

An Update on the Greek Sovereign Debt Crisis: Putting the “Jitters” in Context

In the past few weeks, concerns about whether or not Greece will default on payments related to its sovereign debt have reached a fever pitch. Jittery markets were further racked by the chaos that occurred yesterday afternoon, Thursday May 6, 2010. The Dow Jones Industrial Average plunged nearly 1,000 points before recovering significantly, ending the day down just over 300 points. While a 300-point drop is significant, the massive 1,000-point intra-day sell-off is thought to be linked in large part to a singular trading error. Although euro-zone nations and the International Monetary Fund have pledged aid in the form of a three-year package totaling over €110 billion (\$147 billion), investors are increasingly worried that other nations with significant debt burdens versus gross domestic product could soon face similar troubles.

Monetary policy assistance has also come from the European Central Bank (ECB). For the second time in two months, the ECB relaxed its borrowing rules to allow the continued acceptance of Greek sovereign bonds as collateral. This is a reversal from its earlier stance in January, when ECB President Jean-Claude Trichet stated the ECB would not accept bonds that were rated below investment grade. This measure should help ward off liquidity crises for Greek banks, which are significant holders of Greek sovereign debt, as they will be able to receive cash from the ECB while pledging Greek sovereign bonds as capital. More controversially, this precedent-setting decision by the ECB could be viewed as a forerunner of a move toward quantitative easing, whereby the central bank uses its balance sheet to monetize the debt of the eurozone's weakest members.

Background

The announcement of a finalized bailout package arrived in the first few days of May, affirming that Greece can service its debt payments due on May 19. However, this package assumes that Greece will have access to the debt markets. The past few months have shown that the Greek government will face more difficulties in accessing these markets in the near term, especially since Standard & Poor's recently downgraded Greek sovereign debt to below investment grade.

The most worrisome aspect is that market participants have not reacted positively to the announcement of a finalized bailout package or to more stringent efforts on the part of the Greek government to curb spending. Instead, investors are avoiding Greek assets on fears that the planned bailout might not be enough to keep Greece solvent. In addition, there are worries that whatever measures are taken for Greece will set the precedent for what to do if other countries such as Portugal and Spain require assistance as well.

Political Ramifications

In order to receive the eurozone/IMF aid package, the Greek government has promised to cut its budget deficit by 11% of gross domestic product (GDP) by 2013 by implementing cost-cutting measures that total 7% of GDP. More stringent efforts will be made to lower debt levels, including pay cuts and pension reductions for public-sector employees, raising the average retirement age, increasing taxes and privatizing some state-controlled industries. While it is certainly necessary for Greece to take action to combat its deteriorating financial condition, this may backfire and cause an even sharper economic downturn than currently envisioned. As noted in SEI's first-quarter Economic Outlook, severely tightening fiscal policy would cause sharply higher unemployment, which would result in an increase in money spent on social services. This, combined with declining tax revenue that results from recessionary conditions, may make conditions even worse in the long run.

These actions have resulted in smoldering anger among the Greek people, as they have taken to streets in protest of these proposals. Unions have planned ongoing strikes, and some protestors have even attacked tourists visiting the Acropolis, posing huge problems for the success of one of Greece's largest industries. These demonstrations turned violent on May 5. Although the majority of the Greek population may be resigned to a multi-year period of belt-tightening, recent violence highlights the risk that their government may be tempted to water down the austerity measures if civil unrest becomes more widespread.

Political ramifications also exist for Germany, as upcoming elections on May 9 are looking grim for Chancellor Merkel's coalition government of center-right politicians. The largest region of Germany is already showing support for more left-leaning parties, and polls currently show that dissatisfaction with local issues such as unemployment and education are the reasons for the change in voter sentiment. Although Greece does not seem to be as important in the eyes of German voters, these elections are one of the reasons that the Chancellor was so vocal in fighting a Greek bailout package. Today, however, the German parliament voted its approval of the plan to assist Greece. All of these issues

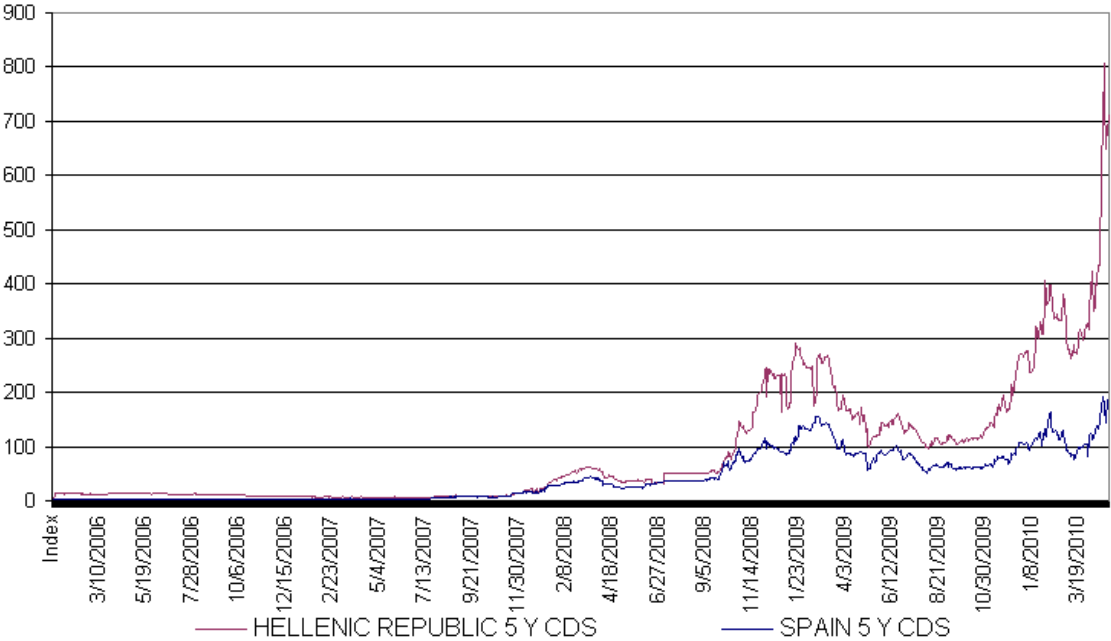
combine to create a precarious situation for the European Union, as speculation continues around whether new rules will be put in place to exclude certain nations from participating or what changes are needed for the Growth and Stability Pact.

Effects in the European Bond Markets

As events have unfolded over the past few weeks, investors' risk appetite has all but dried up. Instead, demand for German government bonds has increased as investors seek a safe haven from the uncertainties of how the peripheral European nations will handle their debt problems. As a result, bond yields for those countries have increased substantially to account for the risks taken when investing in these sovereign bonds. The downward price momentum for bonds issued by Greece and other debt-laden countries has been similar to the U.S. Financials sector during the market downturn of 2008.

Recent credit-rating downgrades continue to affect Greece as well as Spain and Portugal, but the prices of credit default swaps show how much more dramatic the situation is in Greece compared to other countries. As shown in Exhibit 1 below, while Spain's five-year credit default swap prices have increased to levels seen during the credit crisis two years ago, current prices for Greece's five-year credit default swaps make those during the credit crisis seem small by comparison.

Exhibit 1: Five-Year Credit Default Swap Prices for Greece and Spain, 2007-2010



One of the biggest issues facing eurozone nations is the probability of increasing yields affecting already beleaguered nations' ability to pay existing debts. This situation could easily spiral out of control if a solution isn't found quickly that will reestablish confidence into European bond markets.

Our View

SEI continues to monitor direct exposures to Greece within its portfolios, as well as to indirect exposures in the form of U.S. and European banks. As of April 30, 2010, SEI has less than 1% exposure in our International Equity Fund underweight relative to the benchmark and zero exposure in the Emerging Markets Equity Fund. International Fixed Income Fund's direct exposure to Greece is 1.29% at this time versus the benchmark of 1.07%. Emerging Markets Debt Fund has zero exposure as of April 30. Increasing global integration makes this problem a widespread issue for developed nations. The U.S. is the biggest shareholder in the IMF, which means that European nations aren't the only ones who have to pay for the bailout, although they will pay the largest amount. We believe that in order for Greece to successfully tackle its problems, it must find a way to become more competitive by taking steps to allow for market-oriented solutions. This could include lowering its tariffs or deregulating its labor market. We are cautious as we await clarity from the Greek government, other eurozone nations and the IMF regarding the specifics of how Greece will reverse its current situation.

At this point, there is tremendous skepticism on the part of investors that Greece will be able to make good on its pledge to drastically reduce its fiscal deficit. As we mentioned above, it is a worrisome sign that the crisis has deepened this week despite the pledges of the IMF and the eurozone to cover Greece's funding requirements in the near term. The path of least resistance still points toward continued decline in the value of the euro against the dollar and a flight of capital to safer havens, both within Europe and from it. We would note, however, that highly volatile trading conditions have prevailed in very recent days. As was the case during the financial meltdown in 2008, strong countertrend rallies could occur with little notice, perhaps in response to additional support measures for Greece or an increase in confidence that the country will indeed proceed with the needed reforms. Although Greek and other European officials categorically deny any intention to restructure the country's debt, investors should not rule out that possibility.

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