

Sovereign default fears: risks and opportunities

AT A GLANCE

- Fears of Greece defaulting on its debt repayments have climbed; other southern European countries are now under suspicion
- Credit default spreads have increased markedly
- The European Central Bank has pledged its support for Greece
- Such market ructions provide volatility, but also provide opportunities for investors with confidence and on-the-ground resources

Global concern over their rising sovereign debt levels has seen Greece, Portugal and Spain, among other European countries, at the epicentre of a marked deterioration in market sentiment. Equity, debt and currency markets have been affected by the default concerns, particularly with many equity markets ripe for a bout of profit-taking having closed 2009 at or near their yearly highs. Investors are looking to the European Union (EU) to see what policy it will take towards these countries.

RISK AVERSION TAKES HOLD

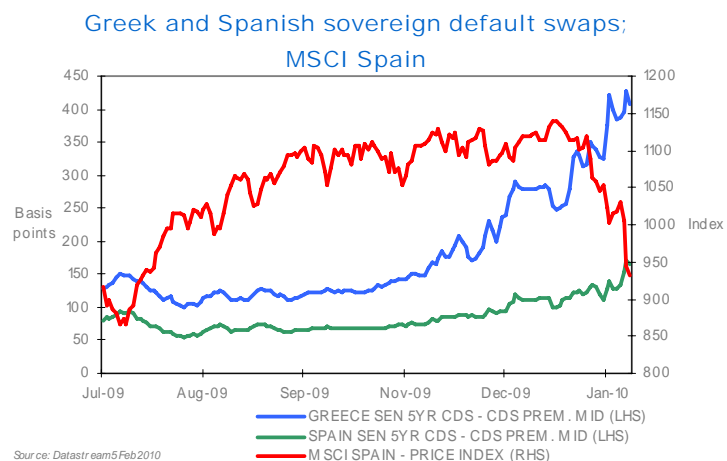
Fears have been gathering that Greece may not be able to service its sovereign debt obligations and that a default may lead to very serious ramifications for the Greek economy. In December last year the gathering clouds over Greece spread to other southern European countries: Spain, Portugal and to a lesser extent Italy, worsened by Standard & Poor's (S&P) lowering of Spain's outlook from 'stable' to 'negative' (after it had cut Spain's sovereign rating from AAA to AA+ in January) only one day after Fitch Ratings had also downgraded Greece. In announcing the Spanish downgrade, S&P said: "The change in the outlook stems from our expectation of significantly lower [gross domestic product] growth and persistently high fiscal deficits relative to peers over the medium term, in the absence of more aggressive fiscal consolidation efforts and a stronger policy focus on enhancing medium-term growth prospects."¹

The clouds have now turned into a storm, assisted by more ratings downgrades, with sovereign credit default spreads blowing out and equity markets falling. Not only southern European markets have been affected. In tremors reminiscent of those seen at the height of the recent global financial crisis, countries and securities not directly related to the situation have also been marked down due to fears of defaults and subsequent counterparty risk.

The fear of sovereign default is so high that Merrill Lynch points out the implied default risk on an index of five-year sovereign debt is now slightly higher than for comparable corporate debt².

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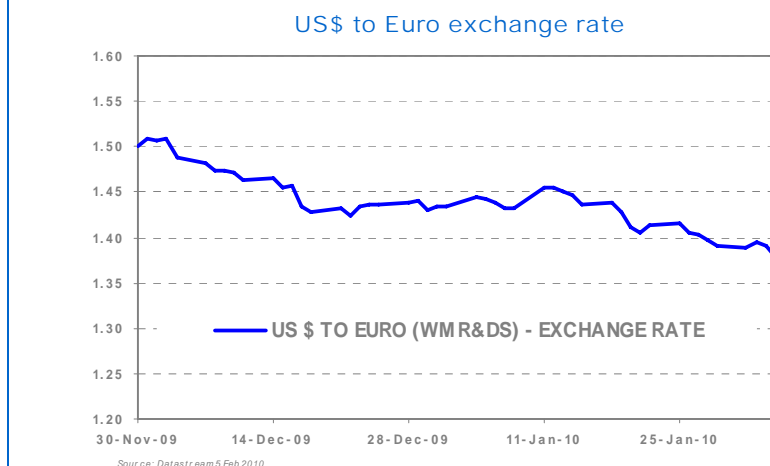
Greek CDS's have surged, southern European markets hit...



The debt profiles of the southern European states is presenting the 16-member European Union with a significant puzzle, undermining confidence in the euro. The euro has lost 4.7% against the

US\$ since the beginning of the year.

...putting pressure on investors' confidence in the euro



THE BACKGROUND

In early 2009 markets were looking at Russia and other eastern European countries as candidates for default. After Dubai's Nakheel World asked for a revision of terms on one of its debt securities late last year, the suspicion has now switched to southern Europe - Portugal, Greece, Spain - and other outliers like Ireland and Iceland. The flurry of downgrades from the ratings agencies, the possible deleterious effects on the broader EU and defensive comments from the finance ministers of the affected countries have been more than enough to keep the sovereign investment risks of these countries in front of investors on a daily basis.

The governments put in place significant stimulus packages in the midst of the global recession but with their economies still moribund they are now struggling to bring their debt loads back down to serviceable levels:

- Spain's budget deficit will be 11.2% of gross domestic product (GDP) this year, according to the European Commission. Its debt burden is forecast to rise to 66% of GDP next year from 36% before the crisis in 2007, according to Commission data. Its economic stimulus measures equalled about 2% of GDP in 2008 and 2.4% in 2009.
- Greece's real GDP growth slowed to just above 1% in 2009 and is expected to remain negative in 2010. With the general government deficit well above 3% of GDP on average over the past ten years, and recurrently large debt-increasing financial operations, government debt-to-GDP ratio exceeds 100%.
- Portugal's debt is forecast to reach 85.4% of GDP this year, the highest level in 20 years. This year's deficit target is 8.3% of GDP.³

Twenty of the EU's 27 nations are running deficits above the 3% Maastricht threshold after the deepest global recession since the 1930s.

With the backing of the European Central Bank, Spain, Greece and Portugal are embarking on ambitious budgets cutbacks to bring their debt loads back into the EU range of sub-3%. Markets are yet to be convinced, but ratings agencies are of the view that the countries' government debt positions are not without hope. "If the [Spanish] government announces concrete fiscal measures that we believe could credibly achieve annual primary surpluses of 2% or higher by the end of the forecast period in 2012, downward pressure on the ratings may abate," Standard & Poor's credit analyst Trevor Cullinan said in December.⁴

THE EUROPEAN CENTRAL BANK'S PERSPECTIVE

Jean-Claude Trichet, President of the European Central Bank, has been taking a double-pronged approach to the problem. While insisting that Greece will remain part of the EU and that all EU countries have the responsibility to keep their government debt levels to the Maastricht limits, he has also pointed out that the overall deficit level among euro countries, at about 6% of GDP, was

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still well below that of the United States and Japan, which are each set to borrow more than 10% of their GDP's this year. "We expect and we are confident that the Greek government will take all the decisions that will permit them to reach that goal" of cutting the deficit below the European Union's limit, Trichet said in early February⁵.

VOLATILITY CREATES OPPORTUNITIES

Much uncertainty surrounds the current situation. How the ECB approaches it will have significant effects for the southern European countries in trouble, but also on market confidence that the EU can hang together while making its members toe the line on fiscal rectitude. The path the EU takes will also dictate the euro's short-term future versus the US\$, an important macroeconomic variable when both the EU and the US are attempting to kick-start their economies by increasing exports.

In such an environment, investors with the confidence and on-the-ground resources to identify opportunities thrown up by the volatility are likely to outperform.

PORTFOLIO MANAGER COMMENT:

EQUITIES

"We have seen a large fall in the Spanish and Portuguese markets related to their budget deficits. The Iberian economies are facing structural issues such as budget imbalances and labour inflexibilities, which meant they were among the weakest performing economies in Europe in 2009. 2009 GDP growth was negative, the important construction sector came to a halt and unemployment threatened to reach the 20% mark. However, was any of this and the current market concerns unexpected? I don't think so. We've known about the budget deficit for years, and the governments have spoken about a number of policies to address this.

"I believe that the recent falls in the stock market are a contagion effect to concerns expressed in Greece, and I see this as an over reaction. In fact, I believe that this volatility event is a great buying opportunity as market valuation falls.

"From an economic viewpoint I believe that 2010 holds more of the same. The downgrade of Spain's credit rating following problems with Greek debt in December 2009, highlights that Spain has many structural issues to resolve before we can be confident of a sustainable economic recovery. It is possible we will see unemployment increasing further over the coming months, which would suggest a patchy outlook for the domestic consumer. Also, an increase in unemployment increases the risk of an increase in non-provisional loans, which one would expect to impact the financial system.

"However, the Iberian banks are generally well capitalised, while I think that the Caixa banks (domestic savings banks) will come out of this with a more solid structure. This will be either from management learning lessons or the weaker Caixa banks being taken over. Overall, this should leave a more solid financial foundation for the economy and equity markets to build upon in the future.

"I also think many investors fail to acknowledge that throughout the last decade Iberian companies put in motion a stringent international diversification plan. Heavy investment, particularly in Latin America meant Spanish companies derive over half their revenues (56%) abroad, while the remaining domestic revenues are generally quite defensive. Spanish companies tend to be quite diversified across Latin America, while Portuguese companies have a strong presence in Brazil. Their diversified earnings bases are major positives, especially during these tough times, and I believe this can more than offset the negatives associated with the domestic economy.

"The Iberian economies do have an influence on the markets, but I think it is not as large as the market is currently pricing in. Despite what happens to the market this year, I do think that stock picking will be more important than in 2009, when sector positioning was important. Such a situation is a positive for this fund given the depth of research at my disposal."

- Firmino Morgado, Portfolio Manager, FF Iberia and FF European Aggressive Funds

FIXED INCOME

The investment team follows the developments of the key sovereign issuers very closely as part of its continuous investment research and involvement in the global fixed income

We have been proactively positioning portfolios to take account of the weakening position of a number of sovereign issuers for some time.

Sources:

1. Market Watch, 9/12/09
2. CLSA "Bits and Pieces" 1/2/10
3. European Commission:
http://ec.europa.eu/index_en.htm
4. Wall Street Journal, 9/12/09
5. Business Week, 4/2/10

markets. The current developments have been well flagged and although the headlines are increasingly negative, we have been proactively positioning portfolios to take account of the weakening position of a number of sovereign issuers for some time. It is important to highlight that these changes in fundamentals are also creating valuation opportunities in the market which we can take advantage of. We continue to research the developing economic situation as an integral part of our process and Portfolio Managers are positioning the portfolios to take advantage of resultant relative value opportunities while managing any downside potential should the situation continue to deteriorate. We are monitoring the situation closely.

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