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Principal Global Investors Market Bulletin

European Financial Crisis Postponed?

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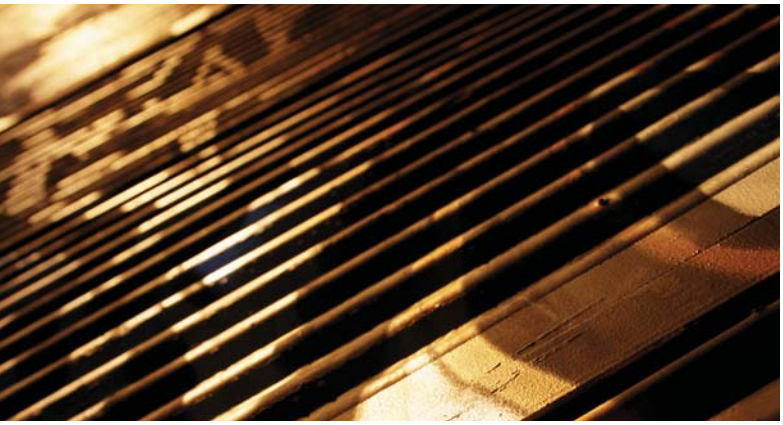

Markets have rallied strongly in response to the audacious €750 billion rescue package the European Union (EU) agreed on over the weekend, as well as a commitment by the European Central Bank (ECB) to buy Eurozone government and private bonds "to ensure depth and liquidity" in markets. The plan consists of €440 billion of loans and guarantees from Eurozone governments, €60 billion from an EU emergency fund and €250 billion from the International Monetary Fund (IMF).

Stock and bond markets are up sharply after a meltdown last week that threatened to shake the global economic recovery. The sheer panic that gripped markets Thursday provided undisputable evidence that the crisis had moved beyond Greece to Spain and could endanger the entire EU if not addressed immediately. Greece and Portugal are manageable, but Spain has several times their debt combined outstanding.

The historic bailout package appears to be enough to calm markets and stay the bond vigilantes for now. However, fundamentals remain poor and we believe this is only delaying the pain EU members will have to face up to eventually. The volume of Greek debt is so large that at some point a rescheduling of that debt, which amounts to a partial default, seems inevitable. The austerity promised, and the support from the EU and the IMF, are sufficient only to delay this, not prevent it. Estimates of the haircut bondholders will take range from 30-70%, and the longer the process is drawn out, the bigger the haircut is likely to be. This will cause a big problem for European banks, whose balance sheets are already thin. Politically this is very difficult, given the damage it will cause to European banks and to their ability to lend.

Indeed, the panic last Thursday had a lot to do with concerns about the liquidity of European banks. The market has welcomed the ECB's commitment to buy distressed European debt to avoid a new seizure in credit markets and ward off another global financial crisis. So for now, peripheral European countries have the support they need and European banks have the liquidity they need to continue to operate normally. However, we are concerned about the cost of these measures and whether they will be enough to resolve Europe's woes over the longer term. Greece and other profligate European countries need to bear the cost of irresponsible financial actions (per EU rules). The moral hazard this massive bailout represents could be costly for Europe's leaders. The result of Germany's regional elections Sunday, which handed a stinging defeat to Chancellor Angela Merkel's center-right party, illustrates how unpalatable it is to the man on the street. We anticipate cuts in government spending and higher taxes to fund the deficits in Europe will translate into lower economic growth in the Eurozone, which will also impact the euro. While the euro has rallied strongly on the news of the bailout package, it is possible the euro could continue its slide as the euphoria wears off, possibly

to parity with the U.S. dollar or even below. This would be highly supportive to European growth down the road. Potential beneficiaries of euro weakness are mostly (German) exporters in Europe. Spain and Portugal, however, are not competitive because of high unit labor costs.

Our equity portfolios are underweight peripheral European countries, both from a stock selection perspective, as well as a macroeconomic perspective. We are overweight Germany and exporters at the expense of periphery countries. For example, we do not own any Greek banks despite their cheap valuation because of their increasing funding costs and declining fundamentals. However, we may in the future purchase more stocks in these countries if we see valuations are becoming extremely attractive given their earnings growth profile.

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CHICAGO 312-541-0250, DES MOINES 800-533-1390, HONG KONG 852-2596-7882,
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