

GLOBAL MARKETS

Beyond Greece

INVESTMENT CONCLUSION

The Greek debt saga reveals a serious risk of a global sovereign debt crisis. Global public sector debt has soared to unsustainable levels as central banks and governments tried to mitigate the impact of private sector deleveraging. But markets are now waking up to this. They are focusing on those sovereigns with large debt burdens and beginning to price accordingly (Figure 1).

We would be out of sovereign debt and would short bunds. We would hold interest-rate caps on the sovereign debt of the US, the UK and Japan. Indeed, we favour being long investment grade corporate debt versus sovereign debt.

ANALYSIS

Is Greece the sub-prime starting point of the global sovereign credit crisis? Numerous are the differences between Greece, Spain, Portugal and Ireland — almost as numerous as the differences between sub-prime and prime mortgages. But there was and is one common denominator — excessive leverage.

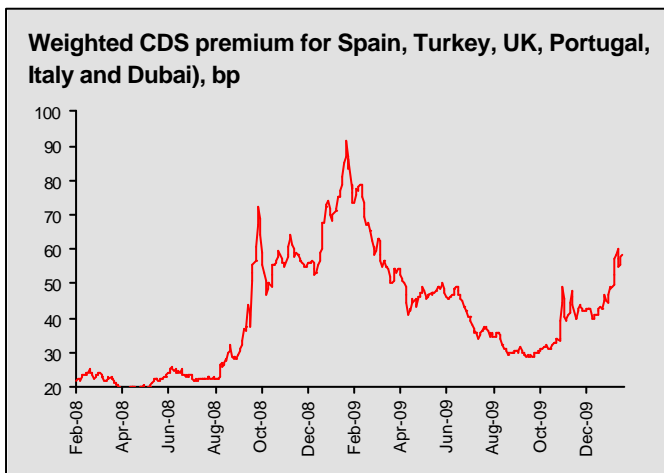


Figure 1. Source: Datastream, Independent Strategy

Excessive leverage becomes a credit crisis when liquidity to fund it dries up. Credit is liquidity. Liquidity dries up when the stock of excessive credit can't renew itself. Then the stock can't be rolled over. So it has to shrink. The only difference between a liquidity crisis and a solvency crisis is that the former is when flows dry up because the stock is too high; the flow and the stock are the same substance.

It is baloney that the policy makers swapped public for private sector debt to combat the credit crisis. They added mammoth public sector leverage to an almost unaltered level of private sector debt to create super

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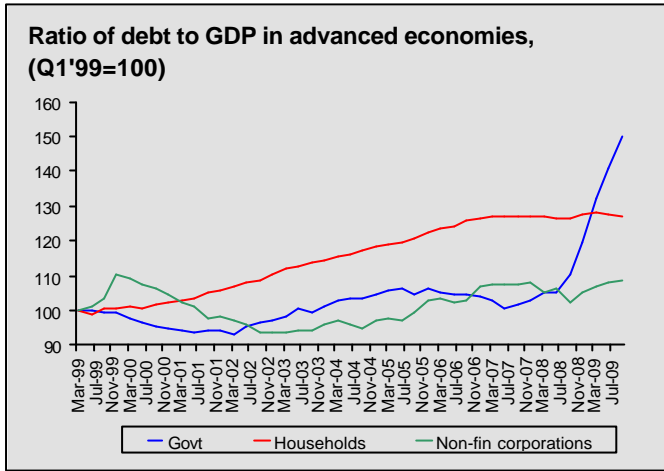


Figure 2. Source: Datastream, Independent Strategy

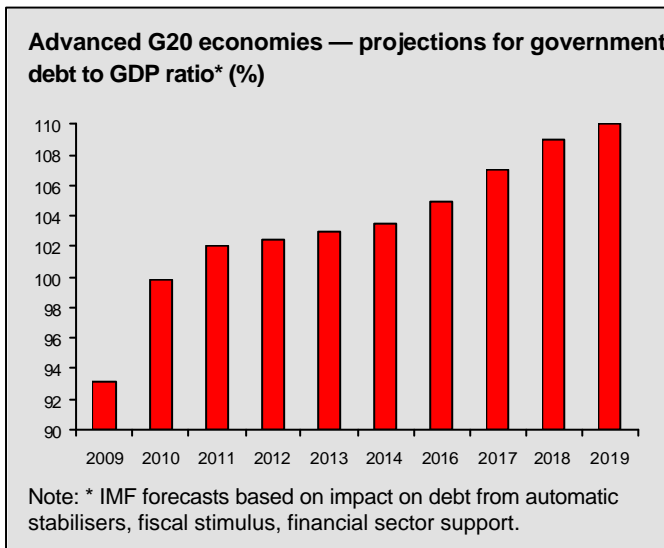


Figure 3. Source: IMF

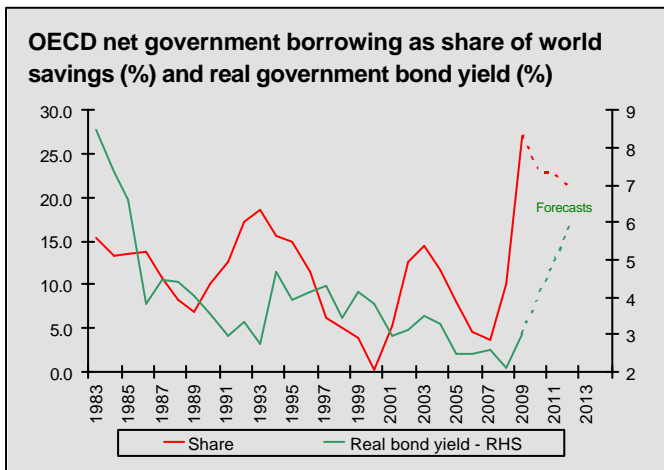


Figure 4. Source: Datastream, Independent Strategy

over-leverage. Deleveraging by the private sector has been minimal (Figure 2).

Now public sector leverage is becoming unsustainable (Figure 3). That is the common denominator between Greece and the raft of other over-leveraged states. How they got there is irrelevant. They arrived at the same destination. The consequences will be the same — a sovereign credit crisis when liquidity dries up.

Why has the sovereign credit crisis not happened sooner? Because sovereign leverage has to be allowed to build to unsustainable levels and liquidity has to dry up. In other words, markets have to become aware that the absolute level of sovereign debt is unfinanceable. That level of unsustainability has already been reached in many minor and major economies.

But markets are only slowly coping on. While OECD government borrowing is set to soak up over 20% of world savings this year, real interest rates remain at lows (Figure 4).

Market awareness is lagging because central banks have been printing the money for financial institutions to buy sovereign debt, and buying it themselves (Figure 5). And households have been ploughing much of their increased precautionary savings into government bonds for safety and yield.

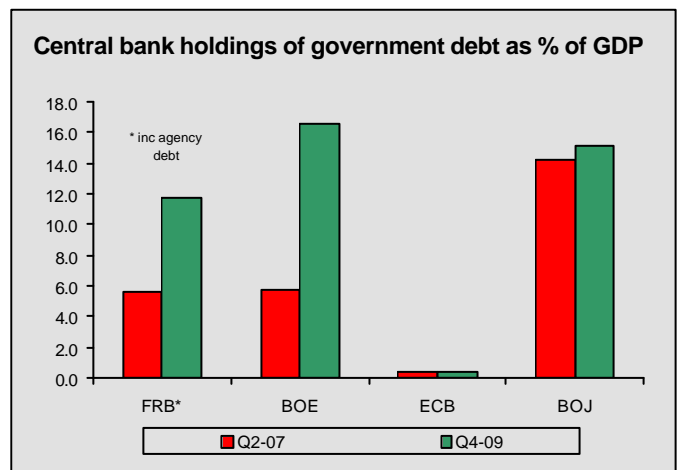


Figure 5. Source: Datastream, Independent Strategy

Received wisdom is that this ‘virtuous circle’ won’t come undone before vigorous economic recovery and monetary tightening. By then, higher yields will matter less because there will be optimism, economic growth and wealth creation. This is wrong. Excess leverage becomes a credit crisis when it does; not when it rationally should. The level of excess debt is all that matters.

When we write we have to be rational (most of the time). Our theory of the next round of the credit crisis was that it would happen when the first derivative of monetary and fiscal stimulus dropped to zero in 2010. It will automatically do so unless the largesse of 2009 is repeated. The effect will be felt on financial assets and the economy.

The arithmetic of stimulus

Keynesians will say that government fiscal stimulus from last year will have raised incomes and generated multipliers that make a repetition unnecessary.

This is wrong for two reasons: 1) in the US, household income has been stabilised by government handouts not by income from work (Figure A); and 2) US households now receive more from government than they pay in taxes for the first time (Figure B).

Figure A: Impact of stimulus on incomes — nominal PDI (% yoy) and household savings rate (% of PDI)

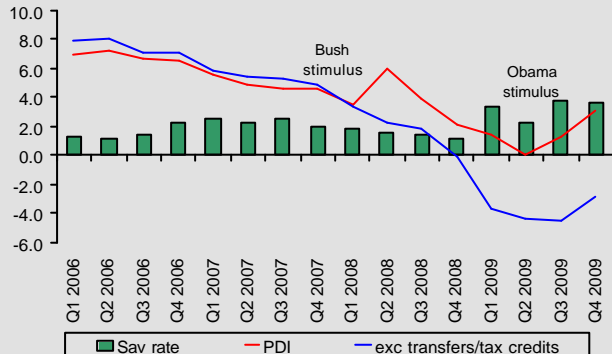
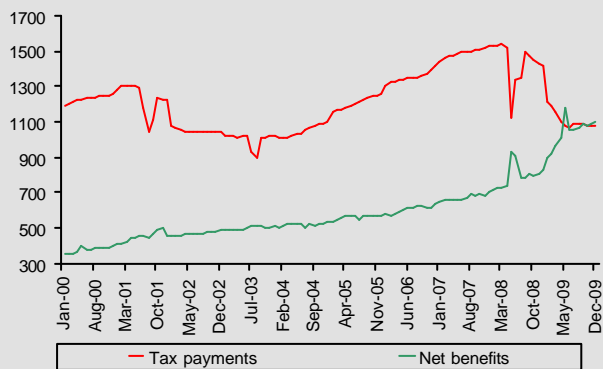


Figure B: US households — tax payments and net benefits (\$ bn annualised)



Inset 1. Source: OECD, IMF

The arithmetic works like this. If an economy grew by 1% last year because of the fiscal and monetary stuff thrown at it, in order to grow by 1% this year it would require twice last year’s stimulus. First, last year’s stimulus must be repeated to offset the shrinkage that would occur without it. Second, another equal (or greater!) amount of stimulus is needed make the economy expand at the same rate as last year on top of last year’s achieved level (Inset 1). This is unfinanceable.

Moreover, many economies have reached the level of sovereign debt where increased public spending detracts from growth (Figure 6). This is the Ricardian effect: people and corporations save to pay the future taxes and reduction in government benefits that deficit

Efficacy of public spending conditioned by debt levels (according to the IMF)

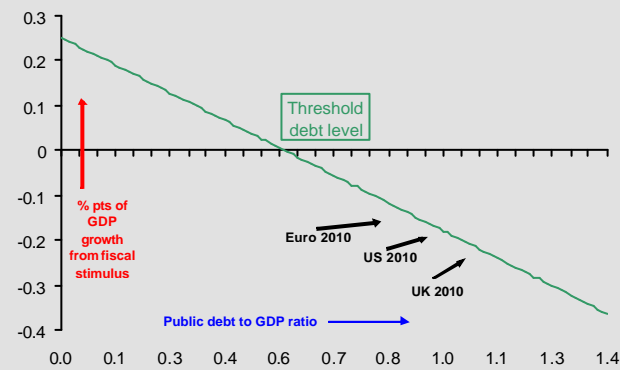


Figure 6. Source: IMF

spending ultimately entails. The hints of a sovereign debt crisis spooking markets make last year's stimulus an unrepeatable act. Liquidity is tightening. The fact that key programmes used to finance sovereign leverage are running out of steam is another factor.

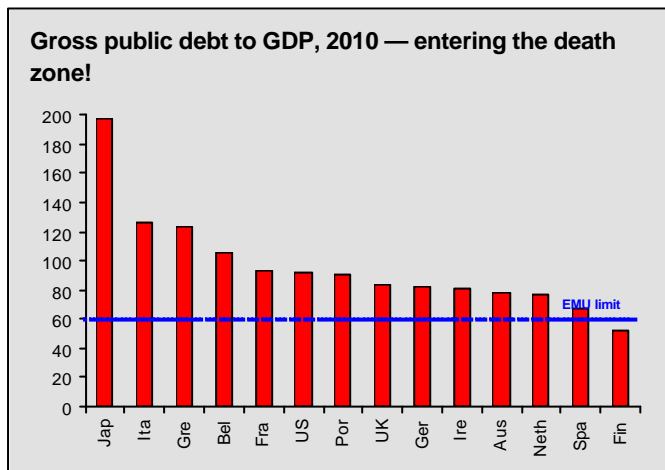
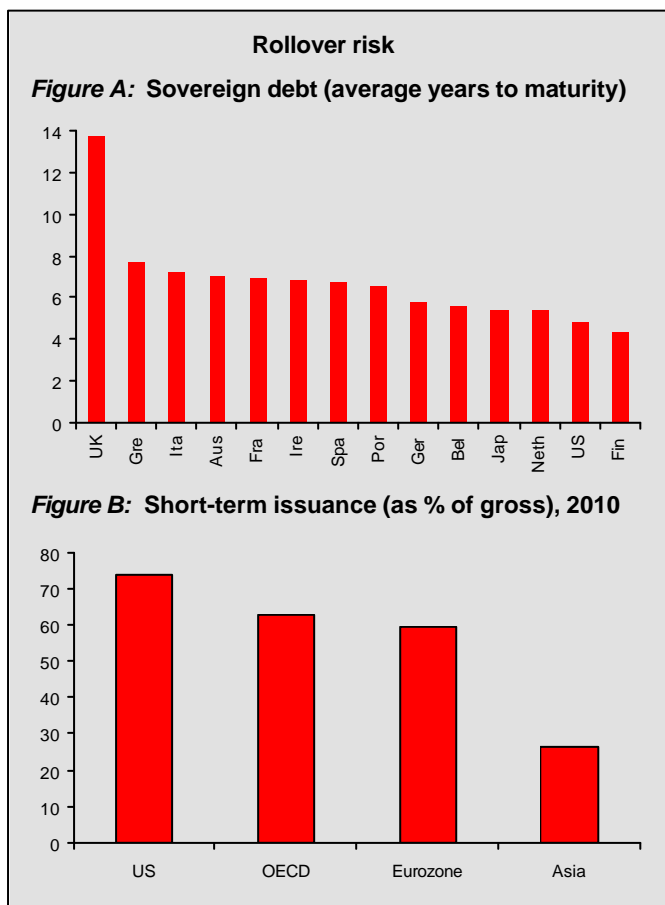


Figure 7. Source: OECD



Inset 2. Source: OECD, IMF

The drying-up of the Fed purchases of rubbish assets from the banks, which allows the banks to put the new money into treasuries, is evidence. So is the end of the UK's QE programme, whereby the BoE bought about 70% of gilt issuance of one of Europe's most over-leveraged governments. If this were a cockpit there would only be red and amber lights on the dashboard.

But the spread of the sovereign crisis may not be like the contagion of sub-prime. When push comes to shove, the Eurozone or the EU will have to maintain Greece's solvency. Then there may be a sigh of relief in markets. But it will not be the end of the crisis. Many other bigger countries outside the Eurozone (Japan, the UK and the US, to name a few) are on the same tracks as Greece, but only a few stops before the Greek train; and some (like Japan) are beyond Greece in terms of penetrating the death zone (Figure 7). It is only a matter of time ...

Stricken, or soon-to-be struck, governments are toying with the idea of 'tolerating' higher inflation to reduce their debt burdens (or incur more). Bogus intellectual theories are being unwrapped to make the con palatable. But markets will not let government get away with debasing the assets they invest in. They will jack up the real yield (not only the nominal yield) on sovereign and other debt to offset the risk.

Governments cannot inoculate themselves from the effect of rising yields because the maturity of their debt is short. Even in the US, the duration of the stock of government debt is only 55 months (Inset 2A). In other words, within five years, interest payments on the stock of government debt would triple if inflation settled at 5-6%.

In Japan, if JGBs got to the same yield as bunds, it would cost the Japanese budget 12% (instead of today's 3%) of total spending and nearly double the current 12% of GDP deficit! Moreover, according to the OECD, governments will be issuing mostly short-term paper in 2010 as they did in 2009 (Inset 2B).

Nevertheless, a sovereign debt crisis will not unfold like a private sector one because governments can theoretically avoid default on their debt by printing money and debasing it with inflation and will try to do so. Governments can also up taxation and reduce spending in ways that aren't available to an over-leveraged private sector in crisis — and their customers are captive taxpayers who cannot flee. And markets will assume a lower default risk for sovereigns than private sector creditors. This may slow the spread of the sovereign global credit crisis.

At the risk of over-rationalising, the most likely catalyst for the sovereign credit crisis is renascent inflation spreading from emerging markets (Latin America and Asia, in particular, where it has been worsening for a time) to developed markets. Inappropriate policies are always the cause of rising inflation. Both emerging and developed markets have similarly inappropriate policies. Emerging markets do have growth, but this may not be enough of a difference to prevent the contagion of inflation.

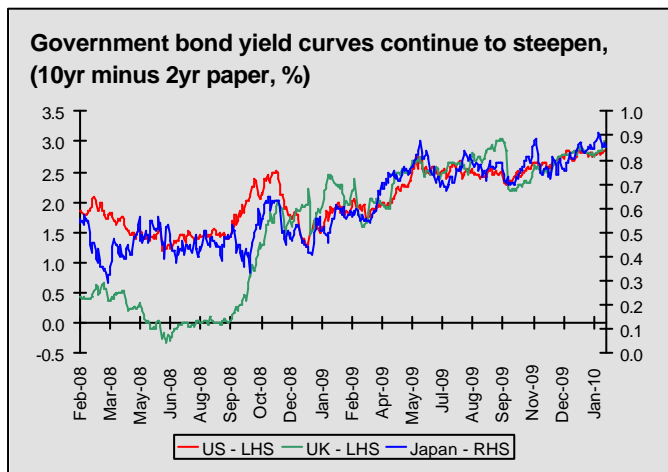


Figure 8. Source: Datastream

INVESTMENT STRATEGY

The investment conclusions are bald enough: stay out of sovereign debt and stick with interest-rate caps or yield steepeners (the US, the UK and Japan — Figure 8).

We are even looking to short bunds, where yields have benefited from flight to quality but may suffer from Germany backstopping the weaker Eurozone members. We have no short positions in the latter, believing they will ultimately either make it on their own or get bailed out within the Eurozone.

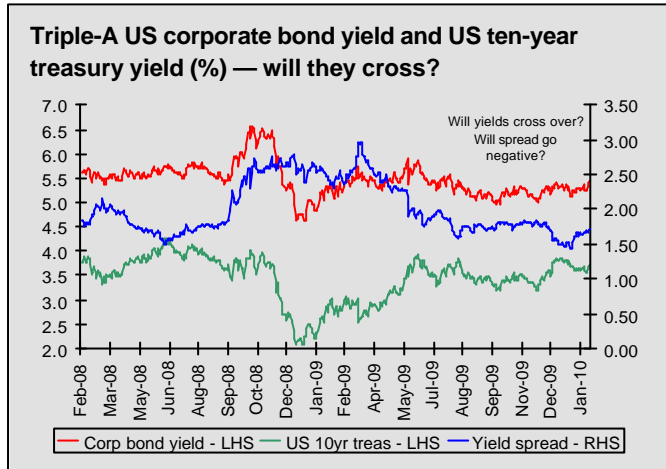


Figure 9. Source: Datastream

Our wild theory is that corporations are cash-flow positive and bad governments are cash-flow negative. Good corporations are not over-leveraged. Bad governments are. We are long the spreads between corporate and sovereign bonds (Figure 9), as decent corporations are better credits than governments and damage from rising inflation would be equal to both debt instruments.