

The Sovereign Debt Crisis - A New Bear Market?

*Structural risks
 are back in focus*

Over the last few weeks markets have focussed back on the underlying structural risk of sovereign debt. With renewed risk aversion commodities, share markets, riskier currencies and debt markets have all sold off and are back to December 2009 levels.

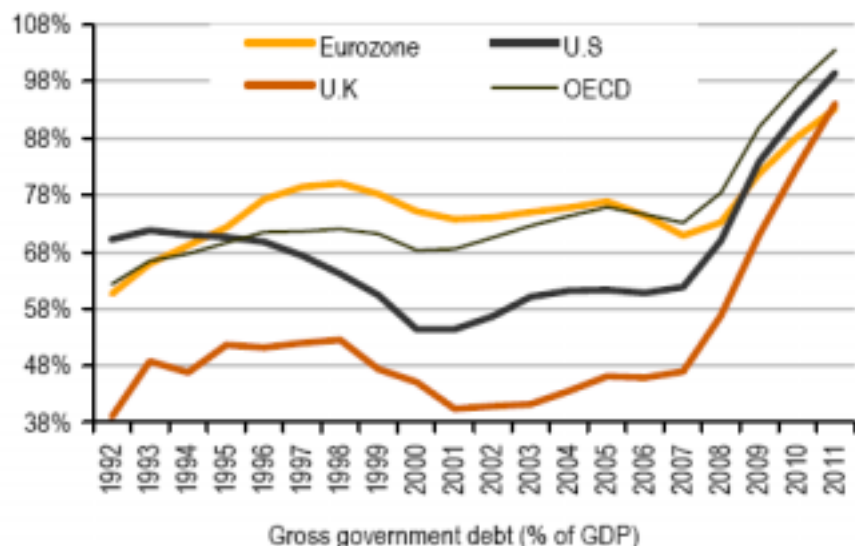
This risk aversion is a function of concerns that sovereign debt levels are reaching critical peak levels and that reduced Government spending in response to the debt peak will curtail economic growth, triggering a second round global recession. While this is possible, is not our central view.

*Sovereign debt
 exacerbated by
 the bailout of
 2008 & 2009*

High levels of sovereign debt are not new and have been significant concern and topic of debate over the last 20 years. However the level of debt was exacerbated by the cost of the global financial system rescue and stabilisation in 2008 and 2009 when Governments were required to urgently spend money to stimulate economic growth as private sector activity collapsed.

This growth in public debt is illustrated in the following graph.

Public debt-to-GDP ratios



Source: IMF/OECD

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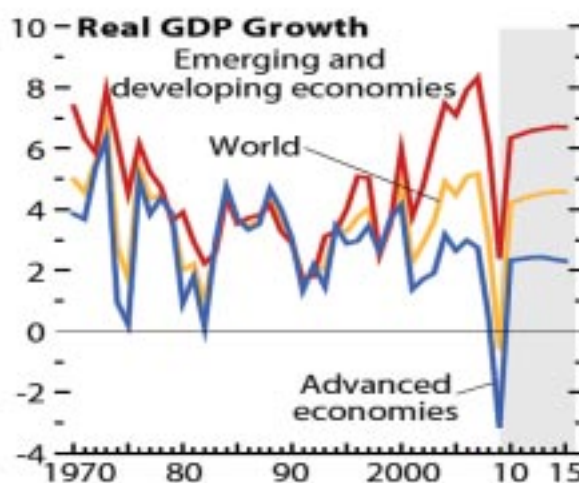
The cost of rescue has been high . . .

The rescue of the global financial system worked and economic growth rebounded strongly assisted by government stimulus spending packages. The cost has been a sharp increase in operating deficits and overall public debt for most developed countries. The theory is that debt can be addressed over the long term once economic growth has recovered and the debt to GDP ratio and cost of servicing the debt falls as GDP grows.

Balancing the short term cost of stimulation against the need to repay it in the future was always going to be a juggling act and many refer to it as the great experiment. Few are in doubt that had the financial system not been rescued and economies stimulated back into life that the world may have fallen into depression. So, the policy was right but what about the cost now?

Sharply increased debt levels and servicing costs are putting real pressure on weaker economies particularly in the Eurozone. Investors are now questioning the ability of some sovereigns to repay their loans and refinance with a growing sense of dread that a contagion affect could spread from the weaker countries to the other indebted countries triggering another round of financial system crises.

In response to this building market concern, the Eurozone members through the European Commission, European Central Bank and with IMF help announced a stabilisation package in May to provide credit facilities for its weaker member countries. This support will only be provided if those weaker member countries start aggressively dealing with their government spending.



Source: IMF World Economic Outlook Apr 2010

Removing stimulus too quickly carries significant risks

This has triggered another concern for markets as there is a real risk that reducing government spending before a full and self sustaining economic recovery is embedded would tip indebted countries and potentially the world back into recession. Clearly, this is not a desirable outcome and some of the panic austerity responses by the weaker Eurozone members (Greece, Ireland, Portugal and Spain) are not particularly helpful. Ireland is a case in point where retrenched Government activity (20% cuts) is actually driving their economy backwards preventing it from growing its way out its debt. They face a hard road.

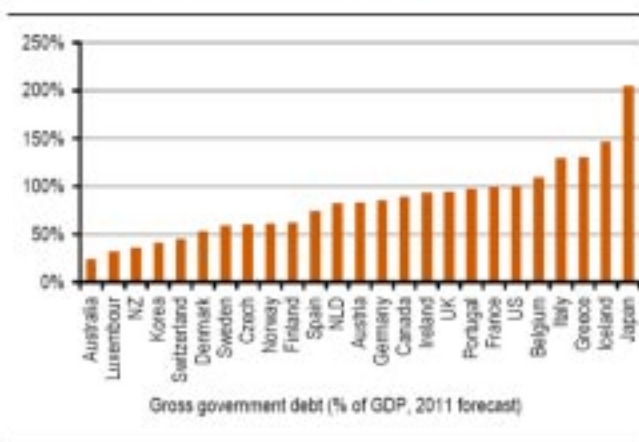
Europe the Primary Problem

At present, the sovereign debt crisis largely resides in Europe and is a function of a weak and disjointed policy response.

The creation of the Euro and common monetary policy block designed to enhance trade and global competitiveness had one major flaw – it was predicated on the basis that member countries would be responsible and adhere to the Maastricht Treaty which required collective responsibility. Instead, not one of the members of the Eurozone have met their ongoing debt to GDP ratios, inflation rates and the Government budget deficit to GDP ratio targets that were agreed on. While monetarily the member states are joined at the hip they remain fiscally divergent.

Europe has the biggest problem

Public sector debt-to-GDP ratios, by country, 2011 forecasts



Source: IMF/OECD

The Euro meant it was possible, for the PIIGS (Portugal, Ireland, Italy, Greece and Spain) in particular to access low interest rate money and then misallocate these funds to low productivity government expenditure and other activities such as over construction in residential real-estate. Not enough funds were deployed into productive behaviour particularly, business investment.

The PIIGS have misallocated capital

Europe, particularly the PIIGS, have been living beyond their means for a decade. Greece for example has an average retirement age of 58 which has recently been raised to 61. They fail to collect taxes from up to 35% of their economic activity and tax evasion is a national sport.

Cheap foreign finance for Greece has enabled them to be fiscally irresponsible to the point they were hiding their true government operating deficits from the EC until October 2009 (following a new government). Sounds like NZ finance company behaviour.

The Solution In Europe

While the global sovereign debt must be attended to, investment markets are really looking for a categorical assurance that Government policies will now be implemented to address the debt problem, sensibly and over time.



The European bailout package is impressive but only provides temporary relief

Fiscal control mechanisms are being put in place

Longer term the Euro may be shelved

In Europe this is proving a challenge with the European Commission and European Central Bank consistently behind the market. There is no doubt the recent ECB 750bn euro bailout package is impressive. The package represents about 11% of the total sovereign debt in Europe and 70% of all the debt of Greece, Portugal, Spain and Ireland. The facility effectively covers all their debt for at least 2-3 years and possibly longer). But, it only addresses the liquidity problems and not the fundamental issue of making members fiscally responsible.

In many ways the bailout represents a moral hazard as it is largely underwritten by the relatively wealthier ECB members (read Germany who has kicked in 160bn euro) and the IMF 250bn euro (read US and Japanese taxpayers). In return, Spanish, Portuguese and Greek Governments have all announced fiscal measures (cutting public sector wages, health and welfare spending and cracking down on tax evasion) to cut their Government operating deficits (from as high as -14.7% of GDP for Ireland and -12.2% for Greece) back to a maximum 3% of GDP p.a. within 3 years. This is a very tall target and still won't stabilize their gross national debt which would continue to rise.

While there is a lot of discussion about Germany leaving the Euro or Greece being kicked out, this is much harder to achieve than it sounds. Members being kicked out (it can't be legally done at present) would simply default on their loans and we would see massive capital flight. While a sharply lower valued Drachma would help Greece be internationally competitive again, its reinstatement could simply fail – who would want a new currency they know is going to devalued?

We don't expect members to leave the Euro. More realistically the Eurozone's 27 members will vote to introduce new institutions that can monitor, control and enforce fiscal policy at the member state level. This will not be easily achieved, but realistically there is no other short to mid-term solution.

Investment markets are looking for this policy intent and we expect it will be signalled over the next few weeks but it may be months before there is sufficient detail to assuage markets. So there is a likelihood of more market volatility in the short term.

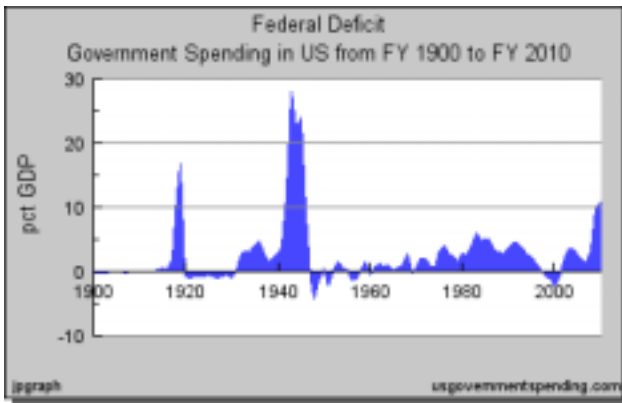
Longer term, we don't expect Greece can both repay debt and achieve sufficient growth to work their way out of their problem. The likely solution will be debt restructuring with international lenders to Greece having to write-off a portion of their loans (possibly 30 to 40%). The same could happen for Spain and Portugal which will be much more painful just like the Latin American debt restructuring of the 80s & the Asian and Russian debt crises of the 1990s.

Also longer term, Euro members will need to determine if they have the ideological and political will to retain their confederation particularly, the Euro. With long-term lower Eurozone growth the likely result of its sovereign debt overhang, wealthier member taxpayers may well lose patience and question the logic of throwing good money after bad. Thus, we would not be surprised to see the longer term demise of the Euro which might be exactly the solution they need to restore efficient allocation of capital across their states and allow them to individually leverage their natural competitive capacities (or not).

In the meantime, economic growth in Europe is still expected to be positive in 2010 with UBS recently upgrading their outlook from 1.5% to 1.7% growth (Germany at 2%) on the back of a sharply weaker Euro increasing the global competitiveness of its members. While these are slow rates of growth and insufficient to deal with sovereign debt growth, they indicate a resilience and show Europe is out of recession and capable of working its way back.

Elsewhere

Sovereign debt levels elsewhere are also significant but less problematic. In the US public debt is approaching 100% of GDP (and likely to exceed this) a level not seen since world war two and Federal budget deficits are approaching 11% of GDP. This rapid rise in growth of debt was a direct consequence of the US Government bailout (continuing) of financial institutions in 2008 and 2009.



Effectively much of the private sector risk has been transferred onto the Government balance sheet in an effort to stabilize the financial system and stimulate economic growth. The intent was to smooth the deleveraging process, control the rate of decline in asset values prevent widespread unemployment and avoid a depression. This strategy though expensive and clearly delaying longer term debt restructuring has been effective.

It can be argued that the US, while running historically high debt levels has the appropriate monetary and fiscal policy tools, policy intent and demographics to grow their way out of their debt problems over time. They also seem to grasp the requirement to ensure sustainable economic growth is underway before commencing a programme of debt containment and repayment. In the meantime its citizens are becoming increasingly nervous about the future burgeoning costs of the new healthcare package, unemployment support, unfunded pension obligations and military actions. The pressure is coming on the Obama administration to show it has a credible plan for reducing deficits and debt levels and we expect to see more constructive policy on this over the rest of 2010 (or they will be forced to by the markets). In the meantime, economic data in the US is showing signs their economy is moving to a self-sustaining footing and they are on track to deliver a 3 to 3.2% expect economic growth rate in 2010. Again, while this is presently insufficient to deal with their sovereign debt growth it shows their economy has moved well out of recession.

While Japanese public debt level at 200% of GDP looks terrifying, unlike Greece (where 80% of its debt is held by foreigners) most of Japan's debt is funded by the Japanese. Their debt problem is domestic. If you net off inter-Government loans, Japanese public debt is actually closer to 100% of GDP. In fact Japan holds more than \$US 1 trillion in foreign reserves so is effectively a net lender to the world. Japan's problem remains one of growth. After being trapped in a deflationary cycle since 1991 (as they did not write-down overvalued assets following the 1990 recession and property market crash) Japan is starting to show signs of growth again). At a 4% growth rate Japan can work itself out of

US debt is also a concern

Japans debt while high is less worrying



its public debt position and the government has plenty of room to raise taxes (when growth has finally arrived) to further repair its balance sheet. Japan's biggest challenge remains its shrinking and aging population. Japan needs to get productivity rising through business investment to offset population decline and this is starting to happen as rapid growth in China and non-Japan Asia is starting to underpin growth in Japan. In the last quarter of 2009 and the first quarter of 2010 Japan achieved their fastest rate of economic growth in 10 years at + 4.9% annualized.

World Imbalances & Market Response

For much of the last decade developed countries have leveraged their economic growth through a combination of private / public debt. This debt has not been used for sufficiently productive purposes, either stimulating non-sustainable consumerism, property/asset inflation and welfare activities. Living beyond our means has become a generational normality.

It takes a brave politician, and only one that has been absolutely backed into a corner to acknowledge the gravy train has stopped and it is time to accept a lower standard of living while the lenders get repaid. Greece, Ireland, Iceland, Latvia, Estonia, Portugal, Spain and now the UK have all been firmly backed into that corner.

We expect that the sovereign debt imbalances will take a generation or more to stabilise and be returned to sustainable levels. For the debtor nations the consequences are sub-optimal growth for longer and a lower standard of living.

Investment markets are now telling indebted nations, loudly and clearly, that it is time to start addressing their debts seriously and to embark on responsible policy to repay them.

Markets now want to see:

- 1) Debtor country recognition of their balance sheet problems and a political determination to address it, but...
- 2) Not suicidal austerity measures that will collapse economic growth and only exacerbate operating deficits and debt levels
- 3) Continued co-ordinated global government policy on financial system stability measures
- 4) European bank balance sheet recognition of losses, capital injections and nationalisation if required
- 5) Sensible 3- 5 year financial market regulation (leverage, disclosure, transparency, accounting, licencing and pricing) but not silly short term panic political responses such as Angela Merkel's ban on the naked short selling of financial stocks (which is ineffective anyway) and only triggers market panic.

These assurances will not come easily and to date have been disjointed and ineffective. Markets have not been reassured as a result and despite better global economic data, corporate profits and signs we are returning to sustainable growth, the appetite for risk has fallen sharply. As the policy makers start to get their collective act together (the reason for Timothy Geitner's visit to Europe this week) we expect markets will start to refocus once again on the global economic recovery story.

Meanwhile, NEWTON ROSS's client portfolios remain well diversified and in high quality assets to cope with this volatility. We have also ensured each portfolio has been designed to work within a pre-defined risk range for each client.

Governments are moving to restore market confidence

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