Saving the Euro Zone

June 2012

Spain has asked for financial assistance of up to €100 billion from the euro zone countries to complete the restructuring of its banking system. We suspect that the imminent Greek elections, as well as the soon-to-be-announced results of the Spanish bank stress tests, made the Spanish bank bailout a matter of urgency. This bailout takes Spain and Europe one step closer to a restructuring of Spanish sovereign debt, and may portend a financial lifeline for Italy as well. At present, there are few buyers remaining for Spanish government bonds. With the tail risk of redenomination hovering over Spanish bonds, and miserable domestic growth prospects, it's no wonder buyers have fled. We believe that once the European Stability Mechanism (ESM) and the International Monetary Fund commit to lending to Spain and Italy, securities markets should be convinced of the permanent status of the euro. We estimate that Spain and Italy's combined refinancing needs, additional government debt, and bank bailouts sum to about €1.7 trillion. Ultimately, such a massive rescue will likely lead to fiscal integration in the euro zone and mutualization of sovereign debts via euro bonds. The euro zone may then follow the United States, United Kingdom, and Japan down the road of debt monetization. To avoid the horrendous costs and chaos of fracturing the euro zone, a wealth transfer from core to periphery must occur. There are no other options. Using this assumption as our base case, we have constructed client portfolios to weather the storm of political machinations in Europe and benefit from the ultimate resolution of the crisis, which may take an extended period of time.

Although the terms and conditions of this bank bailout have yet to be finalized, we expect the bailout funds will go to the Kingdom of Spain and its agency, the Fund for Orderly Bank Restructuring (FROB), and FROB will directly inject these funds into the banks. This new package fails to break the link between the banks and the sovereign, because the loan will be a liability for the Kingdom of Spain. The additional sovereign debt burden pushes Spain closer to further credit downgrades, closing the government's access to the bond markets at a reasonable cost.

Here is our summary of the bailout plan:

Positives:

- Spain will have capital in place once the bank stress test consultants estimate the total losses in the banking system (top-down estimates should be available June 21, with further detail to be provided by end-July). Since the European Financial Stability Facility (EFSF)/ESM will supply the funds, Spain will not have to tap markets directly and the term of the loan could be very long (15+ years), giving the FROB adequate time to implement a well-organized workout. Exact terms are still to be determined.
- The recognition of bank losses and recapitalization of the banking system is a prerequisite for stabilizing Spanish gross domestic product (GDP) and revitalizing the economy.

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- The injection of funds into Spanish banks reduces euro zone bank counterparty risk and should help restore transparency and credibility.
- This "near death" experience may give Spanish politicians the protective cover needed to impose significant labor market reforms.

Negatives:

- Spain has limited access to debt markets. If Spain cannot fund ongoing fiscal deficit and debt maturities, the country will need an even larger sovereign rescue package. A conservative estimate could be as large as €500 billion.
- If the ESM participates in the bank bailout, then the ESM might be senior to existing Spanish sovereign debt, with negative consequences for existing debt.
- A Spanish sovereign rescue has the potential to undermine confidence in Italy, France, and even Germany, as those countries would be required to provide a substantial portion of the rescue funds. The table below illustrates the impact of just a Spanish debt bailout on the debt/GDP levels for the main contributors to the EFSF/ESM, assuming Italy cannot participate.

Impact of EFSF / ESM on gross government debt

Country	2011 gross debt (% GDP)	2014 gross debt (% GDP)	2014 nominal GDP (€bn)	Potential share of EFSF	Potential share of ESM	Proforma 2014 gross debt (% GDP)
Austria	72.2%	73.4%	355	4.8%	4.8%	83.5%
Belgium	98.5%	96.7%	422	0.0%	0.0%	96.7%
Cyprus	66.8%	NA	20	0.0%	0.0%	NA
Estonia	6.0%	5.1%	20	0.0%	0.0%	5.1%
Finland	48.6%	53.0%	225	3.1%	3.1%	63.3%
France	86.3%	90.6%	2314	35.1%	35.1%	101.9%
Germany	81.5%	75.8%	2940	46.7%	46.7%	87.7%
Greece	160.8%	158.1%	221	0.0%	0.0%	158.1%
Ireland	105.0%	117.5%	180	0.0%	0.0%	117.5%
Italy	120.1%	123.4%	1700	0.0%	0.0%	123.4%
Luxembourg	20.4%	NA	47	0.4%	0.4%	NA
Malta	68.0%	NA	8	0.0%	0.0%	NA
Netherlands	66.2%	76.5%	673	9.8%	9.8%	87.4%
Portugal	106.8%	114.4%	186	0.0%	0.0%	114.4%
Slovakia	44.6%	49.9%	84	0.0%	0.0%	49.9%
Slovenia	47.3%	58.5%	40	0.0%	0.0%	58.5%
Spain	68.5%	87.4%	1170	0.0%	0.0%	87.4%

Source: Redburn

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Despite the attempt to design a cohesive euro zone, European political leaders have succumbed to nationalism in this crisis, encouraging private capital and credit to return to each country of origin. A euro zone-wide deposit guarantee scheme would likely alleviate the nervousness and lack of trust between member states. Unfortunately, such a broad deposit scheme also consumes the emergency funds, leaving even less for individual country bank and sovereign bailouts. To break the damaging link between bank and sovereign, the euro zone will need to form a banking union – one that has the power to guarantee deposits. We also believe that the "new and improved" euro zone will likely issue some type of unified euro bond, backed by the European Central Bank, the sole institution with the power to act as lender of last resort to all member states. Clearly, there are no easy solutions to this dilemma. For the next several weeks, we expect volatile equity markets and euro exchange rates. Causeway is using this period of market unease to add to holdings in the highest quality European financial institutions, and trimming other financial sector stocks trading at fair value. In comparison with our client portfolios from a year ago, we expect more share price stability from below-average-risk stocks (based on projected price volatility) to provide portfolio ballast. Bargains in the cyclical and financial sector stocks have given our investment team another opportunity to "trade up" and buy market leading franchises. We will use this opportunity with the expectation that any improvement in the economic cycle, especially in Europe, should spark a rebound in share prices.

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