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Investment
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**Eurozone -
Is the patient
healthier than
we think?**

November 2011

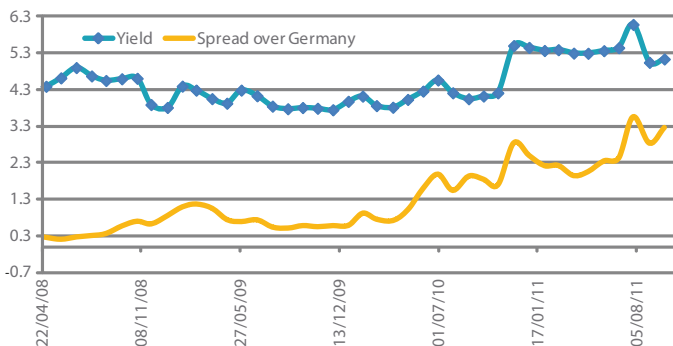
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Summary

- A critical underlying cause of the Eurozone crisis was the external imbalances of the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain). The move to fiscal austerity amongst the PIIGS has led to weak economies, which has caused fiscal revenues to decline, thus forcing more fiscal austerity. Indeed, we are currently at the worst stage of the cycle.
- However, there are signs of progress—fiscal deficits are being cut and external deficits are also shrinking rapidly. We do not believe that the markets have truly appreciated this fact, with PIIGS bond yield spreads over German bonds remaining high (see chart 1). The good news is that the latter have fallen sharply, so Spain has not actually encountered such large increases in borrowing costs. Other PIIGS may witness large declines in borrowing costs once external deficits are seen to be declining and as the European Central Bank (ECB) and European Financial Stability Facility (EFSF) may change bond purchasing trends.

Chart 1: Spain 10-Year Bond Spread



Source: Bloomberg

The recent improvement in PIIGS' current accounts indicates that economic rebalancing is occurring. A broad range of European officials recognise that the PIIGS' adjustment process will be a long-term one. Unfortunately, investors are not always so patient and bond investors are notably skittish, so they are not waiting patiently for such results, especially when they are being openly challenged to bear the burden of any poor sovereign investments. However, we believe that the recent improvements will eventually be realised by investors, especially if the latest promising numbers continue or even pick up in September.

Indeed, if conditions in Europe calm and the market pessimism that has characterised the past few months recedes, then we could see a reduction in volatility in the Australian bond market.

Domestic yields have been extremely low of late, but confidence that Europe is on the right track might ease prices, causing yields to pick up. Current 3-year and 10-year bond yields are lower than the cash rate of 4.75% as the market prices for the Reserve Bank to cut rates. But with a stronger Europe that is demonstrably seen to be taking its problems in hand, pressure on the Australian market should ease. Indeed, focus might fall on the relatively strong domestic data that is currently being overwhelmed by negative investor sentiment due to nervousness about the "European problem" and whether that contagion could spread more widely.

External trade and current account data

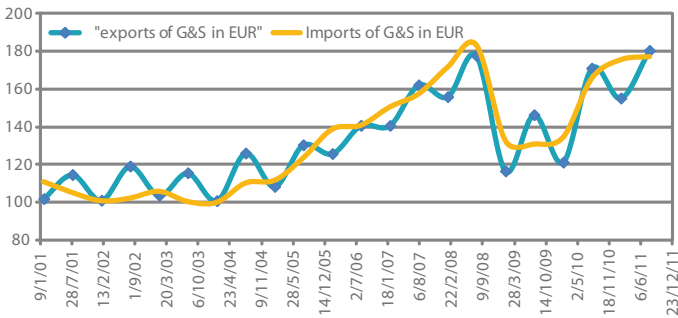
Studying the external trade trends among the PIIGS is very useful, although it hardly gets mentioned in the media. The good news is that there has been strong progress on this front. The first item to note is that the external trade and current account data for the overall Eurozone is well balanced, whereas the US remains broadly in deficit.

In addition, within the current account data, it is important to concentrate on trade in goods and services (G&S), as tourism is such a large part of the Eurozone economy and even more so for the PIIGS countries. Unfortunately, this data is often released six weeks after quarter-end, but the good news is that such exports continued to be firm through August, and well above the pre-Lehman crisis levels.

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Chart 2: Eurozone trade in euros (bil.)



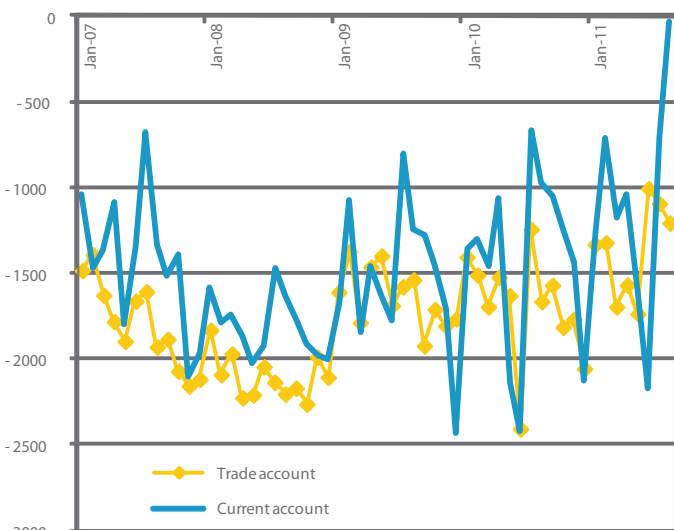
Source: Bloomberg

Importantly, the countries that were worst affected by the crisis were those with large current account deficits. This indicated that domestic demand was far too high and likely financed via unstable internal (based on wholesale borrowing or a large loan-deposit ratio) and/or external capital flows. These countries count on tourism for a crucial portion of their economy, so studying industrial production or goods exports (as economists seem to typically do) is not particularly useful.

Portugal

Portugal has long had a massive current account deficit, at 9.9% of GDP in 2009 and above 10% in the prior five years. The trend had improved only gradually since the first half of 2010, but the number just released for August showed a major improvement. August is typically a better month due to tourism, but this August's number moved to nearly zero, an item hardly reported in the press or in brokerage reports. Indeed, it is difficult to get brokerage estimates, but we expect the current account deficit to fall to 5% of GDP in the second half of 2011 and to 2% in 2012 (the International Monetary Fund (IMF) expects 6.4%), which the market would likely eventually recognise as a major positive. Obviously, an improvement in external trade has a positive effect on GDP, as well.

Chart 3: Portugal external accounts (euros bil.)



Source: Bloomberg

Unlike Spain, Portugal's bond spreads vs. Germany have widened to double-digit levels, with nominal 10-year yields nearly triple what they were before 2010. Very short-term borrowing costs (including to supnationals) are not as burdensome, but it is important to get bond yields down. Portugal is highly integrated into the Eurozone's power structure and its new government is largely trusted to carry through with its pro-market reforms. As Germany and the supnationals hold Portuguese civil servants in fairly high regard and the country's economic abuses were not as severe as in Greece, there is less likelihood of a private sector involvement (PSI) restructuring of Portuguese debt. However, reform efforts and large privatisations must be continued even in the face of protests and there should be a heavy emphasis on attracting tourism.

Ireland

Ireland has had a fairly good record in external trade for many years due to its competitive wage and tax structure within the Eurozone. However, its current account deficit (which is only announced quarterly) was very large before 2009 (5.8% of GDP in 2008, for instance) due to the income expense of large overseas borrowing to fund its property bubble. In the second half of 2010, Ireland shifted to a current account surplus and ended the year at 0.5% of GDP. In the first half of 2011, it shifted back to a deficit, but only a minor one, and the IMF expects a 1.8% surplus this year.

Chart 4: Ireland quarterly current account (euros bil.)



Source: Bloomberg

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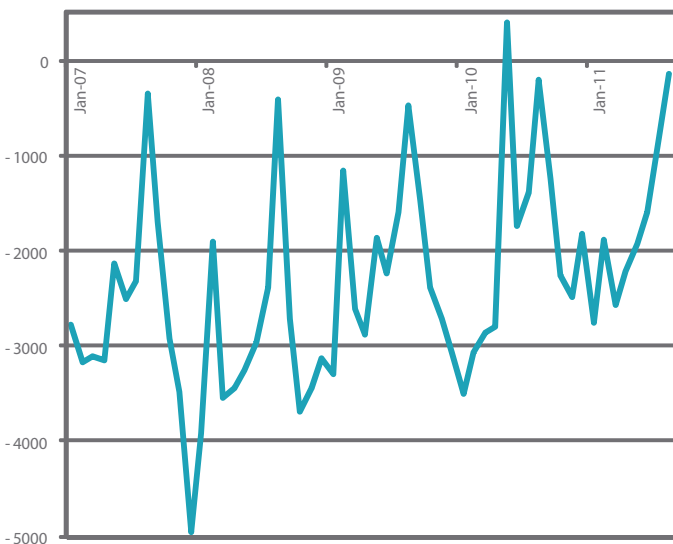
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Greece

It is difficult to say anything positive about Greece without seeming either ignorant or optimistic, but the market has punished it exceedingly hard for its past misdeeds. The government has made great strides, especially now that the latest reform package has been approved. But full implementation of this package along with privatisation, now administered by an EU body, needs to proceed with haste. Meanwhile, tourists must not be scared away by strikes and aggressive attention needs to be paid to wealthy citizens in terms of curbing capital flight and tax evasion. Without heavy "bad cop" pressure (especially from the northern Europeans who need to be convinced that they are not subsidising continued bad behaviour), the Greek Parliament and people would not accept reform. Now that the demands are being met, some pressure must remain in order to prevent backsliding, but the peak of pressure is very likely behind us.

As for the current account, it is much like Portugal, with deficits over 10% of GDP for many years (10.5% in 2010, 11.0% in 2009 and 14.7% in 2008) and only mild improvement until very recently. Indeed, July showed a major improvement (-38% year-on-year) and the just-announced August number was the best for that month since 2006. The IMF expects a decline in the current account deficit to 8.4% in 2011, but we estimate it below 8%. For 2012, the IMF estimates it at 6.6%, but it could well be below 5%, in our view. Of course, like any country, the current account depends on the interest rate it pays on its debt. Nearly all of its recent debt is either very short-term funding at around 4% or to supranationals at bargain rates. Just because the market price for the bond yield has surged to ludicrously high rates, does not mean that Greece's interest costs have increased, as they have not refinanced such long-term bonds nor will they need to through 2013 if they stick to the IMF plan.

Chart 5: Greece monthly current account (euros bil.)



Source: Bloomberg

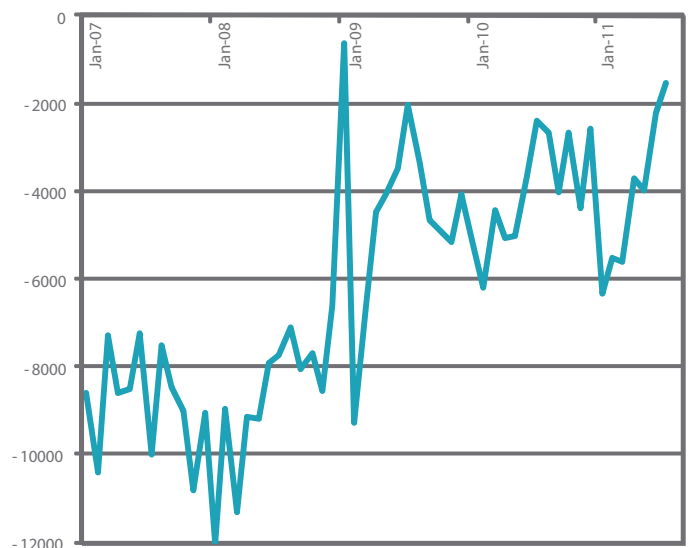
Of course, in Greece's case, its bonds will be subject to restructuring. We continue to expect this to be voluntary and that rates on old bonds do not truly represent Greece's cost of capital. Meanwhile, as a final reminder, in 2012-2013, besides reducing government debt, privatisation proceeds will offset much (if not more than all) current account deficits, as foreigners will likely be the major buyers. Lastly, we believe that Greece will have a major upward GDP revision based on its capturing of the large grey market activities via enhanced tax collection. This will bring down fiscal and external deficit numbers as a percentage of GDP (and gross and net debt outstanding ratios as well), which will likely positively surprise the markets. In sum, we continue to expect Greece to stay in the Eurozone.

Spain

Spain is experiencing an economic crisis much like Portugal's, only much larger. However, its civil service (especially its central bank) is also held in quite high regard by northern Europeans and they trust that it will carry through with the current reform plans, as well as implement new ones as necessary. There would, however, obviously be pressure if there is backsliding, but the potential for a PSI restructuring seems remote in our view. As noted in the introduction, its bond yield spread over German bonds remains high, but the good news is that the latter have fallen sharply, so Spain has not actually had such large increases in borrowing costs. Unlike the PIIGS under IMF programs, Spain continues to issue long bonds, so it is critical to avoid large increases in yields, otherwise the current account will widen.

On the current account front, there has been remarkably good progress, with the GDP deficit dropping from 9.6% in 2008 to 4.6% in 2010. The IMF expects deficits of 3.8% in 2011 and 3.1% in 2012 and we expect the numbers to be better than this, at 3% or below this year and below 1% next year. For July (the latest data available), the deficit fell to the lowest level for that month since 2002. After a few worryingly large deficits early in the year, the trend seems strongly in the right direction, with both trade in goods and services contributing.

Chart 6: Spanish current account (euros mil.)



Source: Bloomberg

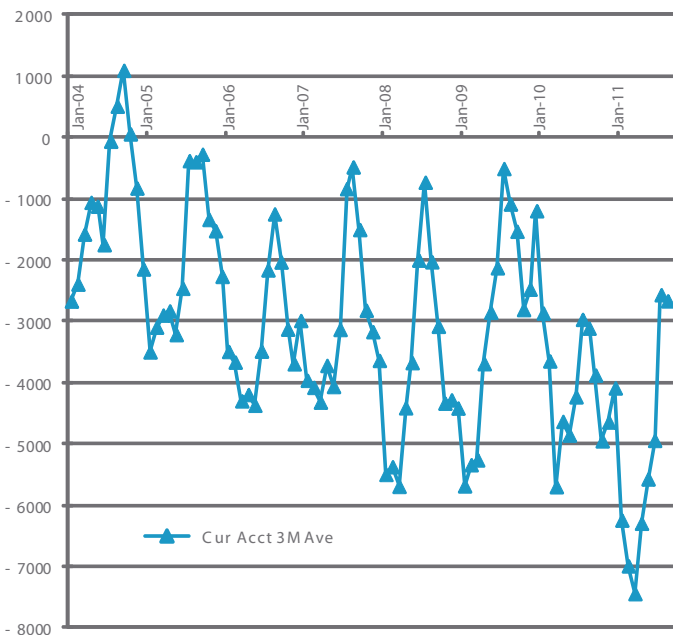
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Italy

The country's current account deficit last year, at 3.3% of GDP, exceeded many analysts' expectations and was actually worse than 2009's 2.8% level. The IMF expects deficits of 3.5% in 2011 and 3% in 2012 but we expect the numbers to be better than this. The three-month average shows a strong improvement trend after a bitterly disappointing first half of the year. Part of the early disappointment was due to Italy's reliance on Libyan oil, which it needed to replace at very high prices and which caused a sharp drop in multinational oil corporate earnings abroad.

Chart 7: Italian current account balance (euros mil.)



Source: Bloomberg

While not a crisis level, Italy's deficit is far from helpful and merits careful analysis. If the ECB had not intervened (as with Spain), Italy's bond financing costs would have spiralled upward, pushing its current account (and budget deficit) to crisis levels.

Italy has progressed on some very important reforms. However, like Greece it needs to enforce tax regulations more carefully. Privatisation is important and further government and labour reforms are essential, while also encouraging the crucial tourist industry. Labour strikes that affect Italy's appeal should be avoided at all costs.

The outlook for PIIGS is not as bad as markets fear

The markets seem determined to cause a crisis and each attempt to solve a problem leads to another problem. However, European leadership is responding with major new efforts to prevent further issues while also not causing moral hazard (allowing investors to avoid pain on the downside and thus encouraging speculation) nor too much pain for voters in the non-PIIGS countries. That said, perhaps policymakers realise that the insistence on PSI, while well morally grounded, actually increased the costs of reform as it created contagion (including causing a directly-linked downgrade of Portugal by credit rating agencies), and thus, higher potential losses by Eurozone banks. This may well end up causing credit contraction globally, but most especially in the Eurozone and Eastern Europe.

It is a delicate balance, but at least progress is being made (whereas other leading countries have yet to begin fiscal austerity) and if the bank capital-raising effort can be achieved without causing a major credit contraction, then the Eurozone is well on its way to stability. Indeed, if the reform effort continues to go well, there is a good chance that the northern Europeans, especially Germany, will continue to mollify their rhetoric and that problems will be handled in a proactive and consensual nature. Although the Germans need to be patient—years of fiscal and tax abuse cannot be solved in one year. If they are not, anti-German sentiment will also likely spread. Germany has already lost the ECB Presidency candidacy and the hardline Jurgen Stark is being replaced by a moderate German, although even Mr. Stark now seems to acknowledge that it was right not to let the PIIGS crisis ensue without major, unorthodox ECB efforts. Moreover, it would be wrong for investors to assume that Mario Draghi will be as conservative as he now appears.

Indeed, the odds of a Eurozone break-up will increase further if monetary policy is too tight in the next few years, and we expect a rate cut in the next couple of months, perhaps including an easing of the interest rate corridor as well. We also believe that the ECB may keep the bonds it has purchased rather than transfer them to the EFSF, which will likely positively surprise the market. It's also far from impossible for it to continue buying bonds, although as led by an Italian, this would likely be done on a basket basis.

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Conclusion

The European debt markets remain over-pessimistic, in our view. One cannot cure a chronically sick patient in one day and progress is already being made. The European issue is partly due to the fundamental problem of economies having to adjust to economic shocks while dealing with a fixed exchange rate. Labour and product markets have to become more flexible as a result. Additionally, there was no mechanism to offset the internal balance of payment imbalances within Europe.

The reduction in these imbalances is a positive, at least for the short term. It seems that new institutions and fiscal rules are slowly being created to help ease this fundamental problem. Ultimately, the ECB has to act for the whole of Europe rather than one area. What is needed is time and encouragement for further current account deficit reductions. In the meantime, we do not believe that the markets have truly appreciated the decline in the PIIGS' current account deficits. When they do, it may well entail declines in market rates.

It might also lead to renewed investor confidence in the Australian market with an increase in bond yields and a reduction in the recent market volatility. Much of the current domestic market disruption is due to politics and associated declines in confidence, with risk aversion reflecting fears about the sovereign debt issues in Europe. If Europe is seen to be stronger, it would also reduce the pressure on the Reserve Bank to cut interest rates further, particularly given the relatively strong domestic data that we have seen of late.

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