

Market Update

31 OCTOBER 2011

At last, Euro leaders recognise the enormity of the task ahead

Most importantly, the result of the summit has bought the Eurozone valuable time for the Union to sort out larger structural issues, which ultimately were at the heart of the crisis.

The Brussels summit held on October 26th lasted through the night, and in the morning European leaders announced that they had agreed on a number of key proposals that will help to maintain Euro viability and integrity for the EU monetary bloc.

While the subject of the summit was focused on addressing the European sovereign debt crisis, the implications of what has come out of the summit will be far reaching for EU membership as we learn more of how Greece's debt burden will be resolved.

INTRODUCING THE THREE LEGGED STOOL

Readers of Russell's market commentary will be familiar with our "Three Legged Stool" analogy, which we believe resembles the design of a lasting solution to the problems within Europe. The results of the summit look to be generally in line with the three-legged stool approach, in that the major elements of each leg have now been designed.

To recap:

Leg 1 required increasing the firepower (both size and remit) of the joint rescue facility (the European Financial Stability Facility, or EFSF), as well as some measures to recapitalise banks in Europe to make them less susceptible to large potential losses on sovereign debt.

One element of the plan envisions gathering investments from foreign sources into a Special Purpose Investment Vehicle. European leaders are confident that large pools of money from foreign Sovereign Wealth Funds (SWFs) like that of China and perhaps the Gulf countries will be forthcoming now. The IMF may also contribute, although there is some doubt if this contribution would be from new capital to be raised among the Fund's members, or from already pre-committed capital. There is also some doubt if the US and/or UK will allow additional IMF contributions to be earmarked to Europe beyond what has already been committed. Should the Chinese and other foreign entities seem willing to participate – which we will know at least by the end of the G-20 Summit meeting next weekend – it should be a clear step in the right direction.

An additional measure to increase the size of the EFSF beyond its current €440 billion level is to use commitments from core countries to guarantee "first losses" on Eurozone countries' sovereign debt. This means that bond holders would be

insured for the initial 20% of sovereign debt, inducing them to be more willing to lend. In some ways this approach would turn the EFSF into a structured debt instrument containing tranches based on varying levels of riskiness. It will be a highly technical and complex task to build this structure, and details are still lacking but the idea is to lever up the €440 billion allowing it to support a much larger capability – perhaps €1 trillion, in case the EFSF has to be deployed to aid a large country like Spain or Italy, both of which are much larger emitters of public debt than Greece, Portugal and Ireland combined.

Finally, regarding bank recapitalisation, it was agreed that banks would need to raise approximately €110 billion to get troubled banks to the necessary capital levels required by European Banking Authority (EBA) stress tests. This will be done by a measure of private capital raising where possible, asset disposals, mergers and as a last resort, state funding. It seems that only in extreme and unlikely circumstances, banks would have to be nationalised, as happened in many cases in 2008 in the post-Lehman aftermath. Bank shares in Europe have rallied, as it seems that minimal stock dilution will take place and that the aggregate number of €110 billion is achievable.

Leg 2 required the recognition that Greek debt was inherently unsustainable.

There has been agreement by the banks and other large financial institutions to accept a 50% reduction in the Net Present Value of Greek bonds. This will reduce Greece's overall debt burden and make it more likely that its public debt will be sustainable in the short to medium term as long as they follow through with their current austerity programmes. There is some fear that not all the banks (who were represented in the negotiations by their lobbying group the Institute of International Finance) will accept this condition, but it seems like this has been a victory by German Chancellor Merkel to get private sector involvement in the costs of the solution.

Leg 3 requires ongoing economic convergence and fiscal measures in peripheral countries to become more competitive economically and to achieve sustainable fiscal dynamics.

On the eve of the summit, Italy was the big worry in this regard. At the eleventh hour, they seemed satisfied the summit would indeed follow through on pension reform and pro-growth measures to alleviate fears that the largest European bond market and the third largest economy in the Eurozone will not have to turn to bailout money. Any backsliding by Italy would be interpreted as a negative, but for the moment this has been another bad outcome avoided in the short term.

Also, there is clear intent that some fiscal and economic centralisation in Europe is on the table and that some joint sovereignty will be implemented in coming years. In many ways the summit has bought enough time for the hard work of negotiating treaty changes and new measures to make the Eurozone a more homogenous economic entity to proceed without the spectre of impending default just around the corner.

Finally, in our stool analogy, the ECB would be expected to continue to provide support to illiquid but inherently solvent entities like large banks or sovereign countries. There is nothing to suggest that they will cease this function, although there is no official commitment that they will. We shall in coming days, with new ECB President Draghi at the helm, understand what the ECB's intentions are.

To summarise:

Russell's stated view and how the summit decisions reconcile to the three legs. While there is potential for disappointment, overall, we reiterate that the summit can be considered to have taken significant steps in the right direction to successfully

address the problems in Europe although there are still some details to be worked out with each leg of the stool.

Most importantly, the result of the summit has bought the Eurozone valuable time for the Union to sort out larger structural issues, which ultimately were at the heart of the crisis.

Gradually as confidence returns, investors can increasingly focus on investment fundamentals such as valuations, the macroeconomic outlook and corporate earnings. As long as the agreements of this week do not unravel, at their current levels, fundamentals are supportive of risk assets.

- Regionally, Europe could recover faster given that it has suffered the steepest market declines.
- Vigilance should be taken toward increasing exposure to European banks. Some of the news-flow from the summit (large debt haircuts) was not particularly positive for the banks.
- The US should adequately participate in any rally, as well as Europe ex banks.

While markets reacted positively to the summit, rallying very strongly on Thursday, this does not mean that we have “missed the rally”. While it was appropriate to be cautious before this unexpectedly good package was delivered, we believe the risk of the worst outcomes – a Lehman like event - from happening from this point on has now significantly fallen.



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