Observation Deck

The Euro Zone on the Edge

Melina Hadiwono, *CFA, Head of Credit Research*

For more than a year, the euro zone's debt drama has been flaring up, fanned by financial challenges in Greece, Ireland and Portugal. With escalating market concerns about the potential fallout from defaults in Greece, the European Union government took a far-reaching reform step this past month, following an extraordinary summit in Brussels. The worsening risk of contagion to Spain and Italy, where banks hold substantial investments in Greece, made a comprehensive policy response crucial, given the large size of the two economies and their respective banking systems.

European policy makers presented a new set of proposals designed primarily to provide additional support for Greece and prevent contagion from spreading to the larger peripheral economies. While it may not prove sufficient to the task — indeed many observers view it as "kicking the can" down the road with key issues unresolved — it is more than many hoped for. The EU government pledged an additional €109 billion in EU and International Monetary Fund loans to Greece and eased the terms with longer maturity and lower interest rates. The financial sector is expected to provide a further €50 billion in support over the next three years. The EU also committed to extend more favorable lending rates to Portugal and Ireland, thereby providing those two countries with more flexibility.

Markets

Treasury Rates	
3-Month	0.10%
6-Month	0.16%
1-Year	0.20%
2-Year	0.36%
3-Year	0.53%
5-Year	1.35%
7-Year	2.09%
10-Year	2.79%

July Total Returns	
ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.01%
ML 12-Month Treasury	0.00%
S&P 500	-2.07%
Nasdaq	-0.58%

Source: Bloomberg, as of 07/29/11

The mandate of the European Financial Stability Facility (EFSF), the rescue fund set up to help resolve the debt crisis, has been broadened to include intervening in secondary markets and supporting banks. However, ample room remains for political maneuvering, as the EFSF needs mutual consent from member states for exceptional financial market interventions. Although the EFSF has been granted more extensive powers, it does not appear that its size has been expanded. And while EFSF has sufficient funds to provide additional support to Greece, and Ireland and Portugal if necessary, it does not have capacity to intervene in a sufficient scale to support Italy or Spain debt while also possibly providing funds to recapitalize banking systems.

Recent news reports state that Europe's biggest banks would voluntarily write down €20.6 billion on their Greek government loans as part of a bond exchange and debt buy-back program. From a broader financial system point of view, the level of write-downs from Greek debt for the large European banks is manageable. While the rating agencies may assign selective default on those particular bonds, the credit enhancement mechanisms in the package are expected to ensure eligibility of Greek debt as collateral with the European Central Bank, a major concern for the Greek banks before the package was announced.

While this package is clearly a positive development for Greece, execution risk remains, as Greece will need to deliver on its commitments for economic reform. In addition, structural shortcomings such as a lack of fiscal union across the EU have yet to be addressed. The agreement reiterates the euro zone's commitment to reduce deficits to below 3 percent by 2013 and will likely to slow the euro zone growth for the next few years.

The policy risk in responding to the fiscal imbalances in the advanced economies will continue to be the key theme for the foreseeable future. Until there is a sustained and broad-based economic recovery across the region, coupled with continued progress on reducing outsized government budget deficits and structural reforms to enhance long-term potential growth, further episodes of financial market volatility cannot be discounted.

Economic Vista
Debi Hanson, *Portfolio Manager*

Economic data released in July reinforced views that the economy continues to retract. The two components needed to kick-start growth, jobs and housing, showed no signs of improvement. Non-farm payrolls increased by a meager 18,000 in June and unemployment rose to 9.2 percent. The U-6 unemployment rate, which includes total unemployed, marginally employed and reluctant part-time workers, was a staggering 16.2 percent.

Housing continued to limp along, with inventory at a 9.4-month supply in June. Existing home sales fell 0.8 percent from the prior month, well below the estimates of a gain of 1.9 percent. New home sales, which fell 2.1 percent in June, fell 1.0 percent for July. Homes prices also continue to slide, according to the Case/Shiller - 20 City Composite, by 0.05 percent for June.

Advance retail sales were up 0.1 percent in June, better than expected, but showing the effects of high gas prices. Surprisingly, the International Council of Shopping Centers Chain Store Sales increased 6.9 percent in June over last year, and 5.4 percent from May.

Inflation continues to rise, but remained well below levels that would cause the Fed to begin tightening. The Producer Price Index and the Consumer Price Index, excluding food and energy, both rose 0.3 percent in June and 2.4 percent and 1.6 percent respectively year over year. The quarterly Personal Consumption Expenditure data rose to an annualized rate of 2.1 percent.

The first reading on 2nd quarter GDP, released on July 29, came in at 1.3 percent, with the first quarter revised down from 1.9 percent to 0.4 percent. Buffeted by gas and food prices, the consumer remained cautious on spending; consumer confidence fell from 71.5 to 63.8 in July, according to the University of Michigan Confidence Survey.

Credit Vista
Michael T. Nguyen, *Senior Analyst, Credit Research*

The automobile asset-backed securities (ABS) sector has proven its resilience since the financial crisis and during the Great Recession. Although the auto ABS sector consists of securities collateralized from pools of auto loans, leases, fleet financing, and car rental receivables, auto loan collateral represents the lion's share of all auto ABS issuance. Typically, auto loans in the U.S. are level pay installment loans with simple fixed-rate interest components. These loans are further classified, by loss performance and credit quality, as prime, nearprime and subprime. Prime auto loan ABS are considered better-performing, high-credit-quality assets with shorter average life maturities.

Even while defaults, losses and delinquency rates spiked for both securitized and managed portfolios during the financial crisis, there were no losses suffered by senior auto loan ABS investors. This signifies the strength of auto loan ABS structures and the adequate sizing of credit enhancement to withstand expected and elevated portfolio losses. Recent vintages have shown improved and stabilized performance to that of pre-crisis levels, as lenders have tightened underwriting standards. In essence, the auto ABS market has recently witnessed positive collateral and credit quality trends in its transactions.

Although auto ABS issuance volume is well below its peak of $90.6 billion in 2006, issuance volume is making a comeback. For 2010, auto ABS issuance represented $63.3 billion of the $116.3 billion of total ABS issuance volume. As of June 2011, auto ABS issuance volume is currently at $36.9 billion for the year.

The outlook for the prime auto loan ABS sector is positive due to current conservative underwriting practices, a strong used vehicle market and stable credit trends in a recovering economy. Auto loan ABS deals are considered high-quality, plain-vanilla structures, with fast-paying bonds with stable ratings performance over the years. For these reasons, we believe it is a good time to leave the grandstand and jump into the driver's seat.

Trading Vista
Minh Trang, *CFA, Portfolio Manager*

Even though the month of July was frothed by concerns over the U.S. debt ceiling and potential default, investors continued to soak up short-term Treasuries, regardless of the dismal yield. Three-month and six-month bills ended the month at 0.09 and 0.15 percent, respectively. The two-year didn't fare much better, dropping from 0.46 percent at the start of the month to 0.36 percent at month-end. This is a far cry from its high for the year of 0.85 percent. Agency spreads remained tight, with paper inside of one year trading at plus 3 to 5 basis points over comparable Treasuries. One- to two-year agencies traded at about plus 8 basis points to Treasuries. Callable agencies, however, were paying 15 to 20 basis points over. As for the corporate space, yields did improve a bit due to higher Eurodollar synthetic forward rates (EDSF). One-year financials traded at plus 10 to the curve at 0.50 percent, while industrials traded flat at 0.40 percent. In the asset-backed securities market, one-year average life autos traded at 0.63 percent or plus 18 to the curve, for the senior AAA rated tranche.

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