Greece deal pits investors against the government
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The Greek bailout could keep investors from making additional sovereign debt purchases, further exacerbating the crisis. This will make the governments even more dependent on the ECB for funding -- something it may not always be able to provide.

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The latest Greek bailout has done little to convince Wall Street that Europe has gotten a grip on its debt woes. If anything, the deal has cemented the view that private investors are second-class when it comes to sovereign debt deals and that credit default swaps offer little protection. This will make it very hard for private investors to trust European sovereign debt, setting the stage for further messy bailouts in other troubled European countries.

It came as no surprise to the markets yesterday that the eurozone would be shelling out an additional 130 billion euros to bailout Greece. The deal, if approved by Greek lawmakers in the coming days, is supposed to be Europe's best attempt to calm the nearly three-year-old sovereign debt crisis.

Putting aside for the moment that Greece will probably not live up to its new and ambitious debt repayment schedule, the deal has managed to pit investors against the European Central Bank and various eurozone governments, shattering the confidence in the once riskless sovereign debt market.

Specifically, the deal was structured where the European Central Bank and other national central banks in the eurozone, which currently hold Greek debt, won't be forced to take the agreed upon 53.5% haircut on its principal, as is the case with private investors holding Greek debt. In fact, the ECB and the various national central banks (NCB) won't be taking a haircut at all. The value of their debt will stay at par, while private investors take all the pain.

This has managed to create a two-tiered system in which the various eurozone governments and the ECB essentially hold senior debt. While the ECB and the NCBs have agreed to forgo any profits they may generate off their Greek debt holdings, it still sends a signal that they are to be considered the senior debt, while private investors hold the subordinated debt.

Investors who chose to hedge their sovereign debt risk with credit default swaps won't be collecting any cash given the way the deal was structured. The 53.5% haircut is technically a voluntary move on behalf of investors, making them ineligible to collect the principal on their loans.

At the end of the day, the deal will probably fail to bring back confidence in the battered European debt markets. In fact, it could cause investors to hold back from making additional sovereign debt purchases, further exacerbating the crisis. This will make the governments even more dependent on the ECB for funding.

The Portugal problem

But will the ECB be there to backstop Europe's debt woes? The ECB and the various national central banks already control around 15% of the European sovereign debt market, according to estimates made by Barclays. The ECB first made those purchases of European peripheral debt last year as part of its Securities Markets Program, an emergency measure in

which the ECB basically stepped in and bought up sovereign debt in an effort to stabilize the market.

This once extraordinary action made on behalf of the ECB may need to be made permanent if private investors continue to shy away from European sovereigns. Pulling out prematurely could cause the system to collapse, forcing another round of bailouts. By that time, European leaders hope to have the newly enlarged European bailout fund authorized and ready for use with around 500 to 750 billion euros to backstop any possible future failed auctions and to keep interest rates at reasonable levels.

But before then, it is largely believed that Portugal and possibly Ireland will try and get some sort of haircut on their debt, throwing the system back into turmoil. Portugal is the one country traders are watching intently. Trading in Portuguese bonds and CDS has dried up on anticipation of some sort of credit event rumbling the nation in the near future. European bond traders tell Fortune they are forgoing sovereign debt and focusing on the nation's corporate bonds where they know they won't be regulated to second-class status. If this continues, Portugal's government will need some serious help when it goes out to raise cash, leading to what many believe would be another nasty bailout.

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