

The threat from Europe – how big?

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Key points

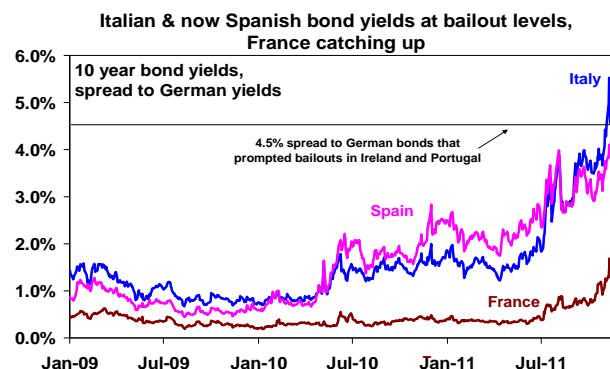
- > The European debt crisis is worsening, posing the major risk to global growth and the investment outlook for 2012.
- > Shares are good value for long term investors, but the short term outlook remains uncertain. Watch for signs of European Central Bank quantitative easing and unlimited bond buying going forward.

Introduction

In late October there seemed to be room for optimism that Europe was going to head off a worst case blow up and that a “comprehensive” plan would be in place by the early November G20 leaders’ forum. However, political blow-ups in Greece and Italy put paid to any respite. The G20 leaders’ forum came up with nothing, and Europe has yet to implement much of what it announced in late October. As a result, the European crisis has continued to worsen, with investors now bailing out of core countries. What does it all mean for the global economy and risk assets?

Contagion on steroids

The past few weeks have seen the European crisis enter a more dangerous phase. It has moved beyond peripheral countries & is now seriously affecting Italy and Spain, where bond yields are at levels that prompted bailouts in Ireland and Portugal. Furthermore it is now threatening even France, Belgium, the Netherlands, Austria and Finland, which have all seen their bond yields rise relative to German yields.



Source: Bloomberg, AMP Capital Investors

The basic concern of course relates to high debt levels. But the weighted average 10 year bond yield in Europe is now 5.4%, versus a US ten year bond yield of just 1.9%, despite the fact US public finances are comparably worse. The US 2011 budget deficit and gross public debt are equal to 10% and 101% of GDP respectively, compared to 4% and 90% of GDP respectively in the Euro zone (EZ). Clearly something else is at play. Speculative contagion working against non-German euro-zone bonds is a part of this. The unintended consequences of policy action are also playing a role:

- fiscal austerity, in the absence of monetary easing, is adding to the economic downturn, which in turn is making investors sceptical that debt will be reduced;
- EZ banks appear to be selling bonds in order to meet heightened capital ratio requirements;
- the haircut on Greek debt has led to a reassessment of the risks of holding all EZ government bonds;
- talk of providing first loss insurance on new bonds has reduced the value of existing bonds; and
- investors have realised credit default swap insurance on bonds may be of little value if it doesn't pay out in response to 'voluntary' debt restructuring.

So the crisis has spread from relatively trivial countries with Greece, Portugal and Ireland accounting for only 6% of EZ GDP and 8% of its debt, through to Italy and Spain (which together account for 28% of its GDP and 32% of its debt), and now to France, which alone accounts for 20% of EZ GDP and its debt. See the next table.

Euro-zone (EZ) debt and GDP compared

2010 data	GDP, billion euros	% of Euro-zone total	Gross public debt billion euros	% of GDP	% of Euro-zone total
Austria	284	3	205	72	3
Belgium	352	4	341	97	4
Cyprus	18	0	11	61	0
Estonia	15	0	1	7	0
Finland	180	2	87	48	1
France	1948	21	1591	82	20
Germany	2499	27	2080	83	26
Greece	230	2	329	143	4
Ireland	154	2	148	96	2
Italy	1549	17	1843	119	23
Luxembourg	42	0	8	19	0
Netherland	591	6	371	63	5
Portugal	173	2	161	93	2
Slovakia	66	1	27	41	0
Slovenia	36	0	14	38	0
Spain	1063	12	639	60	8
Total	9204	100	7859	85	100

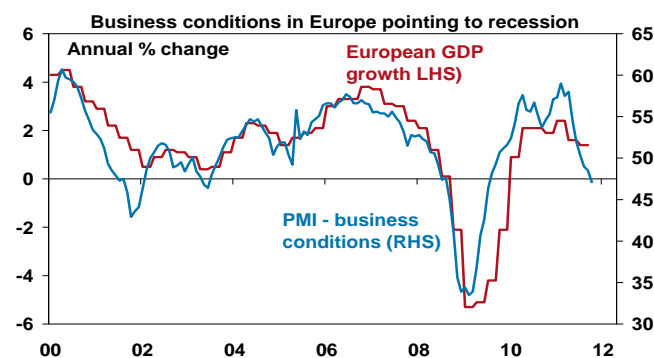
Source: Eurostat, AMP Capital Investors

Much of the current turmoil could have been avoided if the ECB had acted earlier as bond buyer of last resort and erected a firewall around otherwise solvent countries such as Spain and Italy. This would have involved the ECB threatening to buy unlimited quantities of bonds in threatened countries in order to ward off speculative attacks on bond markets, and running much easier monetary policy (cutting interest rates to near zero and quantitative easing) to provide an offset to fiscal austerity. Despite suggestions to the contrary, there is no legal barrier to the ECB buying bonds or

undertaking quantitative easing. The ECB Statute prevents it from buying bonds directly from governments, but there is nothing preventing it from buying them in the secondary market and of course it has already undertaken quantitative easing during the GFC. Rather, a desire to force economic reforms on troubled countries, avoid moral hazard, misplaced fears about inflation and political squabbling have brought Europe and hence the world to a dangerous place. Sure the ECB has been buying bonds, but only on a very limited basis. Since last May it has bought €195bn worth of bonds or \$US263bn. But this has been sterilised by the sale of short term debt and compares with a massive \$US600bn worth of debt purchases by the US Fed under QE2.

Three scenarios for Europe

Leading indicators are pointing to recession in Europe. The question is now how deep and financially disruptive it will be?



Source: Bloomberg, AMP Capital Investors

Put simply, there are three possible scenarios for Europe.

- **Muddle through:** the cycle of 'revolt, response, and respite' continues to repeat, with periodic interventions that never go far enough but are enough to avoid a major blow up. This is what Europe has been going through over the last 18 months, but it's questionable it can continue this way with core countries now being affected.
- **Blow up:** the crisis comes to a head with a deep recession – Euro zone GDP falling 5-10% in 2012 – and a financial crisis rivalling the GFC. This would be bad for growth assets – shares, commodities, the \$A and euro.
- **Aggressive ECB monetisation:** the ECB finally realises the crisis is threatening deep recession and price deflation and so moves to undertake aggressive quantitative easing to push down bond yields and head off economic calamity. This would probably be too late to head off a mild recession, and there would still be a lot of mopping up to do, but it would at least head off the Blow Up scenario. This would be positive for growth assets, albeit with the usual bit of base building.

Ultimately we think the ECB will capitulate and become lender of last resort but it may require more pain in markets before. While we have been expecting a mild EZ recession, the risk of a blow up and deep recession is rising as the crisis spreads into core countries, fiscal austerity intensifies, economic confidence continues to slide and social unrest increases. Even Germany appears headed for recession.

Europe and global growth

There are three channels by which the recession in Europe will affect the rest of the world, including Asia and Australia. These are via trade, the global financial system and confidence. The Euro zone (EZ) absorbs around 25% of US exports, less than 20% of Chinese exports and less than 10% of Australian exports. Rough estimates suggest a 1%

fall in EZ GDP would knock just 0.1% off US GDP, 0.4% off OECD growth (including the direct effect of the EZ contraction), 0.1% off Chinese growth and less than 0.1% off Australian growth via trade impacts alone.

If the EZ contracted 5% in a 'Blow Up' scenario, it would knock roughly 0.6% off US growth, 2% off OECD growth, 0.5% off Chinese growth & 0.4% off Australian growth.

However, these figures are likely to understate the impact. First, European banks are shrinking their balance sheets in order to strengthen their capital ratios. A lot of this will come out of their foreign operations. The Bank Credit Analyst estimates that a 10% shrinkage of EZ banks' \$US25 trillion in loans could pull \$US1.2 trillion of debt out of the global economy, equivalent to 2% of world GDP. Of course this doesn't mean a 2% contraction in global GDP (as eg corporates can rely on record cash holdings) but the impact is still negative. While Asia & Latin America are self sufficient in terms of funding (being net global creditors), they will still be affected as EZ banks play a big role in trade finance.

Second, are the financial effects that may result if a major EZ bank fails, the impact on the cost of funding as credit markets tighten and the loss of wealth associated with share market falls. A fall in the value of the euro would also have a dampening impact on global growth and EZ sourced profits.

Finally, there is the impact the ongoing European debt crisis is having on consumer and business confidence. Confidence levels are clearly depressed globally, but so far there has been only a mixed impact on actual spending – eg retail sales have held up in the US. But obviously the impact could rise if the European crisis continues to worsen.

Overall our assessment is a mild recession in Europe would dampen global growth but would not cause a global recession. But a 'Blow Up' scenario with a 5-10% EZ contraction and significant financial dislocation would threaten a return to global recession.

What about Australia?

While Australia has a small trade exposure to Europe, it's still vulnerable via the impact on its major trading partners in Asia and via financial and confidence linkages. While a mild recession in Europe would only have a minor impact on Australia and leave it on track for 3% or so growth next year, a deep EZ recession would be a big threat. That said, our assessment remains that Australia should be able to avoid a recession under this scenario given plenty of scope to cut interest rates and provide further fiscal stimulus, a lower \$A would provide a buffer, corporate gearing is low, household saving is high and mining investment is likely to remain strong. In other words, 2012 growth would be confined to the 1-2% range, but should avoid recession.

So where does all this leave investors?

Unfortunately the outlook for investment markets remains uncertain in the short term. While there is great long term value to be found in share markets – with Australian shares offering a higher cash flow than bank term deposits – further falls in the short term are a high risk. So for short term investors it remains a time to stay cautious.

Watch the ECB – if it announces unlimited bond buying and quantitative easing it would be a very positive sign, particularly with shares cheap and most investors bearish.

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