

WOODSTOCK

QUARTERLY NEWSLETTER

Europe is a Mess

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We couldn't go to press with a newsletter at this time without some comment on Europe. While some of the volatility in our financial markets can be attributed to our own fiscal challenges, Europe's financial condition is also weighing heavily on markets throughout the world. The fundamental problem is that the Eurozone has one currency (monetary system) and 17 different fiscal systems. The monetary system cannot accommodate the diverse needs of those 17 different economies and has no effective way to enforce fiscal discipline on its members. The Eurozone may eventually take some steps toward greater fiscal integration, but Europeans are not ready to politically integrate in what would be analogous to a shotgun wedding.

The Eurozone established the European Financial Stability Fund (EFSF) in May 2010 to help fund the bailouts of heavily indebted members. So far, Greece, Ireland and Portugal have received bailout packages. This past July European leaders proposed expanding the fund to €440 billion from €250 billion to deal with additional issues and a greater need for capital. This expanded commitment, however, must be legally approved by the parliaments of all 17 nation members, making for a deliberative and painstakingly slow process. Over the last two weeks countries from outside the Eurozone have expressed their frustration at the pace of progress as markets throughout the world retrench due to a lack of confidence in western leadership.

Officials have insisted that Greece's second bailout package, also negotiated in July, would not constitute a default. Under the proposal, debt holders would be given a series of options, some of which would entail an EFSF guarantee, but holders would have to extend their maturities and take a 21% write down on their existing principal. Since then, fiscal progress has continued to disappoint, largely because the Greek economy is shrinking faster than expected. EU officials are now talking

about renegotiating the bailout a third time, allowing Greece to write-down its debt by 50%. While Greek Prime Minister George Papandreu is committed to fiscal austerity, his party is becoming increasingly unpopular. Greeks are resentful of the austerity measures they see as being imposed by their foreign financiers. It's quite possible that at some point Greeks will experience "austerity fatigue" and defiantly opt to expand fiscal deficits.

Meanwhile, European countries with strong savings rates, particularly Germany, resent the idea of giving away hard-earned tax dollars to profligate countries. German Chancellor Angela Merkel has been an advocate of helping Greece, but this position is costing her political support. Given that neither the Greeks nor the providers of bailout funds are particularly pleased with the prospect of ever expanding bailout terms, the current arrangement could easily fall apart. A more dramatic default may be necessary to appease public demands and at the same time effect a change in public attitudes on both sides of the equation. Unfortunately, it would mean Greeks suffer further hardship.

There would be multifarious implications of such a default. Concerns would be: (1) how would Greece continue to fund its government spending after default; (2) would there be a run on all Greek banks; (3) would European banks (particularly German and French banks) continue to be solvent if they have to write down their sovereign debt holdings; (4) would fears of sovereign default spread to other European countries, according to their level of debt-funded spending; and (5) would Greece leave the Eurozone? Let's take these issues one by one.

(1) With debt financing alternatives closed to Greece, the government would not be able to spend more than the tax revenue it collects. Even though the Greek economy has already

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contracted some 12%, the budget deficit still accounts for 9% of GDP. The Greek economy is small enough that the EU could step in and realistically provide some assistance for some period of time. A default would reduce Greece's debt burden and increase the likelihood of any subsequent financing getting repaid.

(2) The Greek banks hold a lot of Greek sovereign debt, prompting fears of insolvency. The European Central Bank (ECB) would probably continue to finance Greek banks. Clearly, a run on the Greek banks would also force the economy to come to a screeching halt.

(3) European banks are not well capitalized. They would have to write down not only their Greek sovereign debt, but Greek private sector debt as well. If default fears spread to other European nations, they may have to write down this debt too. The International Monetary Fund has estimated that European banks' exposure to countries with debt problems could be as high as €300 billion. Insolvency of a major European bank would be unthinkable, so someone would have to provide further funding for them. The US Troubled Asset Relief Program (TARP) provided equity funding to US banks in 2008, and it is likely that either the ECB, the individual country central banks, or the country governments would be forced to enact a similar program in Europe.

(4) The most concerning risk is the threat of financial contagion. In 1998, fears of currency devaluation ravaged Asian economies. Likewise in 2008, fears of insolvency gripped investors in US investment banks. The prices of stocks and bonds of US banks fell like dominos. The European debt crisis could fit this model. We do not know that contagion will take hold, but if officials do not appear to be in control of the situation, it is more likely to happen. If Greece defaults, investors would worry about Portuguese, Irish, Belgian, Spanish and Italian debt. Whether the fears are justified is somewhat moot - fears of insolvency can become self-fulfilling. As investors lose confidence in a country's ability to repay its debts, the interest rate demanded on new debt and refinancing rises. Higher debt service burden puts further pressure on the country's budget. Economic contraction can also exacerbate the problem, and be self-reinforcing. As we are seeing in Greece now, economic decline increases fiscal deficits, making

it even more difficult to repay existing debt. While interest rate spreads for many sovereign debt issuers have already widened significantly, contagion has been constrained by the belief that a Greek debt restructuring would not be disruptive.

The fiscal problems in other European countries are not nearly as bad as in Greece, but if investors start to panic, that hardly matters. If the debt markets shut down for Portugal and Ireland, the EFSF could probably cover their fiscal deficits for a couple of years, buying governments time to make further adjustments. However, Spain and Italy, responsible for 12% and 17% of Eurozone GDP respectively, are the 800 pound gorillas in the room. It is extremely difficult to see how any European government body could fund these deficits without resorting to printing money. Analysts have estimated that the EFSF would need anywhere from €1 to €3 trillion to support their near term fiscal needs.

(5) Greece may decide that it's better off solving its economic problems by leaving the currency block. The country could reintroduce the Drachma, which would then rapidly devalue relative to the Euro. However, leaving the Euro would create as many problems as it would solve. Many Greek companies have debt denominated in Euros. Determining how existing contracts get re-denominated would provide a massive legal problem, and could force many companies into bankruptcy. For this reason, many European leaders are encouraging Greece to stay in the Euro.

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Members of the Eurozone

	Government Debt (% of GDP)	Government Sector Deficit (% of GDP)
Greece	149.6%	-9.2%
Italy	119.9%	-7.8%
Ireland	102.7%	-13.2%
Belgium	100.0%	-8.6%
Portugal	94.0%	-7.7%
France	84.4%	-5.8%
Germany	82.5%	-1.7%
Austria	72.8%	-6.9%
Malta	69.7%	-2.8%
Spain	63.6%	-2.4%
Netherlands	63.2%	-2.1%
Cyprus	63.0%	-7.4%
Finland	46.0%	-0.9%
Slovenia	45.2%	-10.3%
Slovakia	42.3%	-4.0%
Luxembourg	18.2%	-3.5%
Estonia	6.4%	-2.5%

**GDP figures are for 2010. Debt and Deficits are as of Q1-2011
Source: Eurostat, The Economist*

Europe is a Mess (continued)

There are different factions within the European system that have different solutions to Europe's sovereign debt problems. Political leaders disagree, and may be thinking that as the crisis intensifies, other constituents will come around to their point of view. The discord and lack of progress is further eroding public confidence. We can only hope that more thoughtful planning is going on beyond the light of public scrutiny.

The other problem is Europe's structure. It takes several months for 17 different parliaments to ratify a new EU proposal. However, the capital markets will not wait for months, and economies will suffer as well.

Until further action is taken, it seems likely that credit in Europe will continue to contract. We have seen this script before. It is not unlike the credit contraction the US experienced in 2008 and 2009. Hopefully investors and political leaders are all the wiser following that episode. The answer is to provide liquidity. If no entity has sufficient liquidity to cover these monumental liabilities, the solution is to print money. The ECB and the Germans are very far away from this viewpoint now, and have not explained what

they would do if the credit contraction continues. If the credit contraction starts to impact the US economy, the Federal Reserve is more inclined to print money. Meanwhile, the German-minded ECB President Jean-Claude Trichet is due to retire in November. His successor, Mario Draghi, a former Governor of the Bank of Italy and a former employee of Goldman Sachs, may be a force for more aggressive monetary policy. Any change in monetary policy could drive stocks sharply higher.

We anticipate further volatility in financial markets as this scenario plays out. Stocks are inexpensive now, discounting at least some of these problems. There is light at the end of the tunnel, but we are in a tunnel. Our challenge is to find spots where we can achieve adequate returns and preserve capital for our clients. Our strategy has always started with building a solid portfolio of good domestic companies. Furthermore, we have recently emphasized a more US centric investment strategy. Though our economy may hit a soft patch, we remain confident that our client portfolios are well positioned to withstand any shock and come out the other side even stronger. ♦

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A Word on Bond Funds

Lawrence S. Foster

I often run into people who ask how I'm managing money in the current market and what I am investing in. To be honest, I find that to be a bit of a trap question because the answer is always "well that depends on the client, and what they already own." However, we do have one issue which is common to nearly all investors today, and that is: "how can I generate income when interest rates are at historical lows?" Occasionally, someone has a thought about a particular high yielding security, but recently a friend told me about his bond fund that was yielding 3.5% pre-tax. After asking a few questions, I discovered my friend was invested in an intermediate term (5-10 year maturities, average likely 7 years), municipal bond fund. With the interest rate on ten year Treasuries now hovering near 2%, it became clear to me that the true yield of my friend's bond fund was something very different than he thought, but to explain it was going to take some time.

Now, the subject of bonds can be very confusing to most people so let me first run through a few basic concepts. In general terms, a bond's "price" is often quoted in terms of yield or yield to maturity. There are several components of a bond that impact yield—they are the coupon rate (interest paid monthly,

quarterly or semi-annually), the price paid for the bond, credit quality and the time to maturity. The yield investors are willing to accept for a bond is set by "the market" on a daily basis and is typically impacted by expectations for inflation, economic growth and anticipation of monetary actions by the Fed.

When general market interest rates move lower, as they have for the past ten years (see chart of 10 year Treasuries on the next page), the price of existing bonds moves higher. So, for example, a 10 year bond paying a 4% coupon five years ago may have sold at par (\$100). Today, a similar 10 year bond paying 4%, would be selling at \$118- in order to match prevailing yields of 2%. However, financial statements can show a different yield that provides a false sense of income and rate of return.

In order to make my point clearly, I show below two different bonds that will mature 10 years from now. If the market is efficiently pricing two comparable bonds, they should have the same yield to maturity. If they have different coupons, the market price will reflect whatever difference is necessary to offset the difference in coupon rates to

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Source: Bloomberg

bring the yield to maturity into line. For this example let us assume the yield to maturity for both is 2% (actual yields for 10 year municipal bonds today are very close to 2%). Bond A is issued at par and therefore pays interest at 2% per annum. Bond B has the same maturity and same credit rating as bond A, but because some bond buyers want to show higher yields, it will pay a 4% coupon annually. Since the coupon rate is higher than the current market rate, we know the bond will sell at a premium and in this case the price to provide an equivalent yield of 2% is \$118.

	Bond A	Bond B
Yield to Maturity	2%	2%
Coupon Rate	2%	4%
Annual Coupon Income	\$2	\$4
Price	\$100	\$118
Current Yield	2%	3.4%
Ret. of Principle at Maturity	\$100	\$100
Gain or Loss of Principal	\$0	-\$18

What is important to recognize is that the yield to maturity for these bonds is exactly the same. The yield to maturity takes into account the timing of payments and receipts. Yes, bond B does pay higher interest, but you have to pay \$18 more for that up front. Most of the higher interest received over the course of the 10 years is actually return of principal (premium)- yet it comes to the holder as interest, not as principal. Therefore, if the owner of a premium bond views interest payments as income, the owner also needs to realize that he or she will have less principal to reinvest upon maturity- having invested \$118 at the start, and receiving \$100 at maturity.

When an investor buys bonds individually, he

or she can control the amount of premium paid for any particular bond. On most quarterly statements an investor can typically review the cost basis, market value and interest (paid or annualized). Often yield to maturity is also displayed, but more commonly current yield is the number displayed. However, bond funds, on the other hand, do not have an end date and therefore they don't typically prominently display yield to maturity. Instead, a bond fund might prefer to show the current yield of the fund (annualized income divided into market value). In the example above, the current yield of the premium bond is 3.4%, but the yield to maturity is really 2%.

Keep in mind that any bond fund, but in my friend's case an intermediate bond fund, will constantly have bonds maturing and proceeds to reinvest. In order to maintain the appearance of a higher yield, premium bonds will often be purchased. Imagine if the fund was largely made up of premium bonds. The current yield could misstate the real yield of the bond fund by 50% or more.

When we buy bonds here at Woodstock, we typically don't like to buy bonds at high premiums particularly for clients who rely on their investment accounts for income. If we do pay premiums, we try to keep the premium within 3-4 points of par. The higher interest payments give the owner a false sense of income. For clients that are concerned about erosion of capital, premium bonds are not a good idea unless they are willing to amortize the premium as an offset against interest received to compensate for loss of principal at maturity. ♦

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