GREECE'S IMPACT ON THE EUROPEAN DEBT CRISIS

Summary

The European leaders had initially planned to unveil a clear action plan to their counterparts at the G20 Summit on November 3-4th in Cannes, France so as to seek support to help overcome Europe's debt crisis. But Greece's surprise decision to hold a confidence vote followed by a referendum threatened to derail the entire rescue plan. Although the referendum has since been called off, Greece's move will affect Europe's credibility to achieve a positive outcome. This report assesses these developments and the read-across to the financial markets.

The European market is expected to stay volatile in the near term given the continued uncertainty surrounding the final details of the comprehensive debt plan. In particular, the outcome of the vote of confidence in Greece coupled with the expected government transition would have a bearing on the successful completion of the amended Private Sector Involvement ("PSI") of Greek bonds. The risk of contagion from the various Greek scenarios remains. We believe that the European heads will look to nudging Greece towards an orderly default once they have sufficiently ring-fenced the other European countries that are at risk. Thus, the comprehensive plan must include a sufficiently enlarged Economic Financial Stability Facility ("EFSF"), a comprehensive bank restructuring programme and an orderly Greek default through the revamped PSI deal. If these are achieved, the European market will be more stable and have upside potential.

Given the above, we are sticking with our recommendation of being weighted towards high-quality, financially strong companies that have limited exposures to the peripheral sovereign debt. We also maintain our Underweight position in the European banks. As they are recapitalized and the impact of their collective de-leveraging becomes more visible, they will remain the weak link in the Euro zone's broader plan to deal with the fiscal and economic challenges in the periphery. Meanwhile, we continue to see attractive investment opportunities in the Consumer Discretionary, Consumer Staples, Industrial, Materials and Energy sectors which have companies that fit our preferred profiles.

Greek Prime Minister George Papandreou unexpectedly announced on 31st October that he planned to hold a confidence vote on 4th November and a subsequent national referendum on the new Greek aid package. His intention was to seek a strong mandate from the Greeks for his austerity programme and to wrestle further concessions on the Greek aid package from his European creditors. This threatened to derail the European "comprehensive plan" that was painfully hammered-out in the earlier EU Summit in October. European leaders had planned to use the ongoing 3rd and 4th November G20 Summit as the platform to unveil this plan. They hoped to gain support from the international community. This report summarises our current assessment of these events and their investment implications.

Greece's Surprise Move

1) The Referendum

After a meeting with German Chancellor Angela Merkel and French President Nicolas Sarkozy on the eve of the G20 meeting, the Greek Prime Minister George Papandreou said that he will not proceed with his planned referendum on the nation's latest bailout plan. The change in stance stemmed from Europe's resolve to withhold all aid including the previously agreed €8 billion that is due to be disbursed in mid-November until the outcome of the referendum is held. The EU leaders also wanted Greece to link the referendum to Greece's membership in the Euro zone. But the confidence vote on 4th November will proceed as planned.

2) Possible Outcomes

The Prime Minister Papandreou and his PASOK party are likely to lose the confidence vote in parliament on 4th November given the growing dissent among the members of his government. These included Finance Minister, Evangelos Venizelos, who broke ranks with Papandreou and strongly protested against the referendum. He is also calling for early elections.

- The best outcome in terms of minimum uncertainty is a failed vote of confidence, followed by the formation of an interim government of national unity which will quickly endorse the second Greek aid programme. An election will have to be called within three to four weeks. Under this scenario, the Private Sector Involvement ("PSI") deal can proceed on schedule. It was decided during the 26th October Euro Summit that a voluntary 50% private sector haircut on Greek government bond holdings will be agreed by the end of 2011 and the actual exchange to be implemented in January 2012.

- The worst outcome is a failed vote of confidence and then early elections that failed to deliver an endorsed agreement due to continued political bickering and the lack of public support for the austerity programme. This will then result in non-disbursement of EU/IMF aid and a subsequent disorderly Greek default. In this case, the PSI deal will be seriously impacted. The impact on financial markets will be severe. While this is clearly a risk, we believe that the new government, which is likely to be a coalition government involving one of the opposition parties, New Democracy ("ND"), is keen to avoid an imminent credit event. As such, the new government is not likely to seek another referendum or to re-negotiate the bail-out terms because Greece cannot meet its next bond issue of €6 billion due on 19th December. Thus, the country has to comply with the creditors' conditions or face the dire consequence of a disorderly default, which will lead to Euro membership exit and a deep recession with spiraling inflation. But the mood of the Greek electorate continues to be uncooperative and difficult to predict.

G20 (and Eurogroup Meeting) Watch

In view of the recent Greek developments and the uncertainty arising from the outcome of the Confidence vote in Greece on 4th November, it is difficult for Europe to garner strong financial commitments from both Emerging and Developed Countries at this juncture. At best, there is likely to be some funding support or credit lines channeled through the IMF to Economic Financial Stability Facility ("EFSF") rather than bilaterally. China has also indicated a preference to buy hard assets instead in Europe.

In any case, our view is that the measures that will be announced after the G20 Summit today (4th November) should be broadly in line with market expectations with some general and non-binding commitment from the international community. But we expect more developments after the Greek confidence vote when there is more clarity as to which government will take over in the country to oversee the austerity programme. Thus, the next key event to watch is the Eurogroup meeting on 7th November which will further explore ways to speed up the leverage of the EFSF. There should also be more clarity on the evolution of the revamped PSI deal.

While we do not expect too many surprises in the action plan to be announced after the G20 Summit to help tackle the European debt problem, it still represents a step in the right direction. We have attempted to summarise our analysis of the various policy options that will be undertaken by Europe, with possibly with some help from the international community.

Exhibit 1 : A Summary Of European Comprehensive Plan Initiatives

Policy	Description	Analysis
Plans to enhance EFSF	• "Levering" the EFSF by three to five times to around €860 billion to €1.3 trillion via credit guarantees for newly issued European sovereign debt using a first loss guarantee of 20% to 30%. This assumes the available EFSF funds are around €260 billion after accounting for the existing Portugal, Ireland, new Greek aid programme and potential bank recapitalisation. • A special purpose investment vehicle ("SPIV") scheme to attract funds from both the public and private sector. There could be some developments on this front during the G20 Meeting.	The resulting amount of funds has to be sizeable enough to support the financing needs for peripheral sovereigns for the next 3 years, which is roughly estimated at €1.5 trillion. This comprises €0.2 trillion Greek bonds, €0.2 trillion Irish and Portuguese bonds and €1.35 trillion for Italy and Spain bonds. The insurance option scheme is not sufficient to provide a full back-stop to the indebted European countries. Moreover, there is the risk that if the guarantees are actually drawn, the credit ratings of some of the creditor countries such as France could be at risk. Thus, details on the size of the SPIV are important.

Policy	Description	Analysis
EU Bank Recapitalisation and funding support	• Comprehensive set of measures to increase the Core Tier 1 Capital of banks to 9 percent by June 2012, including sovereign marks as at September 2011. • The European Banking Authority (EBA) estimates that the additional capital requirement for the European banks is €106 billion. • The challenges of Basel II. Following the stress test, debate has shifted to both the adequacy of the stress test, and the fact that not all risk models are created equal. Some of the banks, with material domestic sovereign exposure were shown to be requiring significantly more capital than those with larger cross-border exposures to Greece. • Many European banks have announced detailed plans to de-lever their balance sheets, with specific focus on US dollar wholesale banking exposures that are non-strategic. Estimates place the de-leveraging at up to $1 trillion in risk weighted assets, which could translate into as much as $2-3 trillion in gross assets.	The banks are expected to first raise capital privately. Only if they cannot will they turn to their national governments and only then the EFSF for support. This is less than the €175 billion estimate made by the EBA in the July stress test and less than some private estimates. We believe the stress test is a rough and poor guide in terms of how well positioned the various banks are positioned to deal with potential stresses. We share the view that the larger issue that is still not fully addressed in the test is getting the banks on similar models to determine capital needs. The Spanish banks highlighted the fact that their capital levels are calculated based on materially more conservative credit risk assumptions. European bank de-leveraging will have implications that could flow back and impact capital requirements in two ways. First, many banks will experience potential losses associated with their run-off portfolios and second, the broader shift in liquidity and economic conditions that may arise could result in a further deterioration in core banking books. We believe that how this process plays out will be a critical factor in determining the overall capital needs for the sector.

Policy	Description	Analysis
Higher PSI on Greek Debt	The private sector has agreed to voluntarily take a 50% notional haircut on their Greek bond holdings on the condition that credible backstops are in place at the same time. But this is now delayed, the extent of which depends on the outcome of the 4th November Confidence vote in Greece. The original plan was to complete the exchange by January 2012.	If the elections in Greece fails to deliver an endorsed support for the Greek austerity programme, then this may further delay the revamped PSI deal or, in the worst case, lead to a disorderly Greek default. Otherwise, the voluntary nature of the agreement implies that a credit default swap ("CDS") credit event is not likely. Although Greece's debt-to-GDP ratio should come down to 120% by 2020, this is still below the 90% mark which is the estimated sustainability threshold for Greece.

Investment Conclusion

The European market is expected to stay volatile in the near term given the continued uncertainty surrounding the final details of the comprehensive debt plan. In particular, the outcome of the vote of confidence in Greece coupled with the expected government transition would have a bearing on the successful completion of the amended PSI of Greek bonds The risk of contagion from the various Greek scenarios remains. We believe that the European heads will look to nudging Greece towards an orderly default once they have sufficiently ring-fenced the other European countries that are at risk. Thus, the comprehensive plan must include a sufficiently enlarged EFSF, a comprehensive bank restructuring programme and an orderly Greek default through the revamped PSI deal. If these are achieved, the European market will be more stable and have upside potential.

Given the above, we are sticking with our recommendation of being weighted towards high-quality, financially strong companies that have limited exposures to the peripheral sovereign debt. We also maintain our Underweight position in the European banks. As they are recapitalized and the impact of their collective de-leveraging becomes more visible, they will remain the weak link in the Euro zone's broader plan to deal with the fiscal and economic challenges in the periphery. Meanwhile, we continue to see attractive investment opportunities in the Consumer Discretionary, Consumer Staples, Industrial, Materials and Energy sectors which have companies that fit our preferred profiles.

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