Absolute Return Partners LLP

The Absolute Return Letter
June 2010

The European Disease

"You cannot turn a pig's ear into a silk purse, and there is no point in pretending that an economy like that of Greece could somehow become a mini-Germany "with appropriate resolve and discipline". And frankly, why should Greece wish to do so? From this standpoint, a mistake was made by admitting into the EMU certain nations who never should have joined the currency union in their current state. Greece was a salient example."

Woody Brock[1]

The last weekend in May took me to Reykjavik for the first time since the credit crisis brought down the Icelandic banking system and with it much of the local economy. I have always enjoyed visiting Iceland. It is a truly amazing country, offering a splendid mixture of fantastic scenery and unrestrained friendliness. You just want to come back for more; however, somehow I expected the crisis to have left deep scars. I am pleased to say that nothing could be further from the truth.

It made me think. How is it possible to be pushed to the very edge of the cliff only to bounce back so magnificently less than 24 months later? Does that hold the key to understanding what is happening to Greece at the moment and how we should expect events to unfold from here?

Prepare for the haircut

Let me begin by offering you this observation: Greece will almost certainly default before this crisis finally blows over, but it may take several more years before they run out of options. Furthermore, the default may be structured in a way that allows them to call it something different. But investors in Greek sovereign bonds will have to take a haircut whatever name they put on it.

The €750 billion rescue package presented a couple of weeks ago should be enough to keep Greece, Spain and Portugal afloat for a couple of years, but Germany's willingness to underwrite the profligacy of other eurozone members will likely run out well before Greece can realistically turn the corner.

Here is the quandary facing Greece: The austerity plan which it has now committed itself to is quite simply incompatible with a return to decent GDP growth anytime soon, yet not severe enough to prevent public debt from continuing to escalate. And, according to the arithmetical logic of the situation, if the Greek economy doesn't return to a growth rate of at least 5-6% per annum (equal to or higher than their cost of borrowing) relatively quickly, Greece will sink deeper and deeper into the quicksand.

In reality, in order to get the escalating debt under control, the Greeks will have to agree to much larger public sector cuts at a time when the local economy is flirting with deflation. As any economist will know, cutting debt in a deflationary environment is extraordinarily difficult; hence my

[1] *Strategic Economic Decisions, Profile, May 2010*

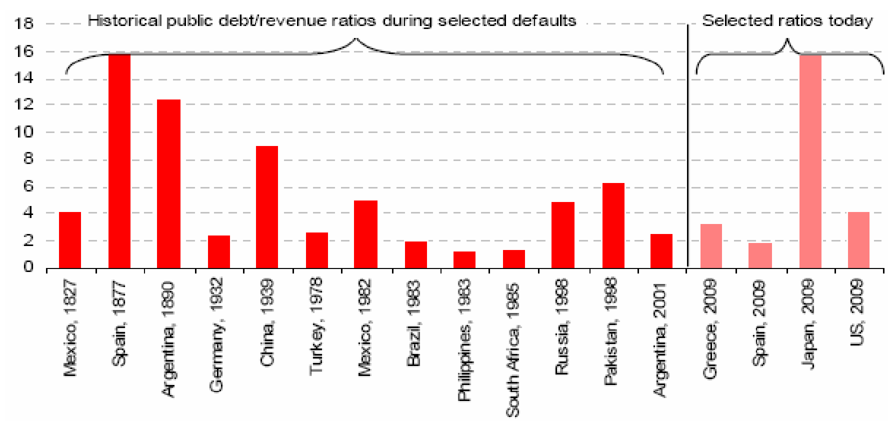
conclusion that Greece will be forced to restructure its debt. The question is not if but when and, as usual, the Germans are in the driving seat.

Merkel has already seen the writing on the wall and needs to create a bogeyman. Her recent ban on short-selling was not so much an attempt to stabilise financial markets as it was a stab at creating a foe the German people can relate to – the speculator. She knows that more money will be required to keep Greece going, but she also realises that her countrymen's patience with the situation will run out well before Greece is back on its feet.

Greece vs. Argentina

To the consternation of EU officials, comparisons have been made between the Greek crisis and that of Argentina in 2001. "Greece is not Argentina" they proclaim. Maybe not. But if the comparison is unfair, it is because, fiscally, Greece is actually in much worse shape than Argentina was prior to its default in 2001. Argentina's public debt was around 60% of GDP; Greece is hovering around 120%. Argentina's budget deficit was 6.5% of GDP; Greece delivered a whopping 16% last year[2]. Argentina's current account deficit was less than 2% of GDP whereas that of Greece was over 11% of GDP in 2009. So the critics are right. Greece is not Argentina. It is actually worse.

Chart 1: How Much Debt Is too Much?



Source: Popular Delusions, Societe Generale Cross Asset Research, 6th May, 2010

So, how much debt is too much? Unfortunately, there is no simple answer. As you can see from chart 1 above, in the past, countries with less debt than Greece have defaulted. Meanwhile, other countries such as Japan, have survived perfectly well despite being burdened with much higher debt levels. It is very much a function of investor sentiment but also a function of who the creditors are. Countries which rely mostly on domestic investors to buy their debt should, all other things being equal, be less exposed. This certainly explains why Japan has managed relatively well despite extreme levels of debt. On the other hand, if the theory holds, countries such as Portugal and Ireland are now in a particularly vulnerable position (see chart 2).

Is Greece in a debt trap?

There has been much talk in recent weeks about whether Greece is about to fall into a classic 'debt trap'. Two conditions need to be met for that to happen[3]: The rate of interest on sovereign debt must be higher than the growth rate of the economy, *and* there must be a persistent deficit on the

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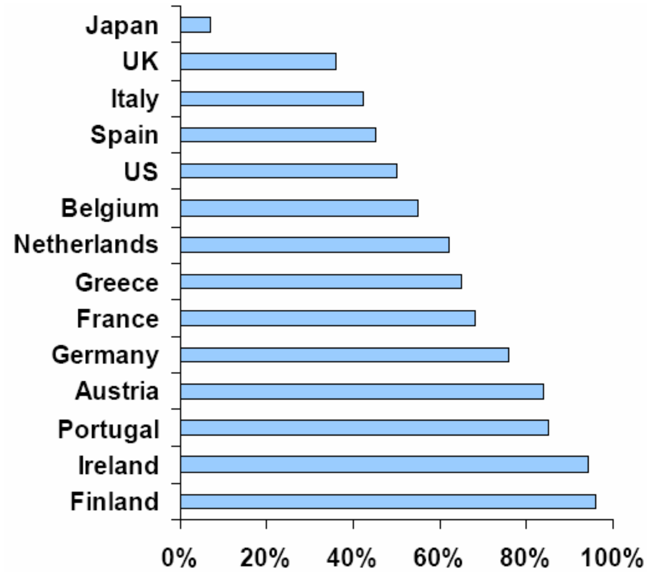
[2] *Don't believe the spin doctors when they tell you that Greece produced a deficit of only 12% last year. On a cash basis, which is the relevant measure, the deficit actually amounted to 16% of GDP.*

[3] *As defined by George Magnus at UBS: "Sovereign Debt: A Structural Crisis and its Implications for Growth", May 2010*

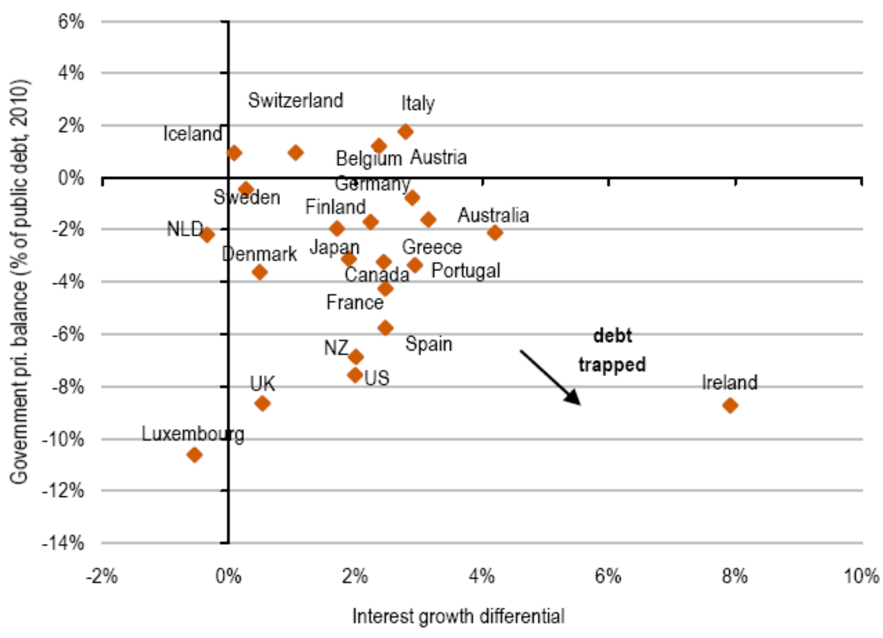
primary[4] budget balance. Chart 3 below illustrates those dynamics. The last place you want to be on that chart is in the lower right corner (where you find Ireland).

Chart 2: Government Debt Held by Foreigners



Source: "Avoiding the Sovereign Avalanche", Citigroup Global Markets, May 2010

Chart 3: Government borrowings vs. interest-to-growth differential



Source: "Sovereign Debt: A Structural Crisis and its Implications for Growth", UBS, 11th May 2010

It should be blatantly clear from this chart that Greece is by no means the only country at risk of falling into the much dreaded debt trap. The United Kingdom, the United States, New Zealand, Spain, France, Portugal and Australia are all in dangerous territory and Ireland is in very deep trouble on this account.

Smoke and mirrors

So what does that mean? Three observations:

[4] *Primary deficit is defined as the public deficit before the cost of borrowing.*

(i) One has to question the quality and sustainability of the €750 billion rescue package announced a couple of weeks ago. The vast majority of the funding originates from *within* the eurozone. As Dylan Grice at Societe Generale points out:

"…distressed eurozone borrowers are to be saved by more borrowing by … er … the distressed eurozone borrowers."[5]

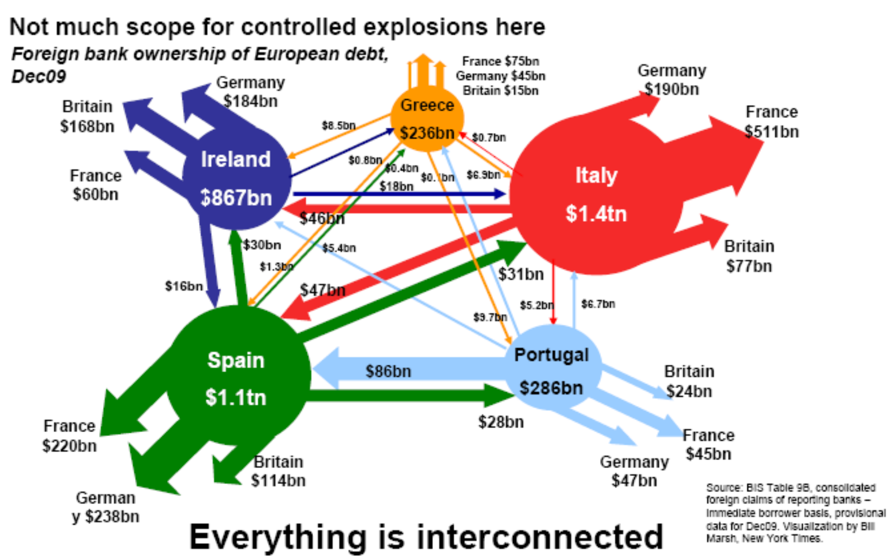
Who do they think they are kidding? We are treated as a bunch of intellectual minnows who are not capable of seeing through the smoke and mirrors created by political leaders who refuse to accept that the euro *in its current format* is doomed. And when we rebel, we are deemed unpatriotic speculators who do not care about the greater good. It is *precisely* because we care that we speak up. Hedge fund manager Hugh Hendry hit the nail on the head last week in an interview on BBC's Newsnight programme when he said:

"*We can spread this over 20 years, or we can get rid of it over 3 years.*"

(ii) This is no longer about Greece, which is just a symptom of much wider and deeper problems. It is not even about the PIGS anymore. No, it is about cross-European contagion risk which threatens the very existence of our banking system. It is this risk that Merkel and Sarkozy worry about when they say that Greece will not be allowed to go down.

European bank balance sheets are stuffed with non-performing loans which should have been written off in 2009. European regulators, however, allowed the banking industry not to come clean in a repeat of the policy mistakes made by Japan in the 1990s. As is obvious when looking at chart 4, German, French and British banks are all very exposed to Greece, Spain, Portugal, Italy and Ireland. The numbers are big enough to take the entire industry down. That is why the decision to bankroll Greece, Spain and Portugal was in reality a decision to save our banking industry.

Chart 4: The Risk of Contagion



Source: "Avoiding the Sovereign Avalanche", Citigroup Global Markets, May 2010

(iii) The harsh lesson learned in recent months is that it is total debt which matters (see chart 5). Spain and Ireland were both very successful in cutting public debt in the years leading up to the credit crisis, but they somehow forgot to control private debt, a mistake for which they are now paying dearly. In fact, the rapid rise in public debt in recent years is *not* so

[5] *Popular Delusions, Societe Generale, 27th May, 2010*

much the cause of this crisis as it is the result of excessive growth in private sector debt over the last decade or so.

Chart 5: Private, Public & Total Debt, Main European Countries

($ billion)	Private Debt as % of GDP	Total Debt as % of GDP	Public Debt as % of Total Debt
UK	215%	380%	14%
Spain	171%	342%	14%
France	155%	308%	18%
Italy	121%	298%	24%
Germany	128%	274%	12%

Source: Evolution Securities, McKinsey, IMF, National Debt Management
Note: Private debt excludes non-financial corporates

Is there a way out?

Is there a way out for Europe? A fiscal/political union would address many of the problems facing the eurozone today. However, by trying to salvage something which was probably beyond rescue in the first place, our political leaders have made a real mess of it and completely lost the trust of the electorate. A crisis has turned into a farce – Greece has become Grease – and, for at least the next generation, Europe has almost certainly missed the opportunity to create a fiscal union. Knowing what we know today, who in Northern Europe is going to vote in favour of a US-style federal union?

Even more sadly, by postponing the inevitable (a Greek default), the probability of a complete collapse of the monetary union has risen dramatically. But our political leaders do not seem to comprehend this. They still believe they can control events, although experience should have taught them differently. Too many of them still consider the European sovereign crisis a liquidity crisis. It is not. It is a solvency crisis with all that it entails. And one of the implications is that the €750 billion rescue package will ultimately prove a waste of money. Taxpayers' money. Our money! There is no easy way out for Europe. Sadly, it is nothing but bad choices.

Some economists argue that whereas the situation is grim in Europe, the debt situation is in fact far worse in both the US and Japan. While it is true that the primary budget deficit is much smaller in the Eurozone than it is in the UK, US and Japan, the argument completely fails to acknowledge that it is the *combination* of high deficit and lack of policy tools to address the problem which is so deadly.

Greece - and about ten other eurozone members - desperately need a cheaper currency, but a falling euro doesn't necessarily do the trick as much of Greece's exports go to other eurozone members. Alternatively, the Greeks may choose to go for an 'internal devaluation' by cutting salaries in the order of 20-25%. People died in the streets of Athens following a decision to reduce salaries by 5%. I don't even want to think about the consequences, should they be forced to make cuts of that magnitude. Again, nothing but bad choices.

A return to the gold standard?

All of which brings me back to Iceland. Last time I was in Reykjavik, the ISK/GBP exchange rate was about 125; it is now 185. That is one heck of a devaluation, and the effect on tourism has been noticeable. Likewise, the UK economy has benefitted from a weak pound. The ability to play the currency card provides countries outside the eurozone with options members of the currency union do not have. They are effectively held hostage by a system which is not a million miles away from the gold standard. So, for those of you wishing for a return to the gold standard, the eurozone crisis should stand out as an alarming example of what might happen if you give up the ability to conduct your own foreign exchange policy.

Chart 6: 2009 Fiscal Data for selected Countries

	Gross Debt	Net Debt	Budget Balance	Structural Balance	Cyclically Adjusted Primary Balance
			% of Nominal GDP		
Australia	15.9	-5.7	-4.0	-2.4	-1.1
Canada	82.8	28.6	-4.8	-3.2	-2.4
Czech Republic	46.5	-0.3	-5.9	-4.2	-3.2
Denmark	45.3	-3.9	-2.7	0.5	0.5
Euro area	81.8	51.7	-6.1	-3.8	-1.1
Austria	72.9	38.1	-3.4	-3.4	-1.2
Belgium	101.2	81.3	-6.0	-3.3	0.4
Finland	43.7	-52.1	-2.2	1.4	0.8
France	84.5	53.1	-7.5	-6.6	-3.7
Germany	77.4	50.2	-3.3	-2.0	0.3
Greece	114.9	86.1	-13.6	-10.4	-6.0
Ireland	65.8	24.9	-14.3	-8.7	-8.2
Italy	123.6	97.4	-5.3	3.0	1.9
Luxembourg	18.2	-44.6	-0.7	-0.5	-1.1
Netherlands	71.4	30.9	-5.3	-3.6	-1.9
Portugal	83.8	55.6	-9.4	-5.6	-2.8
Slovak Republic	36.7	7.2	-6.8	NA	NA
Slovenia	NA	NA	-5.9	NA	NA
Spain	59.3	33.2	-11.2	-6.6	-5.6
Hungary	85.2	58.8	-4.0	-1.6	2.3
Iceland	117.6	35.4	-15.7	-15.3	-6.5
Japan	189.3	96.5	-7.4	-6.5	-5.6
Korea	33.2	-34.5	-1.8	NA	NA
New Zealand	27.0	-14.7	-1.2	0.7	-0.2
Norway	59.9	-140.4	9.6	-4.4	-7.0
Poland	58.1	25.7	-7.1	-6.8	-4.7
Sweden	52.7	-16.7	-0.5	1.4	1.4
Switzerland	44.4	9.9	-0.7	-0.2	0.3
United Kingdom	71.0	46.9	-11.5	-9.2	-6.8
United States	83.9	56.4	-11.2	-8.9	-7.3

Source: Citigroup Global Markets, Global Economics View", 26th April, 2010

Which brings me to the last question of the day: Will the euro survive?

Had you asked me the question a couple of months ago, I would have said almost certainly. But two months is a long time in a crisis of this magnitude. And those with the power to make changes are not exactly making the right choices right now. But, if you would allow me to paraphrase Sir Winston Churchill for a moment:

"You can always count on them to do the right thing after they've exhausted all other alternatives."

The problem in a nutshell is that it is Germany, not Greece, which is the problem[6]. Let Greece go down the drain and the market will move its attention to Portugal and Spain. Let those countries go and Ireland, Italy and probably also France will be next. It is quite simply a horror scenario.

It is the fact that there is no easy solution that drives down the euro in the currency markets at the moment. I fully expect the EUR/USD exchange rate to reach parity before the end of this crisis but will admit that bearish sentiment on the euro has now reached extreme levels which suggests to me that a (dead cat) bounce may be imminent.

If Germany were to pull out, it would spell the end of the euro so, true to Churchill's words, they will probably go through the entire catalogue of alternatives before conceding defeat. One option apparently being considered at the moment is an extension of all maturities on Greek sovereign bonds combined with a significant reduction of coupons (at least this is what I hear through the grapevine). This would mean a drastic haircut for investors such as you and me but, interestingly enough, not for

[6] *Germany's unit labour costs (a measure of global competitiveness) has risen by 20-25% less than most other eurozone members since the introduction of the euro.*

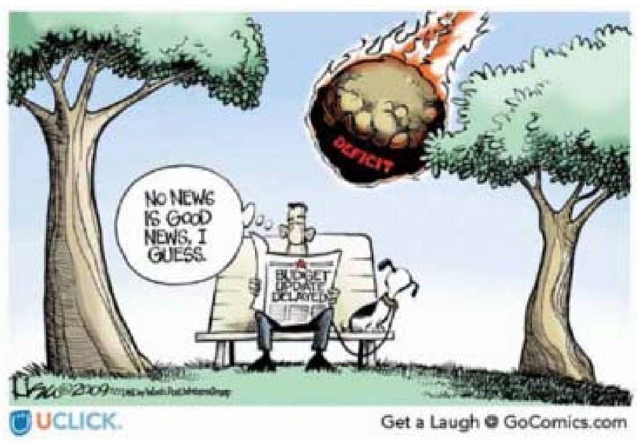
European banks which, under prevailing rules, would be permitted to mark those bonds at par. Voila!

Such a solution does not, however, address the underlying problem (Germany being too competitive for most eurozone members) which is why it is akin to wetting your pants to stay warm, as we say in Denmark.

My best guess at the moment, and it is only a guess, is that the euro will eventually be replaced by a new euro (neuro?) with Germany, Austria, Finland, the three Benelux countries and potentially also Denmark and Sweden (neither of whom have adopted the euro) as founding members. One or two old East bloc countries may also be invited to join. Poland? Slovenia? The Czech Republic? I am less convinced that France will be welcome in this club. The rift between the Germans and the French continues to grow with the French no longer even bothering to hide the fact that, at the end of the day, they only really care about themselves.

However, whether it will be the euro, the neuro or something else which prevails, there will continue to be a European currency, because there is a need for one. Allow me to finish just as I began this letter – with a quote from Woody Brock's May 2010 research paper:

"*Indeed, while it is easy to deride the whole euro project as pretentious and unrealistic, the fact is that a third global currency is sorely needed. After all, Europe consists of a large number of contiguous states that constitute the largest economic bloc in the world. There is much to be said for this bloc to have its own currency. This point is rarely emphasized but it is as true as is the claim that the euro is unworkable!*"



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