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**Event**

A study on Europe's sovereign debt problem

**Special Views**

EU members adopt "just-in-time" rescue plan

The bailout for Greece will likely be short-term emergency loans

More bad news is expected, especially towards 2Q

Debt problem for Europe is expected to last for a while

Negative impact on Asian markets will slowly dissipate

Unwinding of carry trade exert pressure on market in the near term

**Summary**

**The problem in Europe today is only a natural evolution.** The evolution of the financial crisis takes the following sequence: over indebtedness was shifted from home buyers on to banks, then transferred to governments, as such the recent sovereign debt crisis in Greece is only a natural development.

**Key of the issue is on successful refinancing of maturing debts.** The pressing issue for Greece is the Euro50bn debt re-financing in 2010, if they fail to roll over successfully, technically the country is in default. Peak of the refinancing will be in the 2Q, therefore we could expect more bad news on this incident in the 1H.

**We think EU members prefer a "just-in-time" rescue operation rather than a full-scale guarantee against debt default.** The most practical solution is for a coalition led by Germany to offer financial aid, possibly in some form of short-term emergency loans. We do not foresee the German would assume the liabilities and prefer the Greek to solve their own problems. We think the strategy adopted by EU members is a "just-in-time" rescue operation, if the timing is misjudged slightly, bad news could ripple through global financial markets.

**Debt problem will probably continue in Europe and negative impact on Asian market will fade out slowly.** Though the debt problem will continue to trouble a number of European countries over the next few years but negative impact on Asian markets will slowly dissipate once the EU has found a way to deal with Greece. We are positive towards HSI performance in the long-term but beware of increasing volatility in the short-to-medium term.

**Beware of a volatile market in the near term.** As we expect there is no real solution to the problem in the near term, weakening of Euro and strengthening of US\$ will continue, forcing carry trade to unwind, this will be a negative force behind global stock markets.

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## Evolution of the financial crisis

To begin with, let us flash back to the beginning of the financial crisis when the low interest rate environment during 2000 - 2003 period helped to foster a property bubble. According to Case-Shiller 20 index, average property price in the US surged by 100% from 2000 to 2006. To aggravate the situation, some home buyers used high leverage, ie. sub-prime mortgages, for these purchases. Finally when the low interest rate had run its course and started to reverse its direction, music stopped and the party was over.

Home buyers suddenly realised they could not afford the mortgage payments anymore and delinquency ratios started to climb. Therefore liabilities had been shifted from individual home buyers on to banks, again the situation had been aggravated by "securitization", through the issue of MBS and CDO, so the property bubble disease was no longer confined to the US but contaminating the entire global financial system.

With the high leverage commonly found in the US and European banks, 30 - 50 times, a 2-4% bad debt provisions against total assets could wipe the banks' equity clean, now the banks began to fall into their own traps.

Pinnacle of the crisis came with the collapse of Lehman Brothers in September 2008 which practically choked the money market, causing highly-leveraged investors to unwind positions, resulting in furious free-fall of global stock markets in 4Q08 - 1Q09.

By then, banks' liabilities were greater than their assets, and they were technically insolvent. To save a total collapse of the banking system, central banks around the world put out rescue programs and emergency funding facilities, effectively liabilities had been once again transferred to another party - the governments. Moral of the story is that one cannot spend more than one earns in perpetuity, someone has to pay for the debts ultimately. Now it is the government's turn.

If one want to look for crisis, then look at where the leverage is being created, and nowhere is there more leverage being created at the moment than on sovereign balance sheets. Federal Reserve's balance sheet has increased by a few folds since the beginning of the financial crisis.

Henceforth, Greece's debt crisis which started to surface a few weeks ago is only a natural evolution of the crisis, Greece being the first country to get into trouble is simply due to the fact that it is the weakest link, its debt-to-GDP ratio is at 113%. More countries would face the same debt problems in the future, such as Spain and Portugal, this seems like an inevitable fate.

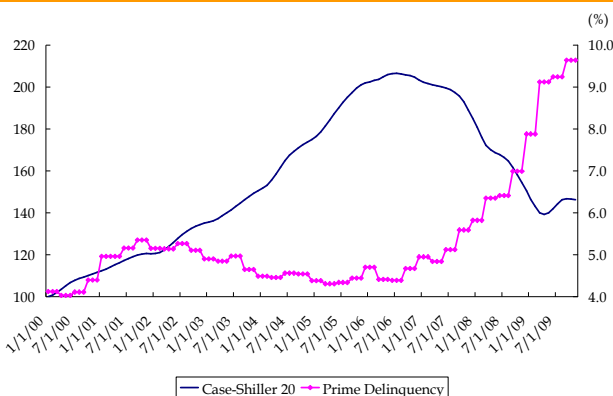
The outlook is indeed grim for developed countries, if one includes off-balance sheet items such as social security, pension and health liabilities, EU and US net liabilities add up to around US\$135 trillion, in comparison the total market capitalization of S&P500 equals to US\$10 trillion.

Perhaps we sound pessimistic, we are towards developed countries but not so for developing countries. Borrowing more to satisfy previous debt obligation will only delay the problem not solving it. Time is the best solution to debt problem, give it 5-8 years, reduce spending and increasing saving to pay down the debts is the most pragmatic way, in our opinion. That is why we think the US and European stock markets will be in a stalemate in the coming few years.

Asia is another story, most Asian countries have much lower debt levels and higher saving, the real question is whether consumption can replace export as the new engine of growth. Undoubtedly bad news from Greece has hit the Asian markets quite hard in the past few weeks, which could linger for a while longer, perhaps another 1-3 months.

Though the debt problem will continue to trouble European countries over the next few years but negative impact on Asian markets will slowly dissipate once the EU has found a way to deal with Greece, whether it is a direct financial assistance or a departure from the Euro-zone. After all, it is the fundamental factors of the economy and individual companies that drive the stock market forward. We are positive towards HSI performance in the long-term but beware of increasing volatility in the short-to-medium term.

Figure 1: US property price and prime delinquency ratio



Source: BOCOM Int'l, Bloomberg

### What options are available?

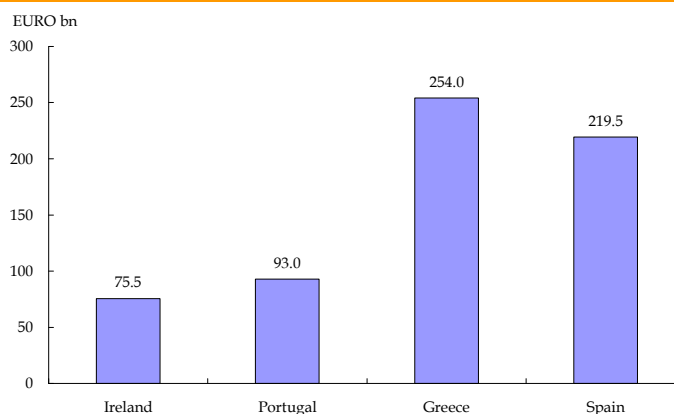
Some say that the European crisis is more severe than the one we saw in the US in 4Q 2008, we disagree, but it is certainly true that the European problem is more difficult to solve given the number of parties involved. There are 27 members in the EU and 16 of them are in the Euro-zone.

The most critical issue at this stage is not the budget deficit of Greece, though it is unacceptably high at 12.7% of GDP, even if the Greek government is determined to tackle the problem, it will take at least 3 years for it to come down to the statutory requirement of 3%.

The pressing issue is the government debt re-financing. Greece has a total sovereign debt of Euro254bn and Euro50bn of them need to be refinanced in 2010, and the real risk is that some of them cannot be rolled over successfully. When the government is incapable to pay down the maturing debts, then technically the country is in default. Peak of the refinancing for Greece will be in the 2Q totaling to Euro22.6bn.

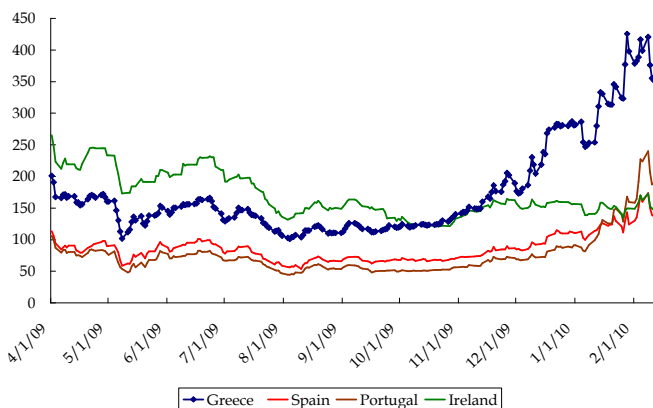
There are three options available: to solve the problem by itself, to gain financial assistance from others, to depart from Euro-zone. Whether Greece is capable to save itself will largely depend on the results of its bond auctions, but given the negative market sentiment now prevailing, we are afraid that its luck will soon run out. Therefore, we will concentrate in analyzing the remaining two options in the following passages.

Figure 2: Outstanding public debts of certain European countries



Source: BOCOM Int'l, Bloomberg

Figure 3: CDS of certain European countries



Source: Bloomberg

### Scenario 1: Who can be the white knight?

Perhaps a loan from IMF would be the ideal choice and more beneficial in the long run because IMF lending is based on conditionality of achieving certain fiscal and structural goals. If the financial aid is coming from member states in the form of lending or loan guarantee, it is very difficult to make them conditional. In effect IMF could "force" certain financial discipline into Greece. It is important to notice that a bailout plan alone does not solve the problem permanently, no reduction of budget deficit would mean inviting more troubles in the future. But given the pride and other political issues, it is obvious that European would prefer to handle the situation by themselves. Therefore we think chances of IMF stepping in are slim, judging from current development.

Do not rely on ECB (European Central Bank) to be the saviour because they simply are not authorized to carry out such rescue operation. There is a "No Bailout" clause in the Maastricht Treaty, article 103 says that: "the Union shall not be liable for or assume the commitments of member governments". The article was specifically written to ensure no EU country would be saved by the EU if it does not respect the Union's economic rules, and that is precisely the case in Greece.

Financial aid from member states seems to be the most probable outcome, the coalition will likely be led by Germany, the strongest nation in the EU. The crisis has surfaced for a few weeks now and how come the German are delaying their rescue action. We think there are three reasons.

(i) The German are conservative, the situation is complex and there is no easy way out of the crisis. (ii) It is the moral hazard, a too-early bailout plan may deter Greece to work out its own problem. (iii) This is perhaps the most important reason, Greece is only the prelude, other debt-strapped countries are in the queue, Portugal, Italy, Ireland and Spain, the crisis might proved to be "too big to save".

Undoubtedly the EU is holding a lot of summits and meetings etc but investors must not have too much faith on these talks, after all they are "talks" only and no concrete plan will likely be reached.

We think the strategy adopted by EU leaders is a "just-in-time" rescue operation, similar to the one we saw about Abu Dhabi saving Dubai World. If the timing is misjudged slightly, bad news could ripple through the global financial markets causing them to plummet like a stone.

From the German's view point, it is more important for them to protect the government's liabilities than to avoid a stock market free-fall, they are not wrong. Investors should be cautious about unexpected volatility.

Another interesting phenomenon we observed in the market lately is that whenever the EU held a meeting regarding the rescue plan of Greece, the US market and Asian market reacted positively while the European market remained calm, implying that they did not expect any good news. It is hard to believe that American and Asian know the matters in Europe better than the European.

The bailout could take any of the several forms, including a direct cash grant, a loan facility linked to other government's borrowing programs, or even a guarantee against Greece defaulting on its debts. Given the pre-requisites mentioned above, we think a direct cash injection is the likely solution which will be short-term in nature encouraging Greece to tackle the problem more eagerly.

### **Scenario 2: It is not entirely unimaginable for Greece to withdraw from the Euro-zone**

This is the worst case scenario and we do not expect it to materialize, but we cannot obliterate its possibility. In this case, Greece will drop out of the euro-zone, adopt their own currency and then devalue it – this is in effect is a soft default on paying back the debt. From another perspective, this is what the US has been doing via quantitative easing – they have printed money – devalued their currency and debts, and therefore defaulted to countries owning their debts, like China. This might not be a bad thing for Greece at all as it can solve its debt crisis more quickly and less painfully. A devalued currency can also help Greece to recover from recession more rapidly.

If this happens, then European bonds and Euro will fall violently as investors expect more sovereign debt defaults to follow, yields will shoot up rapidly making refinancing more difficult and more defaults will ensue, capital will be withdrawn from Europe and probably flee towards US Treasuries.

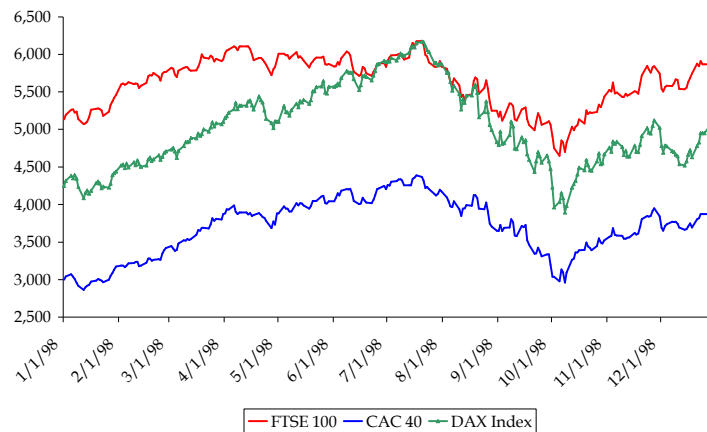
There are three things to note. First, some suggest that it will be more catastrophic than the Lehman Brothers incident. Indisputably, this is bad but we doubt that it would be worse. When a corporate goes into bankruptcy, it will disappear overnight leaving liabilities to be borne by the creditors. We cannot remember bankruptcy of any sizeable financial institute in the last 30 years, except Lehman. Neither a country nor a currency can vanish overnight, when a default occurs, creditors will suffer losses but will unlikely to lose everything.

We have quite a number of sovereign debt defaults in the past two decades, the most memorable one is perhaps the Russian default in 1998. Following the incident, European stock markets were under downward spiral pressure for three months and lost an average of 28%, bad enough but not the end of the world.

Secondly, other debt-strapped countries may be encouraged to choose this easy way out of their debt burden. Then Euro stands the risk of being disintegrated, as some academics proclaim that Euro is an “experiment” not a “currency”. Again do not be over concerned on this issue because this will not be an abrupt incident, namely it will not take place overnight, this will take a long time to materialize, may be 5-7 years.

Thirdly, defaults by these countries will ultimately be translated into high loan losses for Western European banks. German exposure to the region amounts to Euro43bn in Greece, Euro47bn in Portugal, Euro193bn in Ireland, Euro240bn in Spain, according to the Bank for International Settlements. If the German think that the debt crisis is “too big to save”, then surely it is cheaper to save their own banking system than to save neighbouring countries. As we explained earlier, these loans will not be annihilated but some losses will be inevitable.

Figure 4: Europe stock market performance after Russian default in 1998



Source: Bloomberg

### Impact of weaker Euro on bond and equity markets

Euro has declined by 3.8% against the US\$ since beginning of the year. The largest beneficiary of a weak Euro will be the US as funds will always find their way to save haven in time of crisis - namely US Treasuries. The US government has US\$2.2 trillion Treasuries maturing in 2010, equivalent to 18% of its total outstanding public debts. One could aptly describe 2010 as the year of refinancing for public debts.

A stronger US\$ is also detrimental to global equity markets forcing carry trade to unwind. The US dollar has become the major funding currency of carry trades as the Fed has kept interest rates at artificially low level and will unlikely to raise it in the foreseeable future.

A fall in US\$ means gains in other currencies, this enhances the returns for the investors, effectively investors are borrowing at negative interest rates. When taking into account leverage employed and devaluation of US\$ since 2009, it is estimated that carry trade could produce an annualized return of approximately 20%.

Carry trade is not a risk-free arbitrage, the biggest risks are change in exchange rate and interest rate hike. If the strength in US\$ continues, then investors would run the risk of losing money. A rise in interest rate would also mean higher funding cost and may erase the credit spread between different assets. In addition, these transactions are generally done with a lot of leverage, so a small movement in exchange rates and/or interest rate can result in huge losses.

In the past, bad news from Europe might have little impact on the Hong Kong stocks, today it is different, investors should pay more attention on how the European debt crisis will unfold in the end.

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Buy: Expect more than 20% upside in 12 months

LT Buy: Expect more than 20% upside but longer than 12 months

Neutral: Expect low volatility

Sell: Expect more than 20% downside in 12 months

**Sector Rating**

Outperform: Expect more than 10% upside in 12 months

Market perform: Expect low volatility

Underperform: Expect more than 10% downside in 12 months

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