



Weekly Market Commentary



October 24, 2011

The Greek Haircut

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Highlights

Despite all the headlines, yields for Italy, Spain, Portugal and Ireland's sovereign debt are at or below where they were in mid-July when the second rescue package for Greece was drafted.

While the second Greek rescue stemmed the decline in the sovereign bond market, as intended, stocks have plunged since then as investors increasingly priced in a greater "haircut" the banks may have to take on their Greek bond holdings.

The stock market's rise, despite no resolution on the terms of the comprehensive rescue package, appears tied in part to the increased clarity around limiting the amount of the haircut, lowering the odds of further bank failures and a 2008-style financial crisis.

The euro was born in January 1999, which means the European common currency will turn 13 in January. When I was 13, I never wanted my hair cut as short as my mother did. So we would negotiate—sometimes right down to the final snip in the barber chair. Neither of us was happy, but we could both live with the outcome. This appears to be the key issue for the stock market as it reacts to the amount of the "haircut" in the ongoing Greek debt negotiations.

The S&P 500 Index gained for a third consecutive week, marking the first time that has happened since February. Last week once again featured solid and better-than-expected economic data and earnings reports and no breakthroughs on European debt problems—although discussions seemed to progress on the amount of the Greek bond "haircut". The S&P 500 Index closed the week at 1238, basically flat for the year, and up 13% from the low of October 3.

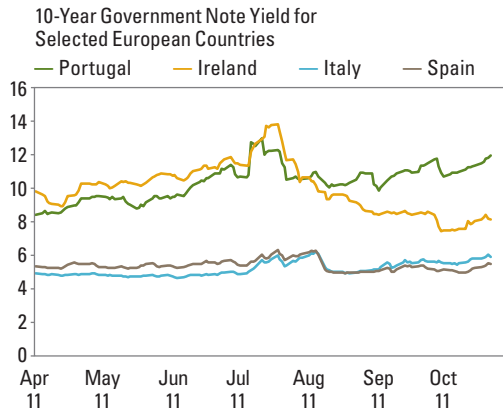
Another European summit is set for this week, as European policymakers move toward finalizing the details of the grand plan to deal with the debt problems that were promised by the leaders of Germany and France for early November. The fact that the various factions could not reach an agreement on the exact elements of the plan this weekend is obviously a negative. Yet, the policymakers would not have scheduled a second summit if they did not have the urgency and the political will to come to an agreement very soon, which could be viewed as an offsetting positive. In addition, there is the possibility that there could be support from international sources, such as the International Monetary Fund (IMF) or China. The IMF has about \$650 billion in uncommitted resources that could be directed towards bolstering the rescue plan.

The sticking point in the deliberations seems to be Germany's insistence that the rescue fund (The European Financial Stability Facility, or EFSF) be denied the ability to borrow potentially limitless sums from the European Central Bank, as France has favored. The final plan to contain the problem is likely to have two key components:

- First, the EFSF will be used to guarantee investors against principal losses on government bond sales or to set up an EFSF-insured fund that would allow for private investors to participate. The resources of the EFSF will offer insurance on new government debt issues by Italy and Spain likely covering the first 20–30% of any principal losses in a



1 Troubled European Countries' Bond Yields At or Below Mid-July Levels



Source: LPL Financial, Bloomberg data 10/22/11

2 Stock Market Plunged After July Greek Bailout Deal



Source: LPL Financial, Bloomberg data 10/22/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

default or restructuring. This guarantee could cover all the sovereign debt issuance of Italy and Spain for the next several years as they regain the market's confidence in their fiscal health, while still providing assistance to Greece, Portugal and Ireland.

- Second, a program for bank recapitalization to fill a shortfall resulting from the "haircut" taken by the banks on holdings of Greek debt. The bank capital needs are dependent upon additional debt relief for Greece in the form of a deeper, voluntary haircut on government debt. To meet the requirement that a debt exchange be voluntary and avoid a technical default that would trigger other problems, the haircut will likely be limited to the 40-50% range, rather than the 60%-plus demanded by Germany earlier this month. The bank recapitalization would be met first by banks themselves then by national governments and then possibly some ECB or IMF contributions.

This haircut issue is a major one for the stock market. The draft agreement on a second rescue package for Greece (to cover 2012 and 2013 funding) took place on July 21, 2011. It was a big event in terms of halting the contagion. So big, in fact, that it stabilized yields for other European countries: Spain, Italy, Ireland and Portugal [Chart 1]. Despite all the headlines, yields for these countries' sovereign debt are at or below where they were in mid-July. However, while that massive policy action stemmed the decline in the sovereign bond market as intended, as you can see in Chart 1, stocks plunged following that day [Chart 2].

The stock market slide that began after the second bailout deal for Greece on July 21 may have been driven by the unrelated debt ceiling debacle in late July and the first few days of August and the ensuing downgrade of U.S. sovereign debt by S&P in early August. But, following these events, a key contributor to the stock market decline may have been the actual terms of the bailout deal. There were over a dozen points to the bailout agreement. One of these was that banks and other private bondholders would voluntarily agree to contribute to the rescue package for Greece in the form of debt exchanges targeting losses of 21% in a one-off, voluntary haircut.

Investors have been pricing in the risk that banks will ultimately be faced with a greater haircut. These rising bank losses have kept the European banks pulling the stock market lower and raising fears of more bank failures and a 2008-style financial crisis erupting in Europe.

On October 3, German officials suggested the haircut may have to be increased—from 21% possibly to as much as 60%—in light of a new funding shortfall and changed market conditions. As these statements were made stocks broke through the early August 2011 low and marked the low point of the year as the market feared bigger and bigger haircuts and the application of those haircuts to the debt of every entity receiving aid from the EFSF.

The stock market's rise last week, despite no resolution on the terms of the comprehensive rescue package in Europe, appears to be tied in part to the increased clarity around the amount of the haircut banks will be forced to "voluntarily" take being more limited than what Germany was pushing



for. This is viewed by markets as reducing the odds of additional bank failures and a 2008-style financial crisis. Ultimately, it may be that finding the haircut that all parties, including the European Central Bank, Germany, France and others, could agree to—if not be happy about—may be the key to restoring confidence.

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