

# Recycling the crisis

The calendar has ticked over to a new year, however that has not changed the state of the market. Equities continue to rally while bond yields sell off, furthering the momentum established from mid 2009 onwards. Can this continue? 2010 can be aptly dubbed the 'year of living dangerously' as the global markets walk a fine line of cleaning up decades worth of debt ridden balance sheets, while attempting to engineer GDP growth, job creation and a seamless exit from the stimulus facilities. Not an easy task.

## A sovereign default may be lying in wait

Adding fuel to the fire is the risk of a sovereign default. As central bankers became engrossed with fixing the financial crisis, fiscal policy was placed on the back burner in most developed nations. Governments recycled much of the bad debt from the private to the public sector, creating imbalances that appear as unsustainable as the originals. In many countries, government debt has swelled to unprecedented levels, and morphed into something that is several multiples higher than any private balance sheet. Typically fiscal deficits expand, often relying on taxpayers to finance them; however this eventually results in a severely depreciated currency, hyperinflation, or even a default. What many investors do not recognise is that sovereign defaults are potentially more disastrous as they can cause not only geopolitical and societal instability, but also lead to severe economic consequences.

The likelihood of a sovereign default looms large over the next few years. In just the past two months, the market has been inundated with news of potential insolvencies following the debt crisis in Dubai and rating downgrades

of Spain and Greece. While Dubai welcomed a \$10 billion bailout from Abu Dhabi, Spain and Greece were not as fortunate.

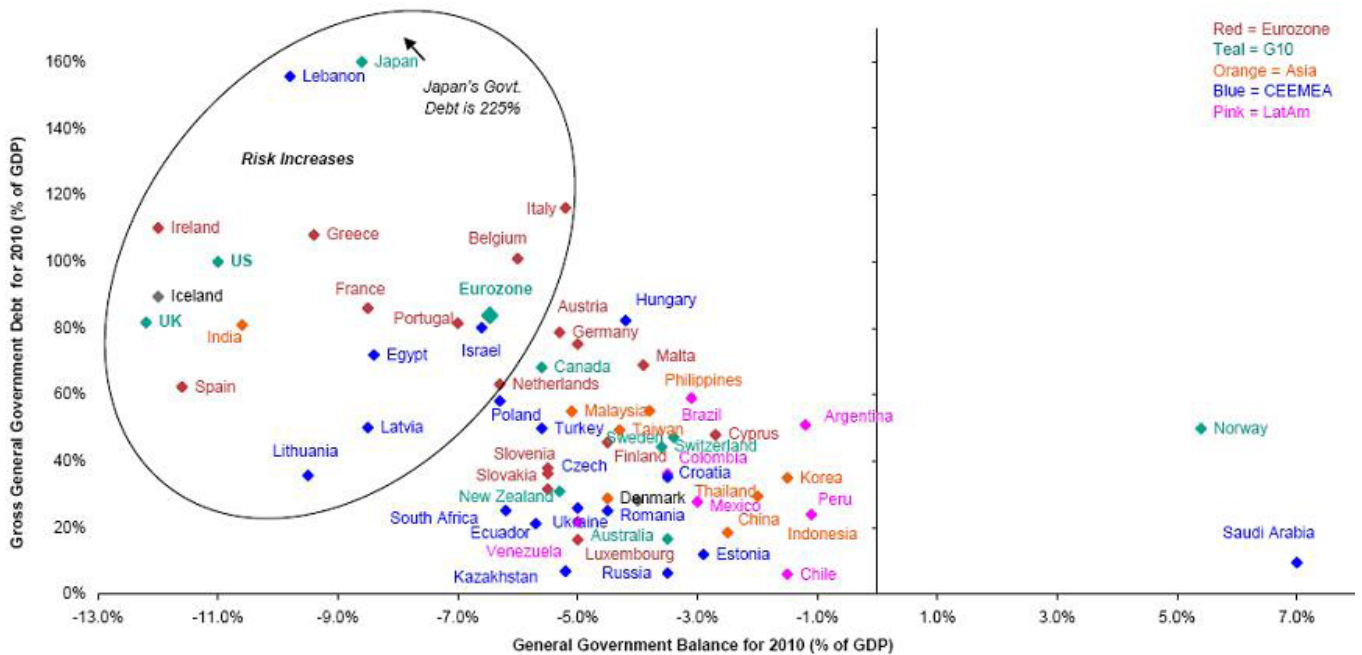
In early December, Spain's outlook was revised down to negative from stable by S&P owing to fears the nation will face 'significantly lower GDP growth and persistently high fiscal deficits relative to peers over the medium term, in the absence of more aggressive fiscal consolidation efforts and a stronger policy focus on enhancing medium-term growth prospects'. Just one day earlier, Fitch articulated deep concern about the health of Greece. According to Fitch, the government debt burden is likely to rise to close to 130% of GDP before stabilising. While the Greek Prime Minister George Papandreou has pledged to significantly cut the nation's budget deficit by overhauling the nation's tax system and reducing government spending, he admits that the budget deficit will be more than 12% of GDP this year, and the country 'faces the risk of sinking under its debt'. Simply put, Greece cannot continue down its current path.

## Huge deficits are unsustainable

Similar to Spain and Greece, other large developed nations cannot continue piling up massive deficits without serious consequences. The chart below displays the relationship between the gross general government debt and the general government balance for 2010 (both as a % of GDP). Countries within the circle are considered to have high gross debt levels and large current budget deficits. Unlike previous crises, the countries posing the biggest risk are in the developed world. The majority of Latin American, Asian, and CEEMA<sup>1</sup> countries have relatively strong fiscal positions, whereas G10 (specifically G4) and Euro zone countries seem the most vulnerable.

<sup>1</sup> CEEMA: Central & Eastern Europe, Middle East and Africa

Gross general government debt for 2010

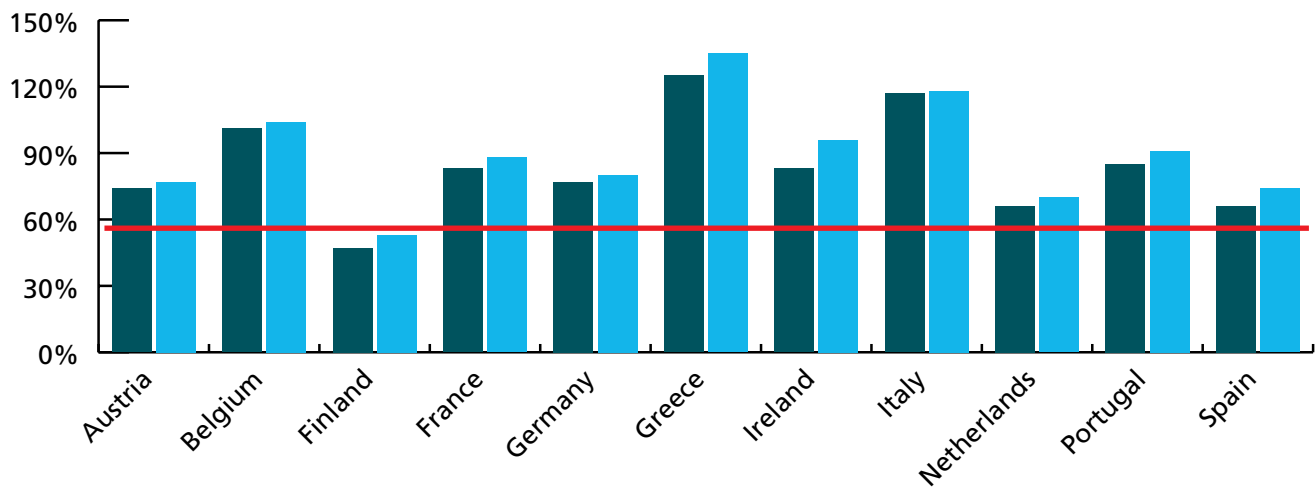


Source: RBS, Moody's database, Fitch Sovereign Database

While the likelihood of default in EMU countries is a possibility, it is unlikely in the United Kingdom and the United States, even though both countries face a grim outlook in terms of their balance sheets and mounting debt. Until recently it was assumed that the credit rating of many countries was bullet proof. However, the Wall

Street Journal has reported that 'half of the 16 euro-zone countries are deemed to be at 'high risk' in terms of the sustainability of their public finances... with rating firms poised for more downgrades and bond markets meting out daily judgment over how governments are doing.'

Government debt as a percentage of GDP



Note: Red line indicates max threshold as per the EMU Maastricht Treaty

Source: Danske Markets, European Commission

## Strong headwinds for the UK and US

The United Kingdom is due for an election this year. A hung parliament would create massive uncertainty potentially causing the UK to lose its coveted AAA rating. The result would certainly have knock on effects to both the currency and government yields, further compounding the task of funding Britain's deficit which is already expected to be well over 13% of GDP – the worst of any OECD country.

The United States is also facing strong headwinds. National debt now exceeds \$12 trillion. The cost of servicing that debt is greater than \$200 billion for 2010, and is expected to reach \$700 billion by 2019. If bond yields move higher, that figure would increase significantly. Estimates show that if Treasury's cost of

borrowing increases by one percent, the cost of servicing the debt increases by nearly \$100 billion. So while it may be in the best interest of the United States to keep rates low, the market may start demanding a premium on bonds based on the enormous debt burden. Furthermore, as the Fed slowly exits the stimulus programs, interest rates will move back to more normal levels.

## Australia is in a good position

While the rest of the world attempts to recover from the global recession, Australia remains very resilient. It was fortunate to encounter only a mild slowdown through 2009 and economists are now estimating that growth will exceed expectations for 2010. All signs point to further interest rate hikes in the New Year as the RBA is focused on returning to a more neutral policy stance.

## Things to think about for 2010

1. With global growth expected to take hold, global government bond yields should continue to move off their current low levels. On the supply side, major developed countries will need to continue to issue massive amounts of debt to fund their fiscal hole. Unless governments reveal clear strategies for decreasing the deficits, appetite for government debt will wane. Therefore, Kapstream does not see much value in holding government debt.
2. The debt tsunami poses a real threat to the global economy. Consumers and governments remain stretched, which will result in a moderate recovery at best.
3. Investments in Australia will provide attractive returns even as the RBA normalises rates. Investors are still able to lock in high levels of yields for extended periods.
4. Equity markets continue to paint a rosy economic recovery. However, macroeconomic risks remain high. Be on alert!
5. In the event that the world can engineer a full recovery, inflation will be a risk. Historically, there has never been a recession that was not followed by inflationary pressure.