The Absolute Return Letter
July 2011

What Happens Next?

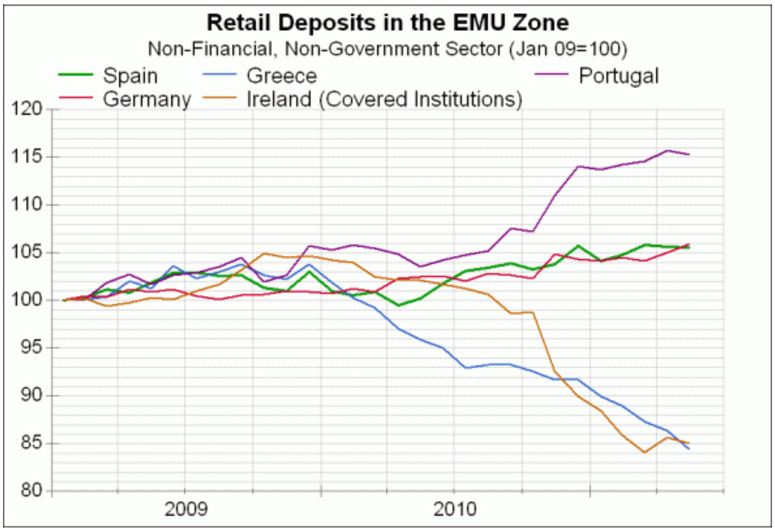
"Anyone who isn't confused really doesn't understand the situation."
Edward R. Murrow, Broadcaster

I can already hear the collective sigh - oh no, not another letter on Greece! The battle fatigue is evident. We are all exhausted from years of fighting the crisis but, at the same time, we are fast approaching the end of the road, at least as far as Greece is concerned, for one simple reason. Policy makers are running out of options, verified by their increasingly desperate reactions to undesirable news.

One recent example: Earlier this week Moody's downgraded Portugal (in my opinion deservedly so). Governments across Europe, who in the past have been highly critical of the rating agencies for being behind the curve, suddenly criticised Moody's for undermining their work. Long live hypocrisy.

No, this letter is about what is likely to happen *after* Greece has defaulted, which is where I am increasingly focused. The can may be kicked further down the road in order to buy additional time, and every trick in the book may be used to portray the default as a benign event (note, for example, the use of the word 'rollover' rather than the somewhat less pleasant 'restructuring' in the latest proposal), but default it will.

Chart 1: Flight to Safety in Greece and Ireland



Source: JP Morgan, Gavyn Davies on FT.com

Greece is now a side show

The reality is that Greece is increasingly becoming a sideshow. Much of the media may not have realised this yet (with a few honourable exceptions, they are still obsessed with Greece), but most investors certainly have. Following the downgrade of Portugal earlier this week, Portuguese, Irish, Spanish and Italian credit default swaps (CDS) all widened substantially. And out there, in the real economy, it is not only

Greek savers who have come to realise that this is going to end in tears. Irish retail bank deposits have dropped approximately 15% since early 2010 (see chart 1).

In fact, the situation is now so bad that the ECB is financing about €400 billion of banks' balance sheets in the crisis countries (see Gavin Davies' blog in the FT here). Given that the combined capital and reserves of the European System of Central Banks is only about €81 billion, the ECB is increasingly at risk of being bankrupted.

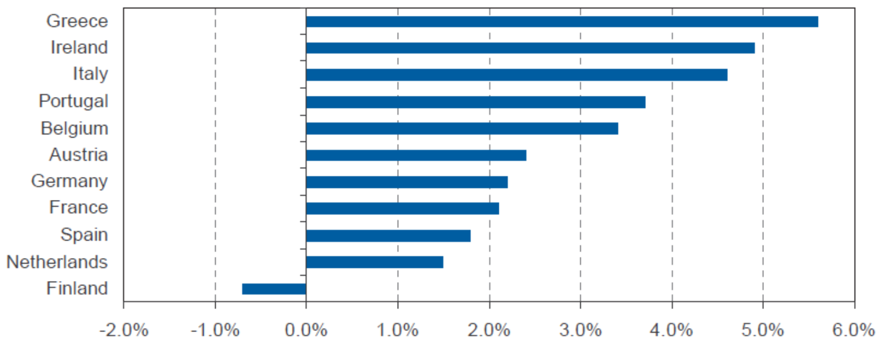
This raises a myriad of questions. What defines a default? Will the proposed rollover of Greek debt trigger a CDS payout? Does the rollover provide a sustainable solution for Greece? What happens if the ECB is bankrupted? How will a default, whether explicit or implicit, affect Portugal, Ireland and possibly also Spain, not to mention Italy?

How much is too much debt?

Before I go any further, allow me to provide some theoretical background which will come in handy as my thinking progresses. To begin with, let's take a look at what constitutes unsustainable debt levels. It is a mathematical fact that as long as nominal GDP growth remains below the average cost of debt (when measured as a percentage of GDP), a country's debt-to-GDP ratio will rise even if the primary budget deficit[1] has been eliminated through austerity.

In plain English this means that Greece would have to grow its nominal GDP by almost 6% per year going forward for debt-to-GDP not to rise further, assuming its average cost of debt remains stable (see chart 2). Ireland and Italy would have to grow by almost 5% and Portugal by almost 4%. With inflation hovering well below those levels in all the countries mentioned, that is a very tall order even during the best of times. And with austerity being forced upon all of these countries it is simply not going to happen.

Chart 2: 2011 Net Debt Interest Payments as % of GDP



Source: AQR Capital Management, OECD

How much is too much debt? There is no explicit formula as to when a country passes the point of no return as it is possible to live with high debt levels for extended periods of time. Take Japan which has lived with debt ratios well in excess of 100% for a number of years. It has been made possible through a combination of high domestic savings and extraordinarily low interest rates. However, Japan is a unique case. As a rule of thumb, when a country's debt-to-GDP ratio exceeds 100% you are in dangerous waters.

The options available

Now, when a country finds itself in a Greek-style pickle, the options at its disposal are in fact quite limited. It can choose to:

(a) default on its obligations;

(b) negotiate lower interest rates in the face of a default (if possible);

(c) inflate (as higher inflation reduces the real value of its debt);

[1] The primary deficit is defined as the budget deficit net of interest payments.

(d) reduce its deficit through austerity;

(e) take measures to stimulate economic growth; or

(f) any combination of the above.

In the case of Greece, inflating its way out is not an option as it doesn't control its monetary policy. Meanwhile austerity, which has been the 'chosen' route so far, not only destroys economic growth (the opposite of what is needed); it is also deflationary which increases the real value of its debt.

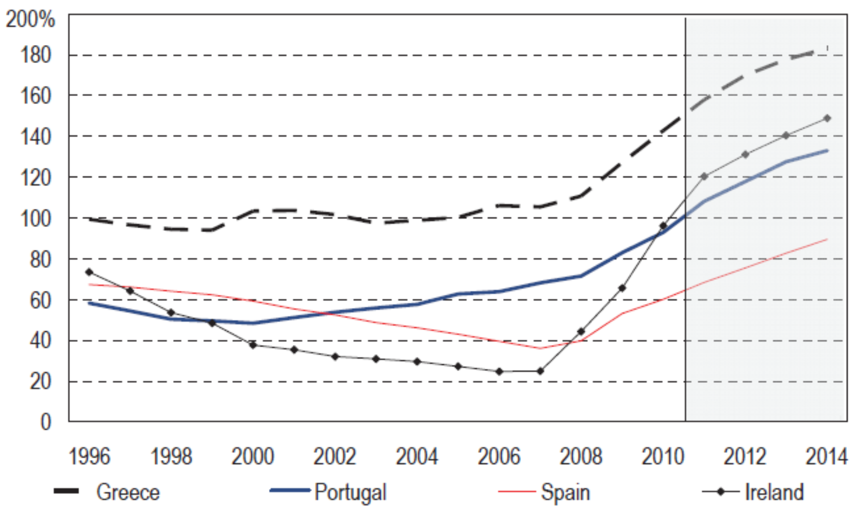
It is perfectly understandable why the creditor countries demand austerity; it is just important to realise that, in the case of Greece, it destroys any hope of economic growth robust enough to avoid the debt trap discussed above. If you apply austerity to a competitive and export orientated economy such as Germany, domestic demand is likely to suffer, but exports may more than compensate for that. However, if you attempt the same trick on a largely domestic[2] economy such as Greece, your 'achievement' will be limited to *lowering* both GDP growth and inflation, both of which will make an already bad situation a great deal worse.

Assuming that austerity eventually reaches a point where it is no longer politically tolerable – and I would suggest that Greece is there or thereabouts – you are left with only two options: Lower the cost of debt or default. Simple as that. It beggars belief that the creditor countries believe a solution can be achieved through austerity only. In the not so distant future the creditor countries will thus be faced with a simple choice: Offer more credit to Greece at *much* lower rates or face default. Given the emerging political landscape in Northern Europe where xenophobic political parties are fast gaining momentum, it could amount to political suicide for the mainstream parties to offer the former, which is why my money is on default.

The bigger picture

Now, let's turn our attention to the bigger picture. Much noise has been made in the media about the contagion risk and why a default in Greece could spill over to other countries and force them into default as well. Citibank published a revealing research paper only a couple of weeks ago[3] which clearly demonstrates why both Portugal and Ireland are on the path towards default regardless of what happens in Greece.

Chart 3: 2014 Sovereign Debt Projections



Source: Citi Investment Research, Eurostat

[2] *I do recognize that Greece has meaningful exports to other eurozone countries, but since Greece cannot devalue its currency against other eurozone members, such exports are in fact domestic.*

[3] *"A Plan B for the Euro Periphery", Citi Investment Research, 24 July 2011.*

Under assumptions which seem quite reasonable Citibank concludes that whilst Greece is in the most desperate of situations with debt-to-GDP accelerating towards 180% over the next 3 years despite all the austerity being forced upon it, neither Portugal nor Ireland can realistically avoid a default with their debt-to-GDP growing to 133% and 145% respectively (see chart 3).

In order to bring the debt-to-GDP ratio down to a more manageable 80%, Citi's research team reckons that haircuts of 65% (Greece), 50% (Ireland) and 45% (Portugal) respectively shall be required (see chart 4). Neither Citi nor I necessarily expect such drastic measures to be implemented this year, possibly not next year either, but the message is clear. Unless something gives, within a couple of years, the eurozone countries will have run out of options, and the hitherto unthinkable will suddenly become the only way out.

Chart 4: Haircuts Required to Restore Fiscal Sustainability

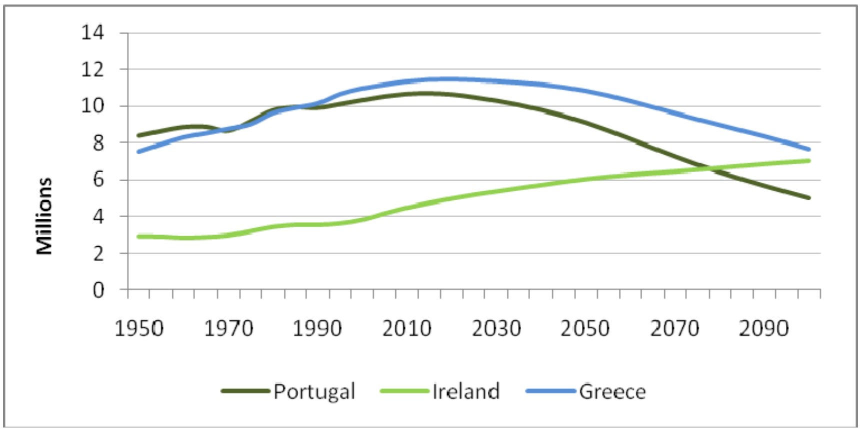
	Government debt in 2014F (% of GDP)	Government debt in 2014F (EUR bn)	Government debt held by IMF+EU (EUR bn)	Government debt held by IMF+EU (% of total debt)	Haircut to Non-IMF debt necessary to achieve 80% debt ratio	Haircut to Non-IMF debt necessary to achieve 60% debt ratio
Greece	179	402	170=57+ 113	42%	65%	77%
Ireland	145	236	67.5=22.5+ 45	29%	50%	65%
Portugal	133	230	78=26+52	45%	45%	62%

Source: Citi Investment Research, Eurostat.

Demographics are a challenge

Longer term, there is not much room for optimism either. Consider what drives GDP growth in the long run – population and productivity growth[4]. I have been visiting the United Nations database for long-term demographic projections, and the result is rather depressing as far as Greece and Portugal are concerned, whereas Ireland is in a much better situation (see chart 5). The populations of Greece and Portugal are peaking now with no improvement expected for the rest of this century. Ireland, on the other hand, can look forward to a respectable rate of population growth, as long as it can stem the current trend where many younger - and better educated - people leave the country to land jobs which are currently not available in their home country.

Chart 5: Projected Population Growth to 2100



Source: http://esa.un.org/unpd/wpp/index.htm. Assuming constant fertility.

Is Spain imploding?

So far I have avoided any mention of Spain. In some ways Spain is better off than the other three, but it is by no means out of trouble. Spain has indeed taken quite forceful action in terms of implementing

[4] *GDP is a measure of total output (production of goods and services) in a country over a given period. Output equals output per hour worked (i.e. productivity) times the number of hours worked (which is a function of the number of people in the workforce). So, when economists project the growth rate of a country over time, productivity and population growth are two fundamental factors in such assessments.*

its own version of fiscal austerity, and the overall level of sovereign debt is still very manageable; however, Spain's problems are mostly in its private sector, and Spain is still to wake up to the fact that it is *total debt* that matters at the end of the day.

More specifically, Spain's problems are concentrated in its banking and construction sectors after years of grotesque overbuilding to the point where well over one million homes stand idle. Even more worryingly, most of those empty homes are now owned by the banks and savings banks with the valuations in most cases not even remotely reflecting reality. Meanwhile the domestic economy is producing one shock after the other. Retail sales have been particularly badly hit with a string of awful numbers this year, and the property sector is showing no signs of life whatsoever. Chart 6 below has been produced by the Spanish national statistics office and shows that the residential property market is literally in the deep freezer with total mortgage lending down 45% year-to-date.

Chart 6: Spanish Mortgage Lending, April 2011 (MoM and YTD)

	Total	Variation rate	
		Inter-monthly	Interannual*
Total properties			
Number of mortgaged properties	50,089	-27.6	-37.5
Capital loaned (thousands of euros)	5,681,336	-29.5	-45.1
Average value (euros)	113,425	-2.7	-12.1
Rustic properties			
Number of mortgaged properties	2412	-19.5	-35.2
Capital loaned (thousands of euros)	351,482	-31.9	-50.6
Average value (euros)	145,722	-15.3	-23.7
Urban properties			
Number of mortgaged properties	47,677	-28.0	-37.6
Capital loaned (thousands of euros)	5,329,854	-29.4	-44.7
Average amount (euros)	111,791	-1.9	-11.3
Dwellings			
Number of mortgaged properties	31,358	-27.4	-38.2
Capital loaned (thousands of euros)	3,351,816	-31.0	-42.0
Average value (euros)	106,889	-4.9	-6.1

*Rates calculated with regard to the final data for 2010

Source: Instituto Nacional de Estadistica

I am reluctant at this stage to predict a Spanish default, but the local economy is showing all the signs of implosion which will not exactly make it any easier to steer clear of default, whether sovereign or in the banking sector. And in this context it is important to remember that the Spanish economy is twice as large as Greece, Portugal and Ireland combined. The Spanish government has hopefully learned from the Irish mistake and should think twice before they embark on a wholesale bailout of the Spanish banking industry.

When speaking to investors I have found that a majority still believe the Spanish banking industry to be relatively well capitalised and able to withstand the current crisis. In my opinion this view fails to acknowledge the substantial number of local banks and savings banks which are up to their eye balls in toxic property assets.

A word on Italy

In this horror story of policy mistakes, Italy probably deserves a mention too[5]. Italy is one of the most indebted countries in the eurozone, so on that account it is at a disadvantage to Spain; however, several factors work in its favour. The private sector savings rate has been high for many years and most Italian sovereign debt is actually owned by the private sector in Italy. It is highly unusual for a country to default when foreign ownership of its debt is only marginal. The main risk as far as Italy is concerned is that spreads continue to widen in which case Italy would be pushed into a situation not too dissimilar to that of Portugal. We note that the spread between German and Italian government bonds has indeed widened recently and now stands at a 10-

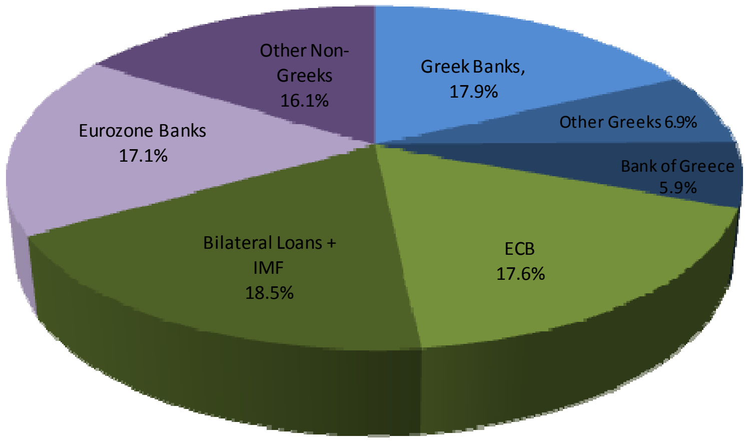
[5] *Italy is the reason PIG is spelled PIIG these days!*

year high. I suggest you read this link for a well balanced analysis of Italy's predicament.

Contagion risk is in CDSs

Besides the obvious contagion risk there are many other reasons why the authorities are keen to avoid a Greek default. The one most frequently mentioned is the fact that it could take down several European banks. The truth is it could, but probably not in the way you envisage. European banks are long about 17% of the €340 billion of total Greek sovereign debt outstanding (see chart 7). A 65% haircut would result in losses of €37-38 billion - not enough to create anything remotely looking like systemic risk.

Chart 7: Holders of Greek Sovereign Debt



Source: Goldman Sachs Global Economic Research, Bank of Greece, IMF

No, the main risk lies somewhere else – in the CDS market. Total net risk to a Greek default is 'only' about $5 billion, but that number masks a much greater risk to those individual banks which have sold CDSs and which would therefore be on the wrong side of the trade, should Greece default. Total gross exposure to a Greek default is about $79 billion and, according to a recent article in the Financial Times, there may be at least one bank which stands to lose as much as $25 billion should Greece default (see here). And the problem doesn't stop there. The very existence of the CDS market could come under threat if one of the major issuers cannot honour its obligations. They will do *everything* in their power for that not to happen.

Now, this is where the story gets interesting. The International Swaps and Derivatives Association (ISDA) is mandated with determining whether a default is legally a default or not. ISDA has established a number of so-called Determinations Committees (one for each geographical region) empowered to determine each and every case. I looked up on the internet who actually sits on the European committee. Surprise, surprise. Ten of the fifteen members are large international banks who also happen to be the most active issuers of CDSs (see the list here). Isn't that a classic case of the fox watching over the chickens? If you stand to lose $25 billion, are you going to vote in favour of declaring it a legal default? There are obviously guidelines they have to follow, but...

Many other questions

There are many other questions which remain unresolved and which add to the ambiguity of the whole situation. An integral part of the Greek disaster recovery plan is to sell Greek assets on a grand scale. I just ask myself: With the ultimate outcome likely to result in a default, and with a possible exit from the euro to follow, isn't it probable that Greece will ultimately devalue whatever currency they introduce? Who will be buying Greek assets in the face of a 20-40% devaluation?

Another question to consider: Is Greece simply playing a shrewd game of extracting as much cash from the EU as possible before giving in to the inevitable? Greeks are not exactly the most stupid people I have come across. They are in fact very astute business people. They can do the same maths as Citibank and others have done. They can see the writing on the wall. But precisely when you realise that a default is inevitable, milking the cow for as long as possible seems to be the optimal strategy.

Consider also the fact that four of the five PIIGS are dependent on one and the same industry for much of their foreign income – tourism. A Greek euro exit would give it – in the eyes of Spain, Italy and Portugal – an unfair advantage and could force those countries to exit as well. How big a role does that play in the ongoing negotiations?

Or consider Ireland which is very dependent on its status as a financial centre. Many investment funds are denominated in euros and domiciled in Ireland. I have asked a number of people as to what would happen to those funds if Ireland exited the euro. Would they suddenly be denominated in the new Irish currency only for investors to be some 20-40% worse off due to the inevitable devaluation? Not one person has given me a straight answer.

These and other questions are the reasons the whole thing is so difficult to unravel which is why they will fight for the euro's survival as if their own lives depend on it. That doesn't necessarily guarantee its survival, but it all but guarantees a long and painful battle. The depressing reality is that the authorities continue to treat the issue as if it is a liquidity problem, not a solvency one. A rollover buys them a bit of extra time but it doesn't fix anything. Even a default doesn't fix anything, as it won't make Greece, Portugal or Ireland any more competitive, and increased competiveness is a necessary condition for long term fiscal improvement.

Conclusion

If Portugal and Ireland, and eventually also Spain and Italy, increasingly get dragged into this crisis – and everything I see on the horizon suggest they will – the €400 billion the ECB has pumped into the banking sector in those countries so far will be pocket money compared to what will be required going forward. At some point the creditor countries will say enough is enough. And if the politicians don't know when to say no, the electorate will do the job for them.

The ECB's strategy for now seems to be one of buying time. As you can see from chart 7, over 40% of Greek sovereign debt is now owned by the ECB, the IMF and the Bank of Greece between them. Speculators should remind themselves that to be entitled to a payout on a CDS, you must deliver the underlying bonds, and if all bonds are in the hands of the ECB and the IMF, a default may not have any consequences as far as the CDS market is concerned. If Greece were the only problem, such a strategy might actually work, but it completely ignores the fact that Portugal, Ireland, Spain and Italy are all lined up behind Greece in the crisis queue.

Assuming the objective is for the euro to survive *in its current form*, the only sustainable solution is a political/fiscal union, but I see zero appetite for that at this stage. A fiscal union will require referendums in all member countries, and Northern European voters will never agree to enter into a fiscal union with a country as systemically corrupt as Greece (if I just upset any of my readers with that statement, I suggest you read this article from the Los Angeles Times).

Therefore the question is not whether Greece will default but what will happen once it has. If Greece defaults but stays in the euro, not only will it not solve the underlying lack of competitiveness, but markets will immediately turn their attention to Portugal and Ireland and force those countries to default, and once they fold, Spain and possibly Italy will be next, so a Greek default on its own could quite possibly make matters worse for everyone.

If Greece defaults and exits the euro at the same time, the market reaction won't be much if any different to begin with, but things may actually take an interesting turn in one particular respect. Once the people of Portugal, Italy, Spain and Ireland see how the Greek economy actually benefits from the exit, they may in fact *demand* an exit in their countries too. It is therefore fair to say that a Greek default, with or without an exit from the eurozone, achieves nothing if the aim is to keep the eurozone intact.

However, there is another way forward. Welcome *the neuro* (on further reflection, perhaps not an ideal name for a new currency). A couple of years ago I advocated a German exit from the euro, as Germany in many ways is the outlier in the union, but I have come to realise that a European currency without Germany will never succeed. What Europe needs to do instead is to create a new currency built around Germany and based on a fiscal union *from day one*. As Germany will effectively be underwriting such a currency, it shall have the right to choose who it wants in the club.

I think that will be the ultimate way out of this mess, but there will be plenty of pain beforehand, as nobody is yet prepared to make this jump. This implies that yield spreads on Portuguese, Irish, Spanish and Italian government bonds will continue to widen relative to German bonds, perhaps dramatically so.

Niels C. Jensen
8 July 2011

Post Scriptum

As an afterthought, it was quite a gutsy move by the ECB to raise its policy rate yesterday from 1.25% to 1.50%. The ECB is desperate at the moment to demonstrate its independence and retain its credibility as a dedicated inflation fighter. And the damage done to the crisis countries is probably negligible given the fact that the normal financing channels are all but closed to them anyway.

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