



McLean Budden Perspective

What Next for the European Project?

August 2011

What Next for the European Project?

The Euro Bond:

The market continues to anticipate the issuance of a Euro bond to stem the current market upheaval and get business back to normal. It's seen as the ultimate policy initiative to halt the European sovereign debt crisis. A Euro bond is one that is issued jointly, meaning that all other members are liable for the reimbursement of that bond. Germany and all other Euro members would be equally liable for the debts of other member states. Naturally, it would dilute the weak with the strong. Many see the 440 bn Euro bail out fund, the European Financial Stability Fund (EFSF) as the blueprint for such a bond.

What is very clear is that such a bond is not forthcoming in the near future given comments by both Merkel and Sarkozy, who are clear that a Euro bond must be preceded by fiscal union. Deficits are to be eliminated permanently and where possible constitutionally enshrined. There is talk of setting up a European finance ministry to oversee the finances of individual states and harmonizing taxes. This is a long process which will require approval of all Euro members. It is not clear that all will be willing to sign up to such a draconian regime, especially as periphery economies continue to contract.

The other option left open by Merkel and Sarkozy is the possibility of stronger member states breaking off from the Eurozone. This would include Germany, France, Holland, Austria, Finland and Luxembourg. Such an event would likely see the collapse of the entire European banking system as losses from the periphery and large weaker states like Italy and Spain would overwhelm all banks. (See chart from Redburn below) It would also create a run on all periphery banks as its banking sector would also collapse. While this was not previously contemplated, it does appear to reflect the message from Merkel and Sarkozy. Those that sign onto the new regime will move forward. What happens to those that don't sign on is not clear. Of great concern, the next Greek bail out may be unravelling as Finland demanded and obtained cash collateral for Finland's portion of the new bail out. The risk that others demand the same is high.

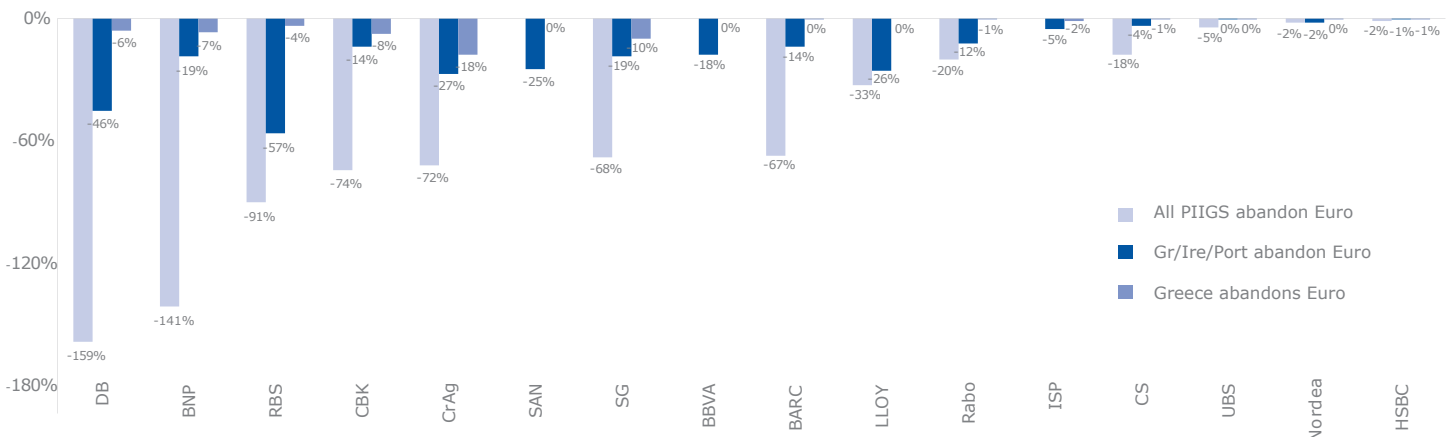
The next few weeks and months:

Under the circumstances, what is likely to transpire in the next few months? European banks will continue to be shut out of US dollar funding. The wholesale funding market in Europe is currently dead and given the uncertainty is unlikely to return in September as many hope. More banks will be forced to tap into the European Central Bank (ECB) for funding, creating a negative stigma, and inhibiting the banks' ability to operate normally. The ECB could come with funding mechanisms, as they did on the previous crisis, which might help. Theoretically, the ECB should demand collateral but this could be waved. Banks allegedly fear counter party risk.

Banks can live under these circumstances for a while but not indefinitely, especially as fears of liquidity feed fears of solvency. It's difficult to see how these will not persist under the circumstances. The ECB is buying Italian and Spanish debt as well as periphery debt. In the first week they bought 22 bn Euros and last week 13 bn Euros. The ECB is diluting the quality of its balance sheet with weak paper and markets may come to question the ECB's solvency. Without more capital the ECB is vulnerable as its balance sheet grows.. The extended powers of the EFSF allows it to buy Bank debt, so the ECB might be able buy Bank debt and sell it onto the EFSF. Such an action would not enhance confidence.

Merkel and Sarkozy have refused to increase the size of the bailout fund, the EFSF, which will be 440 bn Euros. This in effect limits the ECB because it is meant to sell its bonds to the EFSF when member states approve their extended powers, expected by late September. Italy's refinancing needs alone would dwarf the size of the fund although the mere presence of the ECB buying should be enough to entice buyers, at least in the short end.

Graph 1: Impact on core tier 1 of countries abandoning the Euro (a > 50% hit implies bank is bust; > 20% implies heavy shareholder dilution)



Source: EBA stress test data for PIIGS exposures, Banks for core tier 1, Redburn estimates and analysis

What Next for the European Project?

What could be some positive developments?

1. The continuation of the ECB buying Italian and Spanish bonds is positive in that it stops the contagion of the sovereign crisis. In addition, the ECB helps the banks as many of their purchases are from the banks seeking to reduce their sovereign exposures.

- > The problem is that the ECB cannot be expected to substitute itself as the buyer of sovereign debt indefinitely. At some point the market will question the ECB's credibility and ability to absorb an increasing amount of lower quality debt. The market may be beginning to allow the ECB more time but how long this regime can be maintained is impossible to judge. It is not infinite.
- > France's bond market is a likely target for markets when they seek to test the ECB's resolve and appetite for more sovereignty.

2. A new bail out fund sponsored by the IMF and funded with excess reserves from surplus countries.

- > This is a recent proposal by the former head of the IMF. It is still too early to say whether this initiative can find acceptance with the surplus countries.
- > Unofficially, traders say the Chinese are already intervening to support the Euro and possibly some European banks.

3. An organized default of periphery countries.

- > While difficult on some banks it would be manageable and arguably already in the price.
- > The ECB would also suffer losses, adding to concerns over its own solvency, but it could be recapitalized.
- > One would probably need a Euro bond or a larger EFSF to avoid contagion.

Merkel and Sarkozy are saying that their agenda will not be dictated by the markets, but in doing so they are increasing the stress on the banking system. There will come a point when it will not be tenable and something will have to give: A Euro Bond or a new Euro Zone. Europe's politicians have given in to markets before and they may do so again, but this time there does appear to be more resolve with Merkel. It may be that it is politically impossible domestically to issue a European wide bond that is ultimately guaranteed by Germany. In the meantime they rely on the ECB to hold the project together, but this has its limits as no one can predict how much time the markets will allow them to continue.

It's impossible to predict the outcome but continued uncertainty mixed with volatility appears inevitable.

Contact Information

Toronto

145 King Street West
25th Floor
Toronto, ON
M5H 1J8
Tel 416 862 9800
Fax 416 862 0167

Roger Beauchemin,
President & CEO

Ralph Daghfal
Alan Daxner
Sue Eagleson
Ted Harris
Brad Hicks
Catherine Jackman
David Kilburn
Soami Kohly
Ed Kwan
Bob Livingston
Robert Spector

Montréal

1250 René-Lévesque
Blvd. W.
Suite 3010
Montréal, QC H3B 4W8
Tel 514 933 0033
Fax 514 933 8163

Patrick Fournell
Bill Healy
Alexandre Legault
Benoit Paradis

Vancouver

595 Burrard Street
Three Bentall Centre
Suite 3043
P.O. Box 49105
Vancouver, BC, V7X 1G4
Tel 604 623 3430
Fax 604 623 3436

Doug Andrews
David Davies
Dave Mason
Colin Sinclair

Chicago

4026 N. Bell Avenue
Chicago, IL
60618
Tel 773 866 9210
Fax 773 866 9211

Bruce MacNabb

United Kingdom

Netherwood,
Furze Chase
Dormans Park,
East Grinstead
West Sussex, UK, RH19 2LY
Tel 1342 329833
Fax 1342 770579

Stephen Watson

Institutional contacts:

Ontario/Atlantic
Québec
Western Canada
U.S.A.
Global

Alan Daxner
Benoit Paradis
Doug Andrews
Bruce MacNabb
Stephen Watson

Private Client contacts:

Ontario/Atlantic

Québec

Western Canada

Catherine Jackman
David Kilburn
Ed Kwan
Bob Livingston
Bill Healy
Alexandre Legault
David Davies
Dave Mason

Foundations/Endowments contacts:

Ontario/Atlantic

Québec

Western Canada

Global

Ted Harris
Brad Hicks
Patrick Fournell
Bill Healy
Alexandre Legault
Dave Mason
Colin Sinclair
Stephen Watson

Managed Asset Program contacts:

Ralph Daghfal
Sue Eagleson
1 877 8 BUDDEN (283336)

McLean Budden Mutual Funds for Canadian Investors:

Michael Bissonnette
1 800 884 0436

Finance & Administration

Barb Lockhart

McLean Budden manages portfolios for its clients on a discretionary basis and does not make recommendations regarding the purchase and sale of individual securities. This report is prepared for informational purposes only. It does not constitute investment, legal, accounting or tax advice or a representation regarding the suitability of any particular investment or investment strategy.

