The Big Fat Greek Bailout

What is going on?

Since the start of the year, the bond markets have been increasingly nervous about the ability of Greece to pay its debt, causing the yield on Greek government bonds to spike heavily and accentuate the crisis. This is a result of years of overspending and low tax receipts. In addition, despite being a member state of the European Union, Greece never met the necessary economic criteria but was allowed to retain membership. During the boom years, the Greek government was able to grow the current account deficit, aided by investment banks and the fact that Germany's progressively larger current account surplus made borrowing cheap for all Eurozone members. Following the credit crunch and the collapse of Lehman Brothers, this imbalance surfaced and investors are once again focusing on the fundamentals of countries' finances when deciding on their ability to repay their loans. The reality of this for Greece is that the country is uncompetitive, has too little tax income and has low levels of production.

What action has been taken and what would be the impact?

Leaders of the IMF and the European Central Bank (ECB) met in Berlin last week and have agreed on an aid package that will allow Greece to return to stability. They have put together a US$145 billion rescue package spread over the next three years to reassure the bond markets and allow Greece to service its debt at an affordable level.

That said, the rescue package will come at a price, as the country will undoubtedly be forced to follow in Ireland's footsteps of implementing significant austerity measures by slashing public service salaries and welfare payments. Ireland has started this painful process, which will make a deep recession unavoidable. What it has done though, is put the country on a sound footing to rebuild public finances and rebase fiscal policy. So far, with almost daily protests on the streets of Athens, the Greek government has been reluctant to fully implement such measures. However, there is now no option left but to cut public spending, increase the retirement age, hike taxes and clamp down on tax evasion. It also remains to be seen whether Greek bondholders will emerge unscathed or will see a reschedule of debts.

Greece's woes have led to questions over contagion risk for other European states with high budget deficits, including Portugal, Spain, Italy and the UK. Whilst these countries do not appear to be in as much trouble as Greece, they will certainly have to follow suit with austerity measures and fiscal retrenchment over the coming years. We believe that all will be forced to reduce their fiscal deficits. The success of this retrenchment hinges on the sustainability of economic growth and it is encouraging that corporate earnings and economic data shows that a recovery is underway and gaining strength. The need for sustained growth also means that we are likely to see a low interest rate environment for a period of time. Once economic recovery is in full swing, the governments will have to start to rebuild their own "balance sheets". The long-term demographics of Europe makes this issue even more pertinent and action unavoidable.

The ECB's initial inaction and hesitation of government officials resulted in elevated fears of a Greek default and worries over possible contagion. The EU commission, Euro area states and the IMF tried to calm investors' fears calmed by announcing a support package aimed at returning the region to stability by on 9th May. The delay meant that the policy response had to be significant in order to prevent bond, equity and currency markets from deteriorating further. The proposed package involves guarantees for the sovereign debt of all EU member states (up to a specified amount) and a bond purchasing scheme (similar to quantitative easing) that together could total over US$1 trillion.

The initial response has been positive with equity markets recouping much of their losses from last week and government bond yields falling towards more 'normal' levels. Fears of sovereign default in the Eurozone have lessened and contagion risks look to have diminished.

European Update

Outlook

This crisis has highlighted many of the weaknesses of a single currency, including the lack of clear leadership and ministers reverting to their own political agenda during times of turmoil. However, overall we believe that Europe will come through this pressure on a sounder footing than when it was formed and we believe the single currency will remain intact (with all its current members). A sustained weakness in the currency would go a long way to offset many of the negatives, especially for the export-dependent Germans.

The European support package is larger than expected and the money has to come from somewhere. In addition, if the support package is not complemented by substantive austerity measures, then the solvency problems could spread further in Europe. Whether these measures can be put in place remains to be seen with serious riots on the streets of Athens highlighting the domestic resistance. Portugal and Spain are to release details of their proposed fiscal consolidation on the 18th May.

A strong Eurozone requires its stable northern states to continue to provide growth and therefore we take encouragement from Germany announcing stronger-than-expected GDP growth for Q1. The currency devaluation, which we believe is largely complete, will also contribute to growth since the Eurozone remains a net exporter. In fact, Germany exports almost 2.5 times more to Asia than to Spain, Ireland, and Greece combined.

For the equity markets, this latest round of sovereign worries have led to some market turbulence, with a number of investors banking the gains they have made so far this year. Once these fears begin to subside, we would expect investors to once again focus on the global recovery and the potential for further gains in the equity markets but this could take time and the path to recovery will likely not be smooth

Important Information

Henderson Global Investors (Singapore) Limited and its affiliates are referred to herein as Henderson Global Investors. This document has been produced based on Henderson Global Investors' research and analysis and represents our house view. **All the information contained in the document is intended for information, illustration or discussion purposes only and should not be relied on for any investment decisions or regarded as a substitute for the exercise of your own judgement. The information contained in the document has not been reviewed or endorsed by the MAS.**

The contents of this document are prepared without consideration to the specific investment objective, financial situation and particular needs of any specific person. It does not constitute an advertisement and should not constitute or form part of any offer or solicitation to issue, sell, subscribe or purchase any investment in any jurisdiction and do not purport to represent or warrant the outcome of any investment strategy, program or product. Any information and views provided herein is subject to change without further notice. None of the material, nor its content, nor any copy of it, maybe altered in any way, transmitted to, copied or distributed to any other party, without prior express written permission of Henderson Global Investors. The information contained herein is obtained and / or compiled from sources believed to be reliable and current and Henderson Global Investors do not warrant, guarantee or represent, either expressly or impliedly, the accuracy, validity or completeness of such information. Henderson Global Investors or any directors or employees of Henderson Global Investors shall not be liable for any damages arising from any person's reliance on this information and shall not be liable

for any errors or omissions (including but not limited to errors or omissions made by third party sources) in this information. Unless otherwise indicated, the source for all data is Henderson Global Investors.

Past performance of any fund, a security, an investment or manager and any opinions, forecasts, assumptions, estimates or valuations made are not necessarily indicative of the future or likely performance of the fund, the security, investment or manager. An investment in collective schemes/funds, and/or other investment products is subject to investment risks, including the possible loss of the principal amount invested. The value of the units and the income from the funds may fall as well as rise as a result of market and currency fluctuations.

Henderson Global Investors (Singapore) Limited Company Registration No. 199700782N
Date of issue: May 2010