



Euro Scenarios November 2011

"Timeo Danaos et dona ferentes"



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**Nothing I say today should be
construed as investment
advice!**





“I am sure the Euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created.”

Romano Prodi, EU Commission President, December 2001



Country	% time in default or restructuring since 1800 (or independence)
Austria	17.4
Belgium	0.0
Finland	0.0
France	0.0
Germany	13.0
Greece	50.6
Italy	3.4
Netherlands	6.3
Portugal	10.6
Spain	23.7

Source: Reinhart & Rogoff, 2009. *"This Time is Different"*. Page 99.



16 November 1532



Atahualpa





- Benign
- Central
- Extreme case
- Tail risk



Leaving the Euro

- Not simple!
- Technical mechanism?
- Forced conversion
 - Bonds; deposits; swaps ???
- Disorderly break-up would lead to material fall in equities (already partially priced in)



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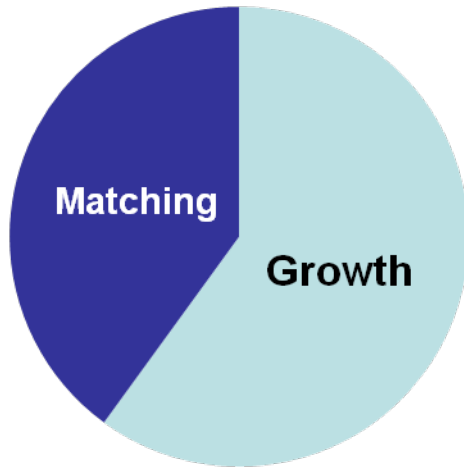
Economic cost of € break-up

- UBS says (September 2011):
 - Cost of German exit = €7k year one and €4k p.a. per German citizen
 - Cost of bailing out Greece, Ireland and Portugal if all three default would be €1k per German citizen

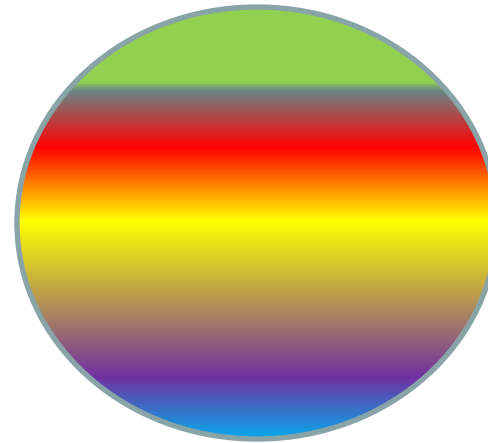


Risk

Old approach



New approach?



Sovereign bonds are not risk free



- LDI?
 - Pooled – credit exposure?
 - Overlay?
- Diversify credit?
 - Global sovereign (inc EM?)
 - European & Global credit
- Diversify Growth assets



Investment strategies

- Benign scenario
 - Equities and other risk assets do well

(Very) low probability!



Investment strategies

- Central scenario
 - Equities and other risk assets continue to be volatile
 - Adopt a truly diversified portfolio
 - Could manage vol through option strategies
 - Increase allocation to EM
 - Exposure to upside of resolution through screened global credit?



Investment strategies

- Extreme case scenario
 - Similar to central scenario but policy responses “behind the curve”
 - Greater value of diversity and hedging
 - More extreme outcomes lead to sovereign and bank default



- Tail risk scenario
 - Dissolution
 - Break away of weak/peripheral
 - Break away of strong/core



- Most likely scenario:
 - Greek default within Euro
 - Euro stays
 - Transition to fiscal confederation; for example:
 - *(Not transfers between governments)*
 - Greater role for ECB
 - Recapitalisation of banks
 - EU budgetary oversight
 - EU financial regulation of banks
 - Bumpy ride to recovery



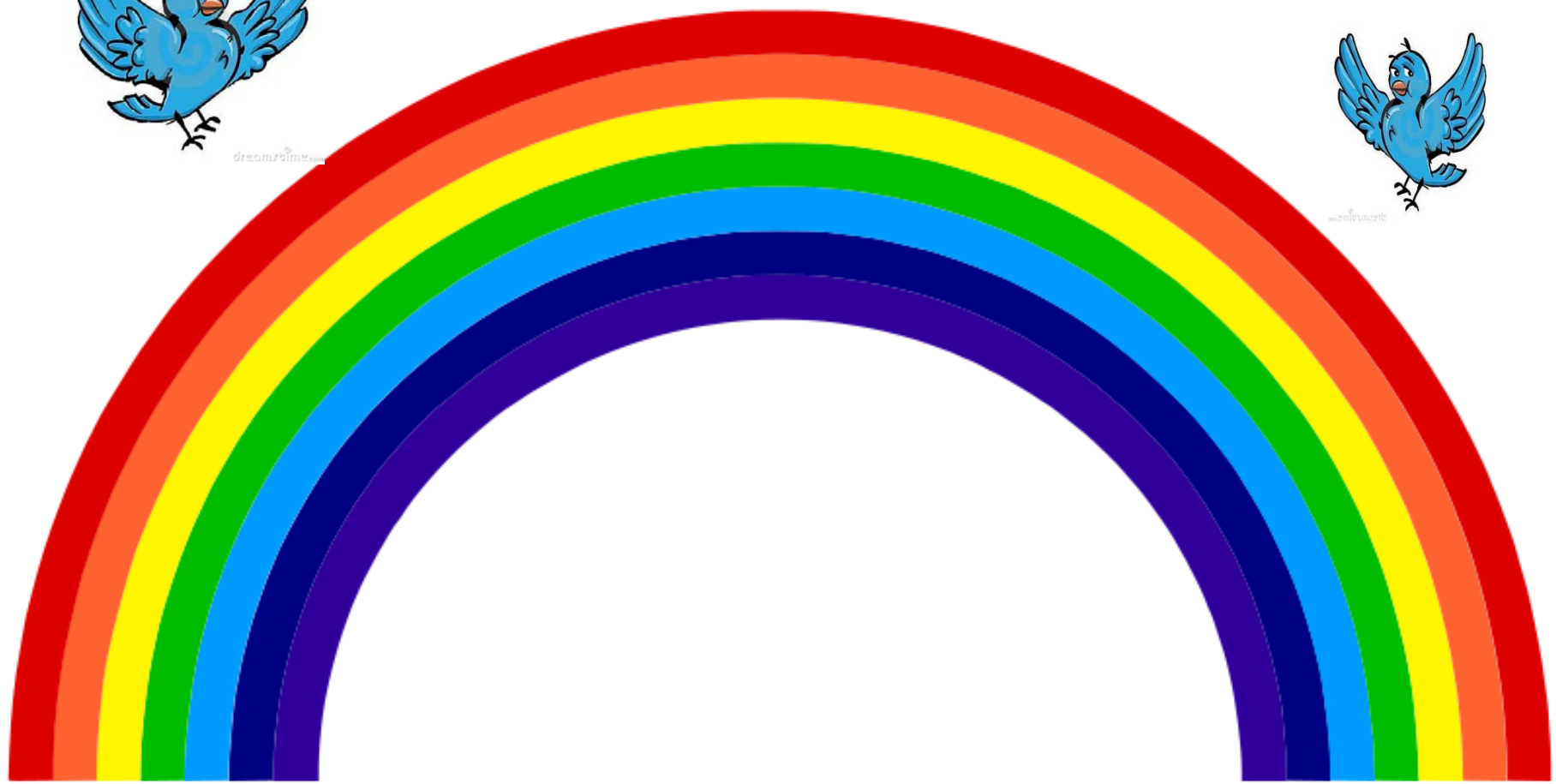
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Appendix





Benign scenario

Austerity measures rebuild confidence in solvency and resolve contagion issues – Italy and Spain have reasonably solid fundamentals. Markets re-evaluate the risks which leads to a decline in peripheral spreads significantly allowing sovereign liquidity and solvency concerns to dissipate. Yields continue to price-in the differences in sovereign credit quality, but to an extent that does not threaten the sustainability of countries' debts. The crisis abates over time.

Low probability!



Central scenario

Continuing commitment of the member countries to the Euro zone and to the solvency of other countries. A sluggish and lengthy process where numerous mini-crises over the coming years are followed by sensible policy moves. This policy response is likely to be evolving over time, taking decisions as felt necessary or as forced to by market pricing. Markets remain very volatile, but the problem eventually gets resolved successfully.



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Extreme case scenario

As above, but European politicians remain “behind the curve” until a major systemic crisis (a Lehman - style event) forces them to implement the policies discussed above.

Increasing probability?



Tail-risk scenario

Policy makers fail/political decision-making process prevents a positive outcome.

A large Euro country (Spain or Italy) may default and this would cause a collapse of the European (and possibly global) financial system. In this scenario, the Euro would likely break up. Very severe implications.

Small but meaningful probability

- Dissolution: Return to individual, domestic currencies
- Break-away of weak/peripheral countries: Creating a stronger Euro
- Break-away of strong/core countries: Creating a weaker Euro