The European crisis has the potential to derail our nascent recovery. After decrying our economy for its consumer-credit-driven fuel, Europe’s decades of personal income and spending—supported by social-welfare policies, funded by government deficits and financed with cheap sovereign debt—is coming to a halt with ramifications for our economy and capital markets. According to Mohamed El-Erian, president and CIO of Pacific Investment Management (PIMCO), “the markets are now catching up to the reality of overburdened public finances in the aftermath of the global financial crisis. These developments are of particular concern to countries with elevated debt levels and challenging maturity profiles for this debt.”

The possible fallout from the Eurozone crisis could push the U.S. into the feared double-dip recession as a result of (i) a rapidly weakening Euro giving rise to reduced demand for U.S. exports and increased imports; (ii) a revaluation of credit risks resulting in a reversal of the credit-spread compression that has benefited U.S. borrowers during the past twelve months; (iii) fiscal-austerity plans in key countries reducing personal incomes, raising taxes and depressing demand for both local and U.S. goods; (iv) market-based losses on sovereign debt holdings causing additional erosion in the capital bases of key financial institutions. Offsetting these potential deleterious effects is the increasing appetite for U.S. dollar-based holdings by central banks.

The Euro has fallen nearly 15% since the start of the year; while it has rebounded slightly in the past several trading sessions, it continues to drift lower, hitting a secular low of $1.21. While Greece, Portugal and Spain—the more troubled members of the Eurozone—represent slightly more than 1% of U.S. exports, the Eurozone as a whole accounts for 14% of total U.S. exports. The strengthening of the dollar may inhibit continued export growth.
while further encouraging expanded imports in the United States by virtue of their reduced cost. There could be a concomitant reduction in domestic demand and production. There has been a dramatic improvement in credit spreads between high-yield credits and U.S. Treasuries. During the past year, the BankAmerica-Merrill Lynch single B index has compressed from 1,700 basis points last May to 550 basis points as of May 1, 2010. However, money flows between U.S. leveraged finance markets and overseas markets are robust. As yields on troubled and distressed foreign credits increase and attract funds from U.S. investments, the offsetting outflows may increase U.S. high-yield rates and restrict credit availability. During the past two weeks, we have seen yield spreads widen by 125 basis points in direct response to the Eurozone crisis. While yield spreads may be widening as a result of either a reassessment of the vulnerability of U.S. companies to a renewed downturn, or more technical funds-flow arguments, the result may be the same: higher borrowing costs and more restrictive credit access as a result of the Eurozone crisis. Greece, Spain and Portugal have all announced dramatic fiscal austerity measures in an effort to bring fiscal deficits below their record levels of 14%, 9% and 11% of GDP, respectively. In all cases, deficit reduction entails some combination of new taxes, reduced levels of spending, decreases in pension and welfare programs, and government employment cuts in wages and positions. The net impact will be reduced aggregate demand and a concomitant decrease in export spending. Moreover, the outlook for economic revitalization in these nations remains grim as the credit markets have now eliminated the use of fiscal policy to stimulate economic growth, while monetary policy remains idle as the European Central Bank (ECB) rejects calls for quantitative easing. This results in a weakened Euro as the only prescriptive available to restore European economic vitality. While the weakened Euro promotes economic activity, its weakness may limit the credit available to support the capital requirements needed to support economic growth. Sovereign nations generating surplus foreign currencies, like China and Brazil, will become increasingly loath to invest in Euro securities. As a result, Europe may experience the heightened demand arising from more competitive prices but lack the credit facilities to support increased production. Moreover, the social unrest in the PIIGS countries arising from government austerity programs may disrupt production flows and severe the link between a weakening Euro and improving demand for Eurozone goods. Eurozone financial institutions may face renewed questions regarding capital adequacy. European banks currently hold $10.4 trillion of Eurozone sovereign debt while the U.S. holds approximately one-tenth that amount. If sovereign-debt issues continue to decline in value, the negative impact on capital adequacy at key institutions could impair credit availability and support for any European recovery. In addition, any restrictions on credit purchases by European institutions may limit their participation in our credit markets, thereby curbing our improved liquidity. The Eurozone’s announcement of a €750.0 billion rescue fund, the result of a joint agreement between the ECB and the IMF, should serve to mitigate the risks to our recovery arising from the Eurozone crisis. Nevertheless, we remain concerned that the need for political consensus to implement this rescue, along with the need for more structural enforcement of austerity measures, may render the program less effective than needed. France continues to seek greater fiscal integration to parallel the monetary union that has
been achieved, while Germany rejects any program in which German resources could be used to prop up less austere nations. Furthermore, the existence of the rescue fund may encourage increased lending to troubled sovereign nations believing that such loans will have the tacit guarantee of the European Union. For middle market companies, the risks arising from European malaise should not be minimized. The state of our businesses, our access to capital, and continued improvements in profitability could very well be affected by the events in Europe, and we encourage companies to weigh carefully their exposure to the elements of the crisis outlined above, and take those actions necessary to insulate their businesses and capital structure from such impacts.

S. Randy Lampert is the founder of Lampert Debt Advisors, which has been providing debt financing services to corporations for over 30 years. During that time, he has completed nearly $15 Billion in debt and equity financings. Most recently, he was a co-founder of the debt capital markets group at a major middle market investment bank as well as head of business development. Prior to that, he founded the Leveraged Finance Group at Nomura Securities that originated principal transactions for a $750 MM fund and underwritings/placements for High Yield Capital Markets. He was a partner with the predecessor to Apax Partners engaged in financings for leveraged buyouts and private equity investments. During his ten years with Salomon Brothers, Inc., he rose to Group Head of the New England Region and executed a variety of investment grade and high yield financings on behalf of technology, telecommunications and industrial companies.