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The European Debt Crisis

by Brian J. Friedman, CFA

During the second quarter the European debt crisis reignited fears that perhaps the global economy and financial markets were no longer recovering, and could tumble back to the lows of early 2009. Many clients experienced renewed anxiety as they relived the fear that gripped the financial markets in the wake of Lehman Brothers' bankruptcy in 2008. In response to the events in Europe the S & P 500 Index slid 15.33% between April 23, 2010 and June 30, 2010. Despite this decline the S & P 500 Index remains 52% higher than the lows of March 9, 2009.

Although the recent debt crisis began in Greece, the associated panic reflected a deeper, more global reality. Governments all over the world stemmed the recent financial crisis in three major ways:

1. They injected equity capital into the banking system to cover loan losses and prevent systemic failure.
2. They guaranteed certain financial system liabilities to prevent a "run on the bank."
3. They boosted spending to stimulate demand and prevent another Great Depression.

Of course, building confidence in the banking system through government guarantees and financing requires confidence in the fiscal soundness of government. These three policies boosted government spending and debt just as the economy shrank, unemployment mounted and tax revenues dropped.

Over the past two years national governments generally followed standard Keynesian macroeconomic policies, insisting that short-term deficits were necessary to stem the economic slide. Unfortunately, a number of governments adopted expansionary fiscal policies despite already high levels of debt and unsustainable long-term financial commitments for pension and health programs. Euro Zone countries, in particular, faced greater pressure because their economies grew slowly over the past twenty years due to lower productivity, heavier regulation and more limited business competition.

The European social welfare model is insolvent based on the expensive commitments governments made to their people. These commitments include generous health care programs, early retirement pensions, and high unemployment benefits. In addition to these various forms of social insurance, European governments actively regulate their economies to create a more "orderly" (in their view) marketplace. Most European governments impose regulations to limit business competition and protect jobs. By protecting existing jobs and employers, however, they reduce incentives to start new companies, innovate and hire additional employees. As a result of these policies European countries suffer from chronically high unemployment, low productivity growth, and sluggish economies.

While all European governments pursue these policies, not all of them pursue them to the same extent. Britain, which is not a member of the Euro currency zone, is generally more free market oriented while France leans toward government intervention and regulation. Germany tends to sit somewhere in-between. Economic growth was generally more robust in Britain over the past twenty years, followed by Germany with France lagging behind. Following even more distantly are the now troubled countries of Greece, Italy and Portugal.

Although Spain and Ireland pursued more free market oriented policies in recent years, they now find themselves in financial hot water due to over-investment and excess capacity. These are the more traditional maladies of the boom and bust economic cycle. All of these countries are now lumped together by the media under the inglorious title: PIIGS (Portugal, Italy, Ireland, Greece and Spain).

Greece quickly became the focal point of global investors because it combines the most troublesome features of all European economies into a single, small package. Greece is one of the least productive economies in the Euro Zone, where the national government still owns outright a number of large companies and tightly regulates the private sector. Greece also maintains a generous welfare state despite a long history of tax evasion by its citizens.

Ironically Euro Zone membership benefited Greece tremendously prior to the current financial crisis. Starting in the 1990's Greece implemented more stable macroeconomic and regulatory policies. These policies substantially reduced inflation, boosted economic growth and allowed the government to borrow money at reasonable interest rates. The same can be said of all the PIIGS countries.

The PIIGS are not all the Same

As fears mounted that a Greek default was imminent, investors fretted that perhaps other PIIGS countries could meet the same fate. Beyond the PIIGS, investors also worried that larger, more solvent countries such as France, Britain and the United States could face a similar situation over the long term. We believe that insolvency is unlikely for most of the PIIGS, and a distant risk for Germany, France, Britain and the United States.

The sovereign debt crisis highlighted four risk factors. While each risk factor is a problem that must be solved over the long term, Greece is the only country that currently exhibits all four. This confluence of risk factors made Greece the epicenter of this crisis, but finally motivated action by all European governments to contain the trouble. The four sovereign debt risk factors are (**please see Tables 1 & 2**):

1. Total government debt outstanding.
2. The size of the government budget deficit.
3. Timing of government debt refinancing.
4. Whether the government debt is owned domestically or by foreigners.

As can be seen in **Table 1**, Japan's debt burden is larger than Greece, yet we do not see the same bond market turmoil in Japan. Similar to the situation in the United States, most Japanese government bonds are owned by Japanese citizens.

Italy is not far behind Greece in terms of its debt load, but its bonds remain more stable. This is because Greece not only has a large amount of debt, but it also has a budget deficit nearly double that of Italy. In addition, Italian debt is held mostly by Italians rather than foreign investors.

Finally, Greece has a daunting bond maturity schedule. The total amount of outstanding debt that will require refinancing over the next five years represents 62% of annual GDP (**see Table 2**). Japan and Italy must also refinance a large portion of their debt, which is certainly a risk factor for their bonds if they do not reduce their budget deficits over the next several years.

While most governments must tackle at least one of the four debt issues outlined above, only Greece is required to tackle all four immediately. Other European countries, however, clearly took note of the Greek predicament and are now acting to cut their budget deficits.

Recent Market Turmoil Motivated Action

As outlined above, Europeans watched in horror as Greek government bond yields rocketed from 4.3% to 13.1% within a few months. Greek bond prices threatened to plummet further as investors worried Greece might default. The Greek government responded with deep budget cuts and tax hikes. When these proved insufficient to calm the growing panic, the European Union and International Monetary Fund pledged nearly $1 trillion in assistance to Greece and the other PIIGS.

Even more importantly for the long run, however, European governments are rewriting their social contracts with their citizens. The shift is not due to an ideological change of heart rather the welfare state is under financial duress. For example, after decades of expanding benefits, the French government proposed boosting the qualifying retirement age to 62 from 60 years of age. While this change seems modest, it will save billions of Euros in the coming decades and is probably a harbinger of changes yet to come.

In addition to budget cuts, tax hikes and monetary assistance, the Greek government announced it will privatize many companies currently government owned. This privatization program should have a triple impact. One, it will generate funds for the government to meet its obligations. Two, it will deregulate largely monopolized markets in a variety of industries. Three, it will force thousands of workers out of the generous state pension system (where many workers can retire at age 58 with full benefits) into the less generous private sector. No wonder Greek workers are protesting on the streets of Athens. Over time a more open labor market should help improve sluggish productivity and economic growth.

Germany, Britain, Spain and other European governments rapidly shifted from stimulus to fiscal contraction in response to the Greek debt crisis. While increased taxes play an important role in reducing budget deficits, budget cuts are significant throughout Europe. Sacred cows are being cut for the first time, marking a shift in long-term policy. While the initial cuts are modest in most cases (with the exception of Greece) the inability of European governments to increase their borrowing will change the direction of welfare state policies for many years to come. We believe this just might be the beginning of a European productivity renaissance if the current pro-growth policy proposals are implemented, and lenders remain stingy in the coming years. Stingy lenders will continue to force the Europeans to rely more on markets and less on insolvent governments.

Table 1

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Government Debt & Deficits as a % of GDP – 2009

Country	Debt/GDP	Deficit/GDP
Japan	178.0	-7.8
Greece	125.7	-10.2
Italy	106.6	-5.2
Belgium	95.3	-6.0
Portugal	81.1	-7.9
United Kingdom	75.1	-12.8
Hungary	72.7	-4.5
Austria	64.3	-7.0
France	60.8	-8.4
United States	53.1	-8.8
Netherlands	49.9	-6.2
Poland	47.1	-3.0
Turkey	46.3	-4.7
Spain	46.1	-9.9
Ireland	46.0	-19.4
Germany	43.8	-5.6
Sweden	37.8	-2.1
Denmark	37.8	-5.8
Finland	37.6	-4.0
Canada	35.7	-4.3
Slovak Republic	33.6	-6.3
Korea	32.6	-2.1
Czech Republic	32.5	-5.5
Mexico	28.2	-1.0
Norway	26.1	9.4
Switzerland	20.7	-1.3
Australia	8.1	-3.1

Source: www.oecd.org

Table 2

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Maturing Government Debt as a % of GDP

Country	2010–2012	2010–2015
Japan	79%	118%
Italy	38%	57%
Belgium	35%	58%
Hungary	34%	51%
France	31%	47%
Greece	29%	62%
Germany	28%	45%
United States	28%	40%
Canada	24%	33%
Netherlands	23%	37%
Portugal	22%	41%
Turkey	21%	34%
Spain	21%	33%
Poland	20%	32%
Finland	16%	27%
Austria	16%	38%
Denmark	16%	26%
Sweden	15%	26%
Korea	13%	27%
United Kingdom	12%	24%
Slovak Republic	12%	25%
Czech Republic	12%	18%
New Zealand	9%	17%
Ireland	8%	18%
Norway	8%	15%
Chile	7%	12%
Switzerland	7%	10%
Mexico	5%	7%
Australia	4%	8%

Source: Bloomberg, L.P.

Market Summary

Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2010:Q2	P/E Benchmark	Over/Under Valuation	Price/Book Value 2010:Q2	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	15.3	27.0	-43.2%	2.9	5.7	-49.9%
Large-Cap Value Stocks	14.5	20.2	-28.1%	1.5	2.5	-40.6%
Mid-Cap Growth Stocks	18.6	24.8	-25.0%	2.5	4.5	-44.6%
Mid-Cap Value Stocks	21.4	19.1	12.0%	1.4	2.2	-37.2%
Small-Cap Growth Stocks	21.5	23.2	-7.3%	2.1	3.5	-40.0%
Small-Cap Value Stocks	36.1	18.2	98.3%	1.3	2.1	-39.4%

**Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.*

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 6/30/10.

Returns by Index

Index	2010:Q2	YTD*
DJIA Total Return	-9.34%	-4.98%
NASDAQ	-11.82%	-6.61%
S&P 500	-11.43%	-6.65%
S&P 500/Citigroup Value	-11.57%	-5.30%
S&P 500/Citigroup Growth	-11.28%	-7.99%
S&P MidCap 400/Citigroup Value	-9.90%	-1.99%
S&P MidCap 400/Citigroup Growth	-9.26%	-0.70%
S&P SmallCap 600/Citigroup Value	-10.42%	-1.51%
S&P SmallCap 600/Citigroup Growth	-6.97%	-0.18%

DJIA & NASDAQ: Bloomberg L.P. as of 7/1/10.

S&P Returns: Standard & Poor's (July 1, 2010) Standard & Poor's Reports June Index Returns. Press Release.

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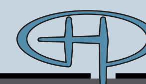

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