



# EUROPE'S SOVEREIGN DEBT CRISIS AND ITS GLOBAL IMPLICATIONS

CAMBIAR INVESTORS

## Overview

The ongoing sovereign debt crisis in Europe brings to mind the famous statement by Samuel Johnson, who noted that “the prospect of hanging concentrates the mind wonderfully.” The catalyst for this financial emergency was Greece—but it has spread quickly to other countries. As the contagion accelerated, stock markets around the world began to correct sharply. This cascade of self-reinforcing market losses constitutes the “hanging” that succeeded in concentrating the minds of Europe’s politicians and policymakers. In response to the growing financial crisis, a massive rescue package has been crafted, totaling nearly \$1 trillion. The package was met with an initial sense of optimism, as policy “shock and awe” led to a dramatic relief rally around the world. However, this exuberance has given way to a more somber reading of Europe’s prospects, and markets have given back all of their initial gains and then some.

We think the European rescue package is likely to succeed over time in counteracting the liquidity crisis plaguing the region (although it may need to be strengthened with a few additional policies). However, the longer-term work of structural adjustment remains ahead and will be an exceedingly difficult process for Europe’s peripheral economies. Given the structural uncertainties facing these economies, Cambiar favors the more robust core European countries such as Germany. In turn, weaker growth for the region as a whole implies a weaker Euro. As a result we also favor core Europe’s multinational companies that benefit from a cheaper currency and exposure to more robust global export markets.

Finally, we conclude that the problems right now are centered in Europe; we think it is misguided to assume that Europe’s debt crisis is inevitably headed to other developed countries like the United States, at least in any investable time horizon. We remain optimistic about the U.S. cyclical recovery and expect the current correction to be followed by healthier market conditions. However, the correction clearly marks the end of the beta rally and a transition to a more challenging stock picker’s market.

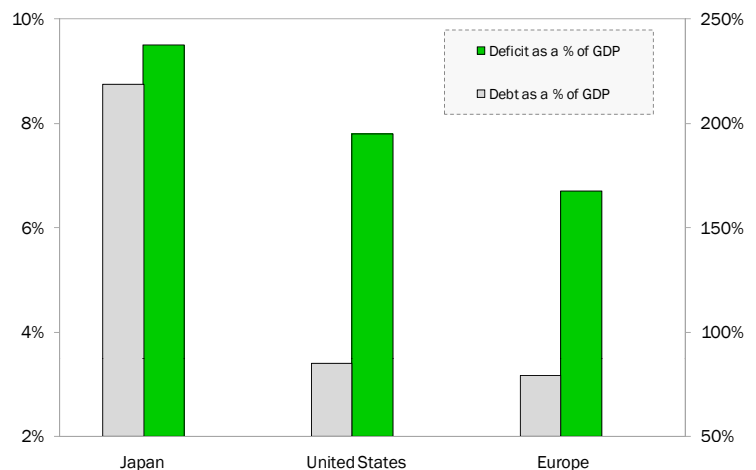
## The Key Issues

Europe’s new “sovereign TARP” is both aggressive and comprehensive. As suggested, we think it will help put an end to European contagion, particularly the vicious circle of falling sovereign bonds, deteriorating macroeconomic and banking sector fundamentals, and additional distressed selling (of

everything from bank stocks to government paper). In effect, the package takes the risk of a systemic failure off the table. However, the long-term process of structural adjustment is just getting started. As markets calm in the weeks and months ahead, attention will necessarily turn to the painful economics of structural adjustment and the complicated and conflict-ridden politics of austerity. Reducing fiscal deficits in weak (and potentially sharply contracting) economies is an exceedingly difficult task; as a result the leadership in peripheral Europe faces important hurdles. In turn, providing funds to bail out the “irresponsible” also makes for difficult politics—stronger core countries such as Germany face their own leadership challenges.

Beyond these specific issues, there seems to be a growing belief that Europe’s problems foreshadow an inevitable fiscal crisis in the rest of world’s industrialized powers. We think this is the wrong conclusion to draw. While we are cognizant of the dramatic long-term fiscal challenges facing countries like the United States and Japan, this kind of extrapolation misses a good deal about what is actually going on right now. The problem today is Europe, its weakened periphery, and the significant problems of coordination among the countries sharing the Euro.

## G3 Debt and Deficits



Source: Barclays, Bank of America; Debt as a % of GDP end 2009; Deficit as a % of GDP - 2010 projections









