GAM Investment Meeting Notes

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Emerging Markets Fixed Income and FX

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- The markets appear to have sided with the view that the European Central Bank will step in to buy unlimited quantities of Italian and Spanish bonds, and more generically eurozone debt, to solve the crisis. This is seen to be the only way it can be brought under control. To illustrate the likely extent of the support needed, the Bank of England currently owns about a quarter of the UK gilt market. A similar slice of the French, Spanish and Italian debt markets would amount to well over a trillion euros. Only the ECB has that sort of firepower. Thus, it seems that the only possible outcomes are the ECB's participation or a break-up of the euro. It is only because the consensus believes in the former, that we are seeing Italian bond yields at 'just' 7% and other yields gradually rising as opposed to a complete market meltdown.
- We believe the biggest worry is that Europe's banking system is on the edge. All the liquidity is accumulating at the core – mostly Germany – rather than where it is most needed. This has created a liquidity problem, with a lack of trust in the banks outside of Europe's 'super core'. That is impacting the bond markets, compromising sovereign solvency and, in turn, making the banks even less safe. Thus, the cycle needs to be broken. The ECB seems the only realistic entity able to do so – for instance, the EFSF seems less than credible given that its own debt is trading at a 200 basis point premium to Bunds.
- The main problem is that Germany is not keen for the ECB to enlarge its role and, if anything, its resolve only seems to be growing. However, Germany may agree to launch eurobonds if at the same time they get constitutional changes in Europe's periphery and changes to the EU treaty that hard-wire the monetary union for solvency. There is no specific timetable for such changes, but if sovereign bond yields were to rise to 9-10% something would have to give. We are some way off such levels now, but a break-up of the euro, which before was seen as a tail risk, has become a real possibility.
- The best-case scenario is that we get something close to a fiscal union in Europe, with the ECB owning most of the eurozone debt and the region enduring 'only' a severe recession. The worst case is that the eurozone breaks up, with results that will make the effects of the 2008 Lehman Brothers bankruptcy look like a tea party.
- We consider France to be Europe's weak point. On the basis of its economic data and particularly its negative current account, France looks very much like a peripheral country. In contrast to Austria, Germany, the Netherlands and Finland, which are running substantial current account surpluses, France has moved from having a solid surplus to a deficit that is not dissimilar to Italy's. Its banking system is also seriously threatened by the current problems, although the downside would be more limited if the ECB does step in to support troubled countries.
- From our point of view, the probability of the ECB stepping in with unlimited funds is low until we get more distress in markets than we are seeing at the moment. Despite the recent rise in yields, Italy is unlikely to default imminently, but the real worry is a financial system crash. A recession would obviously increase the chances of such a crash. Ultimately, the ECB is unlikely to allow the exit of countries such as Greece and Italy, as that would be likely to create bank runs on almost all other European countries. Thus, its support alongside some fiscal architecture for Europe is likely to be on the agenda in the forthcoming EU summits.
- Looking at the year to date, both GAM Star Emerging Market Rates and GAM Emerging Market Rates Hedge Fund had a difficult time until September, but have broadly made up for that in the past eight weeks or so.