Europe's Sovereign Debt Crisis: Impact on Stock Markets

"I think we need a bigger boat!"

The words of Martin Brody, played by the late Roy Scheider, ring true today with regard to Europe's spluttering attempt to avoid a sovereign debt crisis. Now that the side-show spectacle regarding raising the US debt ceiling (i.e., whether the US would self-immolate) has passed (for the near-term). The issue for the markets relates to two items:

1) The prospects for Europe avoiding a financial crisis
2) The outlook for the US economy

It will take time and many more data points to determine whether we are headed for another recession (double dip) within the next 12-months. Crackerjack maintains a baseline view that we will not though we will be monitoring the US economy vigilantly.

The Genesis of this Crisis:

The PIGS (an acronym for: Portugal, Italy, Greece, Spain) plus Ireland have been under tremendous financial stress due to a simple economic reality which came to roost, governments spent more than they took in for years upon years in a row. A review of the past decade worth of fiscal policies for Greece and Spain get you to think why the crisis hasn't happened until now!

The good news is that market participants know that Greece and Portugal cannot pay back their debts – (not 100 cents on the dollar anyway). Greece and Portugal combined are some 3% of the EU-27 economy so this aspect of the crisis has always been containable.

The elephants in the room:

Ok, well the *dwarf elephants* in the room are Italy and Spain. These two countries matter as they make up close to 23% of EU-27 GDP. Each country has a different set of problems. Both sets of problems are manageable because each country has a robust enough economy to avoid a crisis - if confidence does not evaporate.

Spain:

Spain actually has less gross public debt relative to the size of the Spanish economy than does Germany or France. The main problem for Spain is that the economy has been in a major funk coming off a severe housing bubble (sound familiar?). Unemployment has been around 20% and there is an inventory overhang of unsold houses. These two problems have led to questions regarding the health of Spanish financial institutions. Round two of all these problems have led to questions regarding the creditworthiness of Spain as a sovereign. Spanish borrowing costs (10-YR gov bond rates) have been range-bound around 5.0-5.5% this year until recently. In the past month, Spanish interest rates have moved up from 5.5% to about 6.25% where bonds traded today and yesterday. For an economy as fragile as Spain's, rolling debt at higher costs creates more of a fiscal deficit, leads to more austerity being needed, which leads to more of a slowdown in the economy – you get it! Vicious spiral.

Italy:

Italy's problems are very different than Spain's. While Spain's economy is very sick, but debts are more reasonable (public sector-wise), Italy's economy is stronger, but debts are more out of control. Italy's debt-to-GDP ratio is well over 100%. Most of the debt is held by domestic Italian institutions, but not all of it. The economy in Italy actually hasn't been so bad. Q1 GDP growth was 3% in real terms (this is stronger than the US). Exports from Italy to the rest of the world are actually up over 20% so far this year. Unemployment is 8% which is much lower than Spain and even

lower than the US. The problem for Italy has been 12 consecutive years of spending more than the government was taking in (fiscal deficit). Greece and Portugal did this too – they both have had austerity imposed on them – and both Greece and Portugal are in a depression. Clearly the market fears are such that Italy will need a bail-out, austerity, will go into a deep recession, and this is scary because Italy is large enough to start dragging the rest of the EU down with them. Italy's 10-YR yields were around 4.75% early this year and have increased to over 6% the past 3 days.

The Solution:

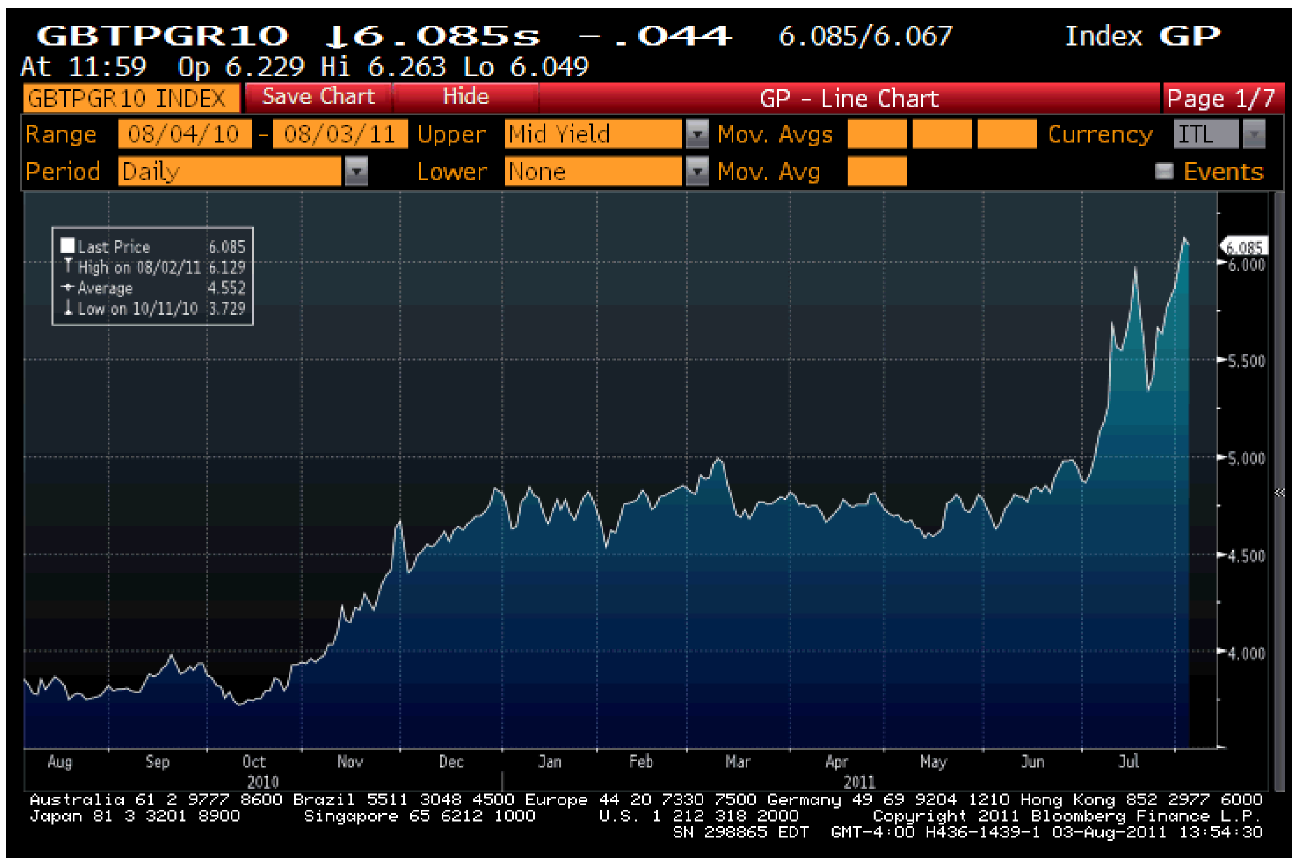
Italy and Spain do not need bail-outs and debt forgiveness the way that Greece, Portugal, and Ireland do. The crisis for these two countries and correspondingly for the rest of Europe, is a crisis of confidence. In order to stabilize things interest rates need to be stable. It is clear to Crackerjack Finance that there are two ways this can happen:

1) Europe's economy quickly gets much better and investors stop worrying about the economies in Italy and Spain (we give this a 1% probability).
2) The ECB is ultimately forced to implement a TARP/QE type solution where they end up purchasing any-and-all Spanish and Italian government bonds in order to stabilize interest rates and borrowing costs (we give this a 99% probability).

The ECB threatening to be a buyer of last resort is an indirect subsidy for Italy and Spain. Why this is difficult is that the stronger countries in Europe, such as Germany, want to draw lines in the sand with respect to how much they "bail-out". What the German's need to realize is that if you threaten to bail-out in large size you get speculators to stop shorting Spanish and Italian bonds and you get them to buy instead. The market effectively does the work for you. Whereas if you keep pointing out how you want to limit the size of bailouts, the market will keep selling bonds, effectively testing the reserve of Europe to avoid a crisis. What is needed is an announcement that the ECB stands ready to buy bonds in size (Trillions of Euros) and then start to buy a little bit. It is our view that Europe, led by the ECB will engage this sort of action this summer.

This will get us focused back on regular economic analysis and should stabilize markets in the second half of the year. There are still an abundance of long-term structural issues but a crisis and near term recession is starting to get priced in by markets. In short, while alarmed by recent events, Crackerjack believes the higher-probability outlook is for no financial-crisis redux and we are investing accordingly – and buying stocks which have gotten cheap on normal valuation metrics (we mentioned Guess (GES) earlier this week).

Italian 10-YR yields:



Spanish 10-YR yields: