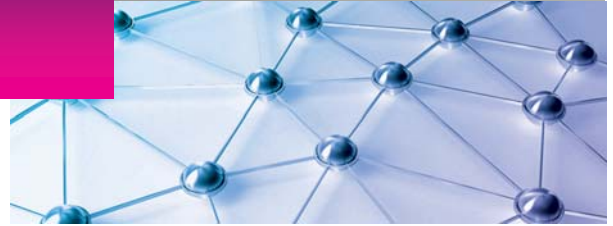


## What's Next for the Eurozone?

BlackRock Investment Institute

December 14, 2011



Heads of state tussle by night, bond yields yo-yo by day and starved bankers forage for funding all the time: The high drama and furious pace of developments in the European debt crisis have not let up.

The December 9 European Union summit wasn't the hoped for "mother of all summits," but we believe it did provide a clearer framework for a solution. In combination with extraordinary measures by the European Central Bank (ECB), it just might prevent this crisis from spinning out of control.

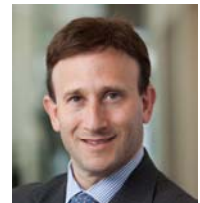
This short BlackRock Investment Institute paper reviews the summit's outcome and discusses what it means for markets and investors.

### Summary:

- ▶ The ECB's actions to guarantee European banks access to funding are crucial: They reduce the possibility of a doomsday credit crunch. Other problems remain, including banks' shedding risk assets to address capital shortfalls.
- ▶ The ECB has made clear it's the lender of last resort for banks – but not for government bonds. That has disappointed some investors, but we believe banks can – and will – pick up some of the slack.
- ▶ Many questions remain: Will electorates approve plans for centrally run budgets? How will the new fiscal rules be enforced? How are the various rescue funds going to work? How will Europe cut budget deficits without killing growth and triggering social unrest?
- ▶ Ratings agencies are likely to downgrade eurozone debt in the near future, but markets have largely factored in these moves for key countries such as France, Italy and Spain. We believe the influence of agency ratings will diminish over time.
- ▶ The debt crisis has triggered hiring freezes and capital spending cuts across the region. As a result, we now expect a eurozone downturn that will cut GDP by 1% to 2% and push Germany and France into recession. Short-term austerity measures could deepen the downturn.
- ▶ Analysts have ratcheted down 2012 profit estimates for European companies, but are still too optimistic. We're focusing on companies with strong balance sheets and emerging markets exposure.
- ▶ Political considerations will keep trumping economics, especially with key elections coming up next year.



**Ewen Cameron Watt**  
Chief Investment Strategist,  
BlackRock Investment  
Institute



**Russ Koesterich**  
Global Chief  
Investment Strategist,  
iShares



**Nigel Bolton**  
Head, European  
Equity Team



**Joe Di Censo**  
Director, Global Rates  
Investments, Fundamental  
Fixed Income

The BlackRock Investment Institute leverages BlackRock's expertise across asset classes and client groups. The Institute's goal is to produce information that makes BlackRock's portfolio managers better investors and helps deliver positive investment results for BlackRock clients.

## The euro crisis tool box

Sometimes the stuff that gets the least notice turns out to be the most important. The ECB's extraordinary actions to secure funding access for European banks (see box below) are a case in point.

Crucially, they reduce the risk of a bank liquidity crisis that would spread around the world. Secondly, they enable national governments to push their banks harder to buy their government debt. We believe that breaking the buyers' strike is key to getting yield spikes under control.

In the near term, the crisis is mostly about the ability to roll over debt, not about the ability to pay. Countries such as Italy will suffer higher rates, which they can afford. That will be tough. But it's not nearly as bad as suffering a loss of market access, which *nobody* can afford.

Don't get us wrong: Rolling over the mountain of debt that comes due early next year is a huge challenge. Eurozone governments need to refinance a staggering 519 billion euros in the first half alone, according to Bloomberg, adding European banks have a similar amount of debt coming due in that same period.

### Unusual Measures. Now for the Delivery...

Key ECB and European Summit Actions

Measure	Ingredients
<b>Easing bank collateral rules</b>	The ECB to accept lower-rated asset backed securities as collateral for ECB funding. National central banks to accept bank loans.
<b>Cutting bank reserve ratios</b>	The ECB to cut the minimum level of reserves banks have to keep at their central banks to 1% from 2%. This frees up 100 billion euros.
<b>Extending bank funding</b>	The ECB to extend funding to banks to three years, from one year now, in upcoming refinancing operations. Banks can call loans after one year to avoid the potential stigma of taking ECB funds.
<b>Agreeing on fiscal discipline</b>	Countries exceeding the 3% budget deficit ceiling to get automatic sanctions. Countries to agree by law to balance their budgets (a structural budget deficit of no more than 0.5%).
<b>New bailout funds</b>	Establishment of the permanent bailout fund, the European Stability Mechanism (ESM), is moved up one year to July 2012. The combined 500 billion euro ceiling for the ESM and existing rescue fund to be reviewed in March. Countries pledge 200 billion euros to International Monetary Fund (IMF) for additional eurozone help.
<b>Private creditor haircuts</b>	Germany drops demand that private creditors share in bailout costs: Future bailouts to adhere to IMF principles.
<b>Cutting interest rates</b>	The ECB cuts main its interest rate 25 basis points to record low of 1%, and is likely to ease further.

**Countries such as Italy will suffer higher rates, which they can afford. That will be tough. But it's not nearly as bad as suffering a loss of market access, which *nobody* can afford.**

European banks need to raise an additional 115 billion euros to close capital shortfalls, according to the European Banking Authority. That likely means more shedding of risk assets, raising the odds for some markets to lock up again and prolonging a European recession.

There's a lot that can go wrong in the near future – which is one reason why we're not ready to call an end to the European debt crisis. In addition, the summit left many questions:

- ▶ How will electorates vote on the plans for central fiscal discipline? The odds of a eurosceptic backlash look high because the summit's price tag essentially consists of budget cuts, job losses and loss of sovereignty.
- ▶ Who will enforce the new fiscal rules? Automatic sanctions for offenders are great, but they only work when they are actually enforced – consistently.
- ▶ Exactly how are the new European Stability Mechanism and other rescue funds going to work? Who will fund them and who will call the shots?
- ▶ How will Europe – and the United States, for that matter – take the hard decisions of closing long-term budget holes on benefits while stimulating growth in the short term?
- ▶ Will we see social unrest spread as painful austerity measures take effect? Italy, especially, bears watching: Does the technocratic government have the mandate to implement much-needed reforms?

## Politics and ratings

The agreed-upon rules to enforce fiscal discipline still need parliamentary fiats and, in some cases, approval by referendum. That means more market volatility ahead. There should be plenty of opportunity – and a real need – to learn about the inner workings of parliamentary and election procedures in previously off-the-radar countries such as Finland.

Expect political considerations to trump economics. The high drama that had the UK back out of the summit accord had its roots in domestic politics. For all the soul searching, we see little impact for UK asset prices in the short term beyond a slightly weaker currency helping exporters.

**There's a lot that can go wrong in the near future – which is one reason why we're not ready to call an end to the European debt crisis.**

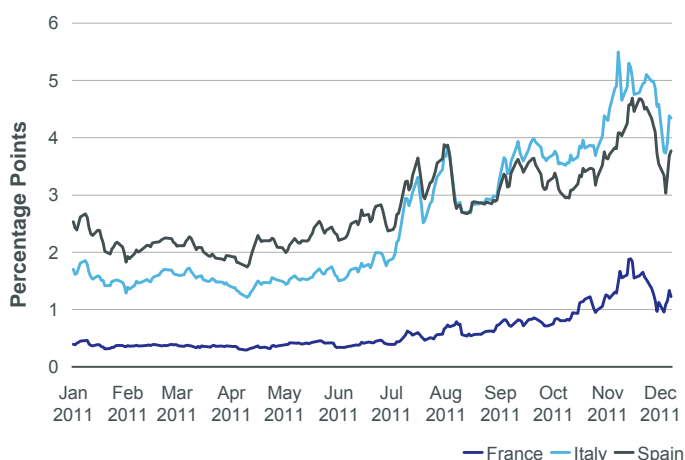
Politics matter more than ever, especially with elections coming up in key European countries such as France, Finland and Greece next year. A finance degree alone is not good enough to anticipate risk and exploit opportunities in this climate.

Ratings agencies are also focused on politics, and have held out the prospect of mass downgrades of eurozone debt. The downgrades are likely to come sooner rather than later, but we believe bond markets have largely factored them in for countries such as France, Italy and Spain. The yield spreads between their sovereign debt and benchmark German bunds have widened significantly this year (see chart below).

Traditional ratings are important, but their influence will likely decrease over time as investors look beyond the ratings agencies' 'ABCs' to focus on the economic, fiscal and political prospects of the issuers. The BlackRock Sovereign Risk Index, for example, already ranks nine issuers ahead of Germany, including South Korea and Chile.

### Warning Signs: Euro Bond Yields Spiral Upward

Yield spreads over German bunds in 2011



Source: Thompson Reuters

## Recession and euro stocks

A big worry is the prospect of a European recession, especially a deep and long one. It's very clear that European companies have started to defer capital spending and stopped hiring. We now believe that we're in for a full-fledged recession, including one in France and Germany, that could cut GDP by 1% to 2%.

### Politics matter more than ever, especially with elections coming up in key European countries.

Short-term austerity measures could worsen the recession, defeating their very purpose of closing budget gaps. Subsequent declines in tax revenues and more spending on unemployment benefits would *enlarge* government deficits.

Don't be fooled: The Merkozy plan to reduce deficits will not work unless economic growth returns. That means European companies need to improve productivity faster than the rest of the world to gain export share. That's a multi-year task. Much of Europe has deep-seated productivity problems that need urgent fixing.

Future interest rate cuts by the ECB and other monetary easing – which we think are likely because inflation should abate – are unlikely to offset the effects of the downturn. The silver lining is that the euro would likely weaken, boosting exports.

What does this mean for European equities? There's no question they are cheap: Eurozone companies trade at 8.7 times 2012 earnings while pan-European stocks (including UK equities) trade at 9.3 times expected earnings. That's at the bottom end of our 35-year range.

The problem is that euro stocks are cheap for a reason. Analysts have ratcheted down 2012 profit forecasts for European companies, but are still too optimistic. Consensus estimates have European companies increasing profits about 10% next year, whereas we think a decline of 5% is more likely. We expect to see a slew of profit warnings in the upcoming fourth-quarter reporting season.

While euro stocks look to be great buys by historical standards, we're cautious. We focus on companies with strong balance sheets. We believe in "self-help stories," companies that can withstand a recession or worse. We prefer recession-proof sectors such as healthcare and food & beverage. And we like companies that derive a large proportion of sales and earnings from emerging markets.

There are fantastic values to be found for long-term investors ... but expect choppy times ahead for now.

---

This paper is part of a series prepared by the BlackRock Investment Institute and is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of December 14, 2011, and may change as subsequent conditions vary. The information and opinions contained in this paper are derived from proprietary and nonproprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy.

This paper may contain “forward-looking” information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this paper is at the sole discretion of the reader.

This material is being distributed/issued in Australia and New Zealand by BlackRock Financial Management, Inc. (“BFM”), which is a United States domiciled entity. In Australia, BFM is exempted under Australian CO 03/1100 from the requirement to hold an Australian Financial Services License and is regulated by the Securities and Exchange Commission under US laws which differ from Australian laws. In Canada, this material is intended for permitted clients only. BFM believes that the information in this document is correct at the time of compilation, but no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by BFM, its officers, employees or agents. International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation, and the possibility of substantial volatility due to adverse political, economic or other developments. In Latin America this material is intended for Institutional and Professional Clients only. This material is solely for educational purposes and does not constitute an offer or a solicitation to sell or a solicitation of an offer to buy any shares of any fund (nor shall any such shares be offered or sold to any person) in any jurisdiction within Latin America in which an offer, solicitation, purchase or sale would be unlawful under the securities law of that jurisdiction. If any funds are mentioned or inferred to in this material, it is possible that they have not been registered with the securities regulator of Brazil, Chile, Colombia, Mexico and Peru or any other securities regulator in any Latin American country and no such securities regulators have confirmed the accuracy of any information contained herein. No information discussed herein can be provided to the general public in Latin America. The information provided here is neither tax nor legal advice. Investors should speak to their tax professional for specific information regarding their tax situation. Investment involves risk. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Any companies listed are not necessarily held in any BlackRock accounts. International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation, and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are often heightened for investments in emerging/developing markets or smaller capital markets.

FOR MORE INFORMATION: [www.blackrock.com](http://www.blackrock.com)

BlackRock® is a registered trademark of BlackRock, Inc. All other trademarks are the property of their respective owners.