

March 10, 2010

Canadian Bond Yields

	Dec. 31 2009	Mar. 10 2010	
Canada 5-yr	2.77	2.82	↗
Canada 10-yr	3.61	3.54	↘
Prov. Ontario 5-yr	3.15	3.09	↘
Prov. Ontario 10-yr	4.26	4.08	↘
Prov. Quebec 5-yr	3.09	2.99	↘
Prov. Quebec 10-yr	4.39	4.22	↘

Source: Bloomberg

Equity Index Returns

% Change	2010 in local currency	2010 in C\$	
S&P/TSX	1.9	1.9	↗
S&P 500	2.7	0.7	↗
Russell 2000	7.7	5.6	↗
MSCI EAFE	0.9	-3.8	↘
MSCI EAFE Small Cap	3.2	-1.1	↘
MSCI Emerging Markets	-0.8	-2.4	↘

Source: Bloomberg

The Greek Tragedy and European Stocks

The recent turmoil in the finances of Greece resembles a Greek tragedy. On top of the intricacies of internal politics, street protests and union strikes, there is a crosscurrent of complex international issues at play.

On one side, Greece is not certain it will obtain the new financing it needs to fund its budget deficit. International capital markets are still willing to invest in Greek government bonds, as demonstrated by last week's successful new issue of €5 billion. But this bond issue comes at a high price: an interest rate that is 3% higher than the current rate on German bonds. At this financing rate, Greece's budget deficit is set to balloon, as interest payments will represent a growing share of the government budget. This is why Greece is asking for the help of the European Union: with cheaper financing from its major trade partners, it may avoid a debt-driven spiral of budget deficits. But by accepting help, Greece would be partly sacrificing its independence, because major spending cuts would be required in exchange for the financial help.

But the stakes are also high for the European Union. If it bails Greece out without demanding deep budget cuts, the EU will be hard pressed to refuse rescuing other financially challenged European Union countries. One such country is Spain. This poses a problem because Spain has a large economy (with a GDP slightly larger than Canada's) and therefore, it would be extremely expensive to bail out. In short, the financial markets are concerned that the Greek debt crisis will infect larger countries and cause damage to the value of the euro.

This dismal picture raises a question for investors: should European stocks be avoided? Certainly, the markets have noticed the European situation. Therefore, the problems are already being reflected in stock prices (year-to-date Greek stocks are down 3% and Spanish stocks are down 7%). In general, when stock prices decline, their expected returns increase because investors pay a lower price for the same stream of future earnings. Furthermore, even if a major euro crisis does materialize (which is far from certain), European companies will continue to be major players in the world economy and may turn out to be an excellent long-term investment.

In conclusion, I recognize that the Greek debt crisis generates significant risks for the European Union. But I believe these risks are discounted in the form of lower stock prices and higher expected returns. Furthermore, European companies will remain viable economic entities despite the current crisis. On another note, my favourite type of portfolio is extremely diversified in order to capture the market rate of return without the risk of losing significant amounts of money due to the demise of one or a group of companies. European stocks are an essential component of such a portfolio. It may seem to go against our natural intuition, but stocks from regions that are in a difficult position only enhance long-term returns, not decrease them.

Raymond Kerzérho, Director of Research