

## Solution to the public debt problem in Europe?

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What a surprising rebound on the stock markets, particularly for a month of October! Historically, October is synonymous with atavistic angst for those negotiating the stock market, having been the month of the 1907 Bankers' Panic, and the month of the Great Crash of 1929 — memories that are scarier than the most sinister of Halloween ghosts. More recently, in 2008, October was the month when, lacking support from government institutions, the venerable Lehman Brothers went bankrupt, causing a liquidity crisis that had a profound impact on the world financial system — the effects of which are still being felt today.

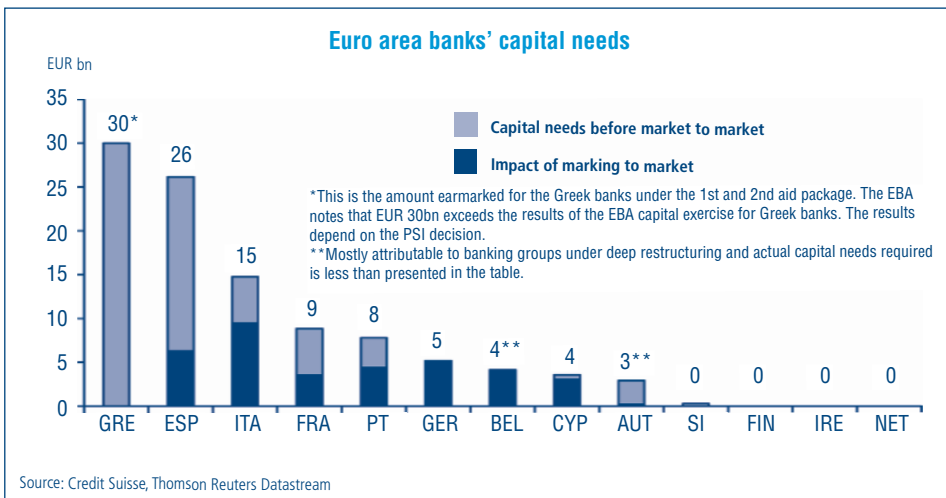
As we were saying: a surprising rebound in the stock markets, which seem to have regained their optimism. An increase of 10.9% for the U.S. large-cap index, the S&P 500; a 6.2% increase for the MSCI - EAFE, the stock market index of developed markets outside America; and a gain of 5.6% for our Canadian index, the S&P/TSX. All these returns are given in local currencies.

The law of communicating vessels can help us understand, in a slightly simplified manner, how the positive capital flows that enthusiastic investors are unleashing onto the stock markets create negative capital flows on the bond markets. It is therefore not surprising to see the Canadian bond market, represented by the DEX Universe, down 0.4%. Within this index, the most important retreats were in long-term bonds (DEX Long Term Bond Index down 1.0%).

The October stock market rebound and the bond market retreat were caused primarily by developments in Europe. Need we recall that since the start of 2010, the sovereign debt problems of several European countries have been looming, like the sword of Damocles, over the economic recovery and over the markets. Greece remains at the centre of the preoccupations and discussions of all European heads of state.

Fourteen summit meetings have been held in 21 months (!) with a view to negotiating a solution to the unsustainable heaviness of the Greek problem and to avoid another financial crisis which would arise from a disorderly default on Greek bonds. October 27 saw the announcement of an agreement between all euro members, aiming to preserve the financial stability of the European monetary union. This

**Rather than going ahead with a "we'll do whatever it takes" attitude, the solution proposed to the financial markets — while certainly a step in the right direction — seems to be stitched with the white thread of diplomatic compromise.**



agreement contains three main components, which we will try to summarize here, along with a summary of the criticisms levelled by economic commentators.

First component: a haircut. According to the agreement, private holders of the Greek debt (essentially European banks) would accept a "voluntary" 50 percent cut in the nominal value of their bond investments. A first estimate indicates that such a cut would reduce the Greek debt by about 100 billion euros. It should be noted that public holders of Greek debt (European governments and the International Monetary Fund — IMF) would not participate in this cut.

There are two main criticisms of this first component. First, the "voluntary" nature of this cut: while it could avoid setting off credit-default swaps, it contains a certain risk in execution. For, even though the agreement was developed with the help of the Institute for International Finance, representing the banks, it is not impossible that some banks will back out along the way. Second, some experts believe this cut is insufficient to bring the total Greek debt to the desired level of 120% of its GDP by 2020. According to these experts, the Greek government still needs to free up an operating surplus (before payments tied to the debt) equivalent to 6% of the Greek budget — which, given the current weakness of the Greek economy, is not necessarily a done deal.

Second component: leveraging of the European Financial Stability Facility (EFSF). As we have said in the past, the problem of excessive debt is not limited to Greece: Spain and Italy are also sources of apprehension for investors. To remedy this situation, European leaders have decided to enable the EFSF to act like a bank, that is, to make more

financial commitments than it has tangible assets (hence the leverage effect). In total, the EFSF could commit up to 1 trillion euros to buy or offer protection on the debt of these troubled countries. All this with a goal of avoiding a potential collapse that would make Greek's problems seem small by comparison, given the much larger economies of Spain and Italy.

With respect to this component, the main criticism concerns the size of the EFSF's balance sheet. At first glance, analysts estimate that 1 trillion euros is a sufficient amount to maintain the interest rates of Spanish and Italian bonds at reasonable levels, if these governments continue the necessary economic and fiscal reforms to contain their future public debt. However, if these reforms do not materialize in a satisfying manner, investors may go back to dumping these bonds onto the markets, and should that occur, the EFSF rescue fund would not be big enough to support the market.

Third component: recapitalization of the European banks. Growing concerns as to the solidity of certain European banks have recently made headlines. In particular, the French banks Société Générale, Crédit Agricole and BNP Paribas were cited in September for their heavy exposure to the Greek, Spanish and Italian debts, leading to a sharp drop in their stock market value. Moreover, the heads of these banks are particularly reticent to recapitalize by issuing shares at the current prices. In response, the European Banking Authority carried out stress tests, which indicated a shortfall of 106 billion euros of capital among European banks. As a result, the agreement contains a clause that forces banks to raise their capital ratio to 9% by June 30, 2012.

On this last point, the only criticism lies in the risk that banks may choose to improve their capital ratio by shrinking their balance sheets rather than by raising capital

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## Table of net returns as at October 31, 2011

	Unit value \$	Net assets <sup>1</sup> in millions \$	Simple returns <sup>2</sup>			Compound annual returns				MER <sup>3</sup> %	Investment Advisor
			1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %		
<b>FOCUS FUNDS</b>											<b>ECOFLEX   MY EDUCATION</b>
Focus Prudent	14.02	151.7	1.1	(0.2)	0.9	1.0	5.6	2.0	3.3*	2.88	Various Managers
Focus Moderate	14.19	228.7	2.0	(1.5)	(1.4)	(0.3)	5.8	1.3	3.2*	2.92	Various Managers
Focus Balanced	14.29	387.1	3.0	(2.7)	(3.7)	(1.7)	5.8	0.6	3.1*	2.97	Various Managers
Focus Growth	14.32	130.2	4.0	(4.1)	(6.0)	(3.2)	5.8	(0.2)	2.9*	3.01	Various Managers
Focus Aggressive	14.31	62.8	5.0	(5.4)	(8.3)	(4.6)	5.7	(1.1)	2.7*	3.04	Various Managers
<b>INCOME FUNDS</b>											<b>ECOFLEX   MY EDUCATION</b>
Money Market	16.92	235.2	0.0	0.0	0.1	0.2	0.2	1.2	1.3	1.47	Industrial Alliance
Short Term Bonds	15.26	208.5	(0.3)	0.8	2.5	1.6	3.7	2.6	2.5	2.14	Industrial Alliance
Bonds	26.14	1,692.7	(0.4)	2.0	5.5	4.0	5.9	3.9	4.2	2.14	Industrial Alliance
Bonds - series 2	17.31	605.7	(0.5)	1.9	5.0	3.8	6.1	3.6	3.9	2.15	Industrial Alliance
<b>DIVERSIFIED FUNDS</b>											<b>ECOFLEX   MY EDUCATION</b>
Diversified Security	17.25	299.1	1.8	(0.2)	0.5	1.3	6.6	2.4	4.0	2.76	Industrial Alliance
Diversified	30.60	1,662.0	3.4	(1.7)	(2.6)	(0.1)	6.8	1.2	4.2	2.77	Industrial Alliance
Diversified Opportunity	18.88	211.9	4.8	(3.0)	(5.1)	(1.4)	7.5	0.7	4.6	2.84	Industrial Alliance
Fidelity Canadian Asset Allocation	15.27	487.4	3.0	(2.9)	(5.2)	(1.1)	7.4	1.9	4.9	3.39	Fidelity
Diversified Income	18.46	178.4	5.0	(4.1)	(6.1)	(1.7)	10.6	3.0	-	2.77	Industrial Alliance
Global Diversified (Aston Hill)	9.69	32.7	5.2	(4.9)	(3.2)	0.2	5.6	-	-	3.12	Aston Hill
<b>CANADIAN EQUITY FUNDS</b>											<b>ECOFLEX   MY EDUCATION</b>
Dividend Income	10.36	139.7	5.6	(4.0)	(6.4)	(5.6)	3.3	(2.4)	5.2*	2.42	IA Clarington
Dividend Growth	13.00	696.8	3.9	(1.8)	(3.5)	0.2	8.1	2.0	8.4*	2.66	Industrial Alliance
Canadian Equity (Leon Frazer)	15.39	179.0	3.8	(0.4)	0.9	4.7	8.9	2.7	7.3*	2.98	Leon Frazer
Canadian Equity Index	16.73	153.2	5.1	(4.8)	(9.3)	(4.4)	5.5	(0.2)	5.0	2.78	Industrial Alliance
Select Canadian <sup>6</sup>	23.75	47.2	7.0	(4.7)	(9.3)	(2.6)	9.2	0.7	6.6	2.72	Industrial Alliance
Canadian Equity Value	35.25	385.2	6.3	(5.0)	(9.8)	(4.3)	5.8	(1.8)	4.8	2.78	Industrial Alliance
Canadian Equity (Dynamic)	15.96	551.3	7.3	(13.6)	(19.5)	(13.8)	7.7	(0.5)	8.8	3.14	Dynamic
Fidelity True North <sup>6</sup>	22.45	346.2	4.7	(3.5)	(7.2)	(1.3)	7.3	0.4	5.9	3.40	Fidelity
Canadian Equity Growth	20.48	233.4	5.9	(6.1)	(10.9)	(4.9)	10.9	3.1	7.3	2.75	Industrial Alliance
Fidelity Canadian Opportunities	25.85	194.1	3.3	(4.2)	(9.7)	(1.6)	19.0	5.8	7.9	3.40	Fidelity

**Returns after deduction of MER (Management expense ratio). Past performance is not a guarantee of future returns.**

The EcoStrategist in Brief / Ecoflex | My Education economic and financial bulletin, produced monthly, and its more exhaustive quarterly version, are available on the Company's website under *Investment Vehicles and Publications*.

<sup>1</sup> Total net assets of the fund including individual and group contracts.

<sup>2</sup> The rates for the period are non-annualized.

<sup>3</sup> Management expense ratio (GST and HST included).

<sup>4</sup> Industrial Alliance has managed this fund since March 2010. Prior to that date, it was managed by Legg Mason.

<sup>5</sup> Indexes presented in this document are total return index.

<sup>6</sup> Not offered in registered contracts and TFSAs.

\* Simulation of past returns as if the fund had been in effect for these periods.

Index funds: Simulation of past returns from the return of the index that the fund aims to reproduce.

## Table of net returns as at October 31, 2011 (continued)

	Unit value \$	Net assets <sup>1</sup> in millions \$	Simple returns <sup>2</sup>			Compound annual returns				MER <sup>3</sup> %	Investment Advisor
			1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %		
<b>U.S. &amp; INTERNATIONAL EQUITY FUNDS</b>											<b>ECOFLEX   MY EDUCATION</b>
Global Dividend (Dynamic)	9.47	55.7	(1.9)	(6.3)	(5.2)	(0.8)	5.3	(1.1)*	-	3.25	Dynamic
Global Equity (Templeton)	8.99	194.1	6.5	(5.3)	(6.8)	(6.7)	0.6	(6.7)	(2.0)	3.38	Templeton
Global Equity	9.00	6.6	5.7	(4.4)	(6.3)	(4.6)	4.3	(4.5)	-	3.24	Industrial Alliance
Fidelity NorthStar®	9.23	34.8	2.2	(6.4)	(9.5)	(4.8)	5.2	(3.4)	-	3.43	Fidelity
Global Equity Small Cap. (DB Advisors)	8.73	85.4	6.0	(5.0)	(7.0)	(2.9)	8.3	(2.7)*	-	3.35	DB Advisors
International Equity Index	6.13	12.4	4.3	(6.5)	(8.6)	(8.6)	0.4	(6.9)	(1.8)	2.76	BlackRock
International Equity (Templeton)	11.13	61.0	6.2	(6.7)	(8.7)	(10.2)	(0.1)	(7.3)	(1.9)	3.33	Templeton
International Equity (McLean Budden)	8.59	6.5	5.1	(6.2)	(7.8)	(8.4)	0.6	(6.2)	(2.0)	3.24	McLean Budden
Fidelity European Equity	7.67	56.2	5.0	(9.3)	(12.4)	(12.8)	0.1	(3.8)	(0.2)	3.44	Fidelity
U.S. Equity Index	7.23	28.6	5.4	0.8	(1.2)	2.3	0.8	(5.3)	(4.1)	2.75	SSgA (State Street)
U.S. Equity (McLean Budden)	8.45	30.7	6.9	(1.9)	(6.4)	(3.3)	(1.1)	(5.5)	(2.8)*	3.20	McLean Budden
U.S. Equity <sup>4</sup>	5.18	9.5	7.6	(1.4)	(5.4)	0.1	1.9	(11.8)	(6.5)	3.09	Industrial Alliance
<b>SPECIALTY FUNDS</b>											<b>ECOFLEX   MY EDUCATION</b>
Asian Pacific (Dynamic)	5.38	46.8	7.6	(14.9)	(18.7)	(18.5)	24.0	6.5	6.4	3.06	Dynamic
Emerging Markets (Mackenzie Cundill)	12.39	42.7	2.8	(19.4)	(25.9)	(19.0)	10.4	(1.2)	6.4	4.32	Mackenzie Cundill
Global Health Care (Renaissance)	11.67	10.9	0.6	(1.3)	4.2	5.4	3.6	(1.7)	0.7	3.56	CIBC
Real Estate Income	21.32	25.8	2.4	0.0	9.9	8.1	19.2	4.4	-	2.78	Industrial Alliance
U.S. DAQ Index	4.44	14.9	5.3	3.5	4.4	6.1	10.7	1.7	(1.6)	2.79	Industrial Alliance
<b>EDUCATION SAVINGS PLAN</b>											<b>ECOFLEX   MY EDUCATION</b>
Diploma Elementary	12.07	245.1	2.8	(1.2)	(2.3)	(0.8)	3.9	(0.6)	1.7*	3.39	Industrial Alliance
Diploma Secondary	11.32	32.9	0.4	0.2	0.5	0.1	2.0	0.6	1.4*	3.40	Industrial Alliance
<b>FUNDS NOT OFFERED TO NEW CONTRACT SUBSCRIBERS</b>											<b>ECOFLEX   MY EDUCATION</b>
Diploma	9.92	174.1	2.8	(0.9)	(2.0)	(0.5)	3.6	(0.9)	1.2	3.40	Industrial Alliance
Dividends	31.99	557.2	4.0	(1.7)	(3.1)	0.8	8.6	2.2	9.1	2.16	Industrial Alliance
Multi-Strategy	7.50	2.1	(0.4)	(4.4)	(5.2)	(4.4)	(3.9)	(7.0)	(1.9)*	4.11	Lyxor Asset Manag.

Returns after deduction of MER (Management expense ratio). Past performance is not a guarantee of future returns.

Reference indexes<sup>5</sup> - Returns as at October 31, 2011

	Simple returns <sup>2</sup>			Compound annual returns			
	1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %
<b>INDEXES RELATED TO INCOME FUNDS</b>							
DEX 91 day Tbill Index	0.1	0.2	0.8	1.0	0.8	2.1	2.4
DEX Short Term Bond Index	(0.1)	1.3	4.0	3.5	5.1	5.0	4.7
DEX Universe Bond Index	(0.4)	2.6	7.0	6.0	8.2	5.9	6.1
S&P/TSX Capped Income Trusts (Total Return)	2.3	2.3	17.3	22.9	20.3	8.8	15.9
SB - World Government Bonds (Can. \$)	(3.8)	4.8	6.9	1.2	1.6	4.9	2.5
<b>INDEXES RELATED TO CANADIAN EQUITY FUNDS</b>							
S&P/TSX 60	4.9	(4.2)	(7.3)	(1.6)	8.7	2.5	8.2
S&P/TSX Completion Index	7.7	(6.2)	(6.2)	1.4	19.7	4.1	9.7
S&P/TSX Composite Index	5.6	(4.7)	(6.9)	(0.8)	11.1	2.7	8.5
S&P/TSX Capped Composite Index	5.6	(4.7)	(6.9)	(0.8)	11.1	2.7	8.5
<b>INDEXES RELATED TO U.S. &amp; INTERNATIONAL EQUITY FUNDS</b>							
S&P 500 (Can. \$)	6.1	1.6	1.2	5.4	4.1	(2.2)	(1.1)
S&P 500 (Can. \$) (Reuters)	5.7	1.5	1.3	5.5	4.2	(2.1)	(1.1)
MSCI - World (Can. \$)	5.5	(2.4)	(3.2)	(0.8)	3.5	(3.4)	(0.2)
MSCI - World Small Cap. (Can. \$)	7.0	(5.0)	(5.8)	1.1	11.0	(1.0)	4.7
MSCI - EAFE (Can. \$)	4.9	(6.0)	(6.9)	(6.5)	2.7	(4.8)	0.9
MSCI - EAFE (Can. \$) (Reuters)	4.5	(6.1)	(6.8)	(6.4)	2.7	(4.7)	0.9
MSCI - Europe (Can. \$)	7.2	(6.4)	(5.0)	(7.0)	2.9	(4.5)	1.4
<b>INDEXES RELATED TO SPECIALTY FUNDS</b>							
MSCI - AC Asian Pacific Free (Can. \$)	3.0	(6.4)	(9.4)	(5.6)	7.8	(1.6)	3.4
MSCI - Emerging Markets (Can. \$)	8.3	(8.2)	(11.4)	(9.7)	15.5	4.2	11.8
MSCI - World Health Care (Can. \$)	0.5	(0.5)	4.5	3.2	(0.1)	(3.0)	(3.4)
NASDAQ 100 (Can. \$)	5.5	4.0	6.3	8.3	13.0	3.8	0.8
S&P/TSX Capped REIT Index	1.4	0.8	16.1	12.5	25.1	6.1	13.0
<b>EXCHANGE RATE (Can. \$ / US \$)</b>							
As at October 31, 2011: 0.9935	(4.4)	4.2	(0.1)	(2.5)	(6.5)	(2.4)	(4.6)
<b>EXCHANGE RATE (US \$ / Can. \$)</b>							
As at October 31, 2011: 1.0065	4.6	(4.0)	0.1	2.5	7.0	2.5	4.8

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on the financial markets. Such a move would have a fatal impact on the European economy, in which companies are traditionally more likely to seek financing through loans than through share capital. We will have to see what measures are taken by the national and European banking authorities to ensure that banks act appropriately.

In conclusion to this summary, it can be seen that the internal rifts in Europe are far from being resolved. Rather than going ahead with a firm commitment and a "we'll do whatever it takes" attitude, the solution that euro zone leaders

are proposing to the financial markets — while certainly a meaningful step in the right direction — seems to be stitched with the white thread of diplomatic compromise.

**Latest developments**

On November 1, Greek Prime Minister George Papandreou announced plans to hold a referendum on the EU bail-out plan at the start of 2012, provoking the wrath of French President Nicolas Sarkozy and German Chancellor Angela Merkel. In light of the popular saying that, "If you owe the bank thousands, then you have a problem. If you owe the

bank millions, then the bank has a problem," this announcement fell on stock markets like a cold shower. Then, on November 3, there was an about-face: to the great relief of stock market investors, the referendum plan was dropped. As we write these lines, on November 4, we are awaiting the results of the Greek parliament's vote of confidence in the Papandreou government. History is in the making. ■