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STANDARD & POOR'S

Greece's Debt Crisis -- Its Implications for Stocks and the Broader Global Economy

Uncertainty over the crisis could cause jittery investors to spread risk aversion to other countries or markets, fueling continued global market volatility.

Are Greece's current debt woes just one more aftershock of the Great Recession of 2008, or the beginning of a new global financial contagion?

After a nearly 10-month rally, the global financial markets stumbled out of the gate in 2010. By early February, the MSCI Europe Index, a key indicator of European Union (EU) market performance, was down 11% year-to-date, while the S&P 500 was down more than 5%.[1]

What is causing the widespread volatility? While there are many potential contributing causes, one of the most immediate seems to be investor fear over Greece's debt crisis, which some say represents a much broader problem for European economies and stock markets and a threat to a broad-based global economic recovery.

Greece's Troubles

Greece's debt woes came to light late in 2009 when a new government took office and revealed that the country had been overspending. It was also under-reporting its debt, which had ballooned to 12.7% of GDP - more than four times the limit allowed by the European Union.[2] In response to pressure from the EU and the financial markets, Greece announced an aggressive plan to cut its deficit to 8.7% of GDP this year and to bring its debt ratio into compliance with EU policy of 3% of GDP by 2012.[3]

Many analysts and investors have expressed doubt that Greece will be able to put its fiscal house in order on its own. That skepticism has bred widespread concern among investors. At the same time, several credit rating agencies have downgraded Greece's credit rating, including Standard & Poor's, which has stated that a further downgrade of Greece's credit rating (currently at BBB+) is possible within a month. These actions have fostered fear among potential investors in Greek bonds, making it very difficult for the country to borrow money to fund its debt.

Although the country recently announced tax increases and spending cuts to help control its deficit, most agree that more is needed. Greece is one of the 16 EU nations that has adopted the euro as its sole currency. As of March 1, the euro had dropped to $1.348, close to a nine-month low.[2] Further declines seem likely if Greece and the EU are unable to resolve the crisis. If Greece were to default on its debt, banks in Greece and elsewhere as well as other countries holding Greek bonds would suffer. A Greek default would also present the first real economic and political viability test for Europe's single-currency financial system. Uncertainty over the crisis could cause jittery investors to spread risk aversion to other countries or markets, fueling continued global market volatility.

Takeaways for Investors

- **Greece is symptomatic of a global issue.** Greece's troubles are representative of a wider problem that started in the wake of the global financial crisis, when governments around the world -- the United States included -- injected massive amounts of monetary stimulus into their economies, much of it funded by new government debt issues. The difficult challenge governments must now face is finding ways to begin digging out from under their enormous debt burdens while also forging long-term plans to strengthen and grow their economies. In short, many global economies are facing what amounts to a fiscal "Catch 22."

- **Demand for U.S. exports may decline.** As countries around the world engage in deficit reduction plans, one of the casualties is likely to be consumer and business demand for goods and services of all kinds, including those exported from America.

- **The U.S. dollar and dollar-denominated assets benefit in the short term.** Flight from the euro has strengthened the dollar and benefitted U.S. Treasury bonds, which are considered a safe haven amid current market conditions. The dollar has risen by 4.8% against the euro year-to-date.[4] However, keep in mind that as the dollar strengthens against the euro, the value of foreign investments translates into fewer dollars, thus eroding dollar-based returns for U.S. investors.

- **Sovereign risk has driven bond yields.** Investors fearful of more debt problems have sold off their sovereign bonds, driving up the rate at which governments can borrow. This "risk premium" raises rates on other assets, such as corporate bonds, meaning companies will also find it more expensive to borrow to fund growth.

- **Long-term trends are positive.** Despite the current travails being played out on the global stage, the long-term prospect for a global market and economic recovery appears to be on track although volatility remains a significant factor to be reckoned with.

[1]Sources: Standard & Poor's; Morgan Stanley Capital International. Performance for the period indicated. It is not possible to invest in an index. Past performance is not a guarantee of future results.

[2]Source: *The Christian Science Monitor*, March 1, 2010.

[3]Source: *The Washington Post*, February 12, 2010.

[4]Source: *The Economist*, February 18, 2010.