

# Russell's view: France takes its turn in the spotlight

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A message to financial advisors and their clients

*France took its turn in the spotlight of the European sovereign debt crisis today, part of a market pressure tactic designed to force core Europe's hand in stabilizing its banking system. Will a resolution be reached? As news continues to unfold about the global markets, Russell Investments' experts will continue to share their insights with you.*

## And today's European country in the sovereign debt crisis spotlight is...France

Volatility has and will continue to be a constant companion in this market environment. We were reminded again of that fact today as we watched the Dow drop 520 points, its ninth-worst point loss on record, in a market sell-off that effectively erased the gains made on Tuesday.

Whereas early-week volatility was based on concerns about the U.S. economy and the mostly psychological impact of the S&P downgrade, Wednesday's drop is the result of the feared contagion effect of the European sovereign debt crisis. The crisis has moved from country to country – hitting the banking system in Italy, Greece and Spain. It's also spilling over into the relatively more stable French and German systems given fears about exposure to shaky European debt. Today it was France's turn in the chute.

France was singled out given talk that it could potentially be the next in line (following the U.S.) for a downgrade of its AAA credit rating, and because of swirling rumors about individual banks and their solvency. The market zeroed in on the fact that France has a strong trade relationship with Italy, and French banks own a good amount of Italian debt. France's stock market absorbed the impact of these concerns, causing it to close down five percent.

The market's focus on France is indicative of the fact that investors are beginning to pile pressure on Europe. In investors' eyes, no market or country is completely safe, and they are making that view known. At some point this pressure, we believe, will create enough incentive for core Europe to address the fundamental solvency problem and stabilize the banking system by making the politically unpopular decision to "write a check" to aid peripheral Europe. Until that is done, capital flight, particularly to the U.S., will continue to be a big risk for core Europe.

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### **We expect core Europe to respond, but it might be a painful process to watch play out**

Despite the angst induced by the U.S. debt ceiling debate, a deal was reached. I have the same expectations for Europe, and I do believe that the resolution we've all been waiting for will come, as Europe has already done what's necessary to avoid outright government defaults, albeit the bare minimum. This will continue to be a very painful process to watch play out. In the end, core Europe will "write the check," holders of peripheral European sovereign bonds will likely have to take a haircut, and peripheral European countries will have to live within their means, but it's good to see that some of these countries have already made pretty significant strides in enacting austerity measures.

As for the U.S. banking system, the market has been pummeling financials, but Russell's view is that the banking system is not in the same precarious situation that it was in 2008. The system is now better capitalized, much less levered and more transparent. We can actually see this reflected in the way that the market is differentiating between bank stocks and pricing accordingly.

Right now, this issue is in the hands of European political leaders, but we believe that they will do what is necessary.

### **U.S. economy, while fragile, is standing on a number of strong pillars**

As for the U.S. economy, the recovery is at a fragile point, but the Federal Reserve has made a strong commitment to stimulating growth – and they will do more, if necessary. Stock fundamentals are strong, business spending is solid, commodity-based inflation has been reduced, the supply chain disruption in Japan is ending and consumers have more money in their pockets.

A bright spot worth calling attention to is the U.S. tech sector, which has held up reasonably well during the dramatic market sell-offs we've seen this week. Specifically, Apple Inc. has overtaken Exxon Mobil Corp. as the "world's most valuable company," passing Exxon for the first time in intraday trading on Aug. 9. This is one notable example of how many companies – particularly in the tech sector – are posting solid business results and holding strong balance sheets chock full of cash – definitely good news. We'll take it.

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