MARATHON
ASSET MANAGEMENT

THE EUROPEAN SOVEREIGN & FINANCIAL DEBT CRISIS

EVOLUTION, SOLUTIONS, AND OPPORTUNITY

WHITE PAPER

Third Quarter 2011

MARATHON ASSET MANAGEMENT

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One Bryant Park, 38th Floor · New York, NY 10036 · Tel: 212.500.3000 · Fax: 212.205.8800

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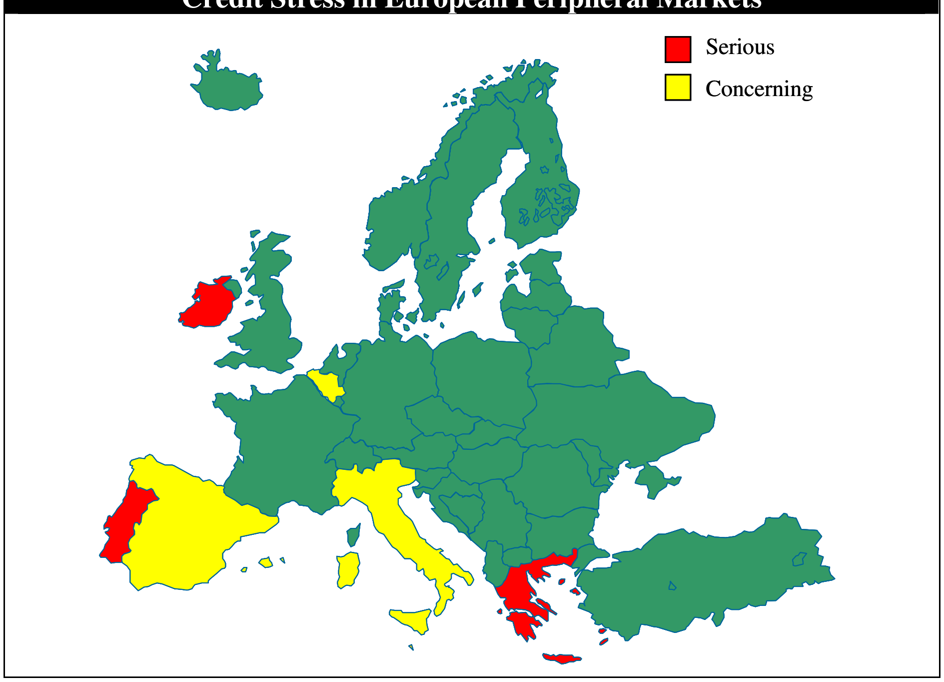
1. EXECUTIVE SUMMARY

This research paper discusses the multi-faceted dynamics of the European sovereign and financial debt crisis, with a comprehensive discussion of the background, status, potential solutions, lessons from historical emerging market sovereign crises and defaults, and the ramifications for banks, economies, citizens, and investors. Fears of default and difficulties in sourcing affordable financing for countries resulted in rescue packages for Greece, Ireland, and Portugal and contagion threats particularly affecting Spain, Italy, and Belgium. The rescues have addressed near-term liquidity but resolving the fundamental solvency issues of the sovereigns and banking systems will require substantial coordination of government policies, capital raising, and financial support to restore long-term market confidence and prevent avoidable debt restructurings. The foundational problems differ across countries, with varying ties to over-leveraged and under-capitalized banking systems, real estate bubbles, excessive government debts and spending, and fundamental economic weakness. The present crisis has been exacerbated by European sovereigns' limited control of exchange rates and monetary policies, as well as declining competitiveness on the global stage, further accentuated by the financial, real estate, and economic crises that began to emerge in 2007. The reactions to the crises have included banking support and government-funded stimulus, resulting in the transfer of private debt to public debt. The present crisis has significantly increased financing costs and restructuring probabilities for Greece, Ireland, and Portugal, while increasing contagion fears and funding costs for the much larger economies of Spain and Italy and their banking systems. The solutions to the European crisis – with progressive efforts led by the governments of Germany and France – will likely preserve the common currency and increase fiscal integration while providing incremental liquidity to support the weaker countries and banking systems, and restructuring sovereign debt of the weakest countries. Similar historical crises in emerging markets have been resolved by restructuring banking systems (now underway in Ireland and Spain) and sovereign debt. European sovereign debt restructurings could include negotiated and market-friendly approaches such as discounted bond repurchases, exchanges, and/or a Brady Bond Plan tailor-made for Europe. As the sovereign and banking issues are resolved, the volatile and uncertain economic and political environment (including questions on future membership in the Euro-Zone), will provide numerous alpha-generating opportunities for experienced and flexible investors.

Credit Stress in European Peripheral Markets



2. INTRODUCTION

The amount of sovereign and financial debt outstanding has soared in recent years, with particularly alarming increases in much of the developed world. This research paper analyses the causes, effects, and potential outcomes of the increased leverage for European countries, with a focus on the peripheral countries with increasing probabilities of restructurings among sovereign debt and banking systems. Our analysis could have encompassed other developed markets such as the U.S. and Japan given their broadly recognized fiscal challenges and increasing leverage; however, these countries have much less default risk than certain European countries due to their diversified economies, low funding costs, reserve currencies, and monetary policy flexibility. Not since 1948, when Germany defaulted on the Nazi-era debt, has a developed country defaulted on its sovereign debt. Meanwhile, during this period (the past 63 years), there have been 68 sovereign defaults among emerging market issuers. In the present sovereign and banking crisis, Greece faces the greatest challenges in terms of excessive leverage and required fiscal reform, and as a result, could be subject to the first debt restructuring in a developed market in multiple generations. Portugal faces similar challenges due mainly to long-term declines in competitiveness, while Ireland's difficulties stem principally from an over-leveraged banking sector affected by the real estate collapse that followed the debt-fueled boom times. Avoiding default and contagion threats from these three peripheral European countries will require near-term solutions coordinated by various European authorities to address liquidity, with longer-term solutions entailing fundamental fiscal reforms and restructurings of sovereign debt and banking systems. The multinational coordinated efforts to impede contagion from reaching larger economies and banking systems facing similar challenges are critical to preserving Europe's Economic and Monetary Union (EMU) since Spain and Italy represent a larger combined economy than Germany.

Deterioration within certain European economies following the recession and near collapse of the major U.S. and European banks in 2008 and 2009 has led to major concerns about European sovereign credits and their financial systems. The present sovereign and financial debt crisis is focused on liquidity, sustainability, and solvency issues confronting the European periphery, defined as Greece, Ireland, Portugal, Belgium, Spain, and Italy. History has witnessed many similar sovereign debt crises, though concentrated in emerging markets rather than developed markets, with a wide range of causes and outcomes. Like certain other sovereign debt crises, the troubles facing peripheral Europe resulted from high sovereign and private debt loads, large government deficits, declining global competitiveness of labor and industry, lack of control over domestic exchange rates and monetary policy, price deflation of real estate and corporate securities, and liquidity and solvency issues within the banking system following weaker lending standards during prior strong economic environments. However, Europe's situation is different from prior crises in terms of absolute scale, the intertwined nature of its governments and banking systems, sharing a common currency that restricts currency devaluation options, the slow economic growth profiles, potential global implications for trade and competitiveness, the absence of banking and currency runs, and the complexities across political and social strata. These sovereign issues will take many years to resolve, requiring long-term political coordination and fiscal determination in order to avoid defaults as each respective peripheral European country struggles to make their economy more competitive while deleveraging their banking system and administering austerity programs.

The economic and financing crisis affecting peripheral Europe has challenged the founding philosophy of the 27-member European Union (EU): the desire for closer political integration and coordination. This noble goal was complicated by attempting to simultaneously allow for continued fiscal and legislative independence among countries with varied economic and social regimes. This fiscal decentralization has added to the complications facing the 17 countries in the EMU, which established the euro (€) as the common currency (fully rolled out in 2002) and empowered the European Central Bank (ECB) to coordinate monetary policy among EMU members. The ECB has historically focused on its exclusive mandate of controlling inflation for EMU members through influencing currency exchange rates and controlling money supply and interest rates, though the crisis has expanded their operations to provide unprecedented bank liquidity and aid sovereign borrowing costs. This patchwork of governmental powers, along with the divergent economic and fiscal performance of various sovereigns, has resulted in the slow and convoluted incremental responses to the deepening crisis. This crisis has produced major increases in bond yields and spreads for credit default swaps (CDS) for more questionable sovereigns and major banking institutions.

The five-year CDS spreads for Greece and Ireland increased from roughly 150 basis points (a basis point is 1% of 1%) in late 2009 to peak above 1,000 basis points and 600 basis points, respectively, during 2010. The liquidity vacuum that began to develop in May 2010 resulted in the €110 billion bailout for Greece (with stringent preconditions for fiscal reform), which has long suffered from weak economic and competitive standing, over-zealous fiscal spending and entitlement programs, and a weak tax collection system. Concurrent with the Greek rescue, European government leaders announced the formation of a €750 billion stability package to address future sovereign financing needs, with funding from the EU, European governments (through the €440 billion European Financial Stability Facility, or EFSF), and the International Monetary Fund (IMF). Although these rescue packages were supposed to silence all questions about the liquidity support for heavily indebted European sovereigns, doubts were left unanswered regarding the deeper issues of economic competiveness and health of financial systems, and ultimately the solvency of governments (Greece's bond yields and CDS prices have recently risen to record levels). In fact, solvency questions have forced a second rescue package for Greece, which is headlined at €109 billion and includes potential principal reductions for the first time, but remains subject to contentious political approvals.

After the first Greek rescue, credit markets recovered temporarily but the renewed focus on fundamentals brought Ireland to the forefront of concerns, though for very different reasons than Greece. Ireland had been one of the great economic successes in recent decades, but the Celtic Tiger over-indulged in the optimism of perpetual prosperity following the euro's introduction and strong economic results, producing a real estate bubble and a related grossly over-sized banking system. The largest Irish banks were soon crippled by enormous levels of troubled loans when property values inevitably turned, which prompted the Irish government to provide guarantees for depositors and investors to prevent banking runs. However, the enormous scale of banking losses overwhelmed the government and triggered the October 2010 sovereign rescue financing package, with the government forced to tap the European support programs created in May 2010. This €85 billion rescue package was the first for the recently initiated rescue funding programs, and required the Irish government to accept numerous conditions involving the implementation of austerity measures and other structural reforms; these were deeply unpopular and inevitably contributed to subsequent political turnover. During Ireland's elections in February 2011, with declarations from Gerry Adams (leader of Ireland's Sinn Féin party) echoing the populist sentiment that citizens should not have to pay for "the sins of bankers", the Fianna Fáil party's multi-decade rule of Parliament came to an end. In addition to changes among leaders, the government has also pushed forward a much needed restructuring of the banking system. The government nationalized two of the largest domestic banks (Anglo Irish Bank and Irish Nationwide Building Society) and has made progress winding them down by transferring assets to the government's "bad bank"; they also divested both banks' depositor base and selected assets to two new "Pillar Banks" (Allied Irish Banks and Bank of Ireland), which also are largely government owned. The banking stress tests run by the Irish government in March 2011 (this excluded Anglo Irish Bank), showed €24 billion of additional capital was needed, on top of the €46 billion already provided. The banks have made significant progress in raising capital, though much works remains to be done. Ireland's struggling economy and need for additional banking capital have prompted its leaders to soften their rhetoric regarding tax rates (suggesting their low corporate tax rates could be increased) and burden sharing among senior bondholders in troubled banks (though losses are assured for subordinated bondholders).

Clearly, the rescues of Ireland and Greece evolved from quite different situations, which also differed from the causes of Portugal's request for a €78 billion financial assistance package in April 2011. Portugal's difficulties resulted from long-term economic and competitive weaknesses, looming debt maturities, and a history of excessive government spending and leverage. Despite continued insistence by government officials that internally driven austerity measures would be sufficient to manage their finances, increasing bond yields made financing costs unsustainable. The lack of market confidence shown by the Portugal's escalating bond yields was furthered by the government missing budget deficit targets for 2010 and admitting prior debt and deficit figures were understated (reminiscent of Greece's earlier admissions of false data). As highlighted in the following table, the high leverage, weak fiscal performance, high bond yields, and high implied default probabilities of Greece, Ireland, and Portugal indicate continued market and sovereign stress.

Summary of Western European and Reference Credits

(in trillions of €)

	Credit Rating Moody's / S&P	10 Year Bond Yield	Probability of Default 5-Yr CDS	2010 GDP	Population (in MM)	Public Debt	Interest/ Revenues	% of GDP: Public Debt	% of GDP: Public + Private Debt	% of GDP: Primary Deficit	% of GDP: Fiscal Deficit
Rescued Countries											
Greece	Ca / CC	17.8%	86%	€ 0.23	11	€ 0.33	16%	143%	341%	-5%	-10%
Ireland	Ba1 / BBB+	8.6%	49%	€ 0.15	4	€ 0.15	7%	96%	322%	-29%	-32%
Portugal	Ba2 / BBB-	10.4%	55%	€ 0.17	11	€ 0.14	7%	93%	372%	-5%	-9%
Contagion Concerns											
Spain	Aa2 / AA	5.0%	26%	€ 1.06	46	€ 0.64	4%	60%	385%	-8%	-9%
Italy	Aa2 / A+	5.1%	27%	€ 1.55	60	€ 1.84	9%	119%	271%	0%	-5%
Belgium	Aa1 / AA+	4.0%	18%	€ 0.35	11	€ 0.34	7%	97%	407%	-1%	-5%
Reference Countries											
Germany	Aaa / AAA	2.2%	6%	€ 2.50	82	€ 2.00	5%	80%	283%	-1%	-3%
France	Aaa / AAA	2.9%	12%	€ 1.95	63	€ 1.64	5%	84%	331%	-6%	-8%
U.K.	Aaa / AAA	2.6%	6%	€ 1.69	62	€ 1.31	7%	77%	451%	-8%	-10%
U.S.	Aaa / AA	2.2%	4%	€ 11.06	310	€ 10.13	6%	92%	354%	-9%	-11%
Australia	Aaa / AAA	4.4%	6%	€ 0.93	22	€ 0.21	1%	22%	238%	-4%	-5%
Japan	Aa2 / AA-	1.0%	8%	€ 4.12	127	€ 9.08	4%	220%	479%	-8%	-10%
China	Aa3 / AA-	4.1%	9%	€ 4.43	1,341	€ 0.78	n/a	18%	163%	n/a	-3%
Brazil	Baa2 / BBB-	12.6%	9%	€ 1.57	193	€ 1.04	14%	66%	146%	2%	-3%

Source: IMF, European Commission, and Bloomberg

The troubles of Greece, Ireland, and Portugal have caused global investor concerns about the liquidity and solvency of other countries in the developed world, thus requiring imperative corrective and decisive actions by authorities to avert contagion beyond these peripheral European nations. Greece, Ireland, and Portugal are each relatively small and similar in scale, accounting for a combined 6.1% of gross domestic product (GDP) for the EMU and under 5% of the EU, but the threat of contagion spreading to the financing markets of larger countries is the critical concern. Spain represents the line in the sand for Europe, as its economy is 1.9x larger than the combination of Greece, Ireland, and Portugal. Spain's problems are complex, with a real estate collapse, a poorly capitalized and uniquely structured banking system, high unemployment, and overall challenges in economic competitiveness. Any failure of Spain – while increasingly unlikely as market access has improved following ECB purchases of sovereign debt and certain banks have made progress in recapitalizing – could jeopardize the survivability of the EMU and fulfillment of the EU's intentions for political and economic integration. Contagion concerns have fueled the proposed increase of the EFSF to a headlined €780 billion (which remains subject to approval from EMU members later in 2011), though its real capacity is restricted closer to €335 billion due to ratings limitations and earlier rescue commitments. Any required rescue of Spain would overwhelm the capacity of the EFSF and the larger financial stability package. Since Italy is even largely than Spain, and considered the next most at risk, financial rescue resources announced to date could be quickly exhausted well before the unique difficulties facing Belgium come into play.

Due to the inadequacy of the present and proposed financial aid packages, and their temporary nature (e.g. the EFSF expires in June 2013), the markets have communicated that a much more significant financing and resolution package must be created and implemented in order to restore investor calm and restore reasonable costs for sovereign financing and minimize the damages from sovereign debt restructurings. The resolution of the

European crisis will require the complex balance of calming markets, financial stabilization, and agreement among multiple governments to avoid default among sovereigns and their intimately connected major banks.

The €500 billion of lending capacity under the European Stability Mechanism (ESM), which is intended as the permanent replacement for the current aid packages beginning in mid-2013, will play a critical role in providing troubled countries the time to economize by implementing fiscal austerity and structural reforms, while also rebuilding investor confidence and delaying potential restructurings. Given the choice to resolve the crisis by "economizing or agonizing", borrowers will surely choose the former, at least as a first attempt, rather than deal with the potential political and economic agony of default. The ESM is intended to allow countries to work through economic weakness and potentially restructure, which could help stabilize the EMU over the longer term by maintaining the present membership and preserving the euro. The priority of preserving the EMU was exemplified by German Finance Minister Wolfgang Schaeuble stating "We are not just defending a member state but our common currency", and EU Council President Herman Van Rompuy warning that debt contagion was a "survival crisis" that threatened the existence of the euro and the wider EU. While it remains possible for members to leave the EMU, this is not the preferred course for Germany and the other strong economies within Europe due to negative economic implications, which could produce higher costs than preserving the EMU and helping weaker members with liquidity and/or restructurings, especially when factoring in the effects on and from banks within departing countries.

Default concerns are justified over the long term for any country with excessive fiscal deficits and leverage, and weak economic growth and competitiveness. Greek Finance Minister (until June 2011) George Papaconstantinou hinted that sovereign reforms could be paired with debt restructuring: "The issue of burden sharing by the private sector is in principle absolutely right...because taxpayers cannot continue to pay the bill and bondholders also need to be responsible for their actions." The likelihood of a Greek debt restructuring is the focus of present debates in the ongoing crisis, with opinion shifting from the original "impossible" towards "inevitable." The numerous and relatively recent defaults of emerging markets illustrate the restructuring possibilities and dangers of countries foregoing control of their currencies and monetary policies, and hence potentially their economic competitiveness and stability. The defaults of Russia (1998), Argentina (2001), and Uruguay (2003), along with the 17 countries that restructured using Brady Bonds (1990-1997), highlight the variety of factors contributing to default as well as different restructuring solutions that could prove prescient in any future sovereign restructuring.

The historical emerging market solutions have included a variety of restructuring alternatives including par reductions, coupon reductions, rescheduling maturities, currency devaluation, inflation, and economic, financial, and fiscal reform. Debt restructurings often accompany reforms of fiscal and social policies, privatizing industries, and selling assets, along with reducing debt service obligations through reduced interest coupons, reduced principal, and/or extending maturities. The restructurings could also include directly or indirectly purchasing bonds at discounts and/or issuing debt ranking senior to existing debt. The ECB and/or EFSF can assist with such restructuring strategies, while also supplying liquidity to subject countries in order to preserve orderly markets and minimize economic damage. While the economic and financing recovery of emerging market countries post-default exemplify sovereign survivability, the present crises is less likely to produce broad-based defaults for reasons including the absolute scale of the problem, the resulting global economic implications (especially for Germany), the interlocking and inter-dependent borrowers and lenders between countries, the inability for banks to absorb losses on sovereign debt positions (which would entail even larger required rescues given their enormous holdings of troubled sovereign debt), and recognition of the danger of contagion spreading to larger economies and banking systems. The European authorities are keenly focused on exploring contained sovereign restructurings for certain peripheral European countries given their unsustainable debt structures and borrowing costs, but want to ensure that actions taken are "bank-friendly". For example, Greek sovereign debt holders could be offered the option to avoid default by exchanging into 30-year bonds with lower coupons; this could allow European banks that hold Greek sovereign debt to avoid write-downs even though they would receiver lesser payments over time. Whatever the form and timing of eventual sovereign restructuring, there is no question that restructurings among Europe's banking systems are occurring with greater haste (as seen in historical emerging market crises) given their dependence on market access and customer confidence. Ireland and Spain, the countries with the most significant banking industry troubles, have each taken significant steps to restructure banks through nationalizations, forcing mergers, segregating lower quality assets, divesting assets, and raising capital. Additional capital is needed by banks to restore solvency, even if not officially declared so by the banking stress tests in July 2011I, which assumed virtually no losses on sovereign debt exposures despite the increasing risk of sovereign restructurings and market prices far below par.

The resolutions to the European sovereign and banking problems – which are most severe in Greece, Ireland, Portugal, and Spain – will require incrementally working through a combination of initiatives over time that will produce a challenging and rewarding environment for astute investors. Portfolio flexibility, shorting capabilities, hedging abilities, restructuring expertise and experience, and thorough knowledge of CDS will all be important attributes to produce attractive investment returns. Importantly, these uncertain times share commonality with historical crises, with potential opportunities across sovereign credit, CDS trading, bank capital structures, long positioning in assets and portfolios divested by banks, corporate credit affected by contagion, and potentially distressed sovereign and corporate bonds.

This research document is organized in the following manner: Section 3 will review the present European sovereign and financial debt crisis, Section 4 details the historical building blocks of the crisis, Section 5 reviews the more concerning countries, banking systems, and the rescues to date, Section 6 discusses the critical governmental and supranational players, Section 7 provides examples and lessons of prior sovereign debt crises, Section 8 reviews the potential near-term and longer-term crisis solutions and outcomes, and Section 9 details the considerations and opportunities for investors. This is followed by an Appendix reviewing CDS and a glossary of the numerous acronyms and terms used throughout the document.

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A Message from Marathon Asset Management

Thank you for previewing Marathon's white paper on "The European Sovereign & Financial Debt Crisis".

Investing in the Emerging Markets and evaluating sovereign restructurings are integral parts of Marathon's institutional DNA. Senior Management at Marathon has extensive experience investing in sovereign distressed debt and has actively participated in many sovereign restructuring negotiations. As macroeconomic uncertainties that have plagued Emerging Markets migrate into Developed markets, Marathon is ideally positioned to take advantage of these market realities. We are excited about the expanding scope of opportunities as we leverage Marathon's key competencies to seek to generate absolute returns through opportunistic trading and value-based investing.

To request a full copy of the white paper updated for third quarter 2011, please e-mail investors@marathonfund.com.