TD Asset Management

forward PERSPECTIVES

Europe: At the Crossroads

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October 2011 - Volume III
Published Quarterly

Europe – At the Crossroads

This summer, there was a significant amount of anxiety over whether the U.S. debt ceiling would be raised. While the immediate issue was resolved, for the time being at least, it did highlight a pressing matter for the global economy. For many years, we have been concerned about the levels of sovereign debt, particularly among the developed nations, and the impact on the global economy.

Although the United States has an undeniably high total debt of US$14.7 trillion, which equates to approximately 100% of U.S. gross domestic product (GDP)[1] , presently we are more concerned about the European sovereign debt crisis. Specifically, we are troubled by Europe's ability and willingness to wrestle control over the widening debt of the PIIGS: **P**ortugal, **I**reland, **I**taly, **G**reece and **S**pain. In this edition of forwardPerspectives, we will focus on the causes of the debt crisis in Europe, why we believe it is a unique situation compared to other developed countries, and what it means to investors.

TD Asset Management Inc. (TDAM) is committed to providing thought leadership on key issues impacting markets or the investment climate in general. At a time when information is plentiful but wisdom is harder to discern, TD's Wealth Asset Allocation Committee's new thought leadership series entitled *forwardPerspectives*, offers insight into market opportunities and risks.

The Rise of a New Economic Zone

On January 1, 1999, eleven countries in Europe adopted the euro as their common currency to become the European Monetary Union (EMU) with Greece and five more member states joining in subsequent years. Through this pact, the monetary policy of the region became the responsibility of the European Central Bank (ECB) rather than each individual country. Fiscal policy remained, for the most part, in the control of the individual countries. While limits were set on the deficit level for each country, the EMU lacked effective controls to ensure individual countries adhered to these restrictions.

The primary reasons for the creation of the EMU were to achieve price stability and improve trade within Europe. With so many countries bordering each other, using a single currency eliminated the need for multiple foreign exchange transactions, enhancing trade. An ancillary benefit for many of the economically weaker countries was the availability of lower interest rates on their lines of credit. By being part of a much larger economic group, these countries were able to borrow funds at rates reflecting the financial strength of the whole rather than the individual.

As a result, economically weaker countries were able to increase their debt without incurring the appropriate interest charges of a similar stand-alone country. Greece, for example, took advantage of the credit worthiness of the European Monetary Union and increased public spending dramatically after it adopted the euro as its currency. In 2001, Greek debt stood at US$136 billion. By 2006, prior to the credit crisis, the government had increased the debt to US$281 billion. Today, total Greek debt exceeds US$430 billion[†].

During the global financial crisis of 2007-2008, many European countries initiated stimulus measures to support their economies and prevent their banks from collapsing. Overall, the eurozone countries increased their total debt by approximately US$1.3 trillion during this period. Ireland alone almost doubled its total debt, which jumped from US$64 billion in 2007 to over US$117 billion in 2008[†]. Although a similar reaction occurred in the U.S., along with a corresponding increase in debt, the structure of the EMU complicates each member country's ability to control and reduce its debt burden.

When a sovereign nation incurs too much debt, it has two primary levers available to reduce its debt burden: fiscal policy and monetary policy. Through fiscal policy, governments can reduce spending on a variety of programs and can raise revenues through higher taxation. With monetary policy, there are a variety of options, all aimed at affecting the level of money in the system and/or the level of borrowing rates.

Unfortunately, this is not the case in the EMU. While individual members have control over their fiscal policy, they do not control monetary policy. In addition, the combination of strong and weak economies in a single currency forces the stronger players to support the weaker ones. The question that arises is, how long will the stronger economies of the EMU, specifically Germany and France, be willing to carry the burden?

Monetary Policy

One option that sovereign countries have to escape the crushing burden of debt is to embark on policies that eventually devalue their currency. Money, as with any other commodity, declines in value if too much of it is available to buyers. By continually increasing the supply of money, a sovereign nation eventually reduces the value of its currency. Normally, this should lead to stronger domestic growth and increased revenues to pay off the higher debt burden.

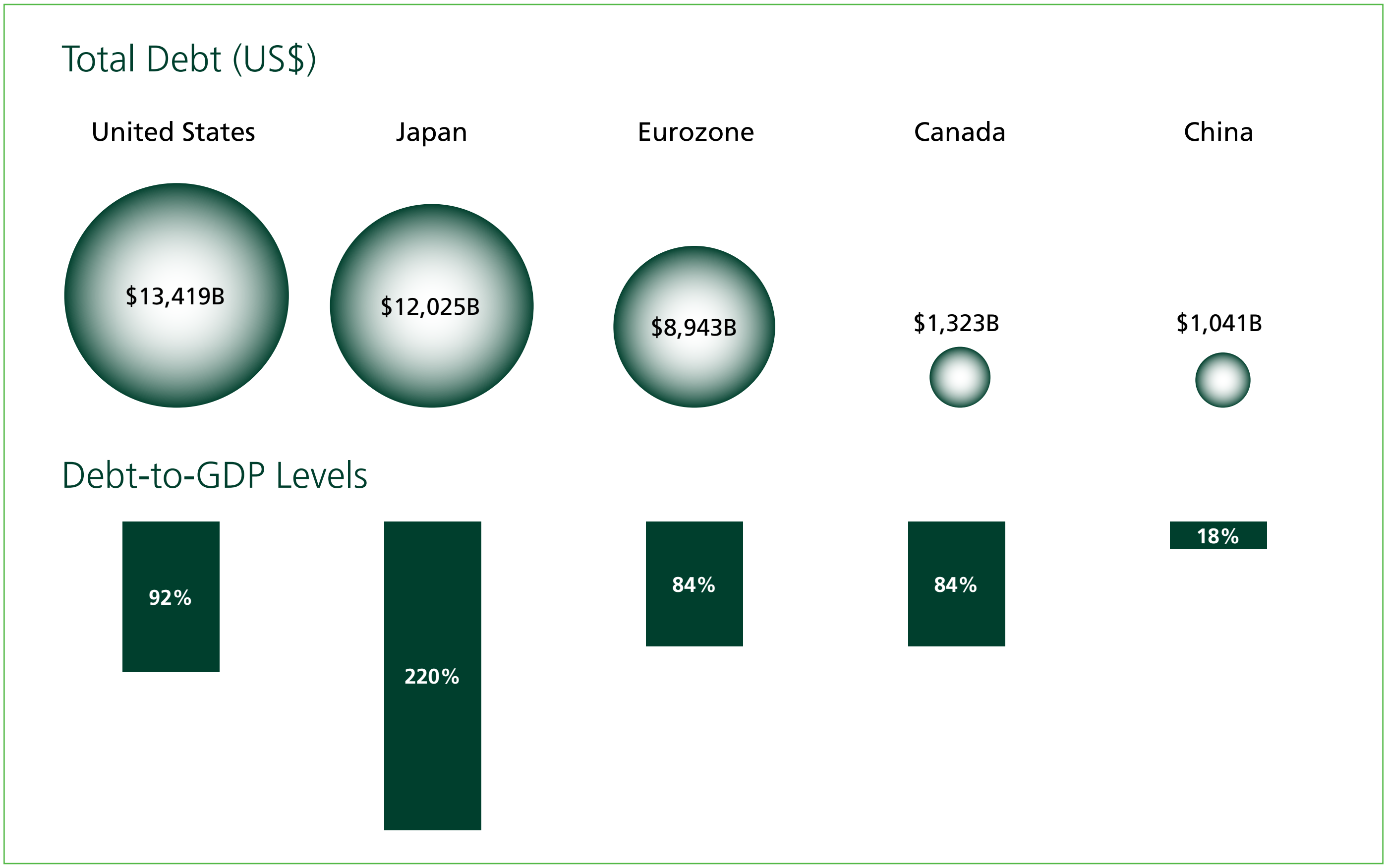
In Europe, the ECB needs to consider the impact of a devalued currency on all of its members, not just on those in distress. Devaluing the currency for the region as a whole would likely increase inflationary pressure. For countries, such as France and Germany, that have relatively robust economies, this could fuel inflation that might hamper growth. Without the strength of the core countries, Europe as a whole may not have the financial power to rescue the floundering economies of member countries such as Greece. As such, it is likely that the ECB will pursue policies that maintain the value of the euro.

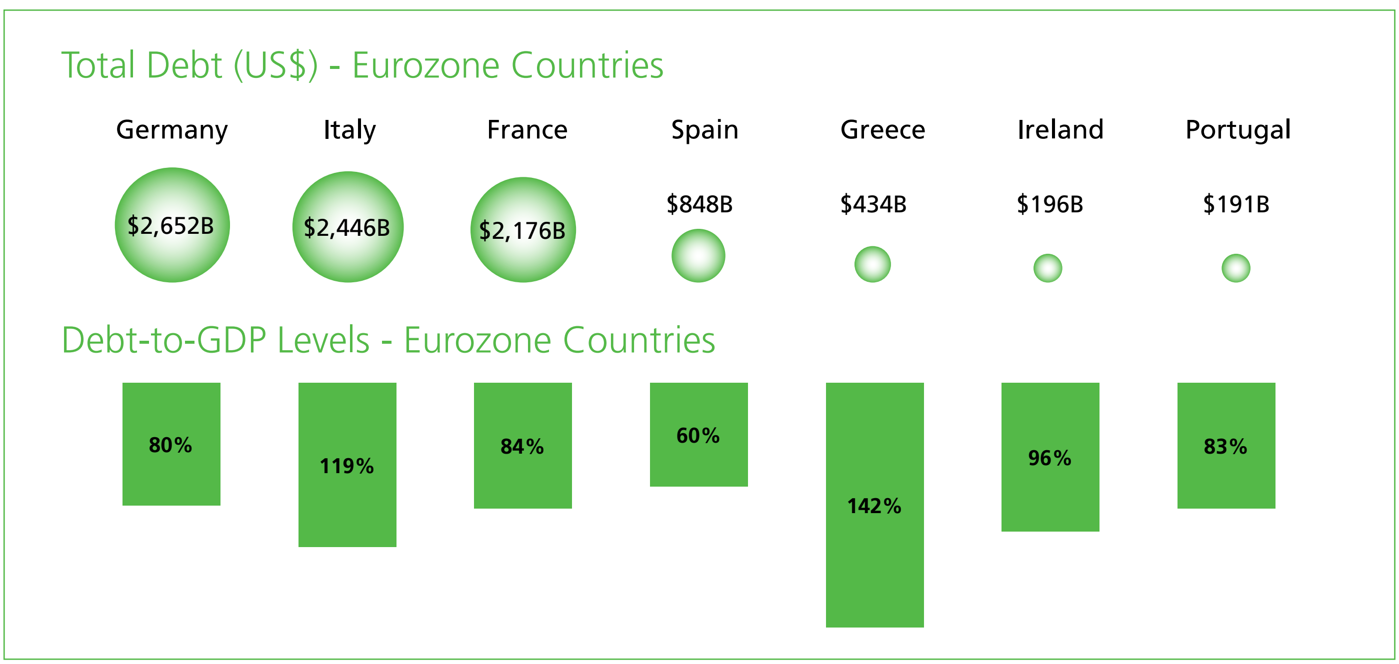
Alternatively, a country can try to grow its way out of debt by encouraging economic activity through a low interest rate environment. Again, since all countries in the EMU are affected by changes in the central bank rates, the strong economic growth in France and Germany may be amplified. Were the ECB to lower interest rates substantially to assist the struggling nations, they could run the risk of overheating the core economies to the detriment of the region.

All for One?

The current situation has also emphasized an imbalance in the EMU, where strong economies with sound fiscal controls and high productivity subsidize weak economies with poor controls and low productivity. While the financially stronger countries have been able, and partially willing, to assist Greece with its financial difficulties in an attempt to control the outbreak, there may be a limit to their generosity. Greece's debt, although significant in terms of a debt-to-GDP ratio, is not particularly daunting in absolute terms for the broader union. As such, a Greek default on its own may be manageable. That said, the negative public reaction in the core countries of Europe may eventually challenge the political will needed to bailout the peripheral economies.

To complicate matters, while the economies of Spain and Italy are large, so is their total debt. For months, there has been some commentary indicating that Spain and Italy are too big to fail due to the size of their economies and their overall impact on global markets. While the debt-to-GDP of the PIIGS is quite high, there is a significant difference between the absolute debt of the smaller members, Ireland and Greece, and the larger members, Italy and Spain. With Spain and Italy owing US$848 billion and US$2.4 trillion, respectively, any financial assistance for them would put a significant burden on France and Germany (see chart below). Therefore, assisting these two countries may be difficult even if there were the willingness to do so.





Source: International Monetary Fund, World Economic Outlook Database, April 2011; TDAM.

The Long Road Ahead

Mother Europe can no longer allow her children to run loose with the credit cards without imposing some control. Given this, we expect that further centralization of control over fiscal policy will be needed in Europe. While ceding control over spending may push some countries to reconsider their membership in the EMU, we expect the weaker economies will have a tough choice to make. Leaving the eurozone may force the weaker economies to forgo the benefit of lower ECB interest rates available to the remaining members. Alternatively, staying in the eurozone would likely mean difficult austerity measures being imposed on them by a foreign central body.

Even with increased central control over spending, the ECB will likely need to walk a fine line on keeping interest rates relatively low. It will need to avoid overheating the stronger economies, while still providing the weaker economies a chance to grow.

In general, over the next few years, sovereign nations and their lenders will face tough choices. Not only will sovereign nations need to achieve a balance between growth and spending, but bondholders may find themselves beholden to their borrowers. Should bondholders refuse to lend, there will be negative impacts on both the credit worthiness of the issuer and the bondholders' own portfolios. In the end, we are optimistic of a positive outcome as it will be in the best interest of both parties to work together to resolve the issue.

The Investor's Dilemma

In light of the issues facing Europe, many investors can be forgiven for assuming that the best course of action is to avoid investing in European markets entirely. After all, Europe finds itself in a difficult situation and will face significant challenges in the coming years. But investors must remember that all debt is not equal. Some level of debt can be good for both companies and countries to allow them the flexibility to expand their businesses or develop programs for the betterment of society. It is borrowers that incur unsustainable levels of debt that investors must be wary of.

With that in mind, investors should also recognize that in the current environment, many developed nations around the world will need to reduce spending to gain control of their debt. With this fiscal austerity, we expect GDP growth in developed nations to remain low in the years ahead. As a result, we believe interest rates will remain low for longer than expected in an effort to stimulate growth. Accordingly, investors will likely find their bond portfolios producing low single-digit returns, at best, for the foreseeable future.

Investors should also recognize that low GDP growth will likely translate into weaker corporate earnings and correspondingly lower market returns. While there are many corporations with strong balance sheets that can likely weather this storm, growth will be harder to generate. That said, we believe that companies with access to developing markets, where debt is low and growth will likely remain strong, should fare better than their peers.

Considering our outlook for bond returns, we expect that an investment in higher-quality, dividend-paying equities will have better returns than bonds. A key consideration for investors is the additional volatility that should be expected in equity investments. With that in mind, we believe that investors will be best served by focusing on higher-quality multinational firms that provide access to developing markets. Ideally, investors should look for companies that can generate stable levels of free cash flow, which can be distributed as dividends. Going forward, we believe that dividend income will likely be a significant component of a stock's return.

TD Wealth Asset Allocation Committee

The committee is comprised of ten individuals from different areas of TD Wealth Management businesses with unique investing skills and experiences. The committee was formed in 2009 to:

- articulate broad market themes
- provide macro asset allocation direction
- identify major risks on the horizon

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[1]Source: U.S. Bureau of Public Debt; TDAM. [†]Source: International Monetary Fund, World Economic Outlook Database, April 2011; TDAM. The statements contained herein are based on material believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. The document does not provide individual financial, legal, tax or investment advice and is for information purposes only. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any fund. Particular investment or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. TD Asset Management Inc. ("TDAM"), The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus, which contains detailed investment information, before investing. Mutual funds are not covered by the Canada Deposit Insurance Corporation or by any other government deposit insurer and are not guaranteed or insured. Their values change frequently. There can be no assurances that a money market fund will be able to maintain its net asset value per unit at a constant amount or that the full amount of your investment will be returned to you. Past performance may not be repeated. TD Mutual Funds are managed by TDAM, a wholly-owned subsidiary of The Toronto-Dominion Bank and are available through authorized dealers. Certain portions of this document may contain forward-looking statements. Forward-looking statements include statements that are predictive in nature, that depend upon or refer to future events or conditions, or that include words such as "expects", "anticipates", "intends", "plans", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. In addition, any statement that may be made concerning future performance, strategies or prospects is also a forward-looking statement. Forward looking statements are based on current expectations and projections about future economic, political and relevant market factors, such as interest rates, foreign exchange rates, equity and capital markets, and the general business environment, in each case assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to among other things, risks and uncertainties, some of which may be unforeseeable. Accordingly, assumptions concerning future economic and other factors may prove to be incorrect at a future date. Forward-looking statements are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any forward-looking statement. Any number of important factors could contribute to these digressions, including general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological change, changes in government relations, unexpected judicial or regulatory proceedings and catastrophic events. We stress that the above-mentioned list of important factors is not exhaustive. You should consider these and other factors carefully before making any investment decisions and avoid placing any undue reliance on forward-looking statements. Further, you should know that TDAM, has no specific intention of updating any forward-looking statements whether as a result of new information, future events or otherwise.

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