

MARKET REPORT

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The past two weeks has been incredibly busy and a lot of important decisions have been made. Initially the stock markets rallied and the interest rates fell in the debt crisis countries as a response to the EU summit. For a while the risk of a Greek bankruptcy and default fell significantly but when the Greek Prime Minister proclaimed a possible referendum about the savings package the market was in free fall and the Greek 2 year sovereign bonds skyrocketed as well as the 10 year bond.

During last Wednesday night's EU summit the EMU politicians agreed to write off the Greek debt by 50 per cent, which is equivalent to decreasing their debt by 100 billion euros. The plan is to halve the total value of the Greek treasury bonds but on the other hand this is based on free willingness. Consequently there are no guarantees that private creditors are prepared to let go of half their claims on the Greek government. However the argument against this would be that there are no other options because a Greek default would lead to suspended payments and then creditors would not be able to get any money back at all. On the bad side, either alternative could end up in a credit event if Greece is not able to honor its obligations. Ultimately that would trigger insurance derivatives like credit default swaps, which would result in an uncontrollable situation.

Furthermore one can ask whether the write down of 50 per cent is enough, since the goal is to achieve a debt level of 120 per cent of Greece's GDP by 2020. That is the same level as Italy's today, which is already too high and thus further substantial deleveraging has to be made to calm the market.

Another conclusion from the EU summit is that the emergency fund ESFS will be considerably expanded to a trillion euros, mainly funded by the Chinese if all goes well. If China will help or not probably depends on what they can get in return, yet it is not obvious what that will be.

At the meeting they also determined to raise and sharpen the capital adequacy requirements and to recapitalize the banks' balance sheets. However there is confusion about who will provide the contribution of 109 billion euros, which is the estimated need of capital to reach a core tier capital ratio of nine per cent.

Simply put, it means that shareholders' equity must reach a level of nine per cent of their total assets. Some of the capital could be raised through public offerings but the question is if that will be enough. An alternative is that the banks cut down their lending, decreasing their assets and thereby achieving a higher ratio. On the other hand that could increase the risk of a dry up in the credit market, which would be unfortunate since the economy already might be going into a recession as it is. A restrained financial policy is the last thing we need right now. Another solution that could avoid this situation could be nationalization; a capital injection through governments stepping in as a major shareholder, which is not unfamiliar to what we saw in the U.S. three years ago.

As a conclusion the general response from the EU summit and the G20 meeting in Cannes is positive. The results show that the European leaders are ready to take decisive actions. Nevertheless there are still many problems to be solved and at the time of writing a coalition government has been established in Greece. This is the end of Giorgos Papandreu's time as Prime Minister. It is now up to this coalition to give Greece access to the second savings package of 135 billion euros and the write off of their debt. Answers lies in the future and only time will tell. The next thing to keep track on could be the outcome from the meetings in Brussels this week when the Greek Secretary of the Treasury meets with the other EU colleagues.

Lastly, market focus has recently turned to Italian bonds as yields rise to record levels. Uncertainties if Italy soon will be excluded from international capital markets increases concerns about the survival of the euro.

Sebastian Ryman, Investment Society

"We are experiencing very demanding times." - Jean-Claude Trichet, ECB President, insightfully describing the European debt crisis.