to independently adjust. Adding the significant fiscal drag as spending is forcibly cut and the upheaval of the political backlash, the outlook for Greece's economy is grim.

Investors are feeling the heat of the Greece fire as it has added to the pressures on markets in recent weeks. However, after having spilled over into some European banks, it is highly unlikely to spread to the rest of the world in a dangerous fashion and trigger another global financial crisis.

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