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The eurozone crisis – potential outcomes

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Stephen Macklow-Smith writes in his capacity as a senior portfolio manager within the European Behavioural Finance (BF) team, with more than 20 years' experience of managing European Equity funds. His views are intended to give some insight into market events from the BF point of view, but are based on personal opinion. His opinions may therefore diverge from other views within J.P. Morgan Asset Management, and do not necessarily reflect the Global Multi Asset Group (GMAG) team outlook, which is based on a 3-6 month time horizon and reflects the investment strategy of our GMAG Group.

Introduction

The eurozone's sovereign debt problems continue to rumble on, contributing to periodic bursts of volatility on the markets. What will be the outcome of the crisis? As officials in Brussels seek to secure the future of the single currency, Stephen Macklow-Smith looks at three potential scenarios, assesses their likely impacts on European companies, and explains why he believes the euro will endure.

The euro's in-built problems

The problems in peripheral euro countries dominated European financial markets in 2010, with much of the uncertainty deriving from a sense that the founding structures of the eurozone are not up to the task of bringing stability to a fairly diverse region.

The original criteria for admission to the single currency set out in the Maastricht treaty didn't deliver the intended result because they paid too much attention to *apparent* convergence, measured by cyclical factors such as inflation and annual deficits, rather than focusing on the structures of the member economies. To take one example, the German model is one of low levels of consumer debt and high levels of saving, with economic growth driven by exports. Spain, by contrast, looks more like the UK or US, with a great deal of consumer debt channelled into residential real estate. This is an inherently pro-cyclical model, since in the good times real incomes rise, encouraging higher levels of indebtedness (and the banks conspire in this by easing access to credit), which in turn pushes up residential real estate prices as well as boosting consumption via higher real incomes and the wealth effect of higher house prices. In a downturn this process promptly goes into reverse, explaining why the debt problems in the periphery (and the US and the UK) have got so much worse. Incidentally, the debt-led consumption model only indirectly boosts productivity, whereas the export-led model makes investment in productivity growth an absolute necessity in order to remain competitive.

The Stability and Growth Pact, adopted by the eurozone member countries in 1997 with the aim of maintaining the stability of the monetary union, turned out to be toothless, partly because France and Germany were the first to breach it. Will the efforts of European policymakers to resolve the debt crisis succeed in producing a more lasting stability, or will the problems built into the euro at its birth prove too difficult to overcome?

Potential outcomes of the crisis

It is impossible to pre-judge the outcome of the discussions that are taking place behind closed doors in the eurozone, but financial markets are pricing and repricing assets every day, so it makes sense to keep in mind a mental roadmap of the potential impacts in various sectors in the affected countries.

At the risk of oversimplifying, we can divide the investable stocks in each country into five groups: multinationals, financials, exporters, domestics, and utilities.

- **Multinationals** will tend to operate in global markets more or less unaffected by local market conditions. In Europe, good examples are oil majors and metals companies.
- **Financials** are clearly the most sensitive to the problems of household, commercial and sovereign debt. Within the financial sector, banks are likely to be worst affected by debt market dislocation.
- **Exporters** will tend to be less vulnerable, and indeed may turn out to be beneficiaries if austerity programmes in the affected countries reduce the cost of manufacturing.
- **Domestics** include local retail, transport, distribution, logistics, entertainment and media. The effect of the crisis on these sectors would depend on the impact of austerity measures on local demand.
- **Utilities** overlap with domestics in the sense that demand for their services is related to some extent to local real income growth, but their products will tend to hold up better than most because of the essential nature of the services they provide. The other major issue affecting utilities, however, is that they tend to carry high levels of debt, so they are vulnerable to changes in sovereign interest rates since their own debt is priced with reference to government debt.

Three possible scenarios

Potential trajectories for the crisis can be reduced to three outcomes. Common to all scenarios is the likelihood of bouts of volatility as debt markets ratchet up the pressure.

Scenario one: The eurozone survives, with some amendment to the structures to allow bailouts for countries that get into trouble (this is the option under discussion currently in Brussels).

Scenario two: One or more country has to restructure its debt while remaining within the eurozone.

Scenario three: One or more country has to leave the eurozone and restructure its debt.

What impact would these scenarios have on European companies?

Scenario one: muddling through

In the first scenario, which we might call the ‘muddle-through’, the impact on companies would be fairly minor, although companies that export outside the euro would probably continue to benefit from a competitive exchange rate as concerns over the durability of the euro prevented it from strengthening. It seems unlikely that any new fiscal transfer structures would entail higher domestic tax rates, and keeping countries within the euro prevents them from devaluing to their own benefit in a beggar-thy-neighbour way.

The threat, though, would come from much weaker levels of domestic demand in the indebted countries as they are forced to try and address their deficits through austerity measures. Even in a muddle-through, there is likely to be some pain for domestics and financials.

Scenario two: restructuring

In the second scenario, the options are more complicated, and much depends on the form of the debt restructuring. One of the key facets of this crisis has been overlooked by commentators but was pointed out by one of our most experienced clients. He noted that while a lot of attention has focused on the fact that Europe has a monetary union without having a fiscal union, people have generally ignored the fact that Europe has a debt union. Fiscal transfers have been made in only a limited way, but debt has flowed across national borders in a completely unrestrained manner. It is for this reason that among the largest creditors of sovereigns and corporates on the periphery are banks in other European countries. This is not limited to the eurozone: Royal Bank of Scotland and Lloyds both have Irish commercial loan exposure. Similarly, the German Landesbanks, which are in effect state-owned, are exposed to peripheral sovereign debt, while French banks, especially Credit Agricole, have exposure to corporate loans (in the case of Credit Agricole these are in Greece, and came with the purchase of Emporiki Bank).

Domestic financials are also large holders of domestic sovereign debt. These holdings have increased in the last two years because it was possible to put up a range of securities as collateral to access European Central Bank funds, which were then invested in (supposedly safe) sovereign debt in order to generate a healthy net interest margin without taking on extra risk.

If countries default, then all holders of sovereign debt would be forced to take a writedown on their holdings, which will impact their profits and hence their capital base. Depending on the size of the writedowns, banks may be forced to raise more equity. Given the reliance of many European banks on state funding this is unpalatable; nevertheless, it is a realistic possibility. Bond markets realise this, and by putting pressure on spreads, they can make a debt default more likely.

Within a eurozone peripheral country, though, what would be the impact on quoted companies of a debt restructuring? Worst affected would be financials, who would lose in every sense: their holdings of domestic sovereign debt would have to be marked down, their own borrowing costs would be forced up, and they would be vulnerable to a shrinkage of domestic demand as higher interest rates bore down on the economy and government spending came under pressure because it could not be financed.

Exporters and multinationals would not be as badly affected as long as they were not highly indebted. Domestics would face the same threat to demand as financials, while utilities would become vulnerable to higher interest costs on their debt and a diminished appetite for their bonds from overseas investors.

Scenario three: restructuring plus euro exit

In the third scenario, the situation would get ugly, which is why there has been so much insistence from European leaders on the continued survival and integrity of the euro. The potential impacts of scenario two would continue to apply, but if a country was forced back to a domestic currency its exchange rate would also very likely fall precipitately. Some commentators have suggested that this would be the 'get out of jail' card, allowing countries to devalue their way to health, but the contingent impacts on corporates would be considerable. Multinationals and exporters would again be affected less than most, but if they had a currency mismatch between their revenues and their debts, they would face an increase in their gearing. Any domestically quoted company with foreign debt would also be hit, and of course financials would be hit hard. Not only that, but eurozone owners of debt of the devaluing country would face a double whammy of a haircut on the value of their investment and an FX loss.

Conclusion: the will to succeed

My own personal view is based on Niall Ferguson's observation that sometimes it is better to read one page of history than twenty pages of analysis: the will to put things right in the eurozone is huge, and underestimated by the markets, and for this reason I would put the probability of one or more countries leaving the euro at zero. The complexity of the negotiation process means that until a deal is struck, the outcome will always be in doubt, but President Sarkozy said in Davos last month: "Never, listen to me carefully, never will we turn our backs on the euro, never will we drop the euro. The euro is Europe, we will never let the euro be destroyed….. It is not simply a monetary or economic issue. It has to do with our identity as Europeans."

If the euro is to be preserved intact and the peripheral countries saved from default, it will require a new set of European structures and a reform of European practices, but don't rule it out.