

## Special Report

Investment horizon: 6–12+ months

### *EMU at a crossroad: Scenarios and investment implications<sup>1</sup>*

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#### Overview

- Fiscal union is very unlikely, as is the opposite extreme – a euro break-up.
- The core scenarios are "muddling through" with ongoing uncertainty, or a big Greek "haircut" with a V-shaped equity market profile.

The unresolved European debt crisis has been a major reason for the market turbulence of the past months. Its outcome will be a key factor in determining whether the European as well as global economy avoids recession, how asset markets develop and how investors should, thus, position their portfolios. Given the uncertainty, we consider various potential scenarios:

#### **Scenario 1: Fiscal union with Eurobonds (10% to 20% probability)**

If EMU were to move to a full-fledged fiscal union with mutually guaranteed sovereign debts ("Eurobonds") default risk would drop sharply. Worries over global recession would give way to a "risk-on" recovery, with:

- Equities, including bank stocks, and more generally cyclical stocks, rising sharply
- Higher risk credits, including subordinated bank paper, recovering
- German, Swiss and US bond prices dropping, while "peripheral" government bonds rally
- Safe-haven currencies, including the CHF and USD, losing ground against the EUR and emerging market currencies
- Cyclical commodities rallying, while gold would likely hold up due to still very low real interest rates.

Such a scenario is unlikely, however, as political support for far-reaching mutual debt guarantees is lacking.

#### **Scenario 2A: "Muddling through" with slow resolution of Greek debt overhang (30% to 40% probability)**

More likely is a "muddling through" scenario, including: Approval by the IMF and EU for disbursement of the next stages of the current Greek loan and ultimately of the second-stage longer-term financing; slow fiscal consolidation in Italy and elsewhere; piece-meal "haircuts" of Greek debt with some write-downs for banks, their limited re-capitalization through national governments or the still-to-be approved EFSF; and ongoing ECB "bridge financing" for banks and government bond markets. Downside risks to the economy would remain in place, as would uncertainty in markets, with, among others:

- Equities on a slow, but very volatile upward trajectory, with defensive segments outperforming
- Credit spreads declining only slowly
- Major currencies in a trading range

<sup>1</sup>For more details see "EMU at a crossroad", Credit Suisse Special Reports, September 26, 2011  
<https://infocus.credit-suisse.com/app/article/index.cfm?fuseaction=OpenArticle&aoid=321115&lang=EN>.

**Scenario 2B: "Muddling through" with intensified crisis, followed by a decisive debt restructuring (30% to 40% probability)**

Given the political constraints to implementing the much needed changes, it is equally likely that the euro crisis intensifies further. In such a case, equities and other risk assets would drop sharply, and the risk of severe banking crisis, recession as well as a euro break-up would mount. Faced with such severe risks, we would expect policy makers to finally spring into action and, in particular, to agree on a decisive Greek debt write-down. Such action would then likely be followed by an intensive relief rally for risk assets.

**Scenario 3: Worsening crisis, possibly leading to EMU break-up (10% to 20% probability)**

In the worst case, the EMU crisis could spin out of control as Greece defaults unilaterally and possibly decides to leave the euro, contagion spreads to other countries, and a banking crisis looms. If not resolved fast enough, a deep global recession would be the outcome. In such a scenario, all risk assets would sell off sharply, with only USD, JPY and (if the SNB eventually chose to drop its current floor) CHF cash, as well as gold, left as safe havens.

**Investment Strategy****Scenario 1: (10% to 20% probability)**

- ↗
  - Stocks (regions: EM, select European, sectors: cyclicals and financials)
  - Financial and non-financial bonds, HY and EM bonds with short duration
  - Credits, incl. bank subordinated paper, EUR peripherals
  - Alternatives: cyclical commodities, EM and long-short equity hedge funds
  - EUR
- - Defensive stocks
  - Continue owning gold
- ↘
  - Long maturity benchmark government bonds (German Bunds, US Treasuries, Swiss Eidgenossen)
  - CHF, USD
  - Move out of cash

**Scenario 2A: (30% to 40% probability)**

- ↗
  - Investment grade short-duration bonds
  - Equities: EM or EM-exposed, US stocks, dividend basket
  - Currencies: selected Asian currencies, NOK, SEK
  - Alternatives: real estate, gold and cyclical commodities, macro hedge funds
- - Major currencies (cash EUR, USD)
  - HY bonds, selected EM bonds, incl. local currency
  - Defensive European stocks, bank stocks (short-term dilution risk due to re-capitalization, long-term neutral)
- ↘
  - Eastern European currencies (HUF, PLN)

**Scenario 2B: (30% to 40% probability)**

- ↗
  - Once policy response is forthcoming and risk-off phase bottoms, risky assets (credit and equities)
  - Currencies: selected Asian currencies, NOK, SEK
  - Alternatives: real estate, gold, macro hedge funds
- - Cash USD, CHF
  - HY and EM bonds, but add after policy response
  - Commodities
- ↘
  - Eastern European currencies (HUF, PLN)
  - As risk-off phase bottoms, long-duration benchmark government bonds

**Scenario 3: (10% to 20% probability)**

<sup>1</sup>For more details see "EMU at a crossroad", Credit Suisse Special Reports, September 26, 2011  
<https://infocus.credit-suisse.com/app/article/index.cfm?fuseaction=OpenArticle&aoid=321115&lang=EN>.

↗	<ul style="list-style-type: none"> <li>▪ USD, JPY, EUR-exposure hedges</li> <li>▪ Cash (potentially managed multi-currency)</li> <li>▪ Government bonds of strong, solvent economies (US, Germany, Switzerland, Sweden, etc.)</li> <li>▪ Alternatives: managed futures &amp; dedicated short bias hedge funds</li> </ul>
→	<ul style="list-style-type: none"> <li>▪ Gold</li> <li>▪ CHF</li> <li>▪ Real estate</li> </ul>
↘	<ul style="list-style-type: none"> <li>▪ Stocks, stocks-related and credit sensitive hedge funds</li> <li>▪ Cyclical commodities</li> <li>▪ Corporate bonds of cyclical sectors, excluding top quality issuers, bank bonds, HY bonds</li> <li>▪ EUR, EM currencies</li> </ul>

↗ Positive ↘ Negative → Neutral  
 Note: Arrows reflect the attractiveness of investment strategies within each scenario.

## Euro crisis Q&A

### Question: Surely Greek debt is on an unsustainable path and can't be repaid?

Answer: Yes. The debt ratio is almost 160% of GDP and rising, with promises of austerity not fully implemented the economy in deep recession. A 21% haircut is planned as part of the second support package to Greece agreed in July (so far three-quarters of holders have indicated they would accept the proposal), but markets discount about a 60% cut and we think that's what's needed.

### If Greece does need a 60% cut on its debt, how to achieve that in practice?

First possibility: The IMF and EU, currently funding the Greek government via a loan program agreed in May last year, become disenchanted with the lack of progress on deficit cuts and refuse to disburse one of the loan tranches (due every 3 months), leaving Greece unable to pay its full wage/pension bill or its debt interest/redemptions. In tandem, the ECB and governments would prepare measures to try to limit contagion (e.g., bank re-capitalization, purchases of Italian bonds – see questions below).

Second possibility: Greece starts at last to convincingly cut its deficit, IMF and EU not only disburse the current loan, they also go on to the second stage, which effectively gives Greece access to official funding for a decade, providing a safety umbrella under which the debt can be gradually restructured by 60%.

### If and when Greece has a big default/restructuring, does that mean it has to leave the euro?

No. Defaulting/restructuring of debt, and leaving the euro, are two different things! Leaving the euro is astonishingly difficult, it is not like the British pound unpegging from the ERM or the Hong Kong dollar breaking its US dollar link, because the old, pre-euro currencies no longer exist. Hence, there is no vehicle for a country to devalue (or revalue) into, and any attempt to re-create them suddenly is likely to create chaos, as the value of assets and commercial contract terms became unclear and assets no longer matched liabilities.

### If Greece does undertake a big default /restructuring, won't there be unstoppable contagion?

This is the big risk. To minimize it, the Greek banks would need immediate restructuring, French and perhaps some other Eurozone banks would need a capital injection to cover their losses. Also, Italy and perhaps Spain, perhaps Portugal (and even Ireland which is doing much better) would need unlimited support from the ECB for their government bonds in the open market.

### Has Italy done enough?

Not yet. The package agreed in mid-September is impressive (includes VAT rise, tax on high earners etc.), but yet more is needed, e.g., maybe a wealth tax. That may need a new government, and the political situation looks complicated now.

**Would the ECB really give unlimited support to Italy and others?**

Yes. Otherwise, the euro could be at risk of break-up, undermining the basis of commerce with a very real risk of depression in Europe, and we don't think the ECB would allow that. There is political pressure on the ECB to limit purchases, and we've seen German members resign or speak out against the purchases, but none of this can stop the ECB majority from carrying on buying. And the ECB has successfully demanded big fiscal cuts from Italy and Spain in return for buying their bonds.

**Won't the ECB run out of money if it keeps buying periphery bonds?**

No. The ECB has no technical limit on the amount of bonds it can buy since it creates euros. All its capital is theoretically at risk if the bonds it has already purchased default, but if the ECB keeps its nerve and keeps buying, and if Italy and others honor their promises to get their public finances in order, then the bonds won't default. And if they do, the EU Treaties require the member states to re-capitalize the ECB.

**How much would it cost to re-capitalize Eurozone banks?**

This depends on the scenario, but our central case of a large Greek default/restructuring would cost EUR 15 bn for the Greek banks and EUR 35 bn for others; these figures get much larger if there's a deep recession or if other sovereigns default.

**Do we need a Euro-TARP to re-capitalize the banks?**

A: That could be stabilizing, and the new European Banking Authority has just demanded that 16 of the smaller, weaker banks be re-capitalized immediately.

**Is it enough to re-capitalize just those 16 smaller banks?**

No. Those banks were selected using the assumptions of the stress tests conducted earlier this year and they do not reflect today's concerns on sovereign debt. To regain investor confidence, we think that proper revaluation of sovereign positions is needed, which would likely show that some of the larger banks in France and elsewhere need more capital. That should be followed by bold re-capitalization using a mix of public and private money. The re-vamped EFSF (see below) could provide some funds, but the political resistance to using public money suggests that much of the money may have to come from the private sector, perhaps partly as CoCos.

**Is it time for investors to buy the banks yet?**

We recommend buying senior debt of some high quality core-European banks, as well as some of the Nordic (ex Denmark) and Australian banks. Don't buy equity yet, some of the weakest banks need major capital injections, and the resulting uncertainty keeps even the stronger names vulnerable.

**Does it matter if all Eurozone governments ratify the new powers for the EFSF?**

Yes. The new powers will allow the EFSF (European Financial Stability Fund) to buy debt of weaker sovereigns in the secondary market (and that in turn could provide funds for bank re-capitalization). It would be a bad signal if this is not ratified, but if it is, it will be helpful without being a panacea. Its ultimate backing by taxpayers across the Eurozone makes it technically a much better vehicle for supporting weak sovereigns than action by the ECB that is ultimately backed by money creation. However, in contrast to the ECB's unlimited scope, it is small relative to the total sovereign debt of weak sovereigns (though there are proposals to leverage it in some way to give it more firepower – and the ECB can always hover in the background ready to resume purchases should the EFSF's funds start to run low).

**Which currencies are safe havens?**

We define a safe-haven currency as one that appreciates during times of financial market stress, with the characteristics of a current account surplus and positive net foreign assets. With CHF now capped against the euro by SNB action, the only remaining safe-haven currency in our view is JPY, where government debt is high but financed domestically. The USD often appreciates against most units during financial stress, despite the US external deficit. This is usually because foreign banks have to buy dollars to square their balance sheets when they make losses on dollar investments; this effect is unlikely to be powerful in the current crisis where losses would be mainly in euros. Within EM, the SGD is a safe haven as it tends to outperform other EM

currencies. But it is not a safe haven in a broad sense, as it tends to underperform JPY, and even USD. SEK and NOK are good diversifiers over time, but often don't perform well in a crisis. Ultimately when choosing currencies, we would not over-emphasize safe havens, rather we suggest diversification, using a basket (which can include gold) appropriate to investors' home currencies.

### **If the euro does break-up, what happens to my euro deposits?**

This is a very uncertain legal area. If the break-up is officially sanctioned by a new Treaty among all participants then the issue would be clarified, but that would take a long time. If one or more countries suddenly tries to leave unilaterally there is likely to be confusion, perhaps chaos, as deposits and contracts become difficult to define. Traditions of "Lex Monetae" suggest that the law of the country issuing money apply to its money wherever it's held. The euro is issued by multiple countries, so if one or more tried to break away unilaterally, deposits held outside the Eurozone would probably stay denominated in the euro as defined by those countries staying inside the zone.

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