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Newsletter

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Why Does Europe Affect Your Portfolio?

When a possible default on Greek sovereign debt becomes headline news, a lot of people find themselves wondering, "How can the problems of a country so small and so far away create such turmoil in the world's financial markets?" What's happening in Europe is probably affecting your portfolio right now, regardless of the quality of your holdings or how well diversified you are.

Bank exposure

One of the chief concerns about the possibility of default on sovereign debt has to do with the financial stability of banks that hold it. For example, some of the largest French banks have already seen their credit ratings downgraded because of their extensive holdings of debt from troubled European countries. If a Greek default made banks reluctant to lend to one another, that could affect credit markets worldwide.

American banks hold very little Greek debt compared to European banks; however, they could face a different challenge. Derivatives known as credit default swaps can create a ripple effect, multiplying a default's impact beyond the bondholders to other financial institutions and institutional investors. U.S. financial institutions are major issuers of credit default swaps, and the potential impact that a Greek default would have is unclear. However, since the 2008 financial crisis, banks have been forced to hold greater capital reserves to deal with contingencies.

Potential for tighter credit creating recession

Lending worldwide hasn't fully recovered from the last financial crisis, and has helped keep global economic recovery sluggish. If banks' lending ability were impaired further by a financial crisis brought on by a default on sovereign debt, pessimists argue that a slowing global economy could be thrown into recession. Europe represents a major market for many U.S. companies, and a recession there would be felt around the globe.

Greece could be the tip of the iceberg

Even though Greece is the immediate concern, Europe's larger economies could pose a bigger threat. Italy and Spain both face debt and deficit problems. Italy's economy is more than five times that of Greece; Spain's is more than four times bigger (CIA World Factbook 2011). If a Greek default would have a ripple effect, default by Spain or Italy could create waves.

To compound the problem, borrowing costs for troubled countries have risen. At recent auctions, nervous investors have demanded higher interest rates to compensate them for their higher perceived risk. As any credit card holder knows, having to pay a higher interest rate makes paying off debt and balancing the budget more difficult.

All politics is local

Recently there have been signs that voters in stronger European countries, such as Germany, may be questioning why they should continue to support others when their own economies are slowing. Also, investors worry that the financial support available from the European Financial Stability Fund (EFSF) may not be sufficient or available quickly enough to avert problems. Though there's no shortage of suggestions for how to deal with the situation--issuance of euro bonds backed by all eurozone members, leveraging the EFSF's existing assets, greater fiscal integration among countries, Greece abandoning the euro--questions about the ability and willingness of other eurozone countries to support weaker members have contributed to investor anxiety.

Financial markets hate uncertainty, and the situation has contributed to the recent volatility across a variety of asset classes. However, eurozone leaders have the benefit of having watched the United States during the 2008 crisis. Also, they have generally reaffirmed their determination to defend the euro.

Uncertainty about Europe could persist for months, so while it's important to monitor the situation, don't let every twist and turn derail a carefully constructed investment game plan. To determine how market events might affect your own portfolio, don't hesitate to ask questions and get expert help.

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