

## Viewpoints

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### The New Year Rang In with High Spirits: Now the Hangover?



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Risk assets got off to a bubbly start early in January, but will investors end up with a debt-induced hangover? Already, we have begun to see a modest pullback in risk assets, after initially sustaining the rally that began in 2009. The combined impact of exceptionally low interest rates, quantitative easing and fiscal stimulus all provided a positive backdrop for 2009.

However, investors may be pausing to ponder the lasting implications of massive global stimulus, deficit spending and the sequential contamination of balance sheets that characterise the New Normal.

Dating back to 2001, corporate balance sheets were in disrepair and through exceptionally low interest rates and tax cuts, consumers were encouraged to borrow and spend, effectively leveraging the household balance sheet. The subprime mortgage crisis exposed the overvaluation in the housing market and the leverage in the consumer sector, resulting in massive losses for finance companies. Through stimulus and guarantees, the burden was shifted to the public sector in 2009.

Many would suggest that the financial system and the global economy have been saved from the brink of the second Great Depression. Some would argue that we have simply delayed the inevitable.

Just as an act of fate or hubris often led to the hero's fall in a Greek tragedy, is record stimulus spending by many governments the fundamental mistake that exposes the fatal flaw and results in disaster, or will it lead to another classic element of Greek drama, a drastic change that transforms ignorance to recognition?

All too often life imitates art, and in this case, the debt and deficit dynamics of sovereign balance sheets could eventually lead to more problems. Sovereign credit spreads are under increasing pressure this year due to the combination of a weak economic recovery and deteriorating government debt and deficit fundamentals.

The following table shows bid-side credit default swap (CDS) levels for a number of countries and cumulative default probabilities using the market-convention 40% recovery rate.

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## Bid-Side CDS Levels and Cumulative Default Probabilities

	5-Year CDS (bid bp)		YTD Change	Cumulative Default Probability
	29/12/2009	20/1/2010		
Germany	24	32	8	2.74%
France	31	44	13	3.75%
Portugal	89	137	48	11.23%
Spain	110	131	21	10.77%
Italy	108	111	3	9.20%
Ireland	157	154	-3	12.53%
Greece	280	340	60	25.60%
UK	79	80	1	6.72%
Japan	65	81	16	6.29%
US	35	41	6	3.50%

Source: Bloomberg and PIMCO

Greece, Italy and Japan all suffer from public sector debt levels that are greater than 100% of GDP and are running public sector deficits over 5% of GDP. France, Spain, Ireland, Portugal, the UK and the US also have public sector deficits of more than 5% but have slightly better debt statistics ranging from 50%–100%.

The dynamics of the sovereign CDS markets are particularly interesting when put in the context of investment grade credit, particularly in Europe where the probability of default in the high-debt, high-deficit countries is acute, as the table above illustrates. The SOVX index, which tracks credit default swap premiums for a basket of fifteen European countries, is trading wider than the iTraxx Europe index, which tracks 125 investment grade companies.

The problem with this simple analysis is that the relative premium levels do not account for the country composition. We can expand the analysis by tracking a bespoke basket of a country's corporate CDS against its sovereign CDS.

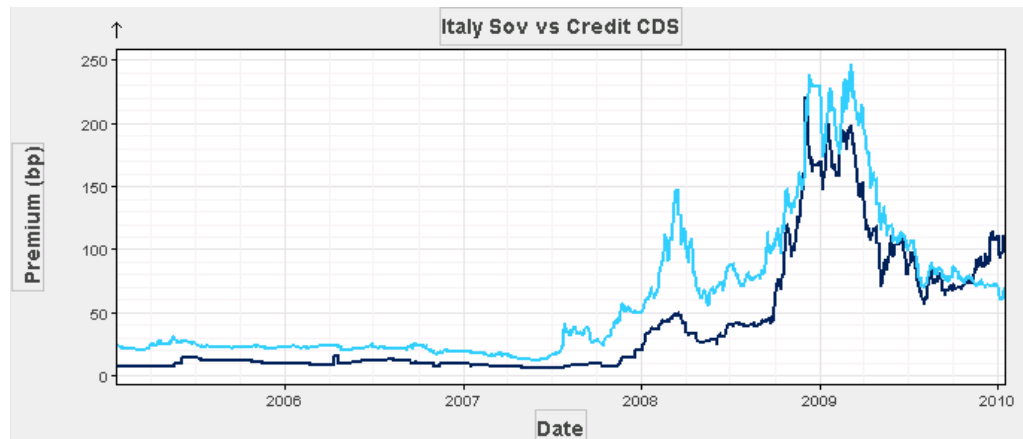
Italy provides a good starting point for a more controlled analysis, as it is the largest European economy with a meaningful default probability priced into the sovereign CDS market. It also has relatively liquid CDS for many of its companies. Spain and Portugal share similar characteristics, albeit with less liquidity, while Greece is more complicated since there are really no liquid CDS for individual companies.

The following chart shows the CDS premium levels for Italian sovereign debt (dark blue line) and for a basket of prominent Italian companies (light blue line). Combined, these companies represent about 45% of the Italian stock market capitalisation.

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## CDS Premium Levels: Italian Sovereign Debt and Prominent Credits



Source: Barclays

The two series tracked each other relatively closely leading up to and during the financial market crisis. Recently, however, concern about debt levels and growth prospects has pushed sovereign CDS spreads wider while corporate credit spreads have continued to narrow. The trend is similar in Spain and Portugal.

While only recent, this phenomenon should spark intense debate among market participants. One camp might argue that it is difficult to justify sovereign credit spreads that are wide relative to domestic companies, as the sovereign will always exercise its right to levy taxes and fees to correct its balance sheet at the expense of the private sector. The other camp might suggest that many corporate balance sheets are pristine, and for particularly strong companies with a global footprint, the risk of default is indeed lower than the sovereign as they can only be taxed where they earn revenue and, in an extreme case, could change their domicile.

One could attempt to rationalise the recent trend as a result of technical factors that drive the sovereign CDS markets, such as a valuable delivery option in the event of default, differences in financing markets or hedging needs by financial institutions. However, these conditions have existed through time, and it is only recently that the spreads have diverged. Furthermore, technical conditions should correct relatively quickly as market participants take advantage of the arbitrage opportunities.

The recent widening in sovereign CDS spreads – particularly Greece – warrants close attention and the coming weeks and months will be critical. In the absence of action, funding costs will continue to increase for high-debt, high-deficit countries, creating the potential for a vicious spiral. Greece recently sold a €8 billion, five year syndicated bond issue. While it was reported to be heavily oversubscribed, it carried a significant yield premium to comparable German Bunds, the bellwether for eurozone bonds. The 6.1% coupon raises the spectre of an increasing interest burden on an already cash-strapped fiscal budget. Furthermore, the issue did not trade well in the days following the auction, raising additional concerns, as Greece still has significant funding needs this year. The situation highlights the urgent, yet difficult, list of choices facing policymakers, including fiscal austerity, super-sovereign intervention or default. Fiscal austerity is politically unpopular and requires deft choices between spending cuts and

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tax increases. Both lead to a transfer of private sector wealth to the public sector and are likely to lead to lower income and profitability with implications for risk assets. Super-sovereign intervention involves transfer from low-risk countries to high-risk countries and could perpetuate moral hazard, contaminate the remaining strong sovereign balance sheets and kick the can farther down the road. Default would seem untenable, but in the absence of austerity or intervention, it may be inevitable.

If the risk perceived by the credit default swap market persists – or continues to increase – the message to policymakers should be clear: There is a limit to deficit spending and stimulus, and the cost of policy mistakes will be to expose the frailty of the system and potentially result in tragedy.

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