The Absolute Return Letter
August 2011

Why U.S. of AA Matters

We have never published the Absolute Return Letter before in August and, hopefully, we will never have to do it again; however, the unprecedented events of recent days and weeks have forced our hand. I will make it short, though. August is for reading, not writing.

Unless you've spent the last few days on another planet you will know by now that Standard and Poors chose to downgrade U.S. sovereign debt to AA+ last Friday evening. A U.S. downgrade is, in itself, almost meaningless. A nation that issues debt denominated solely in its own currency and which is in full control of its monetary policy, *cannot* default unwillingly. Nations default because they run out of foreign currency to service their debt, but the U.S. doesn't need foreign currency to service its debt. One could thus argue that the rating agencies shouldn't even bother to rate U.S. sovereign risk. But they do. And one of them has now decided that U.S. sovereign is no longer AAA.

So what does it mean? Near term, other U.S. financial institutions (Fannie Mae? Freddie Mac? JP Morgan?) will be downgraded as a result - perhaps as early as today or tomorrow. Following that, if Standard & Poors wants to maintain whatever credibility it has left, it will probably have to downgrade a few sovereigns as well. France springs to mind; it is not far behind the US as far as profligacy is concerned, and it may prove difficult for Standard and Poors to justify the AAA rating it currently assigns to France.

If France is downgraded, a number of French banks will almost certainly be downgraded, following which other European banks will face the same destiny. Such a scenario has the potential to cause calamity across Europe. The 90 European banks which recently went through the (so-called) stress test organised by the European Banking Authority need to roll a total of €5.4 trillion[1] (!) of debt over the next 24 months. A massive amount even during the best of times. Probably undoable during times of stress. As Ambrose Evans-Pritchard, in consultation with Willem Buiter of Citigroup, pointed out in the Daily Telegraph over the weekend[2]:

"…the issue is not how long Italy and Spain can ride out the storm in bond markets. There would be a banking and insurance crisis long before sovereign defaults came into play, simply because the fall in bond prices on the secondary market is causing carnage to bank books (among other transmission mechanisms)."

With its downgrade of U.S. sovereign debt, Standard and Poors has started a chain of events which can only make things worse in an already crisis hit eurozone. For that reason, the decision to downgrade was not only badly timed but also ill considered; that it was probably justified is of little relevance at the moment.

In another development this morning, the ECB has announced that it is expanding its bond purchasing programme to include the entire

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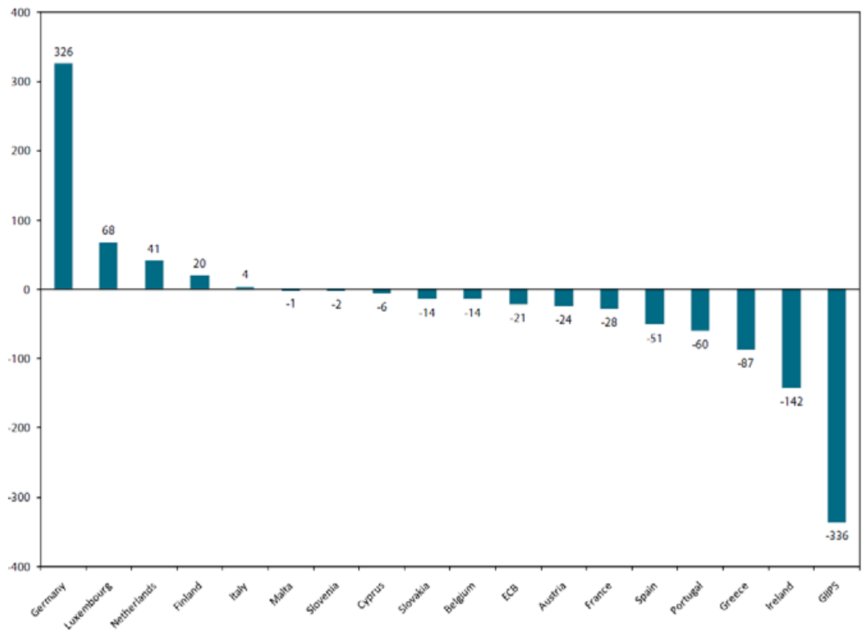
[1] *Source: 'Europe on the Brink', Peterson Institute of International Economics, July 2011*

[2] *http://blogs.telegraph.co.uk/finance/ambroseevans-pritchard/100011278/please-europe-either-put-up-or-break-up/*

eurozone – thereby implying that it is now buying Spanish and Italian government bonds. The effect has been immediate with Spanish and Italian 10-year bond yields falling 60-70 basis points. European stock markets, on the other hand, are not visibly impressed. After an initial rally, most markets are now down as investors fret over the longer term growth outlook in the eurozone.

Germany's role in all of this is pivotal. If you have any doubts, look at chart 1 below. Germany has almost single-handedly carried the eurozone through the crisis so far. Germany, however, demands responsibility from its troubled partners (which is fair enough). Merkel knows that with the next German parliamentary elections little more than a year away, domestic politics will increasingly set the stage for her in the months to come. She knows she is in a mine field and will have to step carefully.

Chart 1: Claims of eurozone members from cross-border payments (€ billion)



Source: 'Europe on the Brink', Peterson Institute of International Economics, July 2011

In German culture, responsibility equals austerity, but austerity translates in to slow growth, and slow growth is the last thing the troubled eurozone countries need right now. There is thus a fundamental clash between the demands made by Germany and the needs of its partners. For precisely that reason, our political leaders need to think out-of-the-box, if the eurozone is going to survive this crisis. Here is what I think is needed:

1. *Establish a credible lender of last resort*. The EFSB with €440 billion of fire power[3] is a bad joke. Italy resides over the third largest bond market in the world with €1.8 trillion of sovereign debt outstanding, €700 billion of which must be rolled over the next 3 years. We estimate that at least €2 trillion would be required to make the EFSF credible.

2. *Get the debt restructuring over with*. The current policy of 'pretend and extend' is extremely damaging, and the sooner our political leaders bite the bullet and accept a haircut is required on Greek, Irish and Portuguese debt, the better.

3. *Support the banking system, not the sovereigns*. A haircut of 40-60% on Greek, Irish and Portuguese sovereign debt will undoubtedly

[3] *As the EFSB will be keen to protect its credit rating, only about €250 billion of the €440 billion in the rescue fund will in fact be available for lending purposes.*

put several banks in to trouble. If the banks go down, we all go down, so supporting them is critical. Where does the money come from? From the same sources which would have provided the funds to prop up the sovereigns (which is no longer required, following the haircut).

4. *Eliminate red tape*. Labour market reforms are required across the eurozone. The Spanish prime minister will tell you he has already done a lot to make Spain a more productive country. The reality is that he is less than a mile into a marathon run in the Gobi desert. This will be painful but utterly necessary. Other reforms will also be required. The September letter will focus on one particular idea I have which could revive residential property markets around the world. Stay tuned.

5. *Think the unthinkable: fiscal union*. I do not for one second believe a monetary union can survive longer term without full fiscal integration. Throughout history, there is not a single successful example. The question is whether Merkel can convince her countrymen (including herself) to join a fiscal union with countries which have proved terribly inept at managing their fiscal affairs? I suspect the answer is no.

The eurozone is well and truly in *Dire Straits* (for reasons which are largely self imposed). Only time will tell whether the political leadership in Frankfurt and Brussels can deliver *Brothers in Arms* or if it will all be *Money for Nothing*. Thus far they have been pretty good at delivering rhetoric, but rhetoric has no staying power, and their willingness to take tough decisions remains unproven. Today the ECB is buying Italian and Spanish government bonds. Let's see what their appetite is like when they have spent €1 trillion and markets remain fragile. For this and the other reasons I have stated previously, my money remains on a complete restructuring of the euro.

Niels C. Jensen
8 August 2011

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