

MARKET INSIGHTS

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The euro crisis: Origins, solutions and investor options



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“We all know what to do, but we don’t know how to get re-elected once we have done it.”

Jean-Claude Juncker, President of the Euro-group

Introduction and summary of options

This paper is intended to put into context the many individual components of the eurozone debt crisis. It is followed by some investment ideas relating to the crisis.

The good news is that the eurozone sovereign debt crisis is not due to a lack of money within the eurozone. The eurozone, as a whole, pays its way in the world and the money does exist to solve the crisis. The problem is that the money is in the wrong places. The savings are in the private sector, particularly in northern countries, while the deficits are in the public sector, particularly in Ireland and the south¹.

Furthermore, time is not on policymakers’ side. There is a growing sense of crisis as rising bond yields in core eurozone countries (particularly in France, but also Finland, Austria and the Netherlands), risk making debt unserviceable in countries that have not until now been associated with debt problems. Meanwhile European banks, which are large holders of eurozone government debt, face liquidity and potentially solvency issues as the value of their sovereign bond holdings fall.

The immediate challenge is to bring down bond yields in Italy and Spain, to prevent them needing a bailout that may not be available, and to prevent further bond yield increases in the core.

How do we manage this? There are two options, which may be implemented separately or combined.

¹In Italy this dichotomy exists within the country to a remarkable extent: household savings of EUR 9 trillion easily exceed sovereign debts of EUR 1.6 trillion. Bank of Italy estimate, 2009.

Option 1: Create fiscal and political union

Make more of the savings of the core countries available as collateral for unlimited loans to the periphery, by substantially expanding the existing bailout fund, the European Financial Stability Facility (EFSF). Bond yields should then fall when investors appreciate the scale of the commitment made by the core countries, and a positive feedback loop takes place, whereby falling bond yields attract investors back into peripheral sovereign bonds. In return the peripheral countries are made to undergo structural changes to their economies to help them regain competitiveness, and surrender control of how the money that they receive is spent. Perhaps combined with some debt forgiveness, so making austerity in the peripheral countries more palatable. And so fiscal, and eventual political, union is born.

But politicians in both the core and the periphery do not, generally, want fiscal and political union due to the associated dilution of sovereignty. Some of the core countries may suffer downgrades to their own credit rating if they guarantee more EFSF loans. Banks will struggle to absorb losses on sovereign debt, and may themselves lend less in an already weak eurozone economy if they need to write off more of the sovereign debt they hold, continuing to hold down regional economic growth.

Option 2: The European Central Bank (ECB) prints money to hold down yields

The new money can be introduced, *unsterilised*, through an extension of the ECB's existing bond purchase programme, in a similar way to the Quantitative Easing (QE) programmes seen in the US and the UK². An unlimited commitment by the ECB to hold peripheral eurozone ten-year yields at, say 3%, might enable the peripheral countries to service their debts at a rate of interest lower than their nominal rate of GDP growth and return to a lower, more sustainable debt/ GDP ratio.

But the ECB is mandated not to bail out governments, which a larger bond purchase programme would represent, for fear both of triggering inflation and of reducing pressure on indebted governments to reform their economies. Indeed, the International Monetary Fund (IMF) has for decades been urging central banks around the world to avoid becoming involved in fiscal policy.

A potential third option, of money coming in from outside the region, looks increasingly unlikely. The IMF has made clear its reluctance to increase its exposure to the eurozone periphery without proportionally larger commitments from the core countries (ie, from the EFSF). Emerging markets may be willing to support the eurozone, but through the IMF rather than direct commitments to the EFSF, and in return for rewards such as more voting rights within the IMF.

The story of the next few months will be about how resistance in both the core and the peripheral countries to one or both of these options is broken down. The focus will be on the leaders of the core countries, particularly Germany, and the pressure that they can exert on the ECB. If there is no agreement we may be looking at countries leaving the euro, with a risk of the disintegration of the eurozone.

1) Context

The eurozone crisis exists primarily because growth is too weak in the eurozone, and globally, to support the debt taken on by a variety of countries, in different ways, over the last decade. Growth is weak because bank lending has been weak, particularly to the small and mid-cap companies that in all countries provide the bulk of employment growth.

Bank lending is weak because many banks are still repairing their balance sheets from the fall out of the US sub-prime market and the resulting credit crunch. The fact that European banks hold large quantities of peripheral eurozone debt adds to their problems, and to their reluctance to lend to the small and mid-cap companies that require bank lending to provide working capital. There is a strong incentive on banks to deleverage and raise or conserve cash, by selling whatever assets they can that won't generate a book loss in the process, and to cut back further on making new loans. Meanwhile, households and large cap companies are paying off debt incurred prior to the collapse of Lehman Brothers, further reducing demand in Europe and the US.

²Sterilisation removes cash from the banking system, to counter the inflow of money created by the ECB when it prints money to buy bonds from the financial sector. The ECB uses short-dated deposit certificates to do this.

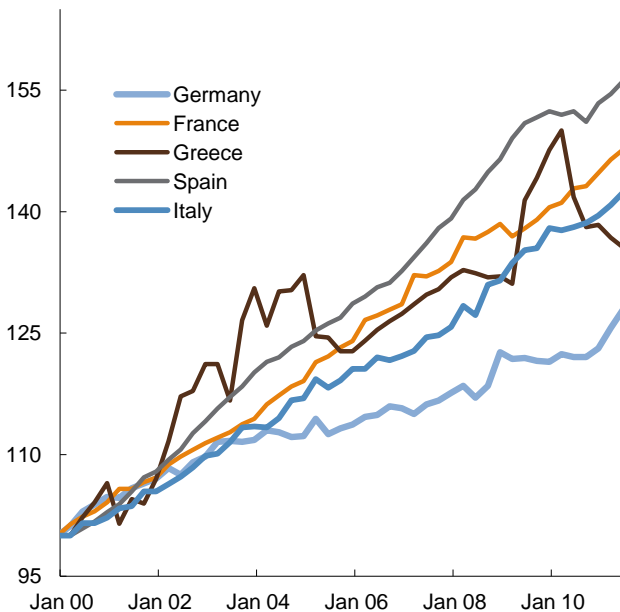
This deleveraging is likely to continue, perhaps for another couple of years (longer if the policy response proves to be inadequate), aggravating the problems faced by indebted eurozone governments and European banks.

2) The origin of the sovereign debts

In the years that followed the introduction of the euro, peripheral governments and peripheral banks borrowed massively. This happened because the new low interest rates that came with euro membership made such debt cheap to service. For governments it allowed infrastructure to be built, it reduced pressure to engage in structural economic reform to improve competitiveness, and banks were able to fuel property bubbles (see the Appendix for details of how the peripheral countries became so indebted).

Cheap debt fuelled growth in most peripheral countries, and with growth came labour shortages and wage increases that in turn led to a steady loss of competitiveness against Germany and the core eurozone region. **Exhibit 1** shows how wages in the periphery and in France grew in the years following monetary union.

Exhibit 1 – European labour costs



Source: Eurostat, J.P. Morgan Asset Management. Last data June 2011, rebased 100 at January 2011.

In contrast, Germany held down its labour costs in the middle of the last decade to restore competitiveness. This improvement in competitiveness generated a strong increase in Germany's exports within the eurozone and internationally, in contrast to weak export growth from the periphery economies, contributing to a strong current account surplus³.

Meanwhile, banks in core Europe and the UK were willing to lend money, both to peripheral governments and banks in those countries, initially because they offered faster GDP growth rates (and hence higher market growth) than home markets. The region also offered an opportunity for core eurozone banks to recycle the deposits made by a strong domestic export sector.

Then, following the collapse of Lehman Brothers in 2008, two things happened. First, banks were urged by regulators to improve their day-to-day liquidity by selling illiquid assets and buying very liquid government bonds. Banks naturally gravitated to those of the eurozone periphery, which at the time yielded slightly more than German Bunds, but like Bunds were classified by regulators as risk free.

Second, large quantities of property-related debt owned by banks across Europe and the US went bad. A vast quantity of bank debt was absorbed by the Irish government in order to protect depositors and holders of bank debt (in stark contrast to Iceland, which refused to bail out the banks' depositors), while many other developed countries also recapitalised their banks. At the same time global growth collapsed, welfare payments rose and tax revenue shrank, adding a further burden to the indebted peripheral countries' budgets.

Bond market investors began to fret that the debt may not get repaid in full from the peripheral eurozone countries because they cannot devalue to promote growth, or print money to repay investors. A negative loop evolved: as peripheral government debt became less attractive, its price fell (leading to a rise in yields), triggering higher interest payments and deteriorating public finances.

³ A country's current account is the net level of combined public and private sector savings. Private sector savings comprise household and corporate savings.

Bank balance sheets, still recovering from the credit crunch, have been hit by the rise in peripheral government bond yields. This has led to fears of a systemic failure of the banking sector if one government were to fail to meet its liabilities. It was agreed by eurozone leaders in October that European banks would recapitalise by EUR 106 billion by next June, but many fear that this is insufficient. Indeed, it is only slightly larger than the approximate EUR 100 billion that private sector holders of Greek debt have been asked to write off in the 50% haircut that was recently announced. But no one knows how much is needed, since we do not know how much of the sovereign debt will eventually default. This will depend on whether a solution is found to the current crisis.

3) How much is owed?

Economists tend not to focus on actual sums, but on how the annual budget deficit and the total accumulated debt look as a proportion of the economy.

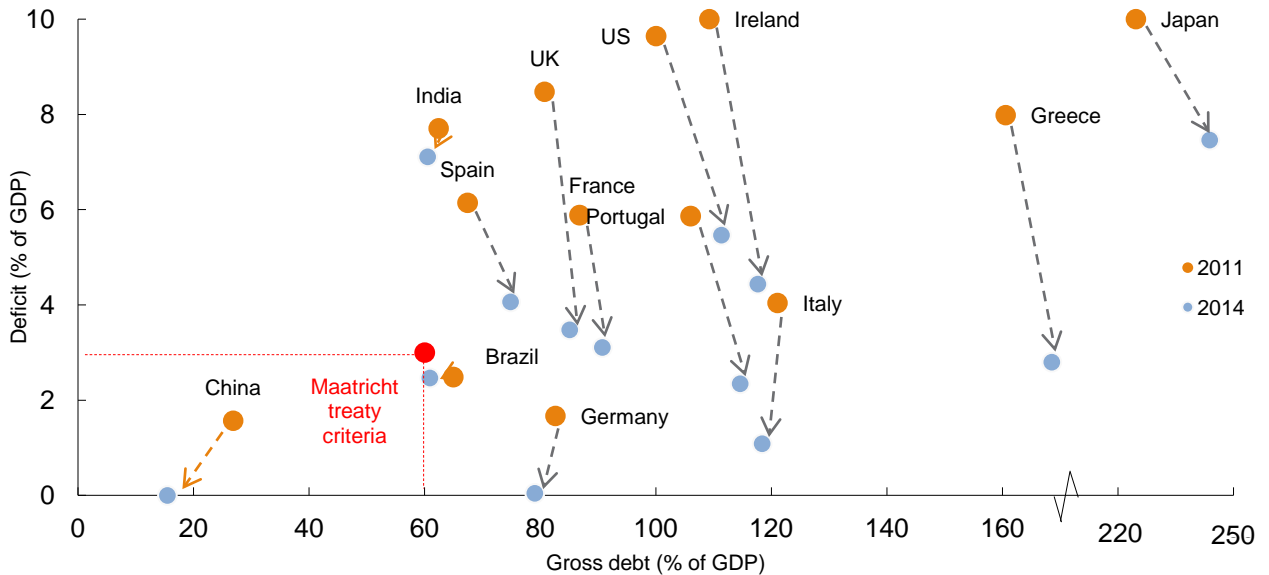
Exhibit 2 shows the debt profile (budget and total debt to GDP) of several peripheral and core eurozone countries, together with the UK, US and Japan and some key emerging economies. We show two dots for each country

- the orange dot is where the countries are currently estimated to be by the IMF, the blue is where they intend being in 2014 based on government plans.

Taking on debt is not, by itself, a bad thing. It can help an economy grow, if used for investment, and faster growth will help to pay the debt off as the tax base broadens. The economist John Maynard Keynes also suggested governments should borrow to stimulate demand at times when the private sector is weak, such as now, and spend money on projects that will increase a country's productivity in the long run. If nominal economic growth is faster than the interest rate paid on the debt, the debt will gradually disappear through the direct effects of inflation and a broader tax base⁴.

But taking on ever more debt becomes unsustainable if a country is not growing and producing increased tax revenue. In some countries there maybe scope to broaden the tax base to include powerful interest groups, and improve tax collection. But these measures aside, servicing debt in an environment of low growth can only come from yet more borrowing, or engaging in massive spending cuts and tax rises that risk choking off the sources of tax revenue.

Exhibit 2 – Government debt by country



Source: IMF Fiscal Monitor, J.P. Morgan Asset Management.

⁴ Nominal GDP growth includes inflation, it is the measure of growth using current prices. Real GDP growth strips out inflation, so we can see real underlying growth.



At what point is the debt unsustainable? The Maastricht Treaty debt-to-GDP limit was 60%, with a budget deficit limit of 3% (there are currently only two eurozone countries that meet these criteria: Luxembourg and Finland). More recently, an influential book published in 2009 by two American economists, Reinhart and Rogoff, have suggested that the danger limit is 90%, beyond which the long-term trend rate of growth is reduced and so repaying debt becomes harder and defaults become more likely (either through inflation, or halting interest payments and/or capital repayments)⁵.

Why does the debt problem appear so intractable? With 17 different countries, the ECB, and the bond market, there are a large number of different interest groups involved, whose views overlap and conflict at multiple points. Furthermore, within each of the 17 countries there are divisions among voters, politicians, and media and business groups. Broad agreement is hard to achieve when there are so many disparate interest groups.

It is worth commenting on the US, UK and Japan. As **Exhibit 2** shows, their debt profile is at least as bad as many of the peripheral eurozone countries whose government bond yields are nonetheless much higher. But in the current environment the advantages that non-eurozone countries have are several. With their independent currencies they can devalue in order to boost growth (they are not tied into a union with a super-competitive core eurozone). Their central banks can engage in unorthodox intervention to support government fiscal objectives, such as QE, something that the ECB has obliquely begun to do in a very limited way (since the ECB purchases are sterilised, it is not QE in the US/UK sense). And most importantly, they can always print money to repay their creditors. The UK enjoys the additional benefit of a long average maturity on its debt, of 14 years, meaning that Britain has to rollover a smaller proportion of its debt each year than any other major economy.

4) Measures so far

In return for austerity measures such as tax hikes and spending cuts, the European Union (EU), ECB and the IMF, the so-called Troika, have given bailouts to Greece, Ireland and Portugal. Spain, and more recently Italy, have introduced austerity measures to pacify restless bond markets, and so head off the need for a bailout. Many

core countries are also engaged in deficit reduction plans of their own.

The EU's contribution has been primarily through the EFSF, which currently has EUR 440 billion of guarantees from core eurozone countries. With these guarantees as collateral the EFSF raises money on the bond market and passes it on to recipient countries. The IMF contributions to bailout packages are smaller, but the organisation provides valuable advice to other lenders as to the effectiveness of the bailout programmes. The EU/IMF bailout funds are released in tranches, on a pre-determined timetable and contingent on the recipient country meeting tax revenue, spending cuts and asset sales targets.

The austerity imposed on periphery economies, from the Troika or by their own governments, has been deeply unpopular. Furthermore, it is having the unfortunate effect of lowering employment and overall demand, and so shrinking the tax base. As **Exhibit 2** shows, this means that for many countries debt-to-GDP actually increases as the annual budget deficit is reduced.

Furthermore, austerity measures can also leave untouched the structural inefficiencies in an economy, as politicians may force austerity on those least able to resist rather than tackle influential interests.

More recently the Troika has acknowledged that an insistence on pro-growth economic policies as a condition for receiving aid might be more suitable. It requires courageous politicians to take on the many vested interests, in the public sector and private sector professions, who will lose entrenched privileges through such reform. But economic growth would increase the tax revenue, reduce welfare spending and reduce the burden of debt as a percentage of GDP.

The ECB has also stressed that the crisis is for politicians to resolve, since it is a fiscal issue. However, it has helped ease monetary conditions through low interest rates, by offering an emergency lending facility to troubled eurozone banks that are unable to maintain sufficient deposits, and through sterilised purchases of peripheral sovereign debt via the Securities Markets Programme (SMP). This held EUR 187 billion of bonds as of 17 November 2011. The ECB has also bought covered

⁵This time is different: eight centuries of financial folly', Carmen Reinhart and Kenneth Rogoff, Princeton University Press 2009.

bonds, currently worth EUR 59 billion. It is the sterilisation of the ECB's bond purchases that makes the SMP fundamentally different from the QE seen elsewhere.

5) The end game

Austerity and/or pro-growth policies take time to bear fruit, but money is needed now. The core region is itself at risk of falling into the negative loop caused by rising bond yields. French yields have risen steadily through the autumn, and we now see previously rock-solid Dutch and Finnish yields also rising. A failed German Bund auction on 23 November suggests that the previously rock-solid Bund market may be vulnerable.

Greece has a particularly difficult repayment of EUR 5.2 billion due on 29 December if the EUR 8 billion sixth tranche of the first bailout fund is further delayed by a lack of political consensus in Athens, while Italy is at risk of failing to rollover EUR 300 billion of debt that matures in 2012.

Around half of the EUR 440 billion available to the EFSF has already been committed to Greece, Ireland and Portugal and it is doubtful whether the remainder would be sufficient to bailout a large country such as Italy or Spain. To compound the problem, if bond investors push yields up to an unsustainable level in one of the two countries, the other is likely to suffer a similar fate and both may need bailouts at the same time. Furthermore, if Italy or Spain required a bailout, the EFSF would instantly lose those countries' guarantee commitment, putting further pressure on the core countries.

However, Germany has explicitly limited its EFSF guarantees to just over EUR 200 billion, or 8% of its GDP, and there is little enthusiasm by other core countries to extend their commitments. Eurozone leaders have struggled to leverage the EFSF to a new target level of EUR 1 trillion, with emerging economies such as China showing little interest in contributing.

The IMF has expressed reluctance to be a main lender, preferring to work as a minority partner in bailouts. Meanwhile, the ECB has warned that it will not continue its (limited) bond purchases indefinitely, because of fear of generating Weimar Germany-style inflation through an endless monetising of sovereign debt.

The European Stability Mechanism (ESM), due to become a permanent replacement to the EFSF in 2013, may be overtaken by events.

6) What is to be done?

There are two ways to avert the risk of disintegration of the eurozone, they are not mutually exclusive and may complement each other. They both involve 'more of the same': more guarantees to the EFSF so that it can make larger bailouts available to the periphery and larger and unsterilised bond purchases by the ECB. At the same time as insisting on structural reforms to the periphery economies in order to boost growth and weaken the interest groups, whose power will be diluted by such reform.

The process may be helped by more widespread debt forgiveness, beyond the 50% haircut imposed on private sector holders of Greek debt. This will reduce servicing costs, helping the countries to grow, and so make austerity and economic reform easier to bear. It will also reduce the perception in some peripheral countries that austerity measures are being imposed so that core eurozone banks are rescued from the mistakes of their poor lending decisions. Debt forgiveness will also require further state aid to core and peripheral banking sectors, so that debt restructuring can take place without fear of a banking sector collapse.

a) Increasing fiscal and political union

Closer fiscal union, which would institutionalise permanent, more flexible and perhaps unlimited EFSF-style guarantees and payments, and which would require deeper political union, has been avoided due to voter opposition in both the core and peripheral countries. Indeed, a sense of the reluctance of politicians to expand the scheme comes from the fact that the EFSF bailout loans are priced at the discretion of the guarantor country governments, and were initially offered at penal levels to encourage borrowers to try all other options first.

But it could help to solve the crisis. The EFSF could become a eurozone treasury, issuing Eurobonds at an interest rate reflecting the weighted average of individual eurozone members' own bond yields. This would enable Germany to share its low borrowing costs with its neighbours, although at the price of seeing higher interest rates for itself. Germany could still issue debt for its own use as Bunds, presumably enjoying lower rates than issuing Eurobonds.

This has always been the preferred solution of the French government, who have seen 'more Europe' as the solution to the crisis, and that of the ECB and European federalists in general. From their perspective, fiscal union is the logical counterpart to monetary union.

However, voters in the core do not want to be permanently 'milked', as the Free Finns party in Finland has described the current system of transfers. And voters in the periphery do not wish to lose still more of their fiscal and political sovereignty that they sense has been lost through accepting the IMF/ EU bailouts. (Although the use of technocratic governments can make it easier to push through reform, providing voters and politicians with useful scapegoats while the necessary reforms are implemented).

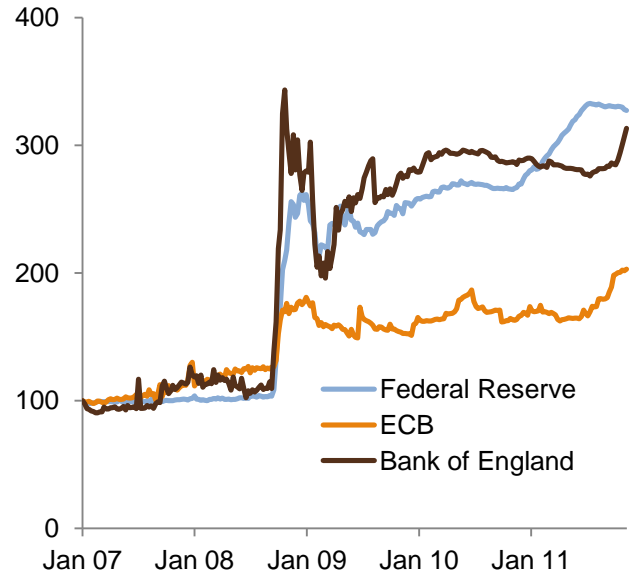
Germany has, historically, not been keen on the idea. But on 14 November Angela Merkel appeared to suggest this is a preferred route for the German government, when she told her Christian Democratic Union (CDU) supporters that 'the task of our generation is to complete economic and monetary union, and build political union in Europe...That does not mean less Europe, but more Europe'⁶.

A tighter inner group of the 17 eurozone countries, moving towards a federal union within the EU, will create a two-tier EU. But the 10 non-eurozone EU members, such as the UK, Sweden, Denmark and Poland, may not object too much so long as the existing single market rules are maintained. Particularly if the alternative is a breakup of the euro and perhaps of the EU itself.

b) ECB intervention

The ECB has allowed its balance sheet to expand only to a limited degree throughout the financial and subsequent eurozone crisis, in comparison with the Federal Reserve and Bank of England, as shown in **Exhibit 3**. It continues to emphasise its aversion to a shift in policy toward more aggressive expansion or so-called QE. It has continually stated that the modest purchases of peripheral sovereign bonds through the SMP, and also its covered bond purchase scheme, have been and will continue to be, sterilised in order to avoid the risk of inflation.

Exhibit 3 – Central bank balance sheets



Source: Bank of England, ECB, US Federal Reserve, J.P. Morgan Asset Management. Rebased 100 at January 2011. Latest data 9 November 2011.

If the ECB massively expanded the SMP, perhaps by offering unlimited and unsterilised intervention on the bond market to keep bond yields below a specified ceiling, investors would be less willing to sell and crystallise a loss and more inclined to hold or even buy periphery bonds. This will break the negative loop, and make servicing the debt viable. It would also keep cash in banks' balance sheets, available for lending to the small and mid-cap companies that require such lending for their day-to-day working capital.

The ECB president Mario Draghi has resisted pressure from politicians to engage in such policies. His argument, supported by the many other core-country central banks within the eurozone system and by the German government, is that to do so would risk inflation and is, in any case, illegal under existing treaties. Instead, critics of the plan say, indebted eurozone governments need to engage in austerity and economic reform. This will then be rewarded by the bond markets through lower bond yields.

⁶ Financial Times 15 November 2011, p.1 Her enthusiasm perhaps reflects the lack of palatable alternative options, rather than a conversion to the cause.

But it is not clear that, with such tight fiscal policies in place throughout Europe, expanding the monetary base through unsterilised intervention would create inflation. Further, the sell-off in eurozone bond markets has become contagious and based on irrational fear (how else can one explain the rise in spreads of Finnish government bonds over Bunds?). Economic reform takes time to implement, and it is not clear that the euro has that much time.

An increase in the money supply caused by the unsterilised purchase of peripheral bonds will gradually correct itself as bonds mature, although it should be acknowledged that this may take a long time and may take place when such a tightening of monetary policy is undesirable.

7) The alternatives

a) A smaller eurozone

It may be that we see one, or both, of the above options put in place but without all the current members. A country may be asked to leave the eurozone, as President Sarkozy made clear at the recent G20 Cannes summit. Equally, a country may wish to leave the eurozone if its politicians feel unable to push through a reform agenda. Whether being pushed out, or jumping out, any gain would come at a cost and brings with it a significant risk of contagion as other countries are forced to exit due to capital flight.

Suppose a peripheral country's government decided to leave the euro. Once this is understood by its general population, there would be an exodus of savings from that country to institutions in core-region countries. This will ensure that savings in euros are not converted to a new and devalued local currency. Savers in other peripheral countries would also remove their money from domestic banks and transfer them to core eurozone-based banks, as a precautionary measure. To avoid currency flight and the collapse of the country's banking system, capital controls will have to be introduced quickly and effectively across the peripheral countries (not just in the country that is leaving the euro). But capital controls would immediately break eurozone and EU treaties, and would currently lead to the expulsion from both organisations. In this way one country's exit becomes contagious.

Meanwhile, a tangled web of assets and liabilities denominated in euros will have to be un-tangled, with the likelihood of peripheral banks folding as they fail to repay borrowings made in euros (due to the capital flight). This will have a knock-on effect on the core-region banks that made the loans. There will no longer be access to eurozone or EU programmes, such as the EFSF.

Some politicians in indebted countries look at Argentina's default a decade ago, and its strong recovery afterwards, as a model of what they might enjoy were they to leave the euro (and probably the EU). However, they ignore the destruction of the banking system and of household savings that also took place in Argentina, and the fact that there will be no outside pressure on the country to engage in economic reform and take on those who benefit from the *status quo* – of course, this may be why they like the idea. Inflation will rise as imports become more expensive, labour unions will demand higher wages, and any near-term gains in competitiveness will probably be lost within a few years.

But what if a rich core eurozone country, or group of countries, wanted to leave the eurozone? This may also cost a country, or countries, more than they expect. This is because core eurozone export sectors, and therefore the core region's economy as a whole, are currently benefiting from the *weakness* of the periphery economies in a manner that perhaps has not been spelt out to their electorates.

To give one example: Dutch voters and politicians are appearing increasingly restless over their country's membership of the eurozone, resenting their tax revenues being used to bail out the peripheral countries. Yet if the Netherlands were to leave the eurozone, Dutch exporters would find themselves with a guilder that would rapidly appreciate (since the Netherlands has a strong current account surplus). Exports would shrink, unemployment grow and recession loom. To regain competitiveness the Netherlands would have to hold wage growth down below inflation levels for several years. On the plus side, interest rates would fall. But until competitiveness is regained, voters may actually find themselves missing the euro.

Furthermore, any core country, or countries, thinking of leaving would see a rush of capital moving in to their economy and so pushing up the value of their new currency relative to the euro. This will create an overvalued currency, exacerbating the problem expressed above.

b) Disintegration of the eurozone

Failure even to achieve stability may lead to the eventual breakup of the euro. This is our least likely scenario since the damage to the EU itself would be immense.

The single market would be difficult to defend in a Europe that may feature more nationalist governments, as special interest groups are placated with subsidies and protection from imports and hostile takeovers. Exporters in the core eurozone countries would struggle in the near term as their currencies appreciate against those of their customers, bringing the continent into recession and dragging down trading partners outside the eurozone. Meanwhile, peripheral Europe would return to permanently high interest rates (that limit growth) if persistent devaluations once again become the preferred method for retaining competitiveness.

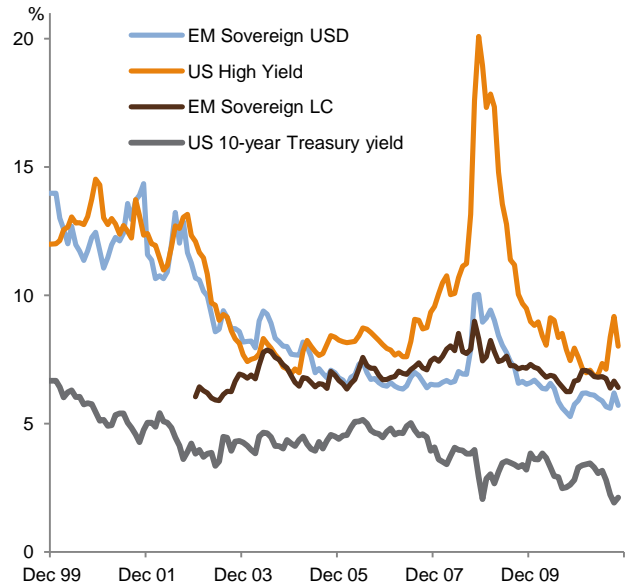
8) Investment options

With the outlook for the euro so uncertain and market volatility likely to stay high until the end scenario is clear, asset allocation favours defensive assets. But with yields on US, German and UK government bonds near record lows, and all three below local inflation rates, the most obvious risk free assets provide low returns. Investors will need to take on some risk if they want to protect their capital over the long term.

Fixed income

Our preferences within fixed income are for US high yield and emerging market sovereign debt, both USD and local currency denominated. As **Exhibit 4** shows, both asset classes saw a sell-off in August and September as investors became increasingly risk averse (this is shown in the spike in yields at the far right of the chart).

Exhibit 4 – Emerging market and US high yield debt



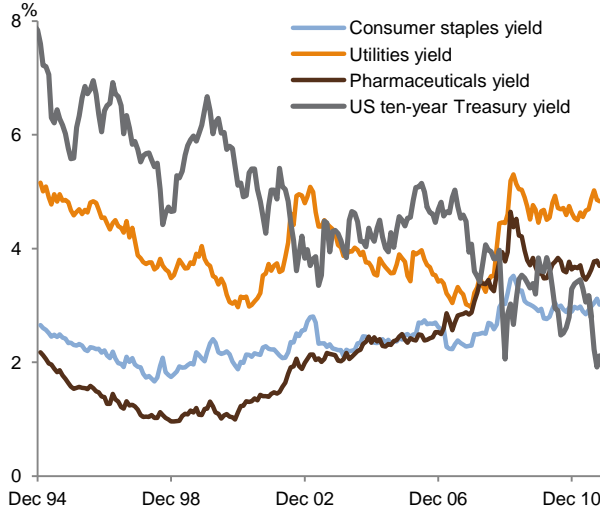
Source: JPMorgan GBI-EM, EMBI+, JPMorgan Domestic HY, J.P. Morgan Asset Management. Last data 31 October 2011.

Yields have come down a little since, but we believe there is more to come over the coming months in view of a recent trend of better-than-expected economic data from the US. Meanwhile, emerging market economies often have much better fiscal positions than developed economies, which is demonstrated in the earlier **Exhibit 2** where we see budget deficits and total debt to GDP for China and Brazil either meeting, or close to meeting, the Maastricht criteria for entry into the euro! Both asset classes offer good yields and the opportunity for capital gain over both the near and the long term.

Equities

Defensive stocks with some exposure to emerging market growth may sound like a contradiction, but European and US stock markets have plenty of such companies. Whether in the consumer staples, utilities, or pharmaceuticals sectors, these are the stocks that can give investors a yield of, often, over 4% with good dividend cover and supported by large quantities of cash in corporate balance sheets. Of course there is a risk of near-term capital loss in such volatile markets, but a strategy of holding on through the crisis should minimise the risk.

Exhibit 5 – MSCI dividend yields



Source: MSCI, J.P. Morgan Asset Management. Last data 31 October 2011.

Exhibit 5 shows the dividend yield of several global defensive sectors from the MSCI DM World Index, relative to the ten-year US Treasury yield. Not only do we see an inverse of the traditional relationship of dividend yields being lower than the yield on government bonds, but in some sectors we can find yields that will go a long way to maintain the real value of invested capital⁷.

Within European stock markets we also see a class of cyclical stocks that offer good growth through emerging market demand, such as companies in the luxury goods and autos sectors. They too should offer some protection from the euro crisis.

Other economically-sensitive parts of the stock market may also be interesting, but within a tightly controlled trading portfolio. High beta stocks that outperform the market on the way up and underperform on the way down, such as financials, can offer strong short term gains during periods of volatility such as we are experiencing. Eurozone small-cap stocks and some single eurozone country funds may perform in a similar fashion. However, a strict approach to buying and selling at pre-determined price points is necessary for such a strategy to pay off. Market timing is not easy, as step changes in trading patterns can catch investors out.

⁷Granted, comparing a global equity index against a single sovereign bond yield is not comparing like with like. However, 1) with multinational companies frequently reporting the majority of their sales from outside the country in which they are listed, this issue exists even when comparing, say, the FTSE 100 yield with the UK 10-year gilt yield. 2) Despite the budget deficit problems of the US, the US Treasury is still the world's preferred risk-free asset class.

Appendix:

How the peripheral countries got into trouble

All of the countries below have seen a change of government, resulting from the crisis.

Greece had relatively strong banks but had a substantial government budget deficit, which for years had been concealed. In early 2010 a new government revealed that the deficit as a percentage of GDP was not 3%, as previously stated, but a startling 10%. Investors took fright, nervous that the debt level was unsustainable, and sold government bonds which pushed the price down (and the yield up). The first EU/IMF EUR 109 billion bailout in May 2010 demanded tax increases and government spending cuts in return. Although the government revenue and expenditure targets have slipped, the plan persists. The sixth quarterly tranche of the plan for EUR 8 billion is currently stalled, pending Greek political consensus over the austerity measures demanded by the Troika. A second, additional, bailout was agreed in July, revised in October and increased up to EUR 130 billion. It has still stricter conditions, including installing a permanent official from the European Commission to advise on how to reform what is generally acknowledged to be a bloated public sector. As with the first bailout, there is some uncertainty as to whether the Greek political establishment and voters will accept the terms. A repayment of EUR 5.2 billion on 29 December looms, followed on 20 March 2012 by a EUR 14 billion repayment. Greece now has a technocratic government.

Italy has, for more than a decade, laboured under a very high debt burden inherited from previous decades but it was steadily making in-roads through running primary budget surpluses (ie, collecting more tax revenue than it was spending, allowing it to pay the interest without borrowing more). Unfortunately very slow growth over the last decade has made it hard to reduce the overall debt as a percentage of GDP. As long as interest rates remained low, this was not a pressing problem. However, following bailouts to Greece, Ireland and Portugal, and political difficulties passing budget reforms at home, investors began demanding higher yields on Italian debt. On 9 November 2011 Italian ten-year bond yields passed 7%, a level that many see as unsustainable. With outstanding government debt of EUR 1.6 trillion, Italy is by far Europe's largest sovereign borrower, and the fear is that it will be unable to rollover the debt as it matures (EUR 300 billion in 2012). Italy now has a technocratic government.

Ireland. Not all the problems were created in the public sector. Prior to Lehman Brothers' collapse Ireland was running very strong public finances, but over-lending was a problem in the private sector, particularly by Irish banks borrowing abroad to lend into the property sector. The size of the banking sector as a proportion of GDP grew substantially, meaning that the country's own resources were insufficient to bailout its banks when property-related debt hit the bank's balance sheets from 2009. The government had to borrow large sums from the IMF/ EU in order to recapitalise the banks. Privately held debt was effectively nationalised, taken on by the Irish tax payer, to ensure that the core-eurozone banks that had lent to Irish banks were repaid. Ireland received a EUR 113 billion IMF /EU bailout package last November and as part of that deal it has successfully pushed through an austerity programme. Consequently Irish government bonds were among the best performing during the third quarter.

Spain. During the property boom, in the decade prior to the collapse of Lehman Brothers, household debt grew quickly due to rising house prices and cheap mortgage interest rates. Better pay in the construction sector contributed to a rise in overall wages, helping Spaniards to pay the mortgage costs. However, this led to a decrease in competitiveness relative to Spain's trading partners and Spain was vulnerable when the local construction sector collapsed and global demand dropped following the credit crunch. **Exhibit 1** shows Spanish labour costs rising faster than those of Greece, France and Italy over the last decade, which themselves outpaced German labour costs. An austerity drive by the government, together with progress on strengthening the secondary banking sector and on pension reform, has (so far) kept Spain out of the headlines this autumn, though its bond yields have been increasing again, recently. The new centre-right government is expected to continue with these policies.

Portugal. Portugal suffers from a similar range of problems as many of the other Mediterranean crisis countries: a bloated public sector and high household debt. It received a EUR 78 billion IMF/ EU bailout package in May 2011.

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