American Century Investments®

The European Debt Crisis: Our Perspective

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One of the most significant factors impacting the investment landscape over the past 18 months has been the sovereign debt crisis in Europe. Fiscal stress in a number of eurozone countries has weighed on the global economy, put pressure on the banking sector, and roiled financial markets worldwide. The following is a look at how the crisis has unfolded, what is likely to happen next, and what that means from an investment perspective.

Debt Crisis Timeline

- **May 2010:** In response to growing concerns about the ability of several European countries to meet their sovereign debt obligations, the European Union (EU) created the European Financial Stability Facility (EFSF). In concert with the EU and the International Monetary Fund (IMF), the EFSF can provide up to €750 billion (more than $1 trillion) in financial assistance to euro-member countries facing troublesome sovereign debt loads. The EFSF's first customer was Greece, which received a financial rescue package totaling more than €110 billion ($155 billion).
- **November 2010:** Ireland, struggling with fiscal problems stemming from the government's decision to guarantee all debt incurred by the country's troubled banking sector, received an €85 billion ($120 billion) rescue package from the EFSF. A newly elected Irish government implemented some fiscal austerity measures, but Ireland's fiscal viability hinges on a banking sector recovery.
- **May 2011:** Almost one year to the day after the initial bailout of Greece, Portugal received €78 billion ($111 billion) in rescue funding from the EU and IMF. Portugal relies heavily on foreign creditors, and when they are reluctant to lend—which has been the case as the country's fiscal woes have worsened—Portugal's economy grinds to a standstill.
- **June 2011:** Facing a stagnant economy, growing social unrest, an inability to meet fiscal deficit reduction targets, and a potential default on its maturing debt, Greece requested a second bailout package from the EU.
- **July 2011:** The EU, IMF, and Greece reached an agreement on a second bailout package. In addition to providing additional loans to Greece, the EU forced the country to adopt more stringent fiscal austerity measures. The agreement also called for a voluntary debt exchange, in which Greek bond investors have several options to exchange bonds maturing in the next few years for new bonds with longer maturities, effectively extending the maturities of Greek bonds to avoid a near-term default. Separately, the EU sought to expand the role of the EFSF to buy bonds on the secondary market and provide funds to euro-member countries to recapitalize banks.
- **August 2011:** The EU took steps to prevent the contagion from spreading to larger but fiscally vulnerable European countries, such as Italy and Spain. Toward that end, the European Central Bank began buying Spanish and Italian bonds on the secondary market, and Italy approved new fiscal austerity measures.

What to Watch For Next

Two major developments related to Greece are set to take place over the next six weeks and will have a significant effect on how the sovereign debt crisis unfolds.

- **Ratification of the second Greek bailout.** Euro-member countries will be voting to ratify the most recent bailout package for Greece. The ratification will also include increasing the size and power of the EFSF. France was the first country to officially ratify the package, and although most other countries are expected to follow suit, there are several nations (such as Finland) that have expressed reluctance with funding additional bailouts.
- **Greek debt exchange.** Investors in Greek debt (primarily banks and insurance companies) will be deciding whether to participate in the debt exchange and, if so, what option they will select. Greece is currently gauging interest and will set formal terms for the exchange in October.

Positive outcomes for both the ratification and the debt exchange, without any major hiccups along the way, should alleviate near-term fears of a Greek default and boost confidence in the EU's efforts to solve the crisis. If, on the other hand, one or both of the measures fail or run into significant resistance, the likelihood of a Greek default would increase, potentially destabilizing the financial system.

OUR TAKE: Despite some posturing and bickering among participants, we expect both the bailout ratification and the debt exchange to be successfully completed.

The Long-Term View

The Greek bailout and debt exchange, if successful, are just the first in a series of challenges facing the EU that will play out over the long term. From a historical perspective, we are in unprecedented territory, and the ultimate outcome is uncertain. But here are some things to keep in mind as the situation develops:

- **Confidence is key.** Debt markets depend heavily on confidence; it is difficult-to-impossible to access the capital markets for funding if potential investors lack confidence in your ability to repay your debts. The fiscally troubled countries in Europe have developed aggressive plans to solve their fiscal issues, but now they must execute and achieve their goals to ease investor concerns and restore credibility.
- **Focus on the economy.** The economic environment can make a big difference in achieving these fiscal targets. Weak economic conditions create headwinds for restoring fiscal strength, but if economic growth recovers, it will make the process considerably easier.
- **Moving toward a fiscal union.** One factor that gives us confidence in a positive outcome is the resolve among EU member countries to keep the union intact. We expect to see more assertive action from the EU to unite eurozone countries fiscally as well as monetarily. The creation and expansion of the EFSF, an insistence on fiscal austerity measures in exchange for financial aid, and a push toward balanced budget amendments in euro-member constitutions represent a meaningful shift toward a fiscal union. This not only bodes well for the long-term stability of Europe and its common currency, but it's also a sensible move—as a whole, the EU is in better fiscal shape than the U.S., and a single fiscal entity would make it much easier to withstand and overcome the current debt problems.
- **Making the rational choice.** It is in everyone's best interest to solve this crisis in an orderly fashion. No one wins if countries default on their debt and/or the eurozone falls apart. The ramifications would be severe and far-reaching—debt-laden countries would suffer significant economic damage, the financial system would destabilize, and international trade would come to a halt. Financial markets have been known to act irrationally, and the herd mentality is well-ingrained in market behavior, but we believe that cooler heads will prevail and the rational choice will win the day.

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Investing in a Changing World

Despite the turmoil in Europe, international bond investments remain attractive as a U.S. portfolio diversifier, as well as a hedge against inflation and a declining U.S. dollar. It's worth noting that, in a period of extraordinary turbulence and volatility, the broad international bond indexes have returned more than 9% so far this year (through August 31). Contrast that with the 6% gain in the U.S. bond market and the –2% return for U.S. stocks over the same period.

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Nonetheless, international bond markets are likely to experience continued volatility over the next 6–12 months. As a result, the investment management team for the American Century® International Bond Fund has taken a cautious approach—less active risk, more diversification, and an emphasis on quality. For example, the fund does not own bonds issued by the three bailout countries—Greece, Ireland, and Portugal—and it has limited exposure to Spain and Italy. From a diversification perspective, the International Bond Fund owns bonds from 17 different countries; Japan, the U.K., France, and Germany are its four largest positions.

The management team has also positioned the International Bond Fund based on a central theme of subpar economic growth but no global recession and no sovereign default. To capitalize on an eventual recovery, the fund holds a meaningful position in non-government securities, which also provides additional diversification, and a currency overlay with an emphasis on economically sensitive currencies such as the Australian dollar and Norwegian krone.

You should consider the fund's investment objectives, risks, and charges and expenses carefully before you invest. The fund's prospectus or summary prospectus, which can be obtained by visiting americancentury.com/ipro, contains this and other information about the fund, and should be read carefully before investing.

Investment return and principal value of security investments will fluctuate. The value at the time of redemption may be more or less than the original cost. Past performance is no guarantee of future results.

Generally, as interest rates rise, the value of the securities held in the fund will decline. The opposite is true when interest rates decline.

International investing involves special risks, such as political instability and currency fluctuations.

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