

# Immediate Insight: Eurozone update

22 July 2011



FOR INVESTMENT PROFESSIONALS ONLY – NOT FOR ONWARD DISTRIBUTION

The Eurozone leaders have come up with a second bailout package for Greece and also significantly expanded the powers of the Eurozone's Eur440bn bailout fund, the European Financial Stability Facility (EFSF).

The initial market reaction has been strongly positive. The Euro has bounced back and spreads on peripheral markets have rallied sharply. The spread on ten year Italian bonds rallied from a peak of 332bps over Germany to 254bps, Spain moved in some 90bps to 285bps over. Rallies in the bailout countries were even more marked: ten year Portugal came in from 1070bps over to 810bps, Ireland moved back to 900bps over from 1143bps, while Greece narrowed from 1556bps over to 1140bps.

For Greece, it is good news. The country gets its second bailout, worth Eur109bn this time. A further amount will come through private sector involvement, with debt holders being offered various forms of debt exchange, into a mix of par or discount bonds, or a rollover. On average, debt holders will take a haircut of 21%. The scheme is labelled voluntary and is expected to have 90% take-up. It is likely to lead to Greece being given a temporary Selective Default rating. This had been a sticking point for the ECB, but President Trichet appears to have been reassured by the fact that the EFSF will give the ECB capital guarantees on any bonds it owns or has in repo. This means that the Greek banks will still be able to borrow from the ECB.

Aside from giving Greece new bailout funds, the summit also agreed to lower the interest rate on loans to all three bailout countries to around 3.5%. The repayment schedules for all have been pushed out from 7.5 years to 15-30 years.

The other part of the deal was to strengthen the powers of the EFSF. The EFSF will now be able to buy bonds on the secondary market (taking over from the ECB). It can only do this in exceptional market conditions, and with unanimous approval from all the Eurozone countries. This move should help stave off market attacks on Spain or Italy.

In addition the EFSF can make precautionary promises of loans to any Eurozone country (similar to how the IMF operates with, say, Poland) as necessary, and can make loans to them to recapitalise their banks. This is most positive for Spain.

One thing that has not changed, though, is the size of the EFSF, which remains at Eur250bn, increasing to Eur440bn once approved by various parliaments. This would perhaps be a step too far, given that we estimate the fund would need to be Eur2-3 trillion in size to bailout Spain and Italy.

As noted above, the markets have reacted well to some decisive moves by the Eurozone leaders. However, while better than expected, we are not convinced that enough has been done to create a lasting solution. The issue of competitiveness has still not been addressed, the bailout countries still have substantial debt burdens to manage and tough reform programmes to implement. The riots in Greece are not going to go away.

We remain underweight peripheral markets in our clients' portfolios and, with the information currently available, are not minded to chase the relief rally.

***DISCLAIMER: Immediate Insight is an instant response by Insight Investment Management. This information is intended for Professional Investors only and should not be distributed to, or relied upon by, other persons. The material in this document is provided for information purposes only. Reliance should not be placed on the views and information expressed when making individual investment and/or strategic decisions.***

The value of investments and any income will fluctuate (this may be partly due to exchange rate fluctuations) and investors may not get back the full amount invested. Unless otherwise attributed the views and opinions expressed are those of the fund manager at the time of publication and are subject to change. The content of this document is valid for one month from date of issue. Issued by Insight Investment Management (Global) Limited. Registered office 160 Queen Victoria Street, London EC4V 4LA. Registered in England and Wales. Registered number 827982. Authorised and regulated by the Financial Services Authority.