



Weekly Market Commentary

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Eurobonds: A Potential Positive Not Lost in Translation

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Highlights

While market participants have been demanding a response by policy makers, they are looking for that response in Europe more than in the United States.

Creating a Eurobond market may provide global investors with a highly liquid, well-rated alternative to U.S. Treasuries. The liquidity boost provided by an alternative to U.S. Treasuries may lower collective yields for the Eurozone members, even for Germany.

Eurobond draft legislation, which may be unveiled soon, may be helpful in providing market participants with a confidence-boosting glimpse of a long-term solution to Europe's debt problems that they have been demanding even if the implementation is not imminent.

Last week, Federal Reserve chairman, Ben Bernanke delivered his speech from the Fed's Jackson Hole conference, the event that helped to turn around last summer's fear of recession. While people along the eastern seaboard lined up at stores on Friday, August 26, to buy batteries and bottled water in anticipation of the unknown ravages of hurricane Irene, gentle Ben provided no surprises to disturb the markets. Instead he provided a review of the Fed's economic outlook and policy options already well known to market participants. The attention on the Fed was misplaced. While market participants have been demanding a response by policy makers, they are looking for that response in Europe more than in the United States.

Last week's gain was the first in five weeks for the U.S. and European stock markets. Indications that the European Central Bank (ECB) was leaning towards reversing rate hikes they implemented earlier this year and signs that a proposal for so-called Eurobonds was gaining acceptance as a longer-term solution to Europe's debt problems boosted investor confidence. In recent months, the U.S. S&P 500 stock market has been driven in no small part by the unfolding events in Europe. European economies, policy makers, debt markets, and the banks that hold the troubled debt have been acting and reacting to the worsening sovereign debt problem, and rising likelihood of a sovereign default. Markets are demanding a policy response that goes beyond bailouts and they may soon get it.

Translating and interpreting some of the European events and parties involved into terms more common to U.S. investors may be helpful to explain why investors are catching on to the idea that so-called Eurobonds are the most likely long-term solution to Europe's debt problems.

The European Commission, unlike the often temporary and powerless commissions of the U.S. Congress (where the answer to every thorny political issue is to avoid the tough questions by putting together yet another commission—remember how the president backed away from his own bi-partisan deficit commission when they finally reported their results), is actually the ruling body of the European Union. It is the executive branch, so think "White House" when we refer to the European Commission.

European Commission regulators are pushing for Eurobonds. The European Parliament (think "Congress") needs to see a proposal for Eurobonds and vote to pass rules allowing them. Most of the European Parliament appears to now be on board with Eurobonds as an end game (even France). The European Commission is writing up the Eurobond proposal now and, as it

European Debt Problem: Europe to United States Translator

| European Entity | U.S. Equivalent |
|---------------------|-----------------|
| European Commission | White House |
| European Parliament | Congress |
| Germany | Tea Party |
| EFSF | TARP |
| ECB | Fed |
| Eurobond | Treasuries |



prepares to present it to Parliament, is seeking to get Germany (think “Tea Party”) on board.

In September, the European Parliament will ratify the flexible mandate of the European Financial Stability Facility (EFSF) (think “TARP”). The EFSF will be able to buy the debt of any country or business or inject capital into any bank in Europe and make it a collective obligation of the Eurozone. The European Central Bank (think “Fed”) is acting in this capacity now, but is limited by what it can buy. The EFSF is a step towards a common European obligation, but is limited by its size. Accompanying the EFSF ratification is the enactment of laws to strengthen Europe’s deficit-limits to keep budget imbalances among Eurozone members from developing in the first place.

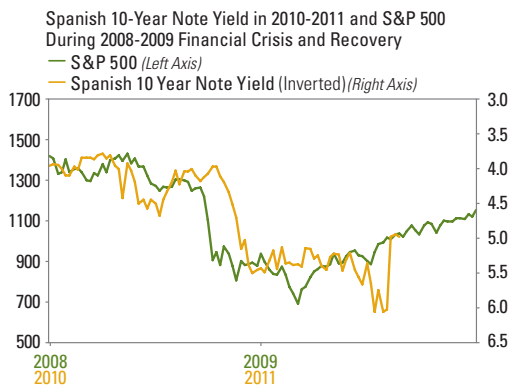
The Eurobond (think “Treasuries”) proposal due out before the end of the year may be released just after the EFSF is ratified by the end of September. The European Commission President indicated that draft legislation for Eurobonds will be presented in the near future, but is unlikely to unveil it until after the EFSF vote. The proposal, which is already well developed, is likely to be a plan where 60% of a country’s GDP would be financed by Eurobonds (or special sovereign bonds guaranteed by the Eurozone) at a common low interest rate and be backed by the credit of the entire Eurozone and the remainder of the country’s debt would be supported by their own issuance backed by their own sovereign credit. For example, Greece has about 150% debt to GDP so 60% would be financed by low rate Eurobonds, while the remainder would be financed at higher rates unique to Greece providing an incentive to keep debt ratios low. This would be a huge benefit to countries such as Greece now facing unaffordable high interest rates on all of their debt coming due.

Why would Germany go along with the introduction of Eurobonds when it would clearly mean a higher interest rate for Germans to help guarantee nearly about \$7 trillion in collective European debt? Because creating a European government bond market of about \$7 trillion would result in the world’s second largest after U.S. Treasuries (\$10 trillion). It would provide markets with a highly liquid, well-rated alternative to U.S. Treasuries, just as the United States has seen its credit rating downgraded by Standard and Poor’s. Six of the members of the Eurozone are AAA-rated (Austria, Finland, France, Germany, Luxembourg, Netherlands). Also, the deficit-to-GDP for the Eurozone is a much better 6% (according to Eurostat) compared to 9% for the United States (according to The Congressional Budget Office). The liquidity boost provided by an alternative to U.S. Treasuries may lower collective yields for the Eurozone members, even for Germany.

If enacted, Eurobonds may likely be a big plus for European stocks and bonds. It would likely be a negative for Treasuries and the dollar given the creation of a competing market for the world’s liquid capital. The potential rise in interest rates in the U.S. could put further pressure on economic growth and housing—perhaps this is part of the reason Bernanke pledged to keep rates low at least through the middle of 2013 and may use maturing short-term debt holdings to buy long-term bonds to try to keep rates down. A weaker dollar does have a silver lining in that it is good for U.S. exports and good for commodity prices.



1 Policy Response Key to Turning Confidence Around?



Source: LPL Financial, Bloomberg data 08/26/11

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

Eurobonds are likely to be the ultimate direction in which European policymakers will go, or will be forced to go, but it may be a while before they get there. In the meantime, even Eurobond draft legislation, which may be unveiled soon, may be helpful in providing market participants with a glimpse of a long-term solution they have been demanding even if the implementation is not imminent. Merely hinting at Eurobonds as a potential solution can create a powerful turnaround in sentiment as a shift begins from a monetary union that markets view as no stronger than its weakest link to a massive economic zone that is stronger than the sum of its parts. This could spark the return of investor confidence and begin to lower yields. Confidence is most important right now, as it was back in 2009 for the stock market. Perhaps not surprisingly, the yields on some of the troubled debt of European nations appear to be tracking the pattern of the S&P 500 during the 2008–2009 financial crisis and recovery [Chart 1]. As I stated last week: the stock market climbs a wall of worry not when risks go away, but when the confidence that they will be overcome returns.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

Debt-to-GDP is a measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes and what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt. The ratio is a coverage ratio on a national level.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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