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Testing the Euro-Zone

Clients have been asking about implications of the Greece debt crisis on the broader financial markets. When worries about Greece's ballooning budget deficit surfaced in late 2009, our inclination was to view the problem as too small to matter. Our reasoning was the Greek economy represents only 2.4% of the euro-zone's GDP and exposure of U.S. institutions to Greek debt is modest, representing about 5% of the \$400 billion in Greek government debt outstanding.

Meanwhile, however, the problems in Greece have mounted steadily and spilled over to other parts of Europe. Standard & Poors recently lowered Greek government debt to junk bond status, and it warned that investors were likely to get back only 30% to 50% of their investment in the event of a default or restructuring. At the same time, the agency downgraded the government debt of both Portugal and Spain, while keeping them at investment grade status. Amid these developments, market participants are concerned the crisis in Greece is morphing into a bigger issue, just as the subprime problem did.

Our assessment is that the crisis in Greece matters, because it represents the first major test of the viability of the euro-zone. Because Greece does not have the latitude to depreciate its own currency or to alter monetary policy, the burden of adjustment rests entirely on its ability to rein in its massive budget deficit. In return for receiving 110 billion euro (\$145 billion) over three years from other European Monetary Union (EMU) members and the International Monetary Fund (IMF), the Greek government recently agreed to reduce its budget deficit from 13.5% of GDP to 3% by 2014. However, market participants are skeptical that Greece can deliver on its pledge.

In our opinion, Greece's debt burden is too great and will ultimately require some form of debt relief. While the rescue package alleviates the need for Greece to tap capital markets in the next year or two, investors are now focusing on whether Portugal and Spain can lower their debt burdens. While several highly-indebted countries in Europe were able to grow their way out of their problems in the 1980s and 1990s, the challenges today are more daunting.

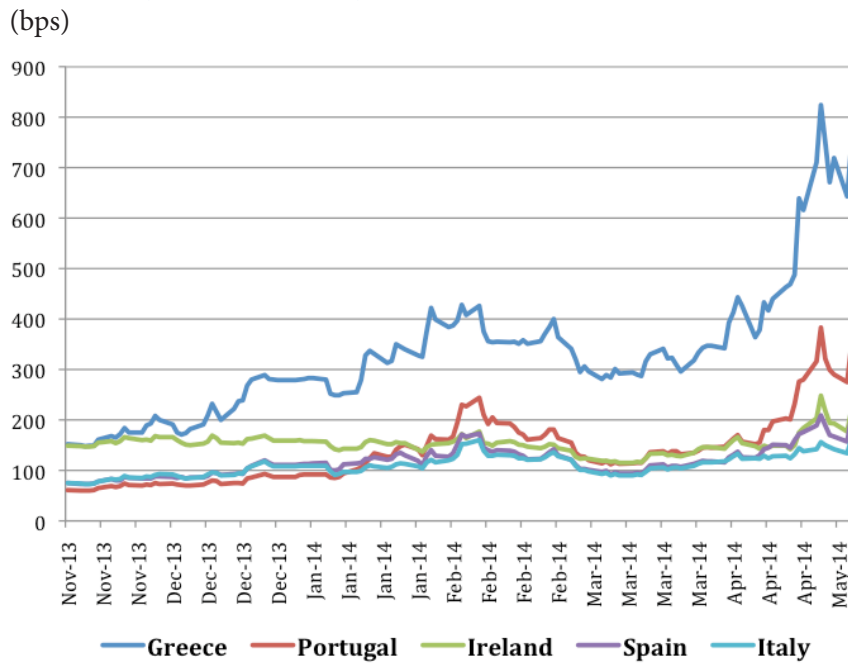
On the investment side, the crisis in Europe has contributed to a recent sell-off in U.S. and world equities, and a rally in U.S. treasuries. However, **we do not expect developments in Europe to derail the global economic expansion**, given the strength in Asia and steady recovery in the United States. **Our main concern is the exposure that European banks have to debt in Greece, Portugal and Spain and the possibility of additional downgrades** of sovereign debt, which could spawn lending cutbacks in Europe. We have not altered positioning in client portfolios, because our holdings of European sovereign and bank debt are minimal. However, we are monitoring the situation closely and would contemplate paring back on riskier assets if the crisis spreads.

Deepening Crisis

A disturbing aspect of the Greek debt crisis is how rapidly it has grown in magnitude and spread among other European countries. Just a few weeks ago, the Greek government was negotiating a one-year support package of 40 billion euro with EMU members. In the wake of S&P's downgrade of Greek government debt by a full grade (BBB+ to BB+), however, the package was expanded to 110 billion euro over three years, including support from the IMF.

Meanwhile, S&P also downgraded the government debt of both Portugal (A+ to A-) and Spain (AA+ to AA), respectively, and investors are concerned that other highly-indebted countries such as Ireland and Italy could be affected in the future. This is illustrated in Figure 1, which shows the 5 year credit default spreads (the annual cost of buying protection against default) for the countries currently in the spotlight. If European financial institutions that hold the debt of these countries wind up taking significant losses, it could affect their willingness and ability to lend.

Figure 1: Sovereign 5 Year Credit Default Spreads



Source: Bloomberg

The recent developments beg an important question: Why have investors suddenly become so concerned about the debt of Greece and other European countries?

Our answer is that the crisis represents the confluence of several factors that are linked to the formation of the euro-zone. In the early 1990s, when the stage was being set for the launch of the euro, the Maastricht Treaty spelled out criteria that countries needed to meet to be eligible for membership, including two that covered their fiscal positions:

- Government budget imbalances were not to exceed 3% of GDP; and
- Government debt outstanding was not to exceed 60% of GDP.

While Greece and the other entrants met these criteria initially, budget deficits for several member states in the meantime have far exceeded those specified in the treaty. (See Figure 2.) To some extent, the ballooning of the budget deficits represents the fallout of the 2007-2009 financial crisis, which took a heavy toll on the European economies. In addition, countries in Southern Europe have been running large current account imbalances, as their costs are too high relative to those in Northern Europe.



Figure 2: Budget and Current Account Deficits within the Euro-zone (as % of GDP)

	Budget		Current Account	
	2007	2009	2007	2009
Germany	0.2	-3.3	7.6	4.8
France	-2.7	-7.9	-1.0	-1.4
Netherlands	0.3	-4.9	8.7	5.2
Greece	-3.7	-12.9	-14.4	-11.2
Portugal	-2.6	-9.3	-9.4	-10.0
Spain	1.9	-11.4	-10.0	-5.1
Ireland	0.0	-11.4	-5.3	-2.9
Italy	-1.5	-5.3	-2.4	-3.4

Source: IMF, World Economic Outlook, April 2010

For a while, investors were willing to look past the immediate situation, because they believed the respective countries would be able to bring their deficits under control once economic growth was restored. Recently, however, investors have begun to question this premise. The catalyst was an announcement in November by the newly-elected Greek government that the country's fiscal situation was much worse than had previously been reported. Since then the terms on which the Greek government has been able to finance its debt have become increasingly onerous, and the Greek government sought the assistance of the EMU and the IMF.

Meanwhile, the crisis in Greece has underscored the lack of a formal mechanism to resolve this issue within EMU. As negotiations between the Greek government and other member states dragged on, market participants began to question the willingness of Germany and other member states to provide assistance for Greece or other highly-indebted countries. By the time the authorities unveiled the rescue package, investors had concluded the problems Greece encountered were basic solvency issues rather than temporary illiquidity problems. If so, the risk is that the 110 billion euro support package for Greece will be squandered and only postpone the inevitable.

We share the market's skepticism about Greece's ability to service its debt. Even with the austerity program, the country's ratio of public debt to GDP is projected to rise further and reach a peak of 150% of GDP in 2013. Meanwhile, its ratio of external debt to GDP stands at 176% of GDP. The associated debt servicing burden is at levels that typically require some form of debt relief. And while the package buys Greece time to make necessary adjustments, it is questionable whether the Greek populace will accept recession over the next few years.

Can the Fallout Be Contained?

A key issue now is whether the crisis can be confined to Greece. On the heels of the S&P downgrades for Portugal and Spain, both countries experienced a widening in their credit spreads versus German government bonds and sell-offs in their financial markets. At the same time, the rescue package for Greece had the unintended effect of adding to concerns about their ability to service their debt obligations.

On the surface, at least, Portugal and Spain share some characteristics with Greece in terms of having large budget deficits (9.3% and 11.4%) and current account deficits (10% and 5%) relative to GDP. However, there are also important differences. For example, Spain's ratio of public debt to GDP (68%) is well below Greece's, and its national saving rate is considerably higher, which should make it easier to obtain financing from the markets.

Meanwhile, both the Portuguese and Spanish governments have been proactive in announcing measures to reduce these imbalances. Earlier this year, for example, the Spanish government announced an ambitious fiscal austerity plan, with the goal of cutting the budget deficit to 3% of GDP by 2013. Also, the Portuguese Prime Minister recently announced that he and the opposition had reached agreement on speeding up its austerity program.

Investors now are assessing whether these highly-indebted countries can reduce their fiscal imbalances significantly without impairing their growth prospects. A special report by the Bank Credit Analyst (BCA) finds some grounds for optimism based on the experience of other highly indebted European countries:

“In many past episodes of sharp fiscal consolidation in Europe, not only did the growth remain positive, but in fact accelerated. There are at least seven instances in Europe over the past thirty years where fiscal deficits were reduced by 10% or more, and in all countries except Greece, growth accelerated.” * (See Figure 3.)

Figure 3: Fiscal Retrenchment in Europe

	Denmark (1982 – 1986)	Belgium (1984 – 1998)	Greece (1989 – 2001)	Ireland (1986 – 1996)	Sweden (1983 – 1988)	Sweden (1993 – 1998)	Finland (1993 – 2000)	Median
Size of Budget Adj. (%GDP)	13.6%	11.1%	9.9%	15.4%	10.2%	16.4%	15.0%	13.6%
Length (years)	4	14	12	14	5	5	7	7
Real GDP Growth Rate Before Adj. (5year CAGR)	1.0%	1.4%	2.3%	2.6%	1.7%	0.6%	0.0%	1.4%
Real GDP Growth Rate During Adj. (5year CAGR)	2.6%	2.8%	0.8%	4.9%	2.8%	2.8%	4.7%	2.8%
Difference in Real GDP Growth Rates*	1.4%	1.4%	-1.5%	2.3%	1.1%	2.1%	4.7%	1.4%

Source: BCA, Special Report, April 30, 2010

Nonetheless, we believe it will be more difficult for highly-indebted countries to grow their way out their problems today. First, global economic conditions are not very robust, and Europe, in particular, appears mired in a slow growth environment for the foreseeable future. Second, the countries in need of adjustment already are in or near recession. Spain’s economy, for example, contracted by 3.6% in 2009, and its unemployment rate is approaching 20%. One of the factors cited in S&P’s downgrade of Spain was that it appears headed for “an extended period of subdued economic growth, which is weakening Spain’s budgetary position.” Third, European countries previously had freedom to depreciate their currencies or to alter their monetary policies to promote adjustment. This no longer is the case for members of the euro-zone.

How will the European Union be able to address these issues? Unfortunately, we do not see any easy solutions. We think the assessment of Martin Wolf of the Financial Times (May 5, 2010) sums it up best:

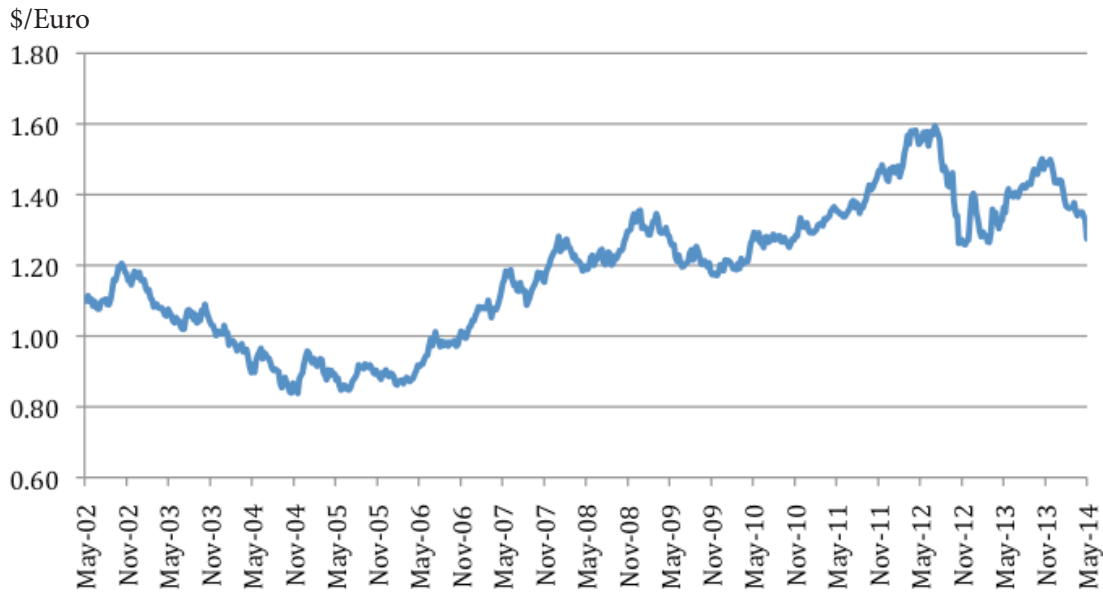
“For the eurozone, two lessons are clear: First it has a clear choice – either it allows sovereign defaults, however messy, or it creates a true fiscal union, with strong discipline to cushion adjustment in crushed economies.”



Investment Implications

In the wake of these developments, it is difficult to decipher how things will play out. What is clear is that the Greek debt crisis has mushroomed into a test of the very underpinnings of EMU. Some observers have described the creation of the euro-zone as the triumph of politics over economics, and the current situation may be characterized as “economics strike back.” With no clear resolution in sight, we believe the euro could slide back to the \$1.20 level, where it was launched in 1999, and possibly fall below it. (See Figure 4.)

Figure 4: The Euro-Dollar Exchange Rate



Source: Bloomberg

The crisis has contributed to a pullback in U.S. and world equities recently, as well as flight to safety into U.S. treasuries. At this stage, however, we do not foresee problems in the euro-zone undermining the global recovery, especially with China and other Asian economies growing rapidly and the U.S. economy continuing to strengthen. But we cannot rule out a “tail risk” possibility of 5% or so that the crisis could eventually spill over to other parts of the world.

Our main concern is that sovereign debt problems eventually could affect European banks and induce lending cutbacks in the region. Such an outcome would add to the risks of a “double dip” in Europe. Thus far, we have not altered our investment strategies for client portfolios, as we have only modest exposure to European banks and no exposure to European government bonds. However, we are monitoring the situation closely and are prepared to pare back on risk assets if the crisis continues to spread.

