Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

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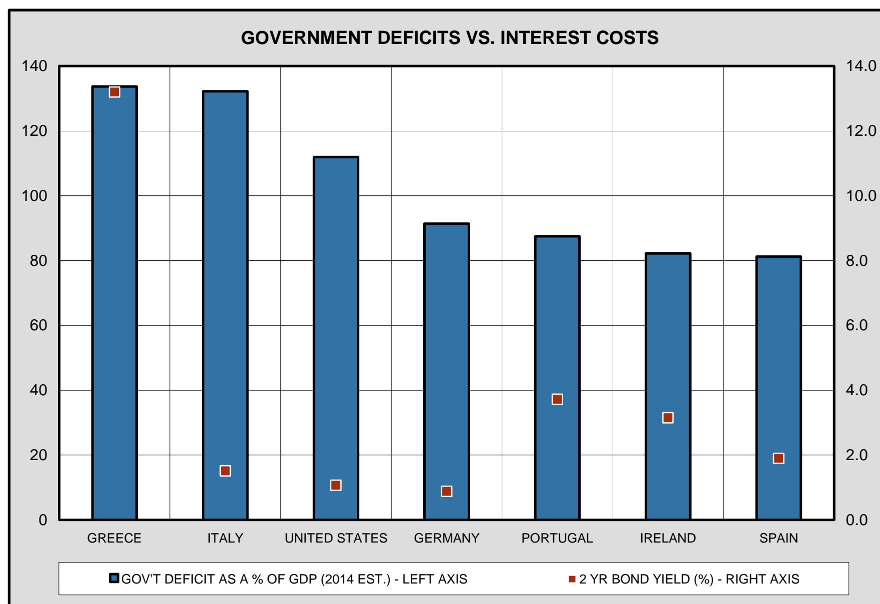
Corners of the financial markets were riveted last week by the ongoing developments in Greece, as the country fights to manage the refinancing of its considerable debt load while also trying to sell an austerity program to its unhappy populace. At the start of this week, the worries continue as rates on 2-year Greek debt have increased to 13% (as compared with a German 2-year bond yielding just 0.88%). Greece's size, at less than 3% of European gross domestic product (GDP), isn't the issue. The market concerns surround whether Greece is the proverbial canary in the coal mine – does its ill health indicate further illness among the other European Union (EU) members and beyond. These worries have led to a 12% decline in the euro currency since its cycle high in late November 2009. So what do the Greek struggles tell us about the outlook for sovereign debt and how the current elevated debt levels will be handled? And what are the broader investment implications for global investors?

Our first conclusion is that Greece is not your average developed economy, which reduces the likelihood that Greece is a template for the experience that other debt-burdened nations will endure. Among the most-discussed European countries, Greece has debt levels that are only equaled by Italy – a country not without its challenges but one with a larger and more diversified economy.



Source: International Monetary Fund, Bloomberg, Northern Trust.
3-Year bond yield substituted in the case of Ireland

Greece's bookkeeping has not inspired confidence, as the EU has just increased its calculated budget deficit for 2009 from 12.7% to 13.6% (and compared with the government's two-week-old forecast of 12.9%). Ireland presents an interesting contrast, as it voluntarily slashed its public spending to bring its deficit (which reached 14.3% of GDP in 2009) in line, and the Irish stock market is one of the world's best-performing this year, with a 16% gain. The nature of the Greek economy, with significant union involvement and lax fiscal controls, makes this turnaround a real challenge. In addition, the historical social contract that workers enjoy stands in contrast to the wage and benefit cuts that will be required to improve the budget, which led union organizers to call for strikes of more than 500,000 workers last week. So now Greek authorities find themselves caught between the merciless demands of the financial markets and the emotional cacophony of the Greek citizenry – which is a no-win situation.

The contagion from Greece's problems has so far been fairly contained within Europe, and we expect this to continue. Two-year yields in Europe range from Germany at 0.88%; Italy at 1.51%; Spain at 1.90%; Ireland at 3.15% (3-year note); Portugal at 3.72%; to Greece at 13.2%. The head of the International Monetary Fund (IMF) stated last week that Europe isn't suffering from a region-wide debt crisis and that the IMF isn't looking at budget problems outside of Greece. Russia successfully accessed the international fixed income markets last week for the first time since its default in 1998, placing $5.5 billion in Eurobonds at spreads ranging from 1.25% to 1.50% above comparable U.S. Treasuries. This is not a sign of increased risk aversion among emerging market debt investors. The turmoil has led to the aforementioned decline in the euro, which seems to be having a salutary effect on the European economy, as the April Purchasing Manager's Index positively surprised and is at a level consistent with 3.0% GDP growth.

The magnitude of Greece's problems raises the odds of some form of debt restructuring, with extension of maturities seemingly the least noxious, and that seems to be what the fixed income markets are reflecting in current bond prices. But whether a restructuring takes place or not will likely depend on the country's ability to demonstrate that it can meet its target of a 4% reduction in the deficit this year, and meet the EU limit of a 3% deficit in 2012. This seems a Herculean task.

So what lessons do we draw from the Greek crisis about the way forward for global financial markets and, specifically, other heavily indebted countries? First, the bond market will likely force absolute clarity on fiscal plans – no vague assurances will suffice. This means that countries like the United States will, at some point, need to persuade global fixed income investors that we can bring down our deficits. Our worry is that the politicians won't have the urgency to act on this until higher interest rates force their hand. So longer-term, higher interest rates seem a likely risk-case. Shorter-term, the travails in Greece look unlikely to derail the strong performance of global financial markets. Investors are delineating the strong from the weak; the global economy is surprising on the upside in most major regions; inflation remains contained; and central bankers are generally quiet. We believe the constructive environment for risk-taking remains firmly in place.

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