

INVESTMENT NOTE

April 2010

A Greek Tragedy - Contagion in Europe

Could the Greek crisis threaten the euro zone?

A wave of risk aversion is, in the short term, sweeping the global financial markets, sparked by further concerns over the viability of a European aid package to the Greek Government. Fears that the issues in Greece may spill over to the rest of Europe's debt-ridden countries, has weakened the Euro and threatens to derail a still fragile global economic recovery.



Greek sovereign debt was downgraded to "Junk Status" (BB+) by Standard & Poor's, a core debt rating agency, this week. The news quickly overwhelmed an otherwise positive week for equity markets. The agency *justified* their move following an *"updated assessment of the political, economic and budgetary challenges that the Greek government faces in its efforts to put the public debt burden on to a sustained downward trajectory"*. This sentiment was echoed by many speculators. It is almost certain that Moody's and Fitch, the other main debt rating agencies, will follow suit, severely pressuring further revaluations of Greek Bonds and effectively closing the debt markets to the Greek Government.

Greece, unable to cut its spiralling budget deficit through currency devaluation (a route followed by Russia in 1998 and Argentina in 2001), has been forced to seek outside help from its partners in the European Union and International Monetary Fund. Whilst reassurances have been given by both bodies that aid will be forthcoming, there is faltering support for implementation of any aid plan. There is a sense that this is caused by (1) a sense that Greece does not warrant financial support until it demonstrates a will to implement austerity measures (unwelcome in Greece where strikes by public workers fearing higher taxes and wage cuts are now common), (2) Any initial package will not be sufficient to actually meet Greece's current and future funding needs and may, therefore, be "a bottomless pit", (3) a lack of support for the aid package by the people of Germany (Europe's largest economy) forcing their Government to remain uncommitted as it looks to political expediency (winning local elections) and (4) the real fear that if Greece is "bailed out", who will be next – Portugal, Spain? And where and when will it stop? This leaves EU officials in a quandary? How can they support Greece without opening the door to every speculator pressurising further other weak economies. One radical solution is for Greece to be temporarily removed from the Euro, allowing it to devalue its currency, improve its debt position and re-enter once (if ever) its finances meet the tests other nations face when applying for EU membership. Unfortunately, this plan is extremely costly, logistically difficult and may effectively prove that the Euro, as a currency, has failed. A more logical and likely option is that a firm consensus is found between European Union members, the IMF and the Greek Government and a firm aid package established alongside some form of debt restructuring. This restructuring, if well managed, would reassure investors and maintain liquidity, though with prerequisite higher risk premiums. **We believe that this is the most likely outcome and fortunately do not subscribe to the many Armageddon theories (especially for the Euro) currently being discussed.** Unfortunately, we do not expect consensus to be reached easily (given the political dynamics of the EU) and, therefore, foresee a period of volatility in the Equity, Bond and Currency markets.

More worryingly, this aid and restructuring plan would give power to the contagion theorists and even, perhaps, question the viability of the Euro. Further downgrades to Greek and other debt-ridden countries are possible until sanity is restored. Even the major economic powerhouses of Germany and France are not immune, given their fortunes are tied to the fate of the Euro and its credibility. In our January 2010 Investment Outlook, we rated Europe, from an investment perspective, as a weak option and have sought Equity and Bond investments elsewhere. This has remained a key theme in our asset allocation modelling, resulting in our negligible European equity and euro-currency exposure within Sterling denominated portfolios and high international exposure within Euro-focused portfolios at this time. We watch as the story unfolds and will look to extreme weakness as a potential for opportunity in the Euro zone.

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