Eurozone Contagion

Janney Fixed Income Strategy

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When Greece finally sneezes, Europe will catch a cold, with symptoms risking large negative impacts for the continental financial system.

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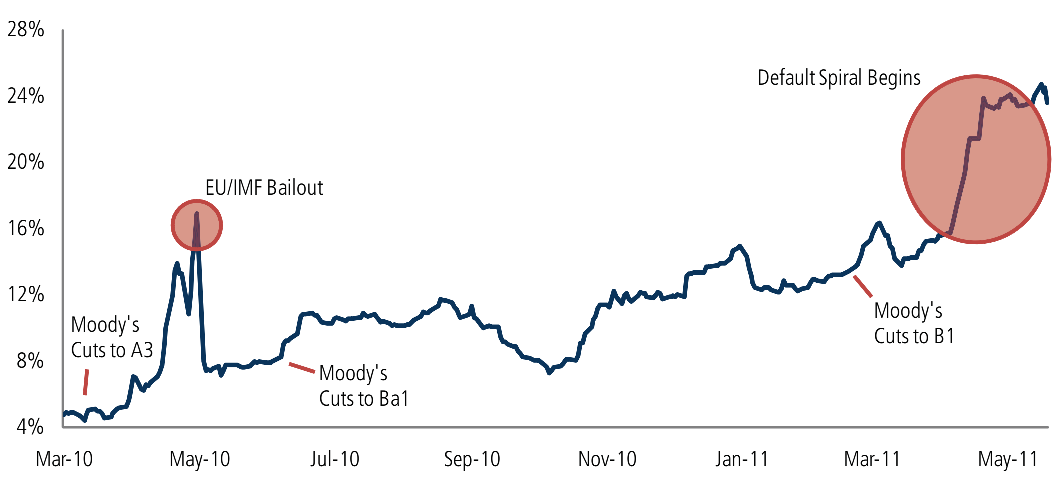
European Contagion

- Greece's predicament is getting more and more slippery by the day in a classic default spiral with only two potential solutions: perpetual bailout financing or restructuring.
- Both solutions come with sizable problems, the first holding implications that will be painful if not impossible for other Eurozone nations to accept, and the second having a complex and uncertain outcome.
- Not the least of the problems with a restructuring is the fact that the ECB owns an estimated €40 – 50 billion in Greek sovereign debt compared to €5 billion in paid-up capital.
- An organized restructuring negotiated among Greece, the EU, and creditors is the optimal outcome, however continued opposition to that plan by other EU members is a major barrier and even this scenario holds significant risk.
- **Given that risks are skewed to the downside, we strongly recommend exiting all exposure (including sr debt, hybrids, and preferreds) to banks domiciled in the Eurozone peripherals and reducing subordinated exposure (hybrids and preferreds) to European financials with large wholesale borrowing positions.**

The job interview for the financial minister of any European country consists of just one question these days: what would you do with Greece? Thirteen months after the European Monetary Union (EMU) member countries and International Monetary Fund (IMF) promised €45 billion in bailout loans, Greece's situation has gone from bad to ugly to heinous. That initial round of bailout financing expanded to €110 billion within a month, and yet, even now, yields on two year Greek bonds are trading at 24 – 25%, a wholly unaffordable level. With that type of financing costs, there's a great deal of risk priced into the Greek sovereign markets and only one thing of which we're certain: Greece is in the midst of a classic default spiral, one of the great paradoxes of the financial markets.

Greece's 2yr Bond Yields Point to Default Spiral



Source: Janney Fixed Income Strategy; Moody's

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In its simplest form, a debt spiral begins when an issuer, be it a corporation, municipality, or country faces an upcoming obligation which it needs to refinance. If the markets deem that issuer to be a poor credit risk, that issuer's cost of selling new debt to pay off its upcoming obligation rises, increasing expenses and further impairing credit quality. If this cycle raises financing costs to unsustainable levels, say 24 – 25%, it becomes wholly impossible for the issuer to pay off upcoming obligations by issuing new ones, hence ensuring a default and earning the name debt or default spiral. As a default spiral is a self-sustaining game, the only way for an issuer to solve a default spiral is by breaking the rules of the game, namely via obtaining external assistance (being acquired, or, in our example, obtaining low cost loans from other governments) or by defaulting. The only way that the first option, obtaining support, can work is if that support somehow restores confidence in the spiraling issuer.

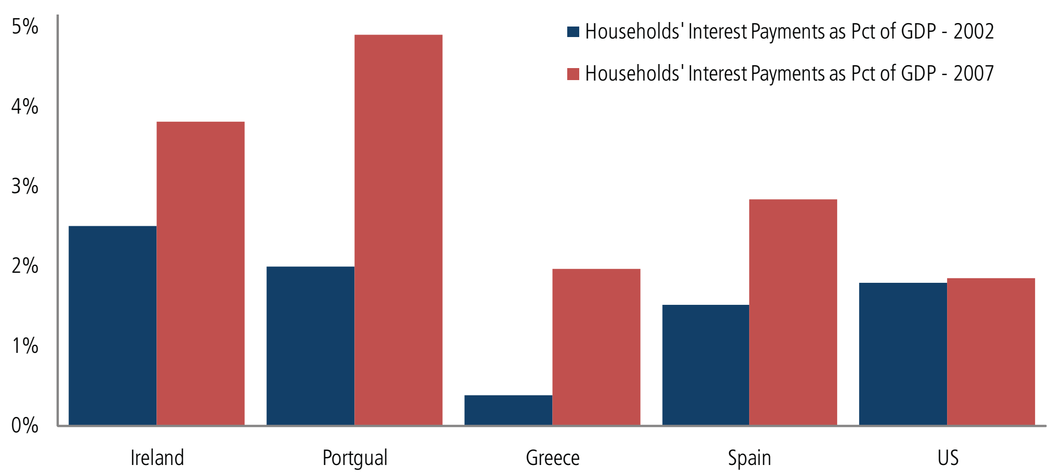
It's not hard to see, in light of this explanation, where the EU's efforts to break Greece out went sideways: they failed to establish enough confidence to reverse the initial default spiral. We can attribute this failure to several factors, not the least of which has been a Hydra's head worth of opinions from various political factions. Greece's own citizens essentially want a default, Greece's politicians want an insufficient level of spending cuts, and the EU collectively wants to hold together—even though individual members are most certainly in private discussing the pros and cons of kicking the Hellenists to the curb. One of the biggest advocates for continued support of Greece is the European Central Bank, not surprisingly, since the ECB carries €40 – 50 billion (the exact number is kept private) of Greek government bonds on its balance sheet.

Bailout Comparison & Implications

Ireland (Baa3/BBB+): Ireland's banking system expanded rapidly during the 2005 – 2007 global credit boom and ultimately came to comprise a very large portion of the nation's economy. Loans to households and non-financial businesses reached 205% of Irish GDP 2008, up from just 70% ten years prior. When the housing bubble in Ireland popped, banks were left with large losses, forcing the Irish government to accept an EU/IMF bailout to prop up the banking system. We consider the Irish problems and eventual bailout to be the result of onetime credit losses which indicates the Irish government should be successful in paying off bailout loans over time.

Private indebtedness has also grown, with interest costs for households expanding 1.5x in Ireland, doubling in Portugal, and more than quintupling in Greece relative to GDP.

EU Peripherals' Households Spending Greater Portion of GDP on Interest Payments



Source: Janney Fixed Income Strategy; OECD

Portugal (Baa1/BBB-): In blunt terms, Portugal is poorer than any nation in Western Europe, an outgrowth of weaker capital investment over the generations. The human capital investment is evident in UNESCO data showing research spending in the country falling 5% behind the next closest EU member, literacy rates falling 3% below the next closest EU member, and an hourly minimum wage 35% below the next closest Western European nation. Fixed capital investment as a percentage of GDP meanwhile runs towards the bottom of the EU pack, indicating a limited push by national industry to reverse decades of prior under-investment. The challenges Portugal faces are far

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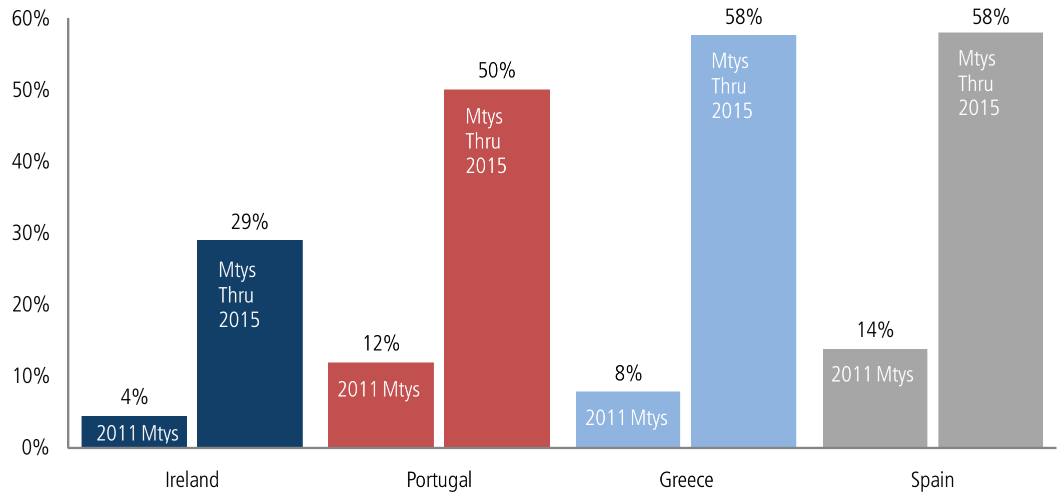
deeper than a tough debt maturity schedule or excessive borrowing; they trace back to an economy structured with limited capital investments, which in turn has created a capital deficit which could well take as many decades to fix as it took to create.

Greece (B1/B): Challenges in Greece are arguably the most complex of the three bailout candidates and include cultural factors such as a very high reported tax evasion rate and heavy reliance on a deep social support system as well as government-based employment. As Greece joined the EU, its borrowing costs declined as a result of implicit support of the Union, which in turn made it possible for the Greek government to continue issuing debt at what amounts to a subsidized rate. In late 2009, that debt issuance necessitated by a structural imbalance between consumption and production ran rather violently into market forces that had been previously held off by the EU. At this juncture, the Greek economy is unable to grow quickly enough to support debt service expense, indicating that any efforts to cut government spending or raise taxes have a finite benefit below what's necessary to reduce indebtedness—hence the current debt spiral.

Debt Maturities & High Funding Costs Mean Greece Bailout Likely Unsuccessful



Source: Janney Fixed Income Strategy

Including bailout loans, Greece has nearly 60% of its debt slated for maturity by 2015, and current funding costs make refinancing entirely impossible.

A Greek debt restructuring will certainly be painful for the global financial system, but how painful depends entirely on whether the political players broadly acknowledge the inevitability of the default spiral. If they do, there remains plenty of time to get the relevant parties—namely Greece, the EU, the IMF, and bondholders—to the table and negotiate an orderly restructuring. In Greece's situation, a simple maturity extension would fail to even address the underlying structural imbalances that have brought the current debt spiral to bear in the first place. In order to escape the debt spiral, Greece needs to reduce its amount of indebtedness, ideally by negotiating principal haircuts on its debt in exchange for large, concrete, and enforceable austerity measures.

An Unstructured Restructuring

The dogmatic refusal of the ECB to address the need for an organized restructuring is, somewhat ironically, increasing the risks of a disorganized restructuring, that is, an unstructured default. In reality, any form of restructuring, even an organized one, holds substantial risks, but the potential downsides from a disorganized default are particularly serious for not just investors holding Greek debt, but ultimately the European financial system as a whole. While we'll attempt to clarify a probable course of events stemming from such a disorganized restructuring (i.e., a "severe case" scenario), the key to positioning for this situation lies in understanding that many aspects of the outcome are inherently unpredictable, which is in and of itself an excellent reason to reduce direct and indirect exposure to Greece and Eurozone peripherals.

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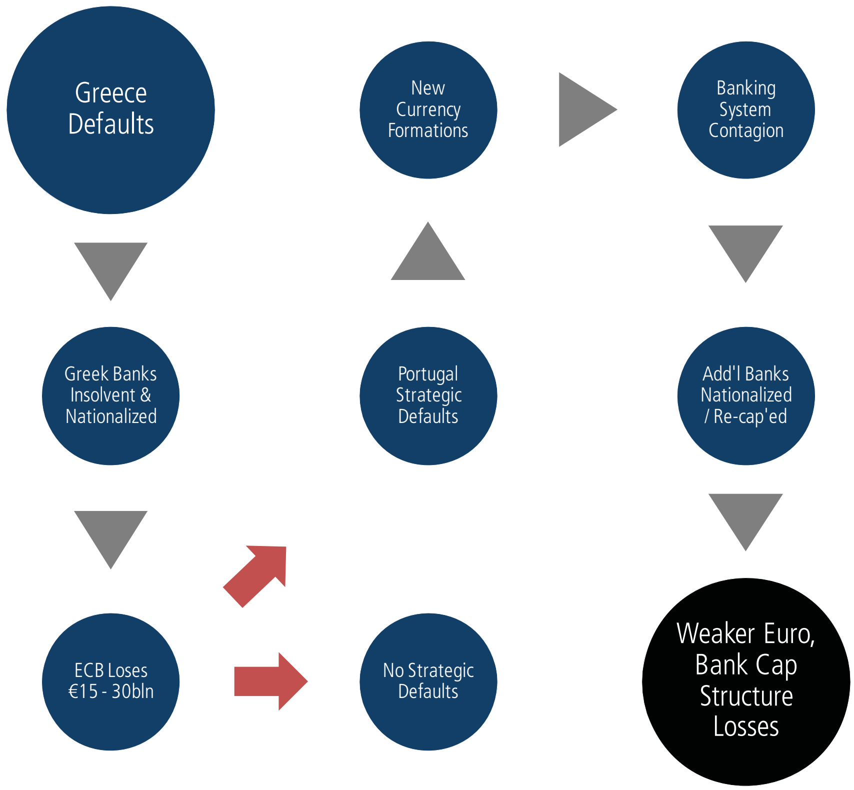
Any scenario involving unstructured default of the Greek government will almost certainly progress to a nationalization of major Greek banks and result in losses across their capital structures.

Knock-on Effects of an Unstrucured Greek Default: The Dreaded Flow Chart



Source: Janney Fixed Income Strategy

- Greek banks, including National Bank of Greece (Ba3/B), EFG (Ba3/B), Alpha Bank (Ba3/B), and Pireaus Bank (Ba3/B) will experience heavy losses and most likely need to be nationalized.
- A restructuring would cost the ECB, eroding most of its €5 billion of paid-in capital, and forcing the Central Bank to obtain additional investment from EU member countries. Financial distress at the ECB could meanwhile prove extremely problematic for global investor confidence, as the Central Bank has been one of the biggest liquidity supporters throughout the financial system. We are not implying that the ECB will in some way "fail," but confidence in its ability to support liquidity will weaken.
- Portugal, as the next structurally-weak member of the peripherals club will need to decide whether to strategically default on its own debt.
  - A Portuguese default could force serious re-envisioning of the entire European Monetary Union and would encourage Greece and Portugal to form new currencies. Devaluing those currencies would be an a la Argentina classic method of cutting debt burdens. Creditor haircuts and the nationalization of Banco Comercial Portugal (Baa3/BBB-), Banco Espirito (Baa2/BBB-), and Banco BPI (Baa2/BBB-) would be all but certain.
  - A no-default decision by Portugal would represent the likely "bottom" of any crisis situation and would likely stabilize market confidence, particularly if reinforced by self-imposed further austerity measures, though the possibility of this option declines daily.
- Regardless of Portugal's positioning, a disorganized default and knock-on effects from the nationalization of local financial institutions would cause substantial losses across the European financial complex and impair the value of the Euro currency.

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Capital Markets Impact

Identifying the degree of potential losses and precisely which institutions are most exposed is next to impossible, however, we have broad-strokes recommendations on the matter.

Recommendation 1) Exit all exposure to banking institutions in Greece, Portugal, Ireland, and Spain.

Our reasons for this first recommendation are fairly self-evident; any restructuring in Greece has a high risk of resulting in nationalization of Greek banks, wiping out all equity and likely forcing equity conversions on preferreds and possibly even hybrid elements of the banks' capital structure. Losses of this magnitude will undoubtedly create knock-on effects among financial institutions domiciled in other Eurozone peripheral countries. The outcome for senior bank debt, particularly in the non-Greece peripherals, is somewhat less clear, but risks are skewed to the downside in this scenario, as even optimists have to acknowledge that any upside will likely take years to be fully realized.

Eurozone peripheral banks will be most susceptible to contagion risk in the event of an unstructured Greek default.

Largest Banks Based in EU Perhipherals Are Most at Risk

Country	Institution	Total Assets (in USD)	Sr Debt Rating	Preferred Rating**
Greece	National Bank of Greece	$174 bln	Ba3 / B	B3 / CCC-
Greece	EFG Eurobank	$126 bln	Ba3 / B	Caa1 / CCC-
Greece	Alpha Bank	$96 bln	Ba3 / B	B3 / CCC-
Greece	Piraeus Bank	$83 bln	Ba3 / B	Caa1 / CCC-
Greece	Agricultural Bank of Greece	$45 bln	B1 / NR	
Greece	Emporiki (Credit Agricole Sub)	$39 bln	Baa3 / NR	
Portugal	Banco Comercial Portugues	$144 bln	Baa3 / BBB-	B2 / B+
Portugal	Banco Espirito Santo	$120 bln	Baa2 / BBB-	Ba2 / BB-
Portugal	Banco BPI	$66 bln	Baa2 / BBB-	Ba3 / BB-
Ireland	Allied Irish Banks	$209 bln	Ba3 / BB	C / C
Ireland	Bank of Ireland	$241 bln	Ba2 / BB+	Ca / CC
Ireland	Irish Life & Permanent	$109 bln	Ba2 / BB+	NR / BB
Spain	Banco Santander	$1,753 bln	Aa2 / AA	Baa2 / A-
Spain	BBVA	$869 bln	Aa2 / AA	Baa2 / A-
Spain	La Caixa	$391 bln	Aa2 / A+	Baa2 / NR
Spain	Banco Popular Espanol	$187 bln	A2 / A-	Ba2 / BB
Spain	Banco Espanol de Credito	$174 bln	A2 / AA	Ba1 / A
Spain	Banco de Sabadell	$140 bln	A3 / A	Ba3 / BB+

** Rating on most subordinated, perpetual or ultra-long security

Source: Janney Fixed Income Strategy; Company Reports; Moody's Investor Services; S&P

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Recommendation 2) Reduce exposure to all European financials' subordinated capital instruments, including hybrids, preferreds, and equity, particularly for institutions with large wholesale borrowing regimes.

Financial institutions which carry a heavy amount of short term debt are more susceptible to liquidity problems that are in turn sensitive to banking system contagion risk. Rather than try to identify which institutions carry which exposure to the Eurozone peripherals (an undertaking we engaged in back in June 2010, when it was still acceptable to call them PIIGS), we've evaluated major financials by their ability to withstand a funding crisis. This assessment falls under the maxim that, while poor income smarts and weak balance sheets maim, a lack of liquidity kills. To identify potential names that might require external support, resulting in potential capital structure compression—e.g., preferred to equity conversions—we focused on liquidity risk, and specifically the ratio of short term borrowing net of cash to total liabilities.

Our liquidity risk score identifies non-peripheral EU institutions that are more likely to experience a loss in the event of a contagion.

EU Banks with High Sensitivity to Short Term Liquidity Needs

Country	Institution	Total Assets (in USD)	Liquidty Risk Score	Sr Debt Rating	Preferred Rating**
France	Societe Generale	$1,630 bln	52%	Aa2 / A+	Baa2 / BBB+
France	BNP Paribas	$2,877 bln	49%	Aa2 / AA	Baa1 / A
Belgium	Dexia SA	$816 bln	33%	A1 / A	B1 / B
Germany	Landesbank	$189 bln	30%	A1 / NR	
Italy	Banco Popolare	$195 bln	29%	A2 / A-	Ba3 / BB
UK	Old Mutual PLC	$319 bln	27%	Baa1 / NR	Baa3 / BBB-
Italy	Banca Monte	$352 bln	23%	A2 / A-	Ba3 / BBB-
France	CIC Credit Indus.	$339 bln	23%	Aa3 / A+	
France	Natixis	$659 bln	22%	Aa3 / A+	Ba2 / BBB
France	Credit Agricole	$2,294 bln	21%	Aa1 / A+	A3 / BBB+
Germany	Commerzbank	$1,086 bln	20%	A2 / A	B2 / C
Belgium	KBC Groep	$462 bln	14%	A1 / A-	Ba3 / NR
Belgium	Fortis Bank	$501 bln	14%	A1 / AA	Baa3 / A-
UK	RBS Group	$2,396 bln	14%	A1 / A	B3 / C
Italy	UniCredit	$1,338 bln	12%	Aa3 / A	Baa3 / BBB-

*Short term borrowings net of cash and equivalents related to total liabilities.

** Rating on most deeply subordinated component of capital structure

Source: Janney Fixed Income Strategy; Company Reports; Moody's Investor Services; S&P

Recommendation 3) Exit all exposure to European sovereigns, take long positions only where necessary in the relative safehavens of France (Aaa/AAA) and Germany (Aaa/AAA) on the run issues.

Any restructuring, be it organized or dis is apt to trigger even further flights to quality within Eurozone sovereign credits. In no uncertain terms, Moody's noted that it would most likely take ratings action on all of the peripheral sovereigns should one, namely Greece, fail to pay or attempt to adjust

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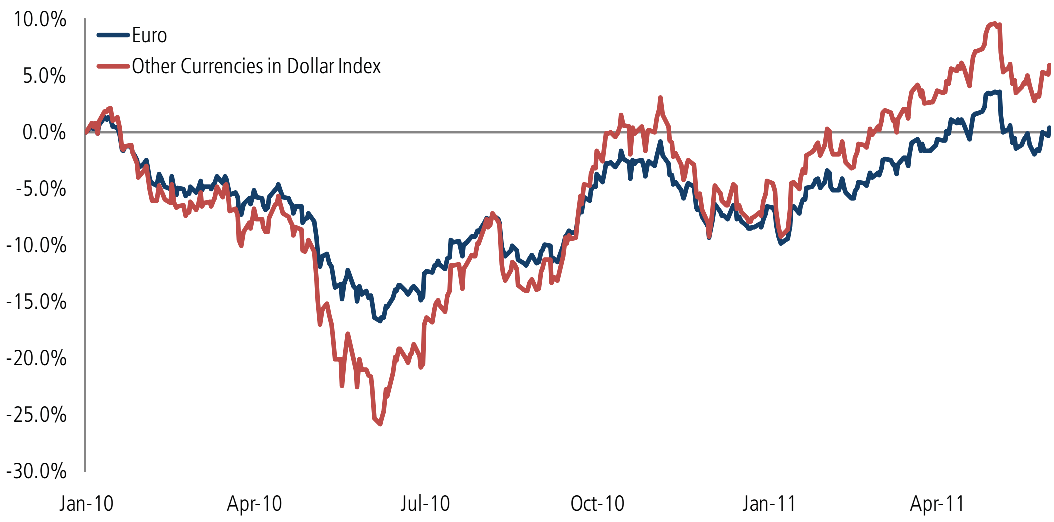
the terms of its outstanding bonds. Fitch's recent move to place Belgium (Aa1/AA+) on negative outlook indicates that even relatively wealthy Eurozone nations will face credit pressures. On the continent, we only see two true safe havens at this point, specifically France and Germany, and even their sovereign credit profiles are at risk from the likely expense of needing to support neighboring nations. Ironically, it's actually these stronger nations that have the most to gain from dissolving their ties to the monetary union, as the standalone economic and credit performance of either France or Germany is stronger than that of the Eurozone as a whole.

Recommendation 3) Short EUR vs USD

The original envisioning of the Euro currency required cross-border consistency to succeed—hence why the Treaty of Maastricht provides no "out" for a nation looking to leave the European Monetary Union, as allowing for an out raises questions about nations' commitments. It remains to be seen, then, how and what ramifications the possible exit of a nation such as Greece might cause to the fabric of the Euro. Since fiscal challenges emerged in late 2009, the Euro has proven impressively resilient in the face of growing economic pressures, trading net unchanged since that late 2009 period. This resilience suggests that the Euro won't be as quick to dissolve in the face of a sovereign default as we first suspected, however, the default and possible exit of one or more countries from the Euro will undoubtedly have significant negative consequences for market confidence in the currency. Moreover, given our economic and monetary policy-based assessment that the dollar has bottomed, a short EUR vs USD position has relatively limited downside risk. Considering shorting bans against most Eurozone financial firms, it's also one of the few ways to earn outright profits from Greece's distress.

Considering short restrictions on EU sovereigns and banks, shorting the Euro is one of few ways to outright profit from Greek distress.

Euro Underperformed Since 2010, but Plenty of Room for Further Weakness



Source: Janney Fixed Income Strategy

We have unusual confidence in these recommendations—particularly those regarding the banking system risks—as a result of relatively limited downside on each of these trades. The potential for default and knock-on effects would take only days, yet any meaningful resolution of EU peripherals' problems will take years to realize, creating a skewed risk profile. Over the Memorial Day weekend, rumors of Germany supporting a third round of Greek bailout loans (that's the ticket: rescue an over-indebted country by lending it even more money) have temporarily relaxed the recent spread widening across peripheral sovereigns and the EU banking system. That relaxation provides an opportune exit point for potentially risky Eurozone exposures.

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