Sovereign Debt: A Matter of Confidence

The U.S. stock market appears to be a prisoner to the headlines, up one day and down the next, depending on expectations for the euro zone. How can you protect your portfolio?

Despite efforts to bolster global liquidity, the stability of European sovereign debt is likely to remain a question mark for the foreseeable future.

The U.S. stock market appears to be a prisoner to the headlines, up one day and down the next, depending on expectations for the euro zone. A recent example was the S&P 500's November 30 rally on the news that the Federal Reserve will lead an effort by six central banks to increase global liquidity and avert a credit crisis.[1] Although this action is a short-term positive for stocks, it does not address the longer-term issue of a lack of confidence in European sovereign debt.[2]

Borrowing Binge

Europe's challenges stem from a history of significant government borrowing by Italy, Spain, Greece, Ireland, and Portugal, among other countries. When the Greek financial crisis first erupted in 2010, questions about contagion led to borrowing costs that suddenly were unaffordable for Greece and many of its euro zone neighbors. A one-trillion-euro bailout fund was created in October 2011, but it quickly became apparent that the fund was not adequate. A coalition of central banks have boosted liquidity with the goal of averting a full-blown credit crisis.

If Europe's debt woes are not addressed, the situation could ignite a credit crunch even worse than the one that occurred during 2008-2009.[3] Tightened credit could limit global expansion, as growth estimates released by the Organisation for Economic Co-operation and Development (OECD) indicate. In many areas of the world, short-term growth is expected to be muted.

Looking Ahead: Slow Growth and Contraction

Country	Expected Change in Gross Domestic Product (GDP) for 2011	Expected Change in GDP for 2012
France	1.6%	0.3%
Greece	(6.1%)	(3.0%)
Ireland	1.2%	1.0%
Italy	0.7%	(0.5%)
Portugal	(1.6%)	(3.2%)
Spain	0.7%	0.3%
United States	1.7%	2.0%

Source: OECD *Economic Outlook*, November 2011.

What Investors Can Do

Although there are no guarantees, the following strategies may help to maintain a portfolio's value as events in the euro zone unfold:

- **Diversify bond holdings.** Be selective in allocations to government debt. Many sovereign nations, including the United States, maintain strong credit ratings along with the financial muscle to pay bondholders. That said, diversifying fixed-income holdings to include municipal and corporate offerings, and being selective in your choices, could make your portfolio less dependent on events in one area of the bond market.[4]
- **Investigate revenue streams outside of Europe.** If you own individual securities, review the revenue streams of the underlying companies to determine how much revenue comes from Europe. Organizations that do a significant amount of business elsewhere, such as North America, South America, Africa, or Asia, may help to insulate your holdings from the worst of Europe's problems.
- **Tread cautiously with Financials.** Standard & Poor's recommends underweighting Financials, which are likely to be most vulnerable to European credit risk and also to be buffeted by domestic economic uncertainty. Many large financial institutions operate globally, which makes it difficult for them to avoid completely challenges facing a particular continent.
- **Look for companies that generate cash.** Organizations with consistent profits may be in a strong position to withstand a credit crunch if lending standards tighten further.

Diversifying your bond holdings, looking for revenue streams outside of Europe, underweighting securities issued by financial institutions, and looking for companies that generate cash can potentially help you stay afloat financially even when Europe experiences stormy seas.

[1]Source: Standard & Poor's. Returns are for November 30, 2011.

[2]Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors.

[3]Source: www.guardian.co.uk, "OECD: Euro Collapse Would Have 'Highly Devastating Outcomes' Worldwide," November 28, 2011.

[4]Municipal bonds are subject to availability and change in price. They are also subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax free, but other state and local taxes may apply.

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