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Heightened European Sovereign Credit Risk Increases Global Market Volatility

On the heels of policy tightening in China and populist financial system reform proposals out of Washington, growing fears regarding sovereign credit defaults in Europe of late have raised volatility in global capital markets. The cost of insuring against default jumped for several euro-zone members with large budget and current account deficits and rising public debt levels. Additionally, investors shed risky assets like commodities and corporate bonds and the U.S. dollar rallied to an eight-month high against the euro. Since mid-January, the Chicago Board Options Exchange volatility index (VIX), known as the 'fear gauge' is up 51% and the Dow Jones Industrial Average experienced triple-digit moves in a stretch of 10 out of 16 trading days.

The price for credit default swaps (CDS) for many highly-leveraged European nations such as Greece, have risen this year. CDS are widely watched, tradable, over-the-counter derivatives that function like a default insurance contract for debt. If a borrower defaults, the protection buyer is compensated by the protection seller.

However, Greece is just one of many economies, including the U.S., with large debt loads as a legacy of the global financial crisis. Extensive government spending to fight the global economic downturn has also led to significant fiscal problems for some of Europe's less dynamic economies like Greece, Portugal, Ireland, Italy and Spain.

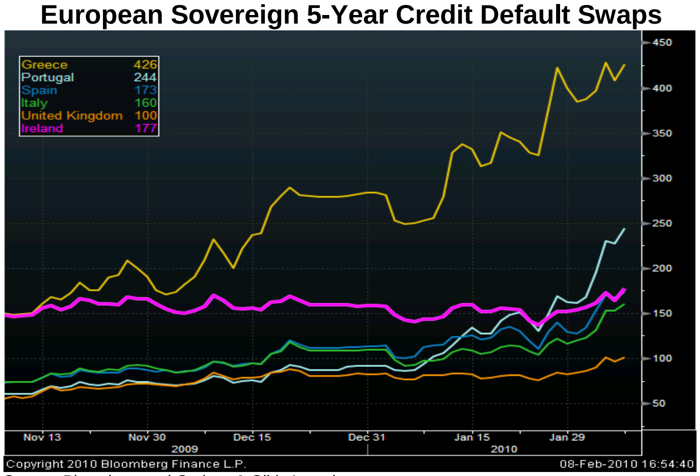
Investor fears relate to issues as simple as a slowing economic recovery to more extreme scenarios such as a broader credit crunch in Europe that would negatively impact banks with large exposure to government debt. Some even fear the possibility of a withdrawal of countries like Greece from the European Union (EU). Greece became the 12th country to join the EU in 2001.

Several near-term options for Greece, whose government deficit is almost 13% of gross domestic product (GDP), include emergency support from the European Central Bank or even the International Monetary Fund (IMF). Default is another possible alternative as the euro-area has no real mechanism to deal with a member that cannot fund itself in the capital markets. Pride and fear of strict conditionality may prevent a call to the IMF. A default by Greece would raise the cost of borrowing for the other troubled EU members and increase contagion risks, as global capital markets have never experienced such a rapid rise in developed market public debt.

The EU structure itself will certainly be questioned, with members such as Germany that rely on exports for growth, save and run a trade surplus, poles apart from economies like Greece that have focused too much on consumer spending, have weak public finances and rely on foreign sources of capital to offset a low savings rate. In February, the European Commission endorsed Greece's 'stability and development plan' a three-year strategy for cutting its deficit to below 3% of GDP by 2012. Greece also recently replaced the head of its finance ministry. Some analysts have labeled the situation in Greece as a 'dress rehearsal' for what the U.S. and U.K. may face in the future; although unlike Greece, the U.S. and the U.K. have advantages such as flexible currencies, and larger, more diverse economies.

Overall, as global economies transition from stimulus to normalcy, we expect capital markets will revert to more historical levels of return from the elevated ones in 2009. Moreover, volatility will likely remain elevated as the market has indicated its unwillingness to do business with over-levered institutions, enforcing the need for a focus on high-quality investable assets.

European Sovereign 5-Year Credit Default Swaps



Source: Bloomberg and Godsey & Gibb Associates

Government Surplus (+) or Deficit (-) as a % of GDP

	2003	2004	2005	2006	2007	2008	2009e	2010e
Greece	-5.7	-7.4	-5.3	-3.2	-4.0	-7.8	-12.7	-9.8
Ireland	0.4	1.4	1.7	3.0	0.2	-7.2	-12.2	-12.2
Italy	-3.5	-3.6	-4.4	-3.3	-1.5	-2.7	-5.5	-5.4
Portugal	-3.0	-3.4	-6.1	-3.9	-2.7	-2.8	-6.7	-7.9
Spain	-0.2	-0.4	1.0	2.0	1.9	-4.1	-9.6	-8.5
U.K.	-3.7	-3.6	-3.3	-2.7	-2.7	-5.3	-12.6	-13.3
U.S.	-5.0	-4.4	-3.3	-2.2	-2.8	-6.5	-9.9	-10.6

Source: Data Insight, ISI and Godsey & Gibb Associates (e = estimated)

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