

Thesis Reaction

24th June 2011

The continuing Greek debt problem

“When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor and least hurtful to the creditor.” Adam Smith, *The Wealth of Nations*

May's Market Commentary covered the impact of the current situation in Greece on government bonds, currencies and the banking sector. The Greek debt problem has been of growing concern for the markets and continues to be the driver of sentiment. It appeared that some form of restructuring would occur but the lack of consensus, both domestically and internationally has been very apparent and a lack of direction over the issue has weighed heavily on the markets.

Where do we currently stand?

Faced with civil unrest against the deeply unpopular austerity plan and waning political influence very few steps have been taken in Greece to abide by the terms of the current EU and IMF bailout agreement. The government has survived Tuesday's confidence vote, but parliamentary approval on 28th June of spending cuts and economic reforms worth €28bn is by no means guaranteed. Greece now desperately needs the next instalment of the bailout facility to meet debt redemptions in July and August totalling €13bn. We had hoped that this week's European Council meeting of EU heads of state and government in Brussels would bring some clarity, and this appears to be the case, with a further package of loans, including a roll-over by some bondholders, now on the table. This is enough to cover the country's funding requirements for some time, and should be sufficient to ensure that the austerity bill is enacted and prevent contagion sweeping through the other PIIGS (the countries of Portugal, Ireland, Italy, Greece and Spain) and the banking sector. A disorderly default would be very serious, as the largest quantities of Greek debt in private hands are

held by French and German banks and insurers, some of which are already weakly capitalised, and it is becoming clear that US banks have been responsible for much of the issuance of credit derivatives on Greek debt and so could have been similarly vulnerable.

There is a risk that another loan package does not avoid the requirement for a more fundamental restructuring of Greece's debt, but simply delays it, prolonging the uncertainty and ultimately making the situation more expensive to diffuse. As Adam Smith alluded to in 1776 in the quotation that opened this note, where a country's debt is clearly unsustainable a debt restructuring is beneficial for debtors, creditors and for overall financial stability. It needs to be carefully stage-managed however, and this has arguably not been the case with the PIIGS so far.

The way the Greek situation develops sets a precedent for Ireland and Portugal to follow a similar pattern. With no overall resolution to the crisis, there is still a risk that it could spread to Spain, and possibly even Italy and Belgium, though these countries have been able to issue bonds at reasonable rates thus far. A crisis in any of the larger countries would have more serious consequences - to keep the current situation in context, remember that Portugal Ireland and Greece are together responsible for only 6% of Eurozone output (GDP). Rapid and indiscriminate contagion due to herd behaviour by international investors, as was seen in SE Asia following the Thai Baht devaluation in the midst of a debt crisis in 1997 is unlikely in Europe, as the countries are better researched and understood.

Assuming the Greek austerity vote passes, the euro is likely to survive the current crisis in its present form. It is considered to be too much of a political project and symbol to be allowed to fail. Adjustments are necessary to restore the competitiveness of the peripheral economies and reduce their structural deficits. This is likely to result in increased pressure for some sort of fiscal harmonisation, or at least oversight, at the EU level. The adjustment process will not be without pain, and we have hedged exposure to the euro out of the European equity holdings in our portfolios.

What are the consequences for Thesis portfolios?

Our allocation to European equities is modest, ranging from 0.7% in our high income model to 5.8% in growth portfolios. The rationale for the holdings is based on the strong performance of the larger European economies (Germany, which accounts for over 25% of Eurozone output, grew by an annualised rate of 5.2% in the first quarter of this year) and strong corporate news-flow and earnings despite the debt concerns. Our preferred fund, the JP Morgan European Dynamic (GBP hedged) fund holds no Greek or Portuguese companies, and weightings of only 0.1% to Ireland and 4.2% to Spain. It is also significantly underweight in financial stocks relative to its benchmark. The JP Morgan New Europe fund which forms part of our emerging market allocation for larger portfolios is concentrated in Russia and Turkey, and has only an 11.5% weighting to EU members, all of which are outside the Eurozone.

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We remain bullish on emerging market equities for the long-term, especially as the pent-up demand from the growing middle classes begins to decrease the reliance that companies in these markets have on western consumers. Equities in general have been weaker on news concerning the PIIGS, but we see the lower prices as a buying opportunity while earnings ratios remain low compared to their historical average levels. The Thesis UK equity model is very underweight in the banking sector. Our preferred bank Standard Chartered has its business centred in emerging markets, and so has very limited exposure to the PIIGS. Some clients' portfolios contain Barclays, which we are currently treating as a hold. Its recent falls in price are partly because of its exposure to Europe, but more due to concerns over the impact of the UK bank ring-fencing proposals.

We have no fixed interest exposure to the poorer quality European public borrowers, but are buyers of lower risk sovereign debt, including UK gilts, which are benefiting from some flows of capital out of riskier sovereign debt. Two thirds of our fixed interest allocations are in corporate bonds, seeking to benefit from strong revenues and healthier balance sheets in the private sector compared to those of public borrowers.

Gold has fared well recently due to uncertainty and low real interest rates, helped in sterling terms over recent days by a stronger dollar. We have taken some profits on holdings this week. The metal still has its place in portfolios, though at current prices we are not buying for lower risk portfolios, as prices could drop sharply if macroeconomic concerns were to diminish, growth to pick up and interest rates to rise.

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