

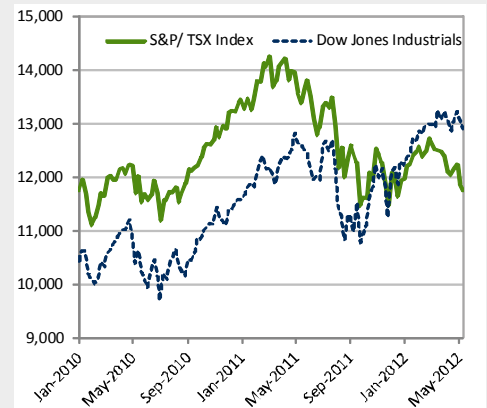
## Euro Tragedy Continues

Volatility in global equity markets has picked up considerably over the past week. The primary cause of this has been the outcome of the French presidential and Greek parliamentary elections as well as fears that the Spanish banking system is in need of a recapitalization. The victory of anti-austerity candidates in last weekend's elections has brought into question not only the appetite for fiscal discipline and much needed reforms in parts of Europe but also the ability to get deficits and debt levels under control. As for Spain, it now finds itself in a position where its banks require a capital infusion in an environment of negative economic growth and rapidly rising inflation. Since late March, as pressures began to build in the region (with bond yields in Spain moving upwards of 6%), equities began selling off. So far the Soxx 50 (a broad European Index) is down 15% while Spain and Greece are off approximately 20%. In late March we recommended that investors take profits (on our recommendation to purchase select European ETFs last October) and reduce exposure to Europe. Considering recent developments we reiterate that recommendation. We also noted that because of the creeping bond yields in Spain and Italy that another round of the European debt crisis could emerge and contribute (together with other factors) to a correction in other equity markets.

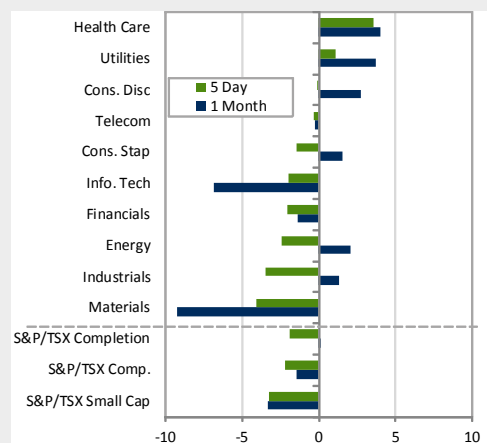
While the situation in Europe looks dire on the surface we don't think it's anywhere near as bad as last year. At that time Europe was cracking at the seams under the combined weight of a banking crisis and real prospect of default that threatened to collapse the Euro as a currency and economic union. Since then several policies have been enacted serving to lessen the strains of the system. First of all the banking system has been recapitalized and provided with ample short-term liquidity from the LTRO. That the banking system continues to function is a major departure from last year. We can see this by looking at the inter-bank lending market as well as the market for US Dollars (see chart on next page). The second departure from last year is that there's no imminent threat of widespread sovereign defaults. While Greece has a debt payment of about €500 million in mid-May authorities say they have sufficient resources to pay even if the Troika (EU, IMF, and ECB) withhold bailout funds. In looking at Credit Default Swaps (see chart on next page) for the major European economies we can see (with the exception of Spain) that this fear index is not showing any major strains.

The main takeaway from last weekend's elections is that confidence in the Euro region as an economic union is collapsing. As evidence many are pointing to the success of fringe parties, both left and right, who either want to renegotiate bailout terms or exit the union. But this success of fringe parties we feel is more a reflection of voter dissatisfaction over austerity and the economy rather than a loss of confidence in the Euro region. Even in Greece the majority of the population (70%) wants to remain in the Euro. While the Greeks may want to lessen the focus on austerity and concentrate on growth no party has been given a mandate to govern let alone exit the Euro (Greeks will most likely have to return to the polls next month). Despite the rhetoric over the need to renegotiate bailout terms and

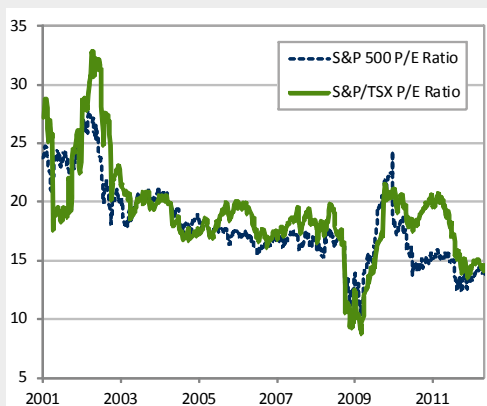
### Equity Markets



### Canadian Market Performance



### Market Valuations



Source: Bloomberg, Raymond James Ltd.

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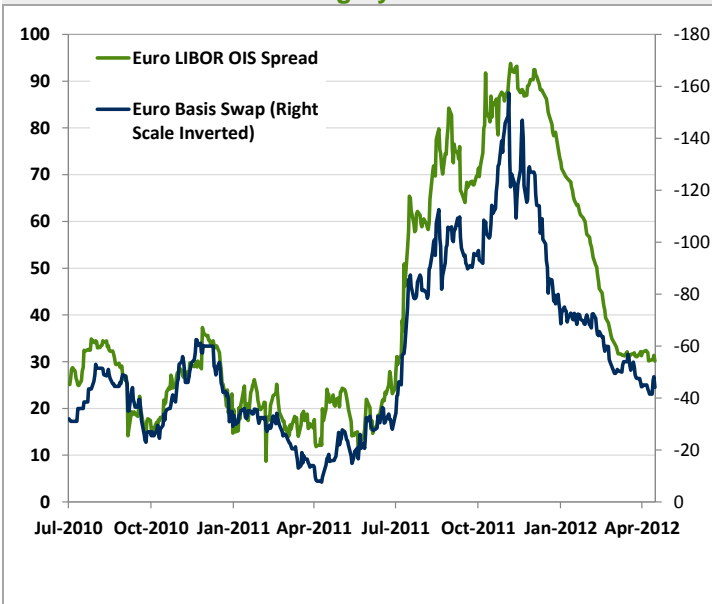
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the rapid change of governments over the past several months things are pretty much *status quo* in Europe as far as the political landscape is concerned. Take Hollande in France for example. While talk of a 75% top marginal tax rate may place him in the radical camp, other proposals such as turning the ESM (European Stability Mechanism) into a bank allowing it to use leverage to control bailouts and bank recapitalizations and enacting growth policies establishes him more as a pragmatic centrist. What the recent elections (and changes of government) confirm is that no government has secured any mandate to exit the Euro. If anything these governments will be committed to working within existing structures and following existing agreements (with only minor adjustments). Although there is an increasing probability that Greece will ultimately be forced to leave the region we would put the odds of that well under 50%.

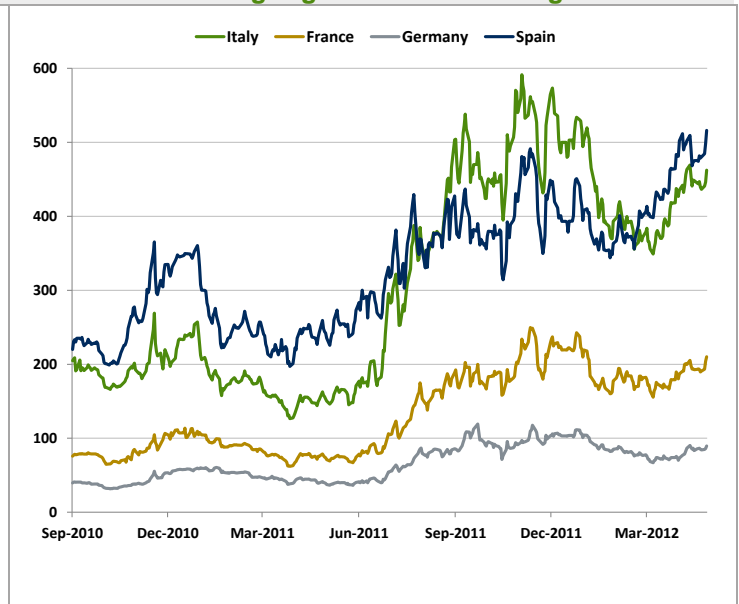
Another big focus has been Spain and the risks in the Spanish banking sector. The government is due to present a plan for the beleaguered sector, but decided to step in early and take over a troubled bank (Bankia). The move helped to stabilize Spanish markets after several days of volatility, but contagion risks remain as European bond markets appear unwilling to fund a bank bailout. The government said it is willing to use public funds to help banks leading to fears that Spain is facing the same fate as Ireland, which was pushed into a bailout after pumping huge funds into the banking sector. If Spain were to back its banks as fully as Ireland did its debt to GDP ratio would push well beyond the 80% danger level. The good news for Spain is that the IMF's Precautionary and Liquidity Line (PLL) and ESM should be able to cover a Spanish bank recapitalization with little trouble so that Spain itself would not have to back its own banks.

Bottom line is that while risks in Europe are building they are nowhere near as bad as last year. Once election rhetoric calms (after next month's French parliamentary and Greek elections) attention should return to focusing on budgets, debt, and growth. As that happens we expect that equity market volatility will calm.

**No Strains in Euro Banking System**



**Default Risk Moving Higher but Not in Danger Zone**



Source: Bloomberg, Raymond James Ltd.

### Important Investor Disclosures

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