

## Why Greece Matters

*Concerns about Greek debt are spilling into global markets, pushing stocks in the U.S and Canada lower, and causing corporate bonds to underperform. Why are problems in a relatively small country (Greece represents 3% of the European economy) having such a significant impact on asset prices around the world?*

**Good question. Here's why.....**

### 1) The Euro's First Test

There's a rising risk that the European Monetary Union, and hence the Euro, is not viable. Clearly, an extreme view. Still, any serious uncertainty about the fate of the world's second largest currency is enough to roil global financial markets.

### 2) Spain, Portugal and Ireland: Next?

As investors demand ever-higher yields to buy Greek bonds, other European countries facing rating downgrades are also seeing their yields rise. The higher cost of borrowing is problematic for countries like Spain, Portugal and Ireland due to high levels of indebtedness, by the governments and the private sector. Will they be the next Greece?

### 3) European Banking System

European banks have significant exposure to Greek government bonds (75% of Greek debt is held outside of Greece) and any debt restructuring would result in immediate write-downs and losses. It is not the size of the Greek debt that worries global investors; it is the interconnectedness of the credit markets and Greece to the rest of the world.

What about the €110 billion (\$146 bill) rescue package announced by the IMF and EU last week? While this provides the funding necessary to fulfill Greece's borrowing needs in the short-term, the market remains unconvinced the country can remain solvent in the longer-term.

The problem is rooted in the make-up of the Greek economy, which has a very large public sector with generous entitlements. In order to bring the deficit and debt levels down to sustainable levels, the government must simultaneously enact massive cuts to spending and raise taxes. Even if the austerity measures are fully implemented (note the violent protests this week) they will dramatically slow the Greek economy, further exacerbating the imbalances. Many believe a debt restructuring of some kind will eventually be necessary.

Unfortunately, uncertainty and speculation over the outcome of the Greek debt crisis increases volatility in the global equity markets. Does this lead to a slowdown in recovery? Will this cause another financial confidence scare similar to the one we just came through? These, and questions like them, make investors nervous. This nervousness is contagious.

As the situation in Europe becomes clearer, and the crisis forces action by European officials, investors will again turn their attention back to the global recovery currently taking shape. The employment numbers out of the US and Canada for April add to the growing evidence that the economic recovery is gaining strength.

While our clients do not directly own Greek sovereign debt, we are still affected by swings in the market place. One Capital Management is keenly aware of this, and continues to monitor the European situation very closely for our clients.