



CUMBERLAND

SOVEREIGN DEBT (The next shoe to drop?)

I'm surprised the markets haven't reacted more to the unraveling of Greece's Sovereign debt. I expected a market sell-off, a rising U.S. dollar and higher Gold prices.

Maybe it's because Greece is only 2.5% of the Euro-Zone economy, it isn't considered an issue, which is probably true, unless it is the tip of an iceberg.

Nonetheless, I think the problem could be serious and I would rather be too cautious than get hit between the eyes with something we saw coming.

History would warn us not to take this situation lightly and how it is handled will have far reaching consequences.

When you dig a little below the surface, the situation is fraught with political game theory alternatives and far reaching consequences of political will in the face of common sense alternatives. In other words, I wouldn't doubt for a minute that the "right" decision is rejected for political gain only to result in what everyone knows should have been, and could have been avoided.

Some of the reading I've done on this subject covers the history of Sovereign defaults as written by "Reinhardt & Rogoff" in "This Time is Different" (Eight Centuries of Financial Folly); along with sovereign credit bulletins put out by Moody's and numerous other articles. So, I thought what might be helpful is to try to convey the "Coles Notes" version of what I've read and then a series of scenarios on how this might play out. Be prepared, there is an awful lot of material to cover so I'm going to provide some facts and jump around a little. As for a conclusion; no one knows quite yet. This could represent a great buying opportunity for some European equities as they discount the worst, or this is the start of something that will unravel and become an economic anchor being thrown to a drowning man.

So here it goes, let's start with a little history.

History

Two authors, Carmen M. Reinhart and Kenneth S. Rogoff wrote a book entitled "This time is different".

After reading it, you come away with the feeling that what is happening today is nothing new. It has happened repeatedly throughout history.

To give you a flavour of what these authors documented, I'll provide a number of quotes and factual passages that you might find informative.

But to put this in perspective, Reinhart and Rogoff attribute the build up of Sovereign debt to either War spending or Banking Crises and recount various episodes of default dating back to 1800. From my perspective, I focused most of my attention on Sovereign issues stemming from Banking Crises and to the time period from the 1930's to present as being most relevant to what we are seeing today.

They also identify a consistent pattern that precedes defaults that will appear very familiar.

Pattern

.... Markedly rising asset prices, slowing real economic activity, large current account deficits and sustained debt buildups (whether public, private or both) are important precursors to a financial crisis.

Sustained capital inflows have been particularly strong markers for financial crises, at least in the post 1970 period of greater financial liberalization. Financial liberalization or innovation has also been a recurrent precursor to a financial crisis.

The build-up of government debt has been a defining characteristic of the aftermath of a banking crisis for over a century.

Reading Notes

“Banking crises almost invariably lead to a sharp decline in tax revenue as well as significant increases in government spending. On average, government debt rises by 86% during the 3 years following bank crises.”

History would suggest that this isn't a surprise.

France defaulted on its external debt no fewer than 8 times; Spain defaulted 6 times prior to 1800 plus 7 further defaults in the 19th century only surpassing France for a total of 13 episodes.

“Greece – from 1800 until well after WWII found itself virtually in continual default.”

“Pre-Communist China repeatedly defaulted on international debts, and modern day India and Indonesia both defaulted in the 1960's.”

“Half of defaults by ‘middle income’ countries, occur at levels of external debt relative to GDP below 60%.”

“By 1947, countries representing almost 40% of global GDP were in a state of default or rescheduling produced by the war but also partly due to the fact that many countries never emerged from the defaults surrounding the Great Depression of the 1930's.”

“Banking crises in advanced economies significantly drag down world growth. The lowering or outright contraction of economic activity tends to hit exports especially hard.”

Weakening global growth has historically been associated with declining world commodity prices.

Banking crises in global financial centers produce a “sudden stop” of lending to countries at the periphery.

Bank crises have historically been “contagious” in that investors withdraw from risk-taking, generalize the experience of one country to others, and reduce their overall exposure as wealth declines. The consequences have been deleterious for emerging markets’ ability to roll over and to service external sovereign debt.

Banking crises in one country can cause a loss of confidence in neighbouring or similar countries, as creditors look for common problems.

“Striking correlations between the number of countries in default on debt and the shared experiences of high inflation (i.e. >20%).”

“Default through inflation became more common place since 1900, after 1940, the correlation nearly doubles to .75.”

“For the period from 1800 through 1940, spikes in commodity prices are almost invariably followed by waves of new sovereign defaults.”

Spain holds the record on defaults. 7 times in the 19th century after having defaulted 6 times in the preceding 3 centuries.

France, defaulted on 8 occasions between 1500 and 1800.

Greece. Number of years in default or rescheduling since 1800 – 50.6 years with 5 defaults.

Other default records:

	Number of years in default or resheduling since independence or 1800	Total # of defaults and/or rescheduling
Germany	13	8
Spain	23.7	13
Argentina	32.5	9
Brazil	25.4	9
China	27.5	9
Costa Rica	38.2	9
Ecuador	58.2	9
Honduras	64	3
Venezuela	38.4	10
Canada	0	0
U.S.A.	0	0

Countries usually default on domestic debt.

“Inflation during the year of an external default is on average high at 33%. However, inflation truly gallops during domestic debt crises, averaging 170% in the year of default.”

Banking crises

Banking crises almost invariably lead to sharp declines in tax revenues, other factors leading to higher deficits can include the operation of automatic fiscal stabilizers and countercyclical fiscal policy and higher interest payments due to elevated risk premiums and rating downgrades. During the modern era, real government debt rises 86% during the 3 years following a banking crisis, and such debt levels are comparable in either advanced or emerging economies.

The common denominator is the banking system which tends to borrow short and lend long. Financial crises cause a “run on the bank” which causes the bank to liquidate assets, under duress.

“Small and medium sized borrowers suffer disproportionately during a recession, with a fair amount of evidence pointing to the bank lending channel as a central element.”

“Periods of high international capital mobility have repeatedly produced international banking crises.”

In 18 of the 26 banking crises studied, the financial sector had been liberated within the preceding 5 years.

“. . . a boom in real housing prices in the run-up to crisis is followed by a market decline in the year of the crisis and subsequent years . . . banking crises tend to occur either at the peak of a boom in real housing prices or right after the bust.”

“Recovery in housing prices is protracted; however . . . in the three years after the crises, real equity prices are on average higher than at the precrisis peak”.

“Since WWII the most common policy response to a systematic crises has been to engineer a bailout of the banking sector, whether through purchases of bad assets, directed mergers of bad banks with relatively sound institutions, direct government takeovers, or some combination of these.”

We have emphasized repeatedly that banking crises are protracted affairs with lingering consequences in asset markets – notably impacting real estate prices and the real economy.

86 episodes of bank crises between 1800 and 1940/ 138 banking crises since WWII. The pattern of pre and post WWII crises are very similar.

In post crisis, general government revenue growth started in the 3rd year after the crises.

The bailout of the banking sector, shortfalls in government revenues, and fiscal stimulus packages imply that there are widening fiscal deficits that add to the existing stock of

government debt. Real stock of debt rises to 186%, 3 years after the crises. The true legacy of banking crises is greater public indebtedness.

The duration of declines in real housing prices, following a financial crisis is often 4 years or more.

Inflation and exchange rate crises have traveled hand in hand, in the overwhelming majority of episodes.

The aftermaths of a severe financial crisis shares three characteristics.

1. Asset market collapses are deep and prolonged. Declines in real housing prices average 35%, stretched out over 6 years whereas equity price collapses are 56% over about 3 ½ years.
2. The aftermath of bank crises is associated with profound declines in output and employment. The unemployment rate rises on average 7% points.
3. The value of government debt tends to explode by an average of 86% in the major post WW II episodes. The main cause is not the cost of the bailout and recapitalization of the banking system. The biggest driver of debt increases is the inevitable collapse in tax revenues. Many countries also suffer from a spike in the interest burden as interest rates soar.

The housing price decline in the U.S. of 28% in real terms by the end of 2008, according to case Shiller index, is already more than twice that registered during the Great Depression.

Emerging markets tend to have a more severe contraction due to the abrupt reversals in the availability of foreign credit.

Current situation

With this as background, let me now try to bring this Sovereign Debt issue up to date.

Since the current problem is specific to Europe, I'll focus on those countries but I've got a few comments to throw in that are relevant to other nations, just to make the point that Europe isn't alone.

Moody's also has some interesting comments that I'll try to work in.

From the history that I have just recounted, it shouldn't be a surprise that Greece is once again in a predicament. It defaulted in 1826 which lasted for 17 years, and again in 1843 which lasted another 17 years. The default of 1860 carried on for 4 years, and one again in 1932 was drawn out for 33 years ending in 1965. Of the past 184 years, Greece has spent 92 years in default.

However, Greece is not alone, as noted earlier, and today we have four other countries that are of concern, Portugal, Ireland, Italy and Spain that are collectively referred to as the PIIGS of Europe.

By size of their respective economies, Greece, Portugal and Ireland are very small and should be of little consequence. But as we shall see, contagion through the banking system could see a problem with even a small country spread and engulf the entire region.

But first here are some statistics to provide perspective.

Country	Budget Def % of GDP 2009	Gov't Debt % of GDP - Q3 2009 (total debit in Euros)	Econ as % of Euro-Zone 6/30/2009	Yield on 2 year notes 4/28/2010	Credit Rating
Greece	13.60%	113.5%(298.5)	2.7%	26%	BB+
Portugal	9.30%	73.6%(126)	1.8%	7.05%	A-
Ireland	12.50%	63.3% (105)	1.9%	3.93%	
Italy	5.30%	116.20%	17.3%	1.82%	
Spain	11.40%	55.0%(560)	11.9%	2.53%	AA

- German benchmark 2 year note has a yield of 0.77% today.
- At BB+, Standard & Poors assigned a recovery rate probability of 30% to 50% on Greek debt.
- Ireland's total debt to GDP might appear low, but when you include total banking system assets which are supported by debt that could become government-guaranteed, the obligations swell by an additional 800% of GDP.
- Greek debt is more than 5 times larger than that of Russia when it defaulted in 1998 and Argentina when it missed payments in 2001.

So how does the contagion spread one might ask? Start with the fact that 85% of Greek external debt is held by financial institutions in other Euro-zone countries, with German and French Banks and insurance companies holding about 40% thereof.

Any loans to Greece by the IMF would rank senior to their sovereign debt. European loans also rank senior.

Banks are required to hold a certain amount of capital against their ownership in these bonds. Bank capital rules give a risk weighting of Zero percent for Government debt rated AA- or higher. This jumps to 50% for debt rated BBB+ to BBB by S&P and to 100% for debt rated BB+ to B-.

So the downgrades are hitting banks that are still overleveraged and financially weak. There is little wonder why these weaker countries are seeing their bonds decline and yields rise as banks and others try to shed these riskier assets. Ultimately, it leads to banks either having to raise more capital or restrict their lending with the obvious consequences to economic activity.

How far can this back up? Well Germany's contribution to the Greek bailout will be 8.4 billion Euros, and France will have to come up with 3.9 billion Euros.

Germany still commands a premium credit rating but, that said, they recently failed to sell all of a 3 billion Euro, 30 year issue and Poland failed to sell about 200 million Euros of a 5 year bond. Maybe it has to do with the level of interest rates which therefore means investors are demanding a higher risk premium for the potential swamp that they are about to enter.

These sovereign risk issues are causing the same reaction in Europe that we saw in the U.S. when investors and depositors became worried about their banks because of bad mortgages and hedge fund problems.

In Greece and now Portugal and Spain, depositors are pulling their money out because they are worried about the banks and the ability of bankrupt governments to guarantee these institutions.

Bottom line, this is all about default risk, it is not Euro risk.

This has now caused Standard & Poors to downgrade the ratings on Greek Banks. The bad economy lowers the ability of borrowers to repay their loans. So the next question is, which other banks are their counterparties? On April 30th, Moody's also downgraded nine Greek Banks including the biggest, National Bank of Greece S.A.

So you can see where this is going if confidence is not restored in the Euro-Zone's ability to deal with potential defaults. However, the fix is not a financial bailout. It is an austerity issue, which is bad for these economies.

So what are the options that can be considered to resolve this problem? As you will see, there are no easy choices. Each alternative has its own set of consequences that force healthier nations to ultimately choose between the lesser of two evils.

What are the options?

1. Greece leaves the Euro.

This still wouldn't solve the banking problem. Cutting countries loose from the monetary union would still leave their bonds outstanding, denominated in Euros.

Consequences

For Greece:

Greece could then devalue the Drachma which would help its economy, but hurt inflation. Unfortunately, it would still have Euro-denominated bonds outstanding which, due to a devalued Drachma, it would probably have to default on.

For Other Euro Countries:

This would probably have a negative impact on other PIIGS as it sets a precedent for what could happen.

The impact on the Euro is anyone's guess, but mine would be that if the Euro got rid of the weaker members it would rise, and possibly dramatically. At the extreme, assume that everyone gets out leaving just Germany. My bet is that it would be a "go to" currency and rise. For Germany, this would be quite bad as their economy is based on exports. Yes, inflation would be less but their exports wouldn't be price competitive.

Therefore Germany is faced with a choice of which is the least bad outcome and the least costly.

- a) Bailing out Greece and benefiting from a depreciated currency, or
- b) Letting Greece leave the Euro, and face an economic headwind of an overvalued currency.

Unfortunately to make this choice, Germany will have to be prepared to then bail-out other countries.

2. Euro countries come up with a credible plan that not only includes a liquidity facility for distressed countries, but one that goes to the core of the problem and also underwrites the banking commitments so that they don't fall into another liquidity trap. This would require something along the lines of the U.S. "TARP" program.

Consequences

Overly indebted countries probably have to adopt an austerity program that pushes their economies back into recession which would impact all of Europe.

However, it would assure lenders to the other PIIGS and therefore reduce their interest rates with a less damaging impact to their economy. This would at least preserve their access to liquidity.

For Europe to do this on its own would likely tax the ability of the European Central Bank, and would require commitments and compromises by healthier countries such as Germany which might be tough to pull-off.

This would suggest that the IMF has to get involved which brings the USA into the game. Why would the U.S. want to bail out Europe? Same reason as Germany, failing to do so would result in a strong U.S. \$/weak Euro and put the U.S. in a difficult position as an exporter competing against countries with weaker currencies.

The economic consequences of what we are facing are truly hard to predict. Countries in recession usually have both fiscal and monetary tools at their disposal.

But now interest rates are already at zero and the system (i.e. Banks) have been flooded with liquidity. There's nothing more to come from monetary policy.

On the fiscal side, governments can continue to prime the pump with more spending if they can borrow. When the borrowing spigots shut off, these governments have nothing left, unless they have their own Central bank. Those that do, then have the option to print money and either debase or inflate their way out. This is not currently an option for the 16 Euro-Zone countries.

Otherwise, default seems to be the only option without economically crippling their people for years to come. So it's hard to see a way out. Cuts in fiscal spending will further weaken their economies and declining tax revenues will therefore increase the deficit. Fiscal cuts will be chasing a falling revenue line; and when they finally catch it, it only means debt doesn't get any bigger and, it still doesn't get paid off.

So where are we now? It would appear that the IMF and the rest of Europe has come to the same conclusion I have. 45 billion Euros wasn't enough. They now are talking about a package of as much as 120 billion Euros with a Greek austerity package of 24 billion Euros while debt restructuring is not part of the package.

In my opinion, this is a strategy to sacrifice the Greek economy to prevent contagion; severe austerity, no way out for the economy but no restructuring of debt either. A statement to all who would lend to other PIIGS. Question is, is 120 billion Euros enough? Some suggest this is a 700 billion Euro problem along the lines of the U.S. TARP Fund.

What does this mean for our Investment Strategy?

Well, that's still hard to determine other than to stay cautious, but we can come up with some broad conclusions and be prepared to read the road signs to know which way things are likely to go.

The easiest way to discuss this is by looking at the consequences in terms of their impact on the Euro.

1. Stable Euro

This would suggest that there is a creditable plan that is working. They fix Greece and everyone calls a time out to see if it works. This might be good for export-oriented European countries, especially Germany as the devalued Euro makes them very competitive.

However, austerity programs will no doubt lower Europe's GDP.

2. Strong Euro

As above, but the "plan" is viewed more positively. The result might be an even weaker European economy as they would lose the competitive benefit of a cheap Euro, but still be faced with severe austerity measures.

3. Weak Euro

The plan doesn't work as it is considered inadequate.

The resolution then gets drawn out and contagion continues to spread. There's political and election risks, especially in Germany. Banks get capital calls.

This result has more easily determined investment outcomes.

First, multinational companies would see some pressure on their earnings forecasts. Given that the S&P 500 companies derive almost 50% of the earnings from overseas this wouldn't be good for the U.S. stock market.

Second, Banks with Sovereign exposure or exposure to compromised banks would be hurt.

Third, the U.S. dollar and treasuries would appreciate, much as we saw in the fall of 2008.

Fourth, this would be bad for the U.S. GDP as the dollar would be less competitive.

Fifth, the Canadian dollar and government bonds could also advance strongly. This would certainly compromise the Bank of Canada and their ability to raise rates as it could provoke a very strong dollar similar to what we have seen take place in Australia.

Sixth, Gold could move sharply higher regardless of the direction of the U.S. dollar.

Seventh, The ECB is probably compromised under any of these alternatives, and rates will likely remain lower than they otherwise would to offset the drag from the austerity measures.

How this deterioration of Sovereign debt in Europe is handled will have repercussions across the oceans if it isn't brought to a credible conclusion, and the banking system will be the main channel of transmission.

However, as an aside, governments that have dealt with fiscal imbalances through drastic cuts in spending have fared better than those that have relied on tax increases. This might prove to be an interesting contrast between what is taking place in Europe and what seems to be before us in North America.

As for stock markets, they have generally recovered and reached new highs within about three years of the bank crisis with recoveries starting sooner in those countries that face up to their bloated spending and make the necessary cuts.

One way or another, whether there is Sovereign debt collapse or hyper inflation, the best alternative for an investor is to hold real property (i.e. real estate, gold or ownership in quality companies), not a fiat currency.

Historically, this could mean there's an opportunity brewing in Europe as their currency becomes cheap, their markets collapse but they deal with their problems.

Unfortunately, not having an independent monetary policy to offset fiscal restraint could make timing different this time.

GRC/amh
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