Absolute Return Partners LLP

The Absolute Return Letter
November 2011

Ignore Egan-Jones at Your Peril

"A country is bust when the markets decide."
Albert Edwards, Societe Generale Cross Asset Research

The ink on the Greek rescue agreement had barely dried before a triumphant, nappy-changing French President with an ego to match the heels of his shoes went on French television to portray himself as the saviour of Europe. *"We find ourselves at the start of a new world"*, he jubilantly proclaimed[1].

Meanwhile, here in the UK, an unconvinced British press did not hesitate to denounce the Brussels agreement as hopelessly inadequate, and the euro sceptics in Parliament, of which there are many, had a field day. The point so sadly missed by many in this country, though, is that we are all in this boat together. As a Danish proverb says, you shouldn't saw off the branch you are sitting on!

A muted German reaction

Perhaps more surprising, and considering the euro project has been saved (for now), the German reaction wasn't exactly exultant. Here is what some leading German newspapers[2] had to say:

Frankfurter Allgemeine Zeitung: *"Whoever believes that the crisis has now passed its zenith is terribly mistaken. It is unlikely that the 'firewall' against market volatility that European leaders had hoped for has now been put in place."*

Die Tageszeitung: *"Above all, €1 trillion simply won't cut it, because not even €2 trillion would be enough. The crisis now has a life of its own and has eaten its way into the heart of the euro zone."*

Die Welt: *"But what does the euro crisis now mean for Europe? It will change the union down to its very foundation. Relations among the member states are likely to become more difficult and battles over resources more intense."*

Kenneth Rogoff, Harvard professor and co-author of *This Time Is Different,* also chipped in, suggesting that the package agreed in the early hours of Thursday, 27 October, will only buy the political leadership in Europe a few months (see here).

Even George Soros was damning in his assessment. Soros is a European with a capital E which is why his words carry so much weight. This is what he had to say about the rescue package:

"Given the magnitude of the crisis it is again too little too late. It will bring relief partly because the markets were so obsessed by the lack of leadership. The mere fact that something was achieved was a major relief and it will be good for any time from one day to three months."[3]

Markets are unconvinced

Not exactly the sort of words one would have liked to hear from Mr. Soros. So what is wrong with the Brussels agreement? For starters, it is

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1 *http://www.spiegel.de/international/europe/0,1518,794601,00.html*
2 *http://www.spiegel.de/international/europe/0,1518,794642,00.html*
3 *http://www.telegraph.co.uk/finance/financialcrisis/8857456/George-Soros-attacks-Brussels-rescue-deal.html*

desperately short on detail, signalling that Europe's leaders have struggled to reach a consensus with the finer details yet to be worked out. But that is by no means the only problem.

No agreement has supposedly been reached yet with the holders of Greek sovereign debt. What happens if investors refuse to play ball? At least some of them are non-EU banks and hence outside the scope of EU regulators who apparently are putting considerable pressure on EU banks to participate in a 'voluntary' deal. Last time we were in this position they were struggling to reach 75% participation, and then the proposed haircut was only 21%. Why is it they now believe they can reach 90% participation if the haircut is 50%?

And it gets worse. According to George Soros, the deal involves only the private sector. What has been touted as a 50% haircut is therefore effectively only a 20% haircut[4]. If you do the maths on Greece, with an ongoing budget deficit in the region of 7-8% of GDP and real GDP growth of -5% for this year and probably also next, a haircut of such modest proportions will do little to reduce Greek sovereign debt over the next few years (read: there will be further haircuts).

If you are still inclined to give Greece the benefit of the doubt, I suggest you study the works of Egan-Jones, a credit rating company located in Haverford, Pennsylvania. Contrary to most other rating companies, Egan-Jones does not receive any compensation from bond issuers (a huge conflict of interest in the world of credit rating agencies) and, unlike most of its competitors who haven't exactly covered themselves in glory in recent years, Egan-Jones has a formidable track record (see it here).

Sean Egan, co-head of Egan-Jones, predicts the eventual haircut on Greece to be close to 90%. He has done his homework and believes that Greece can support no more than €40 billion of debt through tax revenues. That amounts to only 10-15% of outstanding Greek sovereign debt. Sean put his case forward brilliantly in an interview in Barron's earlier this year. You can find it here.

Attention turning to Italy

What's more, Sean Egan expects the crisis to be replayed in Ireland, Portugal, Spain, Belgium and Italy. The argument is the same. What can reasonably be expected in tax revenues? What does it cost to service the debt? The conclusion is depressingly similar. None of these countries are likely to be able to fully repay their debt. Italy was forced to pay 6.06% only ten days ago on a 10-year auction - a price which they can hardly afford. Now, less than two weeks later, the same 10-year bond is trading above 6.6% after Berlusconi, always the man for an eye-catching remark, made a complete fool of himself over the weekend by saying that investors shouldn't worry – Italy's restaurants are still full (as I write these lines, there is a rumour coming out of Italy that he is about to resign and Italian equities are jumping in undiluted joy).

Italy is not Greece though. It has many things going for it that Greece hasn't but Italy is now paying the price for past sins. You may wonder, why now? The world and her mother have known of Italy's fiscal problems for a generation or more. What has changed? In truth, not a lot but there is no hard and fast rule as to when a country is bust (chart 1). Japan should really be bankrupt at current levels of debt but clearly isn't. Spain with its low levels of sovereign debt shouldn't really be in trouble but clearly is. As Albert Edwards dryly remarked in a recent research paper: "A country is bust when the markets decide"[5].

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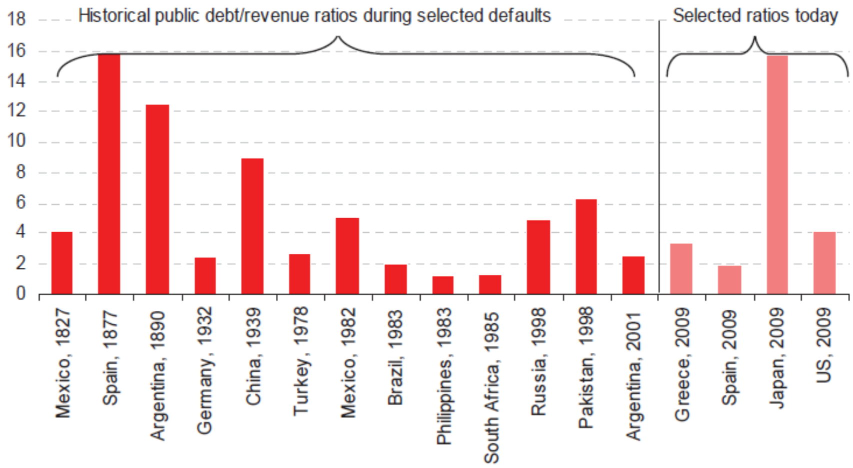
4 *Other commentators have put the number closer to 30%, see for example here*
5 *Societe Generale Global Strategy Weekly, 3 November 2011*

Chart 1: Debt to Revenues at Selected Sovereign Defaults



Source: Societe General Cross Asset Research

Through 20+ years of fiscal mis-management, Italy has worked up a debt-to-GDP ratio of about 120%. Admittedly, Japan's debt-to-GDP is even higher but with the noticeable difference that it is paying 1% on its 10-year bonds. Italy's government bond market is Europe's largest with about €1,600 billion outstanding (chart 2). If Italy goes down, the European dream is over. For precisely that reason, Italy remains *the line in the sand* for Europe[6].

Chart 2: Bonds Outstanding by Asset Class and Country

EUR (bn)				Covered Bonds			Corporates				
Country	Total	Sov	Quasi-sov/ SOE	ALL	Public Sector	Others	ALL	Sen Fin	Sub Fin	IG Non-Fin	HY Non-Fin
Austria	291	185	44	31	21	10	31	12	7	11	1
Belgium	365	314	5	0	n/a	n/a	46	9	7	28	2
Denmark	485	112	11	339	0	339	22	6	4	10	1
Finland	108	80	1	10	0	10	17	3	1	10	3
France	2,239	1,310	168	320	76	245	430	92	83	226	29
Germany	2,597	1,019	464	640	412	228	425	130	108	160	27
Greece	318	281	4	20	0	20	10	2	6	1	0
Ireland	196	90	14	66	37	29	17	4	1	5	7
Italy	1,894	1,593	12	37	10	27	205	53	33	101	17
Netherlands	796	314	78	41	0	41	278	163	35	67	13
Norway	167	47	13	72	2	70	36	8	2	24	1
Portugal	187	123	8	29	1	28	14	1	0	13	0
Spain	1,225	577	99	362	18	343	114	26	18	63	7
Sweden	380	104	12	189	0	189	75	35	9	30	1
Switzerland	265	74	0	62	0	62	129	62	22	43	2
UK	2,334	1,306	17	209	4	205	522	146	133	221	22
Total	13,848	7,528	944	2,426	581	1,845	2,370	753	469	1,015	134

Source: Morgan Stanley Credit Strategy, November 2011

Over the next two years, Italy must refinance €400 billion worth of bonds (chart 3). The bond market is telling you it is going to be a challenge. The ECB has until very recently seemed capable of controlling Italian bond yields through market interventions; however, over the last week or so, Italian yields have continued to rise despite ongoing ECB purchases. According to Italian bond market insiders, there have been days recently where the only buyer has been the ECB. This is unprecedented in a market of that size.

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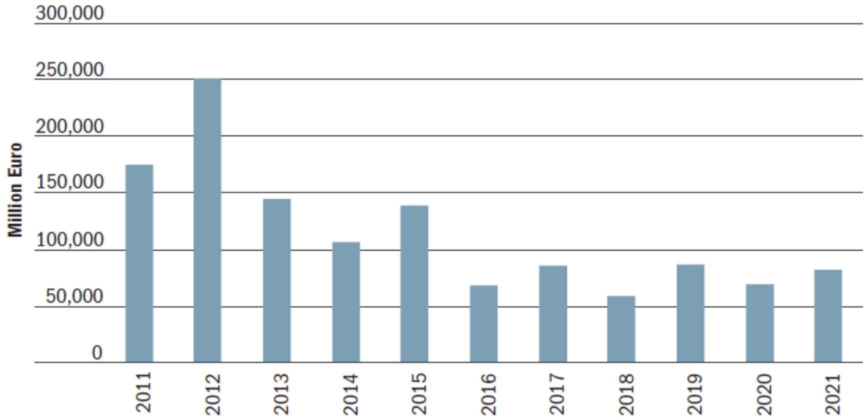
[6] *Expression borrowed with thanks from Steen Jakobsen, Chief Economist at Saxo Bank. See here for details.*

Chart 3: Italian Sovereign Refinancing Needs

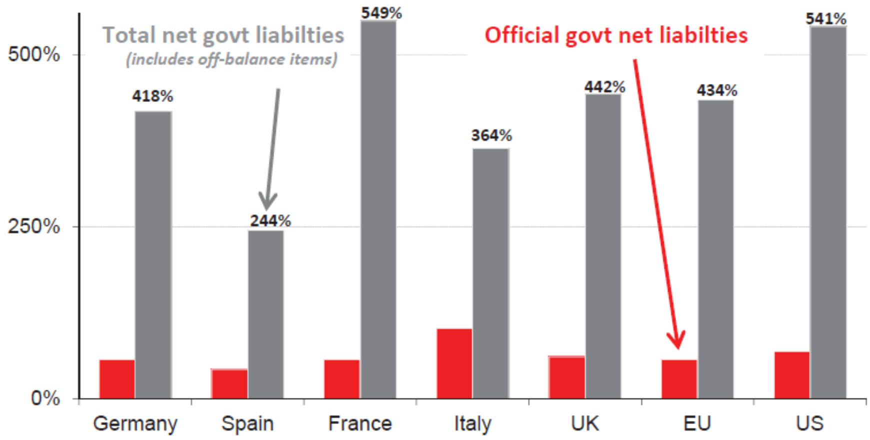


Source: Pioneer Investments, July 2011.

Future liabilities are massive

And the story gets worse; in fact much worse – not only for Italy but for pretty much every major country in the OECD. The truth is, our governments are not telling the full story. Future liabilities (mostly pension-related) are to a large extent kept off balance sheet, resulting in true obligations many magnitudes higher than the widely publicised official debt ratios (chart 4). If you have the stomach for the full and unmitigated truth about future liabilities, look at this link.

Chart 4: Total On- and Off Balance Sheet Government Liabilities (% of GDP)



Source: Societe Generale Cross Asset Research, 27 October 2011.

At the Fed summer symposium in Jackson Hole earlier this year the Bank for International Settlements (BIS) presented a paper which spelled out the challenges facing policy makers in the years to come[7]. The authors concluded:

"A clear implication of these results is that the debt problems facing advanced economies are even worse than we thought. Given the benefits that governments have promised to their populations, ageing will sharply raise public debt to much higher levels in the next few decades. At the same time, ageing may reduce future growth and may also raise interest rates, further undermining debt sustainability. So, as public debt rises and populations age, growth will fall. As growth falls, debt rises even more, reinforcing the downward impact on an already low growth rate. The only possible conclusion is that advanced countries with high debt must act quickly and decisively to address

[7] See *http://www.bis.org/publ/othp16.pdf*

their looming fiscal problems. The longer they wait, the bigger the negative impact will be on growth, and the harder it will be to adjust."

Is monetisation the solution?

More and more analysts conclude that the ECB will ultimately be forced to monetise debt in the eurozone to give it a fair chance of survival. The problem with this line of thinking is that Merkel only secured the support of the Bundestag for the Greek rescue package on the strict condition that the ECB will *never* be permitted to pursue such a policy and herein lies the challenge for the ECB. Does it adhere to German demands which will almost certainly engineer at least a decade of abysmal economic growth in Europe? Or does it risk the wrath of Germany with everything that entails, including a possible German exit from the eurozone? I am not entirely sure which outcome will prevail, but I do know that the answer to this question will ultimately define the European political and economical landscape for at least a generation.

Given Germany's history you can understand why they are slightly paranoid about monetisation of debt; however, inflation should be the least of our concerns in the current environment. De-leveraging is by definition deflationary, not inflationary, which provides monetary policy makers with a unique policy opportunity. For that reason I fully expect the ECB eventually to join the Fed and the BoE in pursuing a more expansionary monetary policy.

The Germans will pretend to be both angry and disappointed but do not be mistaken. A weak-ish euro is a massive advantage for Germany's large export industry and the Germans would be mad to leave the euro in exchange for a new currency which would instantly appreciate in value.

Chart 5: Merkel Carries the Weight of Europe on her Shoulders

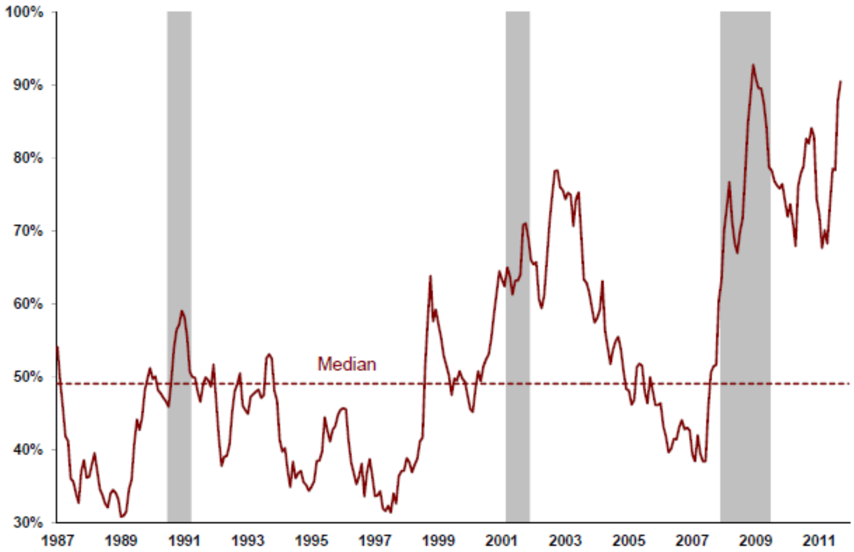
Source: The Guardian

The boomers need income

All of the above leaves investors in a bit of a pickle. With a wave of retirements fast approaching from a generation of boomers now in their 50s and 60s, investors need income but, where income is (deemed) safe, yields are low, and where yields are attractive, investors do not want to go. That is at least the case in the market for sovereign risk.

An alternative to sovereign risk is corporate risk. Corporate bond prices – particularly in the high yield space – took a knock back in July-August as investors reduced the risk profile in their portfolios and they have not yet fully recovered. As a consequence, high yield spreads, measured as a percentage of total yields, are near 25-year highs (chart 6) but, unlike sovereign balance sheets which are in a sorry state in many countries, corporate balance sheets are overall in good condition.

Chart 6: U.S. High Yield Spreads as % of Total Yield



Source: Kingdon Capital Management, JP Morgan.
Note: Shaded areas indicate U.S. recession.

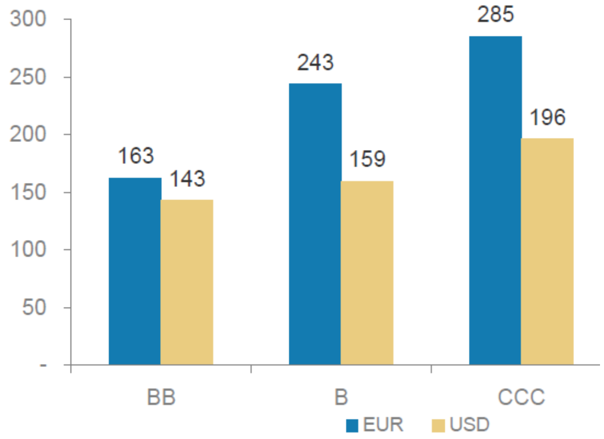
Meanwhile, default rates are close to 25-year lows (chart 7), reflecting a combination of solid balance sheet improvements over recent years and an economy that is muddling through if not firing on all cylinders. Equally importantly, high yield issuers took advantage of a benign funding environment in 2009-10 to refinance existing loans and bond issues. This effectively means that the refinancing needs for corporate bonds issuers for the next several years are only a fraction of that of sovereign issuers. (Unfortunately, I do not have a similar chart for Europe but would expect the picture to be broadly similar.)

Chart 7: U.S. High Yield Default Rates near Lows

Source: Kingdon Capital Management, JP Morgan.
Note: Shaded areas indicate U.S. recession.

Returning to the European opportunity set for a moment, high yield spreads are currently more attractive here than they are on the other side of the water (chart 8). This is partly due to the eurozone crisis and partly because of inferior liquidity in European markets when compared to US high yield markets. However, European corporate balance sheets are by and large of comparable quality to US corporate balance sheets, providing an attractive opportunity for investors.

Chart 8: Leverage Adjusted Spreads More Attractive in Europe



Source: Morgan Stanley

Conclusion

Take another look at chart 2. European non-financial companies have issued just over €1 trillion of investment grade debt and about €134 billion of high yield debt, representing a market about 15% the size of the €7.5 trillion EU sovereign bond market. If more and more investors buy my thesis – that many corporate bonds offer better value than government bonds – there is the potential for a massive valuation shift between the two.

Having said that, I wouldn't touch the market for corporate bonds issued by financial firms - a €1.2 trillion market according to chart 2. The good times are over for Europe's banks. The future will be characterised by higher capital requirements, less risk taking and thus lower return on equity. At the same time, as the sovereign crisis worsens (yes, it is going to get worse before it gets better), policy makers will not be able to ring fence the banks in perpetuity. Bond holders will suffer the consequences.

On the other hand, the appetite for income will continue to grow – from private investors keen to secure some steady income during retirement but also from pension funds faced with a tsunami of retirements amongst their members over the next 10-15 years. This dynamic is already in play and has driven bond yields in (so-called) safe havens down to levels considered unimaginable only a few years ago.

It is a fallacy that there is a shortage of capital in the world today; there is actually plenty of dosh around. What the world lacks is not money but risk appetite and that could take a long time to change - a very long time. Confronted with this reality, investors will increasingly look for alternatives to the meagre returns of 1-3% they are offered on those government bonds deemed to be relatively safe. As long as corporate treasurers continue to manage their balance sheets as well as they have done in recent years, they could fill a void for which there is enormous appetite.

Precisely for that reason I fully expect more and more investment grade corporate bonds to trade at yields equal to or below that of comparable sovereign bonds and I certainly wouldn't be astounded to see significant yield compression in high yield over the next few years. Just one note of caution: expect the road to be bumpy!

Niels C. Jensen
8 November 2011

Important Notice

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