WAISC 2011
The Sovereign Debt Crisis Two Years On: Road to Recovery or Pathway to Perdition?

Sovereign Debt: Road to Recovery or Pathway to Perdition?

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Recovery Partners

The Age of Financial Repression : Themes

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Policy Challenges: Demographics/ Risk Management Failings/ Fiscal constraints. Results in problems with:

Currency Markets

- ✓ *USD Currency War*
- ✓ *Rising Commodity Prices : Arab Sprig effects*

…..also affects:

Lending Markets (and low income countries who import USD denominated commodities)

- ✓ *ZIRP (DEAD US curve / destruction of leverage)*
- ✓ *Basel III – (Built in capital constraints/ loan rollovers / Monetary Destruction)*

…..are Crippled because of a:

A Restructuring Deficit

- ✓ *Moral Suasion*
- ✓ *Mark to Market Rules*
- ✓ *Prompt Corrective Action Law*

Because of this Risks are increasing

The situation is little changed from what we reported on last year, with the exception that the situation is getting a little closer to the edge in both Europe and North America

Sovereign Debt Crises are not new; we have seen sovereign defaults and economic collapses of sovereign states over centuries, back into the times of the Greek and Roman empires.

What is different now is the prevalence and severity of interconnected events. Irresponsible ballooning of sovereign, corporate, personal and institutional debt is global in nature and the traditional sources for bailouts (i.e. United States of America?) are in a state of indebtedness that makes it extremely difficult for the authorities to apply needed solutions.

What is also different is demographics and the shift in economic output: The traditionally strong economies of the G8, most importantly the US and Germany are weakened by an aging population, a smaller workforce and less economic output. This is partly due to a relocation of skilled employment to China, India and other emerging markets. Recovery from the stress of 2008/2009 has been proving to be much more difficult than the remarkable growth phase witnessed after WWII.

Vicious cycle will be painful

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Structural deficits of the public purse exist everywhere, and well beyond the point where stimulus spending runs out

Ageing demographics come with increasing funding gaps for social security, public pensions and health costs

With a smaller portion of the population engaged in producing GDP in the real economy, those that produce income will have to be taxed more to support structural deficits that have not been taken care of and the part of the population that is drawing funds from the welfare state

The private sector is not going to pick up fast enough to replenish the fiscal coffers. In order to survive, private enterprise will continue to increase efficiencies, migrate manufacturing to low cost jurisdictions, reduce workforce in saturated economies and write off the cost of restructuring.

The result is depressed tax revenue from corporations and increased unemployment in Western economies that transform into pure service and consumer economies while Emerging Markets pick up the manufacturing jobs. Cutting the vicious cycle will be painful if not politically impossible:

Political Difficulties

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This leads to a picture of Western Economies continuing to pile up structural deficits with a depressed tax base and ballooning unfunded liabilities towards a rapidly ageing population. Sound sustainable? We think not.

Higher levels of Public Debt are typically associated with a weaker ability to generate rapid growth thus reinforcing the risk spiral;

So far the authorities in the West have chosen a policy path that refuses to recognize these issues and is encumbering the taxpayers of many countries with much higher debt loads while allowing zombie companies and banks to continue operating.

This is building up pressure for the proverbial Train Wreck.

Political Risks

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Europe is now clearly facing political risks from the fact that a population that has grown accustomed to benefits from an unsustainable welfare system will be asked to suffer cuts in public sector wages and social security benefits. Implementing these changes is extremely difficult in a heavily unionized environment and in one that sees the gap between rich and poor increase. Social unrest such as seen in Greece and Spain are just a foretaste of what is in store.

In the US, you can add already unprecedented unemployment levels, ethnic tensions, regional income gaps and the fact that the population has constitutionally supported easy access to firearms of all calibers to the mix. The spectre of social unrest turning into violent riots staged by heavily armed "discouraged workers" becomes more than just a remote possibility in this scenario. This kind of development has the potential to create a significant political crisis in the US, which in turn would have negative feedback effects on the Global economy.

Political Risks

- ***In one scenario, the US, currently the leading force in global politics will come under increased global pressure: former and current enemies (including Al Qaeda) will try to benefit from US domestic and international weakness; the US will have trouble maintaining its global military leadership role as they won't be able to appropriately fund not only their military, but more importantly non-US bases; China in this scenario might step in to seek a deal with the US for Eastern Hemisphere control. All signs suggest that the "deck" holding the global balance of power is being re-shuffled in favor of what we today still so ironically call emerging economies…***
- ***However, the biggest risk here is simply that it has proven very hard to sustain political support for fiscal consolidation plans over the timeframes required for these programs to work. And that inflation risk is beginning to emerge in a number of economies.***

The Track Record

The markets have hailed the Greek, Portuguese and Irish bailouts as evidence that the Sovereign Debt crisis is receding and the appropriate solutions have been identified and are being applied.

The reality is that there are only a handful of success stories among the more than 140 attempts at fiscal consolidation in the last few decades. Defining "success" as a consolidation that reduces Debt/GDP by at least 10%, something that is required for all of the Sovereign zombies, yields a list of only two countries, New Zealand and Canada that have done so in the past.

To clarify this further, there has never been a successful effort mounted in a situation where numerous countries are attempting to achieve the same thing in the aftermath of a Global Financial Crisis (GFC).

Is an Inflation Crisis Brewing?

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Official CPI based price inflation rate on a year-over-year basis rose in the month of August to 3.77% compared to 3.63% in July, 3.56% in June, 3.57% in May, 3.16% in April, 2.68% in March, 2.11% in February, 1.63% in January, 1.5% in December, 1.1% in November, and 1.17% in October. From the low in November, year-over-year CPI growth has increased by 243%!

Inflation is now spreading beyond food and energy and to the areas the Fed focuses on with core-CPI, which excludes food and energy. Core-CPI has now risen 10 months in a row and core-CPI is about to break the Fed's 1.5% to 2% target range,

Core-CPI was up 1.95% in August on a year-over-year basis compared to 1.77% in July and 1.64% in June. Because the BLS likes to round all CPI numbers, core-CPI on a year-over-year basis is now officially 2% and at the top end of the Fed's target range.

Last year in October of 2010 prior to QE2, year-over-year core-CPI growth was at a low of 0.6%.

CPI inflation is also up in the Euro-zone, China and other emerging economies

Charts and Tables

Baby Boomers are Falling Off the Perch!!

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Old people have always been a drag on an economy. Migrating tribes left them behind. Eskimos put them out on the ice. In times of famine, for example, they stopped eating so the young might live.

Boomers will be retiring at the rate of 10,000 per day over the next 18 years. They will sell stocks to finance their remaining years.

According to the San Francisco Fed mortality has doomed the stock market, says the S.F. Fed. P/E ratios will likely be cut in half. Investors are unlikely to see their stocks return to 2010 levels, says the report, until 2027. And this assumes that US companies will continue to grow profits as they did since 1954. Likely?

Deutsche Bank came out with a report of its own confident that the "Golden Age" -- 1982-2007 -- is over. In its place is a "Grey Age." Instead of the nominal 12.8% gains of the Golden Age, investors have gotten returns of -- 2.8% per annum for the last 4 years. Deutsche Bank expects stock market investors to lose about 10% of their money -- in real terms -- over the next 10 years, while the economy goes through 3 recessions

Demographics

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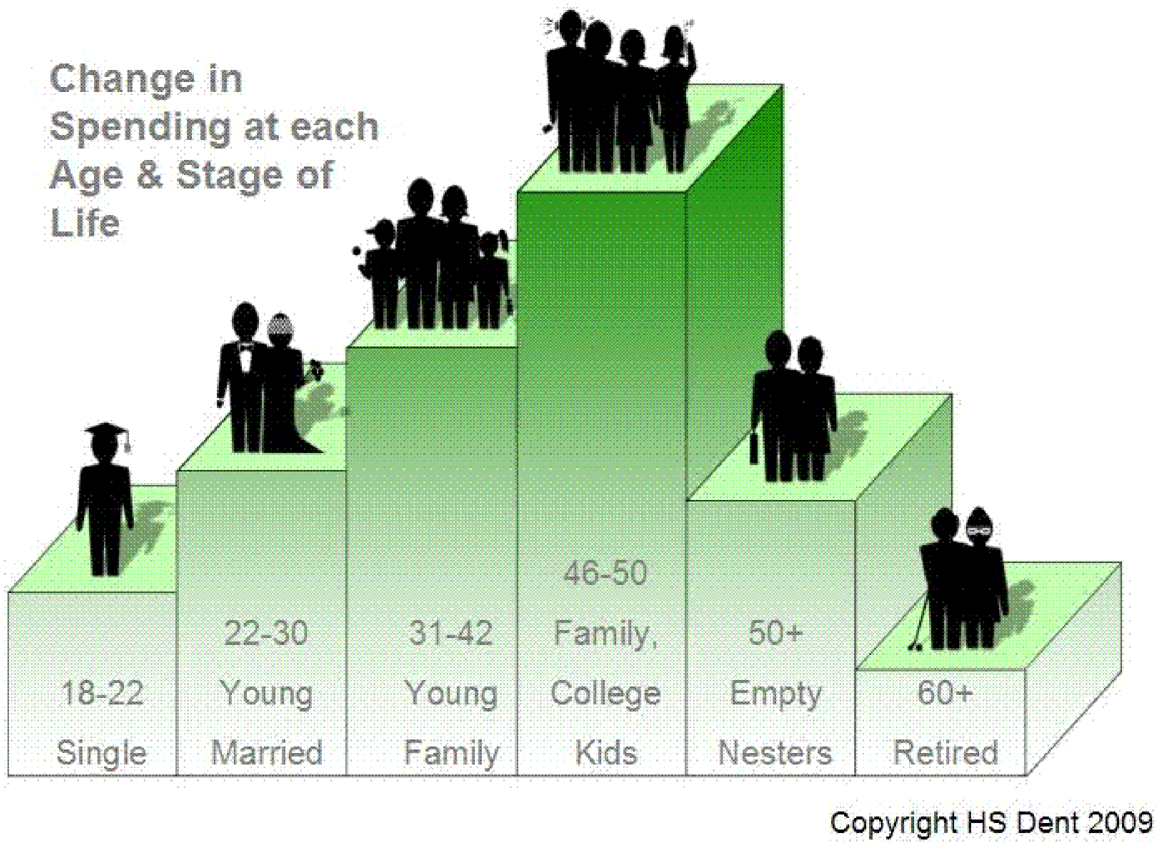

Spending Patterns by Age Group

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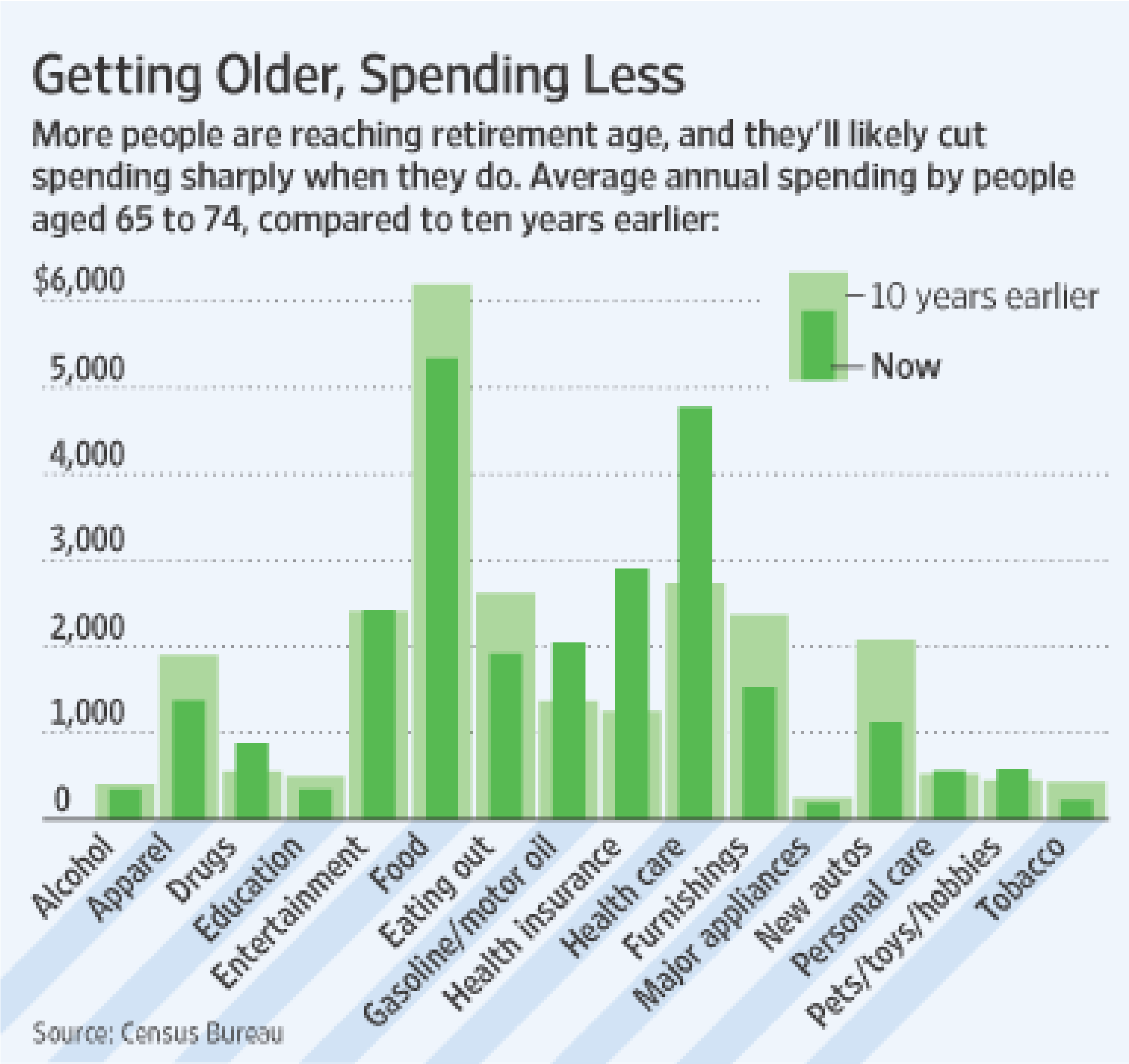

Sovereign Debt Ratings – The Red Zone

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Gross government debt (in percent of GDP)						
Country	2011	2012	2013	2014	2015	2016
Japan	229.1	233.4	238.0	242.4	246.7	250.5
Greece	152.3	157.7	157.0	152.5	149.4	145.5
Ireland	114.1	121.5	125.8	125.0	123.5	121.5
United States	99.5	102.9	105.6	107.5	109.4	111.9
Portugal	90.6	94.6	97.5	100.8	103.7	106.5
United Kingdom	83.0	86.5	87.4	86.5	84.4	81.3
European Union	81.8	82.8	82.8	82.1	80.9	79.4
Iceland	103.2	97.1	92.1	85.3	80.9	73.8
Canada	84.2	83.1	81.0	78.5	75.6	72.6
Germany	80.1	79.4	77.9	75.8	73.8	71.9
Switzerland	52.7	51.2	49.7	48.3	47.0	45.7
Mexico	42.3	42.1	42.0	41.9	41.6	41.4
Denmark	45.6	46.5	46.3	45.1	43.0	40.2
New Zealand	35.8	36.4	36.5	36.1	33.7	31.7
Argentina	40.7	36.7	35.8	35.3	34.3	31.4
Russia	8.5	8.8	9.5	11.3	13.5	15.9
China	17.1	16.3	15.0	13.4	10.9	9.7

International Monetary Fund, World Economic Outlook Database of April 2011, for countries: [1], for the European Union: [2]

*Cross Border EU Sovereign Debt**

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(USD millions)

	Portugal	Ireland	Italy	Greece	Spain
Britain	$24	$189	$77	$15	$114
France	$45	$60	$511	$75	$220
Germany	$47	$184	$190	$45	$238
Total owed to "Big 3"	$116	$433	$778	$135	$572
Overall Total Debt	$286	$867	$1,400	$236	$1,100
Debt / GDP	75.2%	63.7%	115.2%	108.1%	59.5%

* Countries in the top row owe the amounts to countries in the vertical column. Gross debt and debt to GDP ratios are in the two bottom rows.

Source: BIS

Loan Loss Provisions

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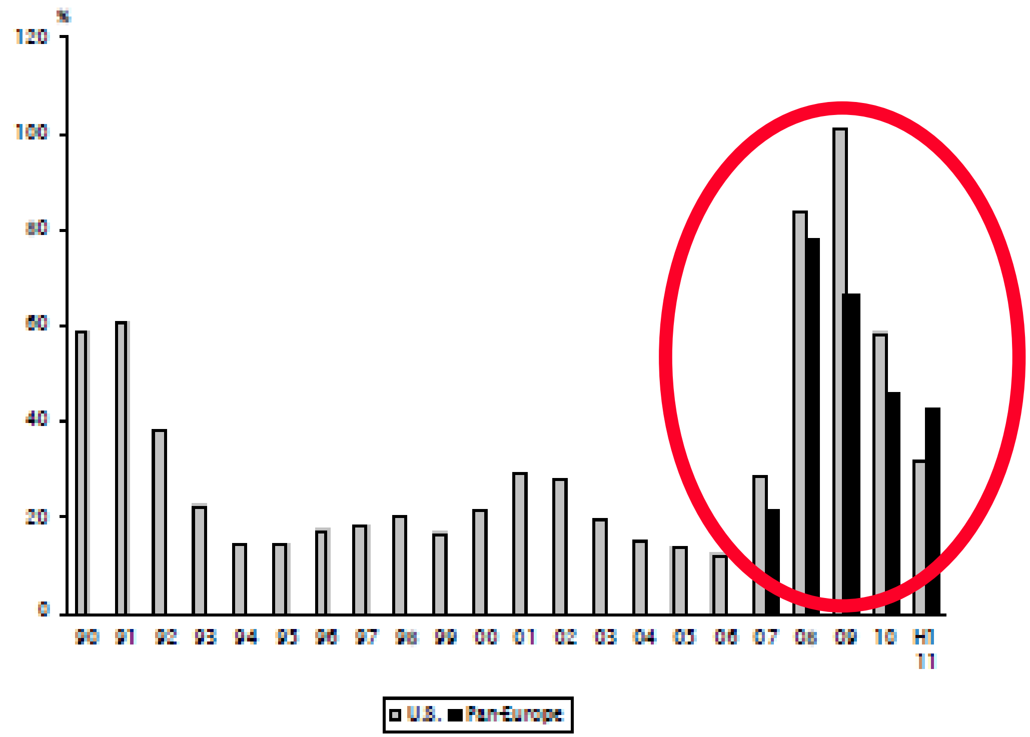
Exhibit 8: U.S. and Pan-Europe: Commercial Banks Provisioning as a Share of Pre-Provisioning Earnings 1990 Through H1 2011



Source: Federal Deposit Insurance Corporation, Empirical Research Partners Analysis.

Potential Sovereign Losses

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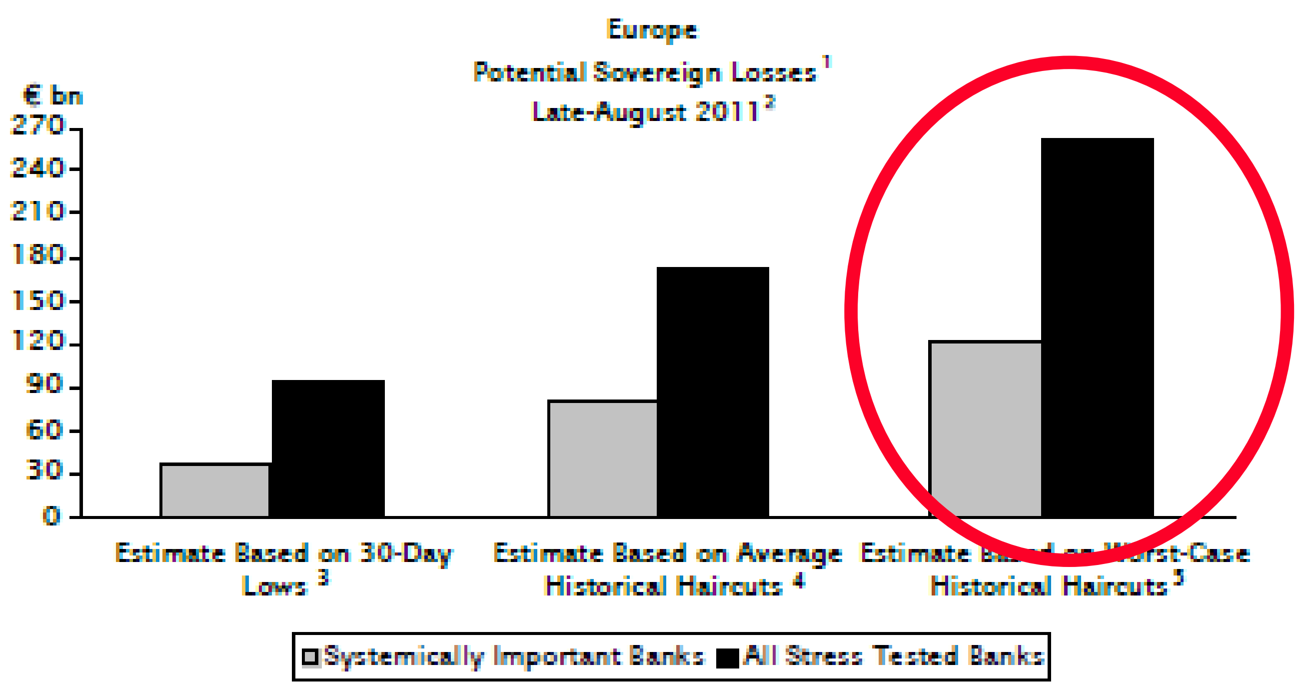

Source: European Banking Authority, Bloomberg LP, Sturzenegger, F. and Jeromin Zettelmeyer, "Haircuts: Estimating Investor Losses in SovereignDebt Restructuring, 1998-2005", IMF Working Paper, July 2005.

[1] Trading book adjusted for year-to-date change in bond price.

[2] Sovereign holdings are as of December 2010.

[3] Marks on the bank book are: Greece (49%), Ireland (34%), Italy (8%), Portugal (35%), Spain (5%).

[4] Marks on the bank book are: Greece (47%), Ireland (47%), Italy (20%), Portugal (47%), Spain (20%).

[5] Marks on the bank book are: Greece (73%), Ireland (73%), Italy (30%), Portugal (73%), Spain (30%).

Euro-zone Correlation

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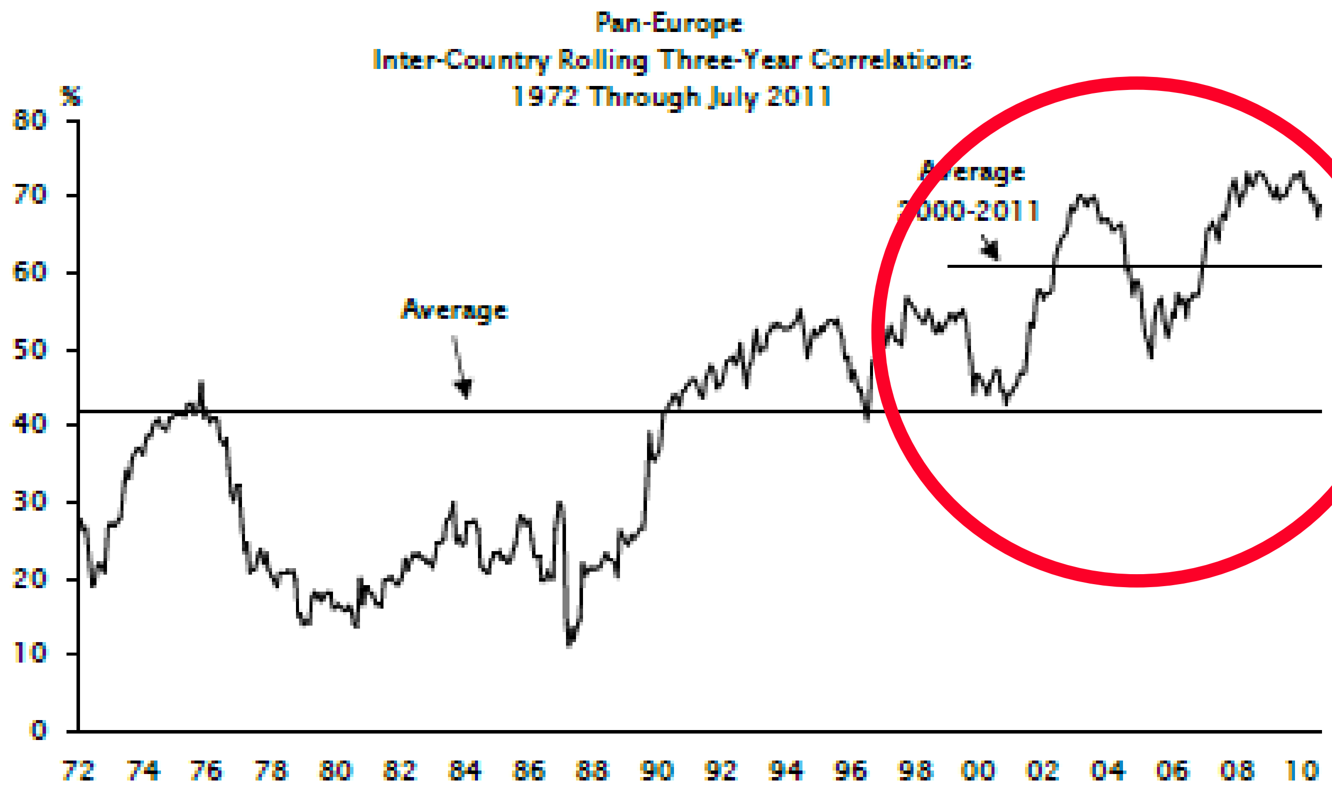

Source: Empirical Research Partners Analysis.
[1] Correlations calculated between 12 countries: Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Norway, Spain, Sweden,Switzerland and the U.K.

Global bank Losses

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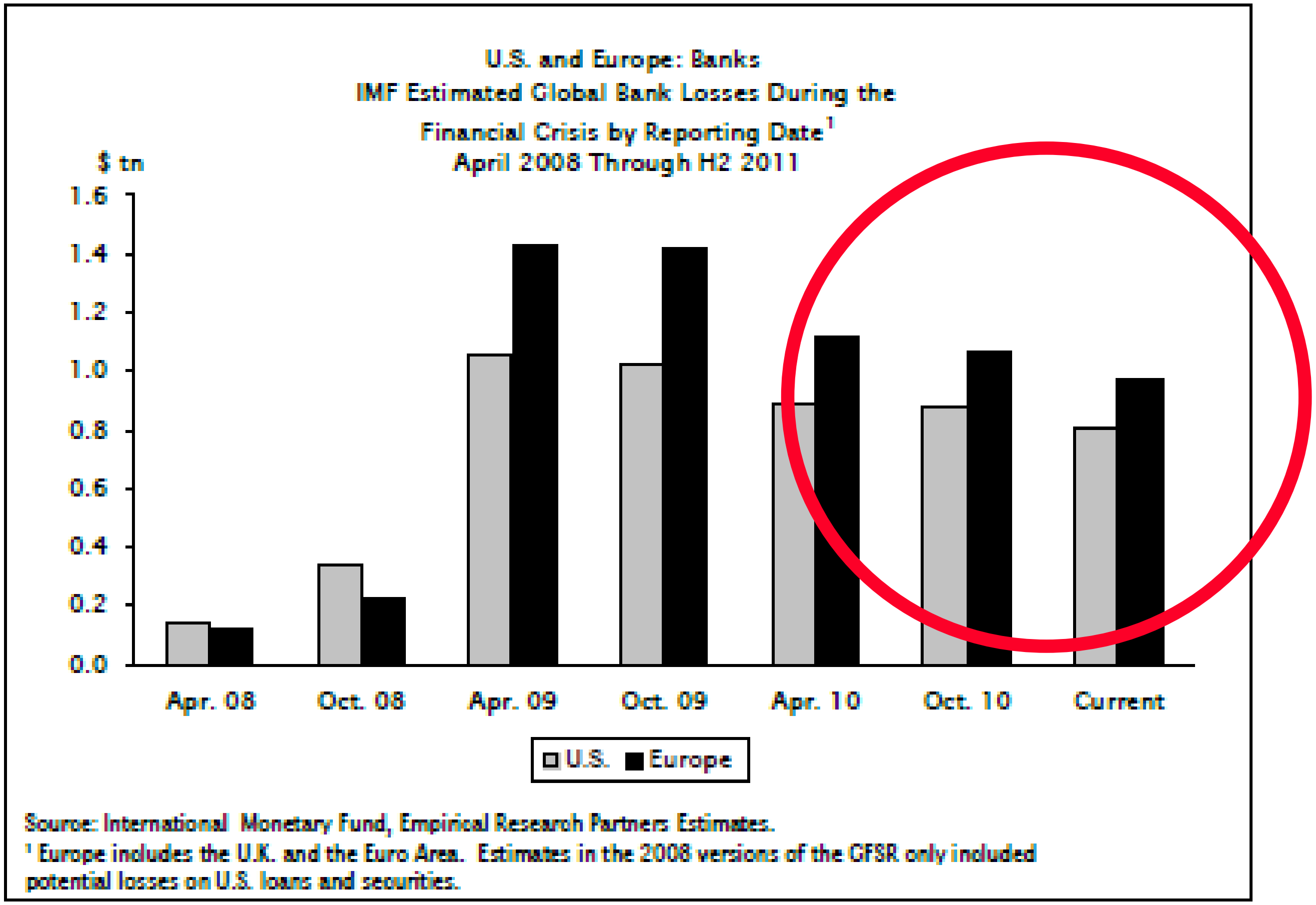

About 2/3 of Global Bank Losses have been realized

Loan Loss Scenarios

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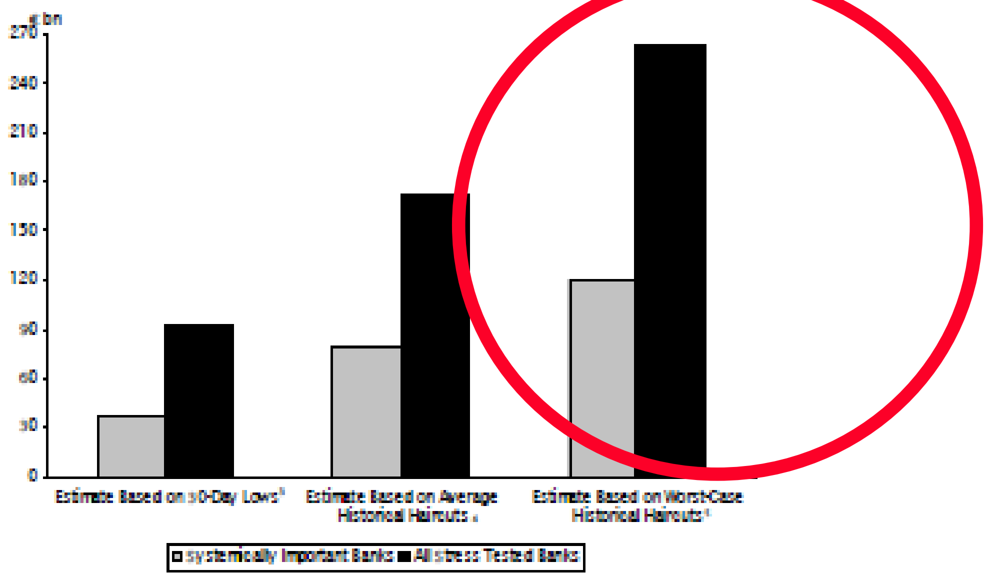

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Timeline Greece: Don't Forget the Others!!

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- ✓Sept. 23-25 International Monetary Fund/World Bank meeting in Washington
- ✓Sept. 23 2 billion-euro ($2.7 billion) Treasury bill matures
- ✓End September Bailout tranche due, the sixth from the April 2010 bailout agreement. European and IMF officials return to Athens in week of Sept. 12 for talks with Greek policy makers on disbursing 8 billion euros in aid. German Finance Minister Wolfgang Schaeuble said Sept. 9 that no funds will be given unless Greece fulfils the conditions agreed in its adjustment program.
- ✓End September Informal deadline for ratification of new powers for the European Financial Stability Facility. Expanding the fund's remit is part of the bailout package agreed on July 21.
- ✓Oct. 3 Euro-region finance ministers meet in Luxembourg
- ✓Oct. 6 European Central Bank rate decision in Berlin
- ✓Oct. 14 2 billion-euro Treasury bill matures
- ✓Oct. 14-15 Group of 20 finance ministers meeting in Paris
- ✓Oct. 17-18 European Union leaders summit in Brussels
- ✓Oct. 21 1.63 billion-euro Treasury bill matures Nov. 1 Mario Draghi replaces Jean-Claude Trichet as president of the ECB

Timeline Greece: Don't Forget the Others!!

- ✓Nov. 3 ECB rate decision in Frankfurt
- ✓Nov. 3-4 G-20 leaders' summit in Cannes
- ✓Nov. 7 Euro-region finance ministers meet in Brussels
- ✓Nov. 11 2 billion-euro Treasury bill matures
- ✓Nov. 18 1.3 billion-euro Treasury bill matures
- ✓Nov. 29 Euro-region finance ministers meet in Brussels
- ✓Dec. 8 ECB rate decision in Frankfurt
- ✓Dec. 9-10 EU leaders summit in Brussels
- ✓Dec 16 2 billion-euro Treasury bill matures
- ✓Dec. 19 1.17 billion-euro government bond matures
- ✓Dec. 22 0.98 billion-euro government bond matures
- ✓Dec. 29 5.23 billion-euro government bond matures
- ✓Dec. 30 0.71 billion-euro government bond matures
- ✓End December Seventh aid tranche may be due

Greek Rollover Profile

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GRAB

Enter value(s) and hit <Go>, Page for details

EquityDDIS

96) View | 97) Capital Structure | 98) Actions | Debt Distribution

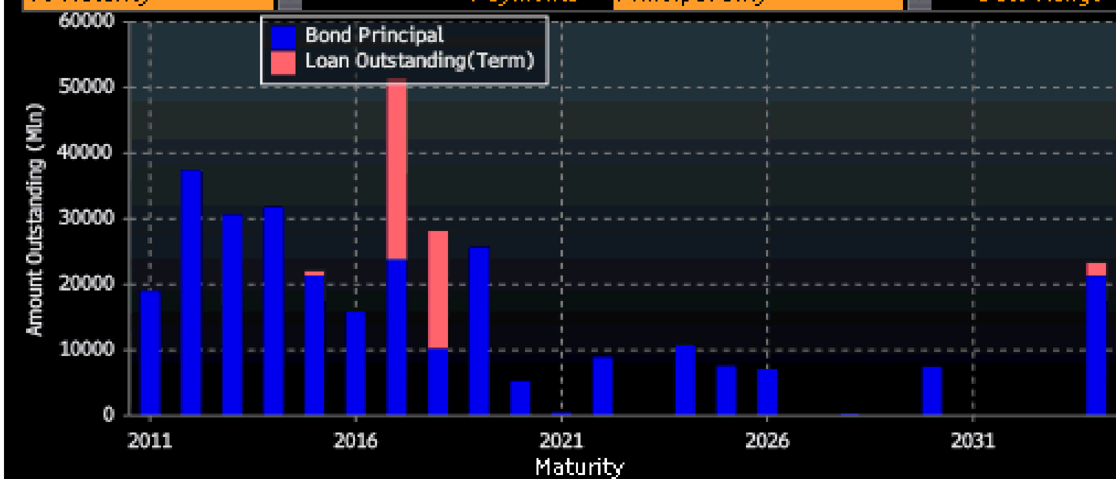
Issuer: Hellenic Republic — or Ticker: — Include: Current issuer and its subsidiaries

Filter by:

Debt Type	Bonds & Loans	Loan Type	All	Maturity Type	All	Currency of Issue	
Coupon Type	All	Sec Type	All	Exclude	None	Country of Issue	

View DDIS Totals: Debt Distribution by debt type

To Maturity — Payments: Principal Only — Date Range: 09/11 - 09/99 — Period: Yr



Year	Amt(Mln)
2011	19,022
2012	37,409
2013	30,576
2014	31,790
2015	22,057
2016	15,823
2017	51,379
2018	28,151
2019	25,661
2020	5,250
2021	500

Total Debt: 333,013.595 EUR

Total # of Issues: 116

Corporate Structure	Debt Tkr	Eqty Tkr	CDS Tkr
Hellenic Republic	GREECE	1004Z GA	GREECE CDS <CORP>
Hellenic Republic Government Bond	GGB	3483030Z GA	
Hellenic Republic Government International Bond	GREECE		
Hellenic Republic Treasury Bill	GTB		
Hellenic Railways Organization SA	HELNRR	1351Z GA	

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2011 Bloomberg Finance L.P.
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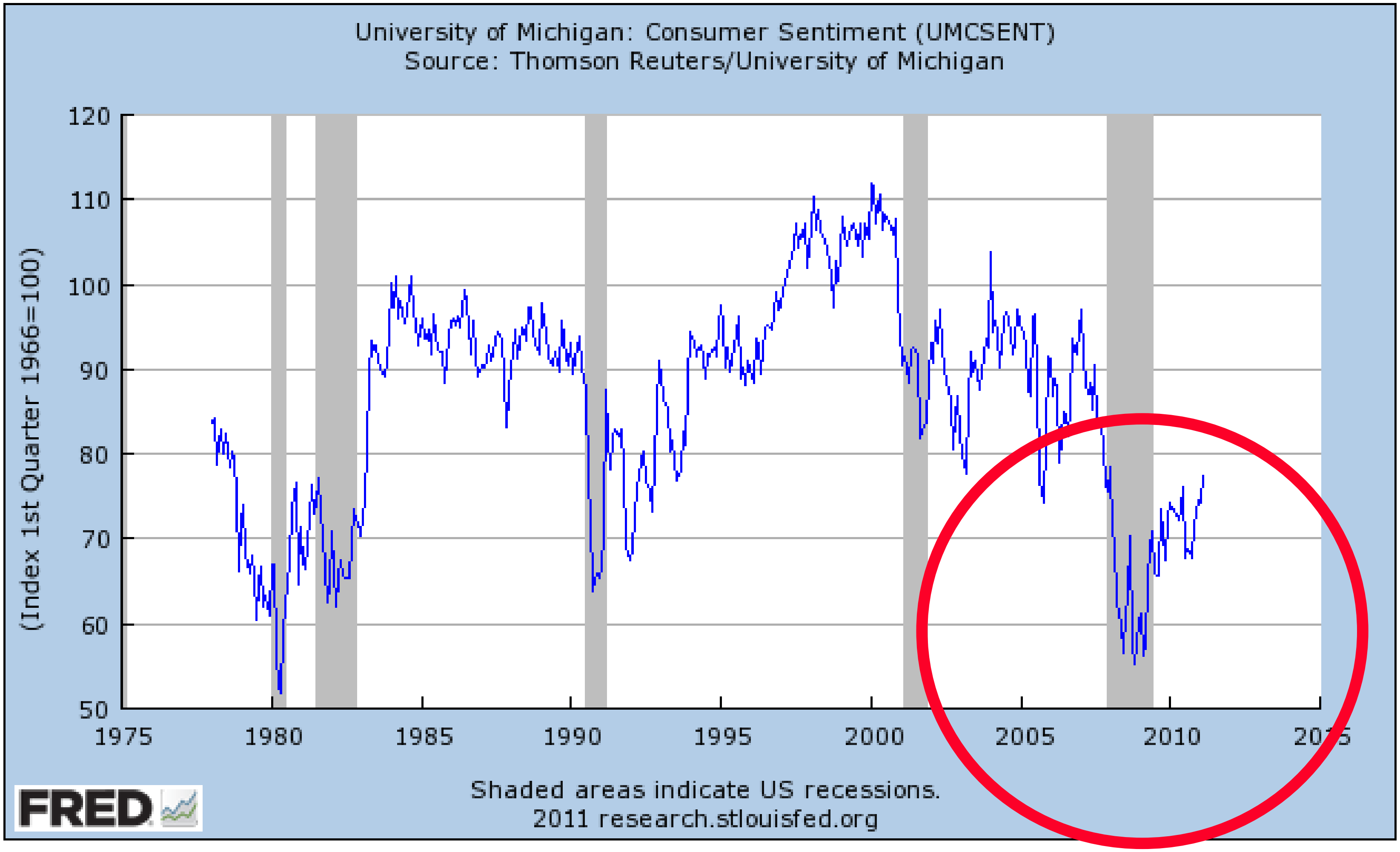
Consumer Sentiment



Homeownership Rate

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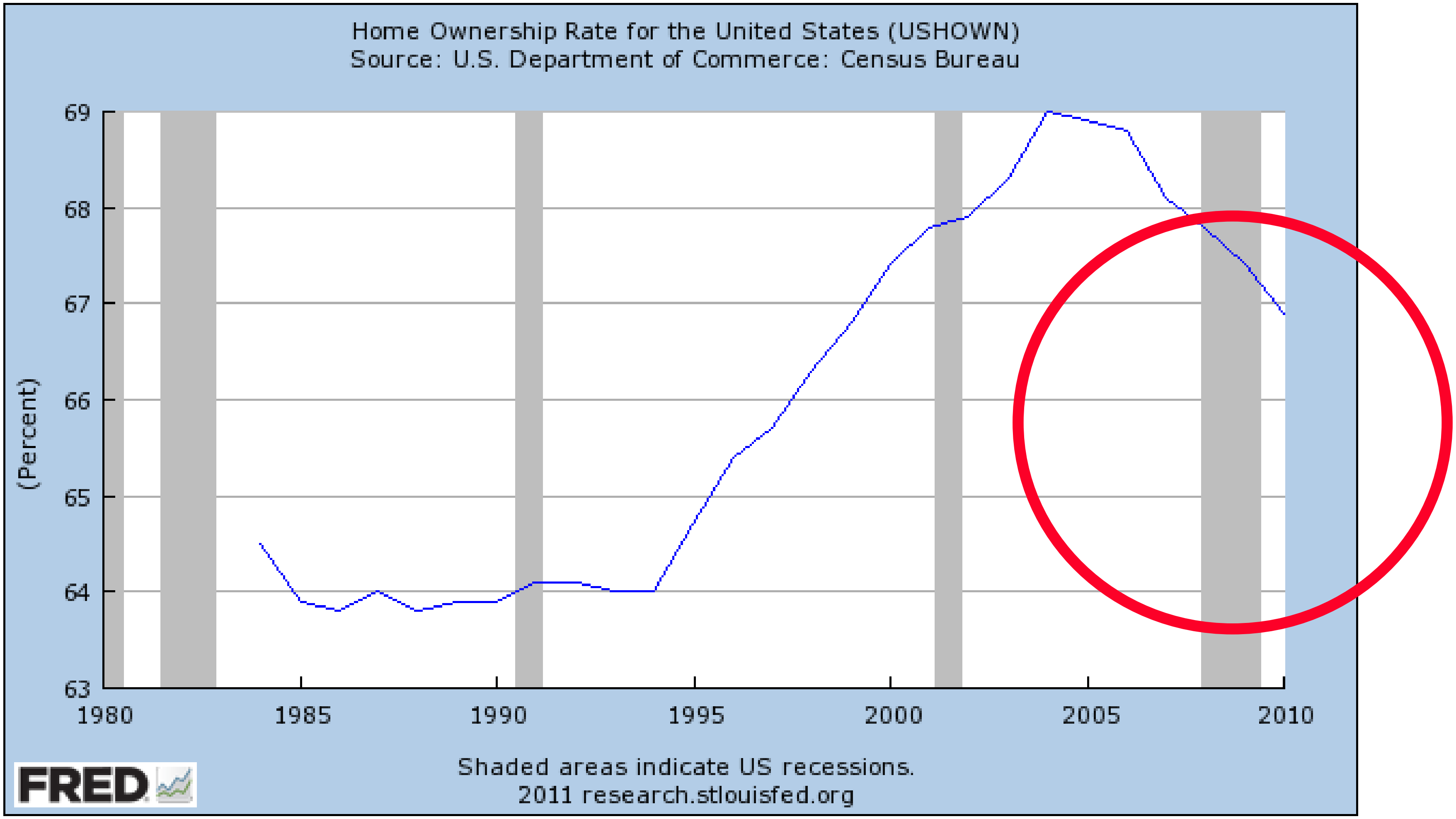
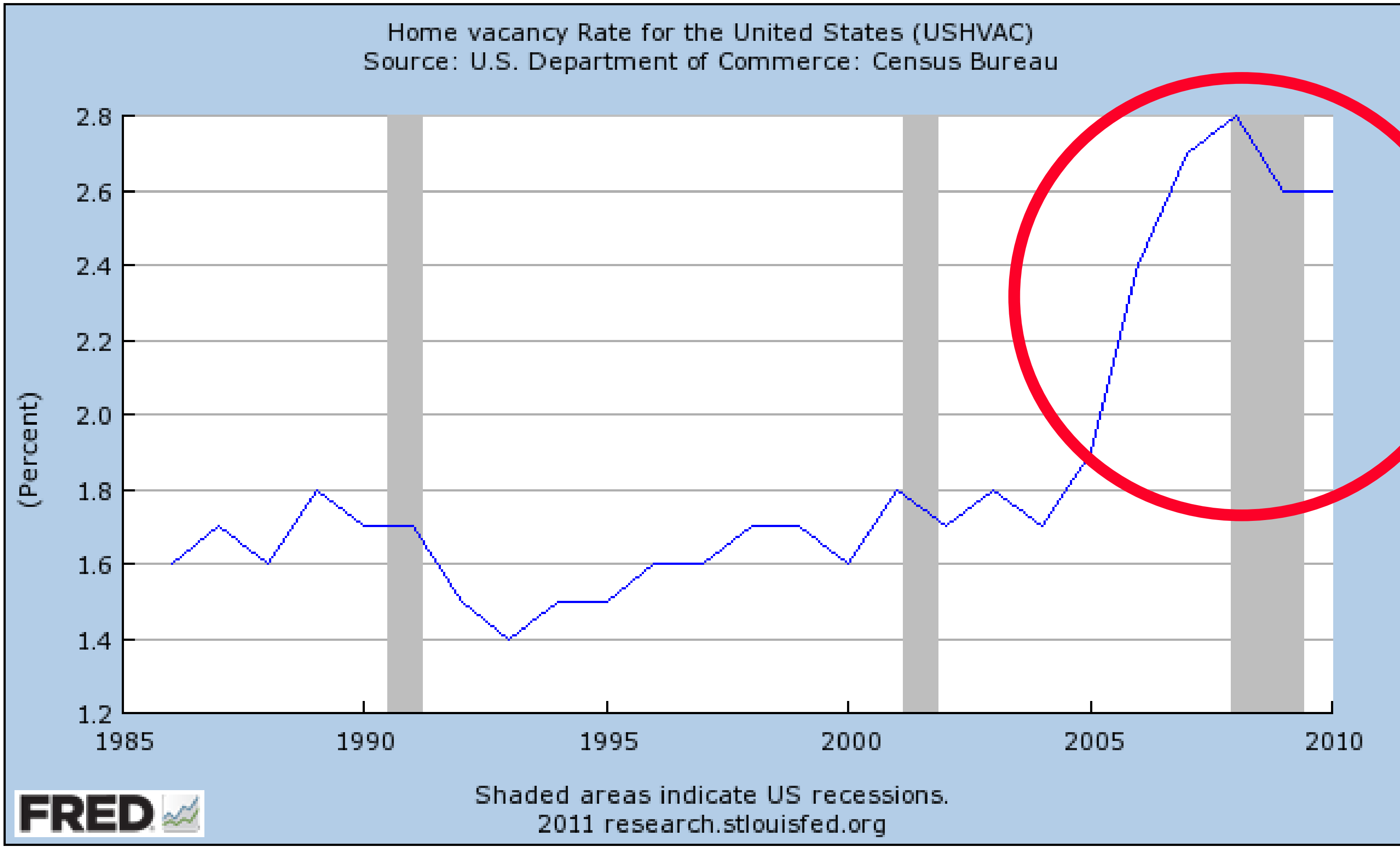


Home Vacancy Rate



US Retail Sales

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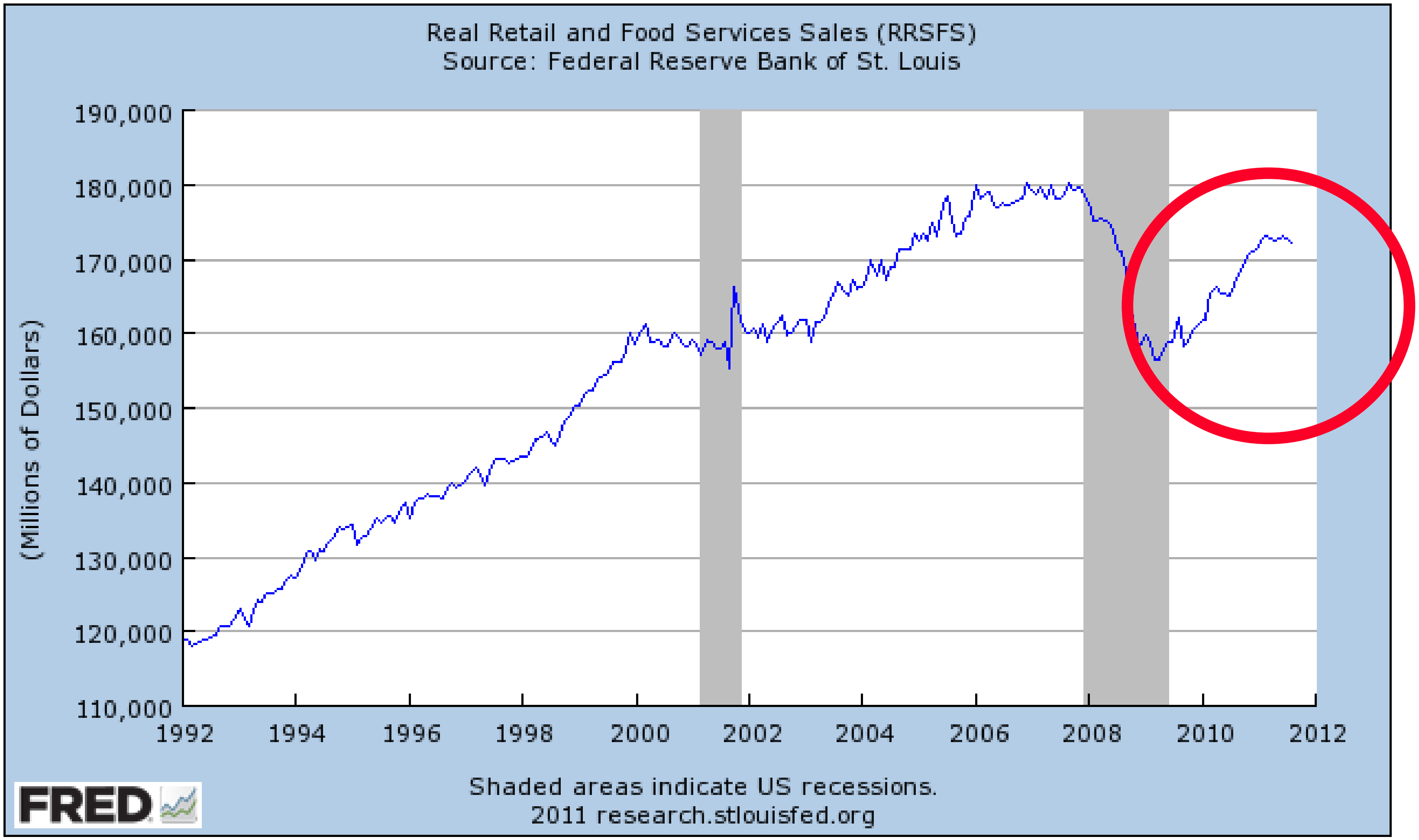

Home Vacancy Rate

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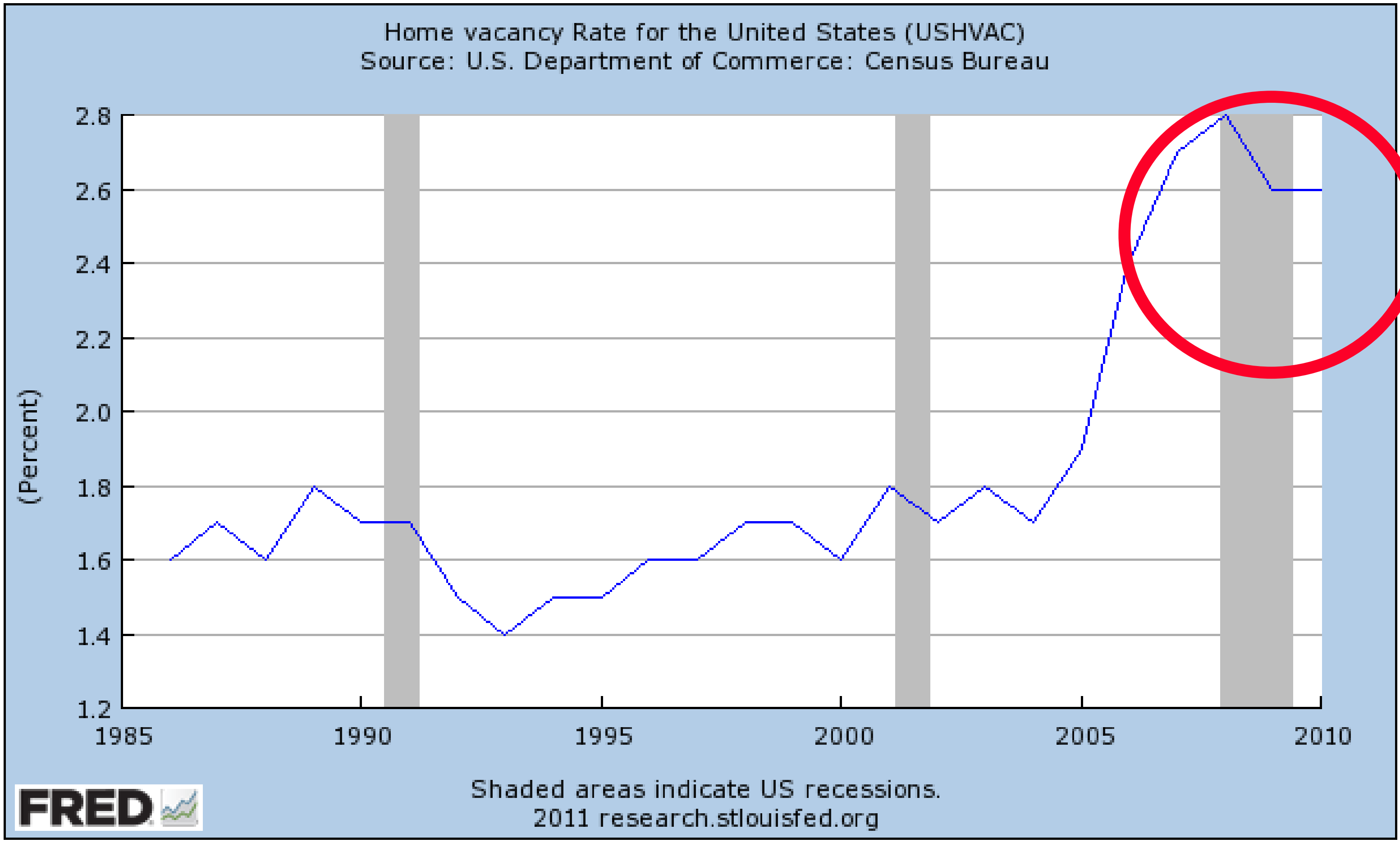

ROE – US Banks

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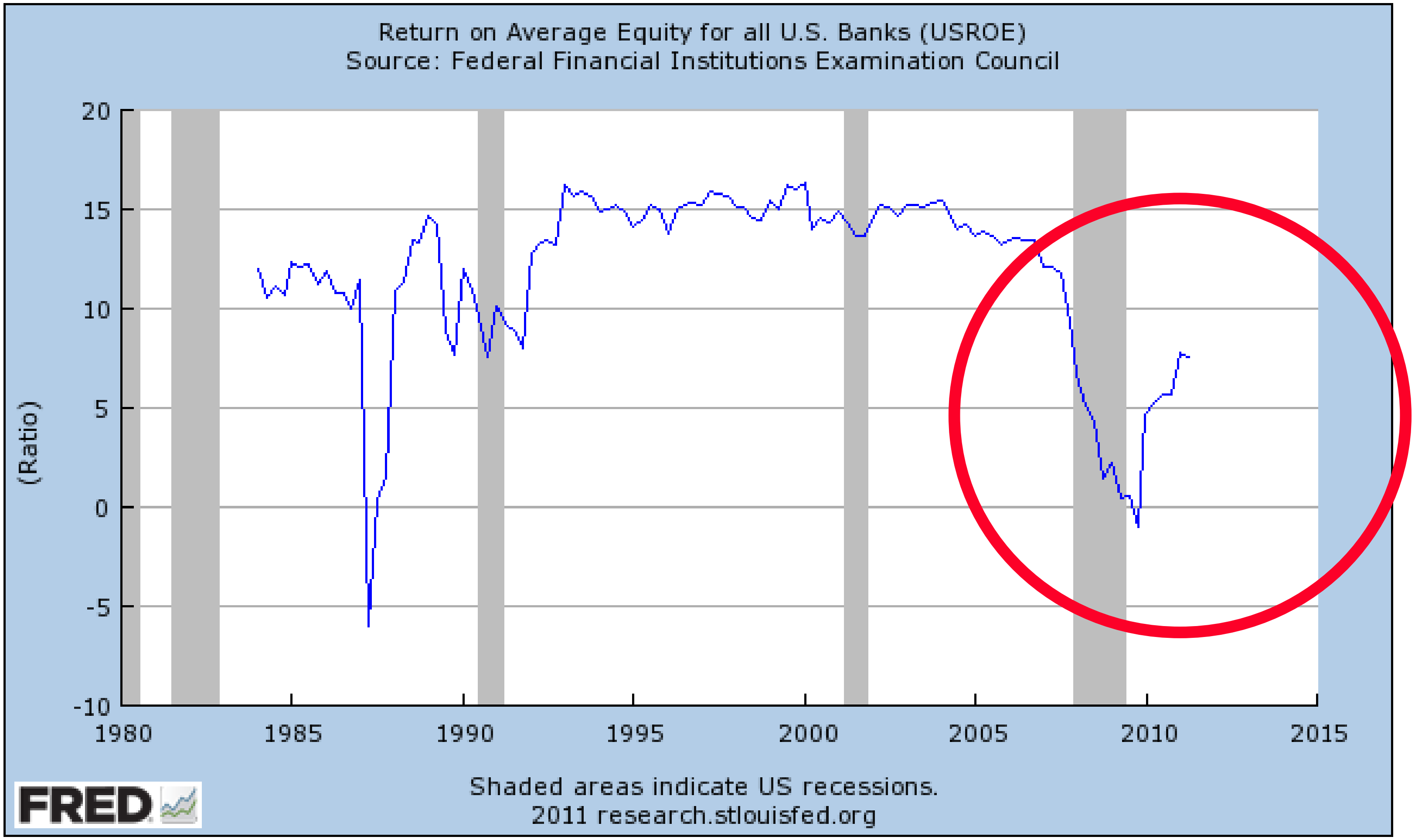

Net Commercial Loan Charge-Offs

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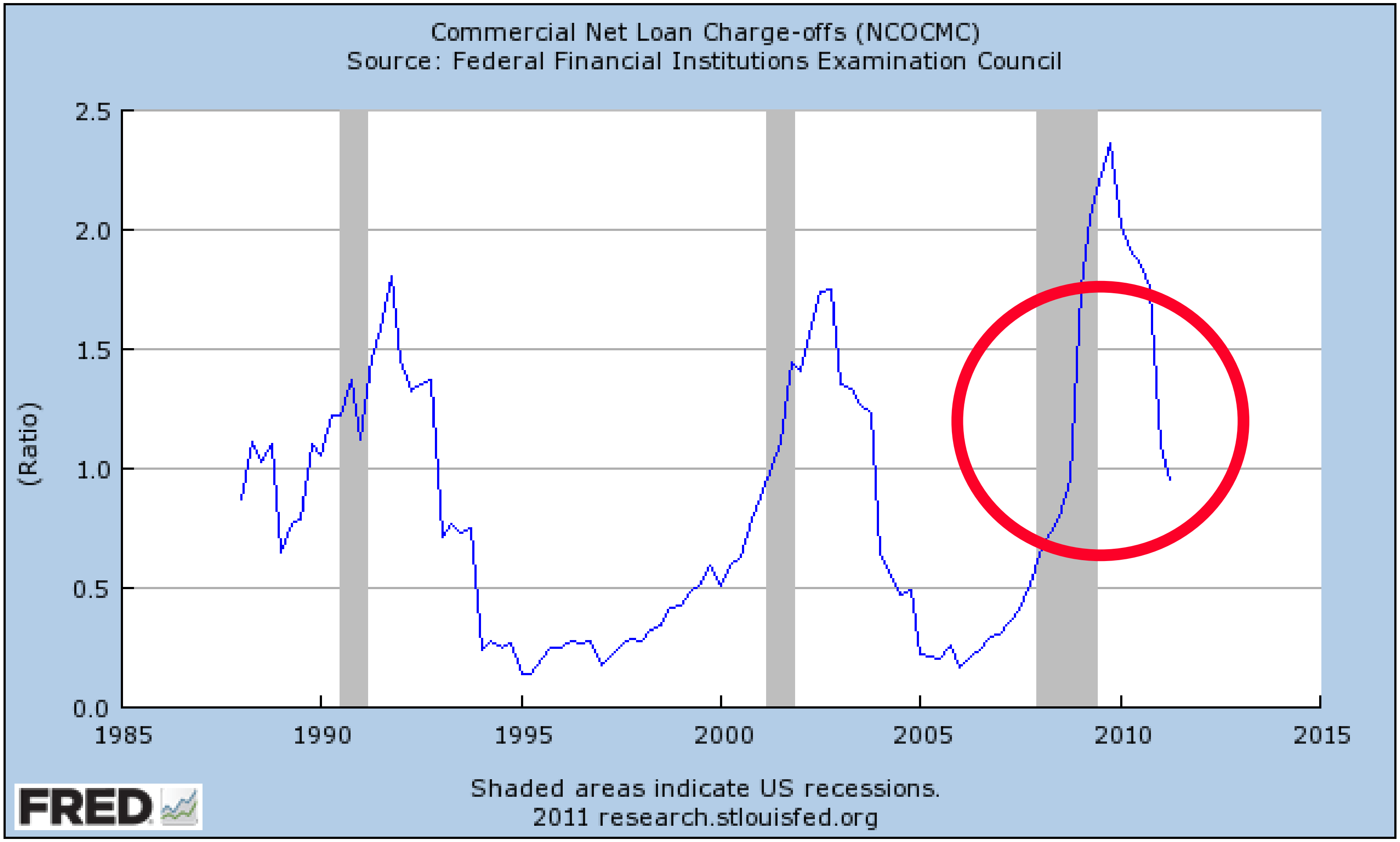
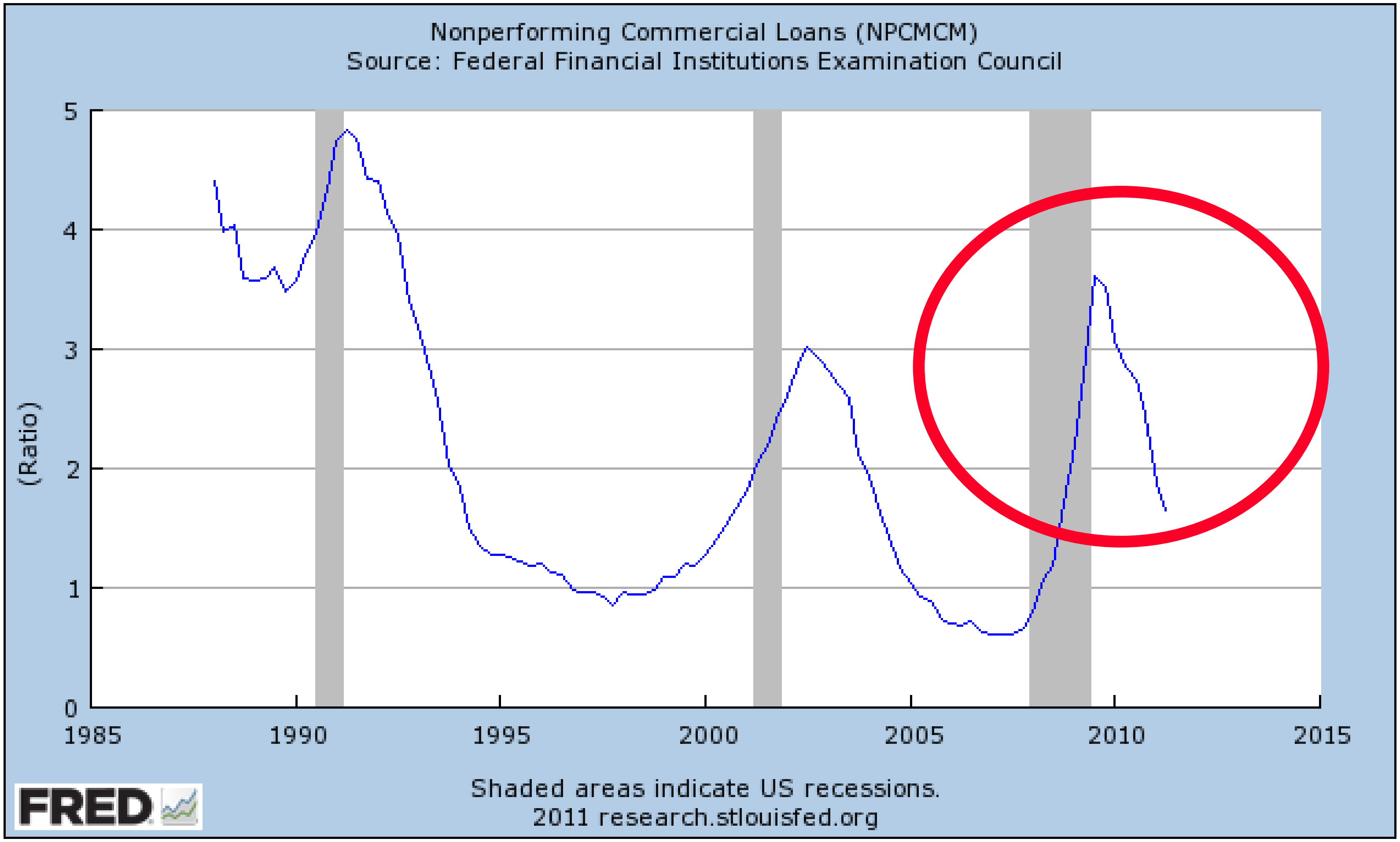


Non Performing Commercial Loans



Net Interest Margin US Banks

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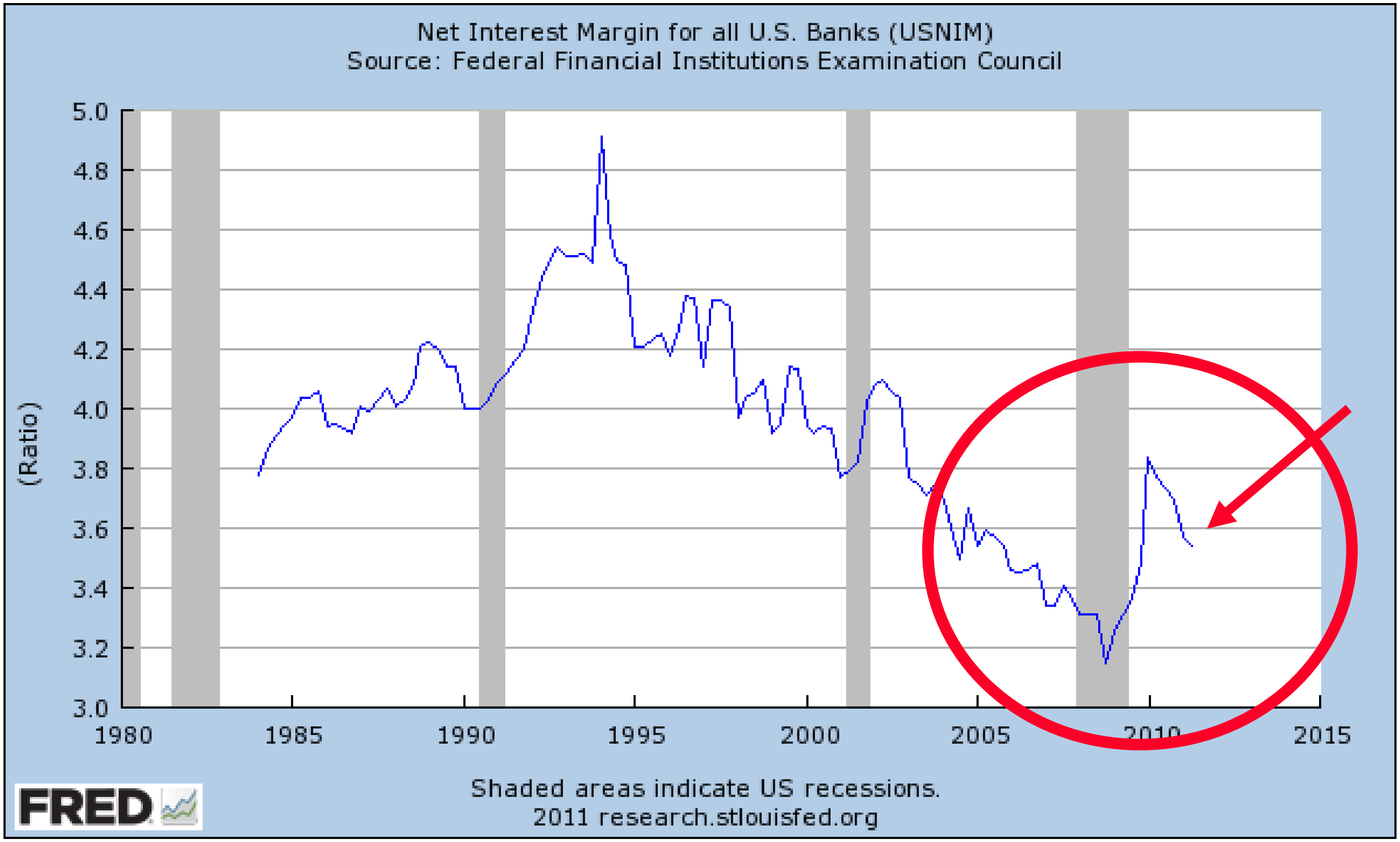
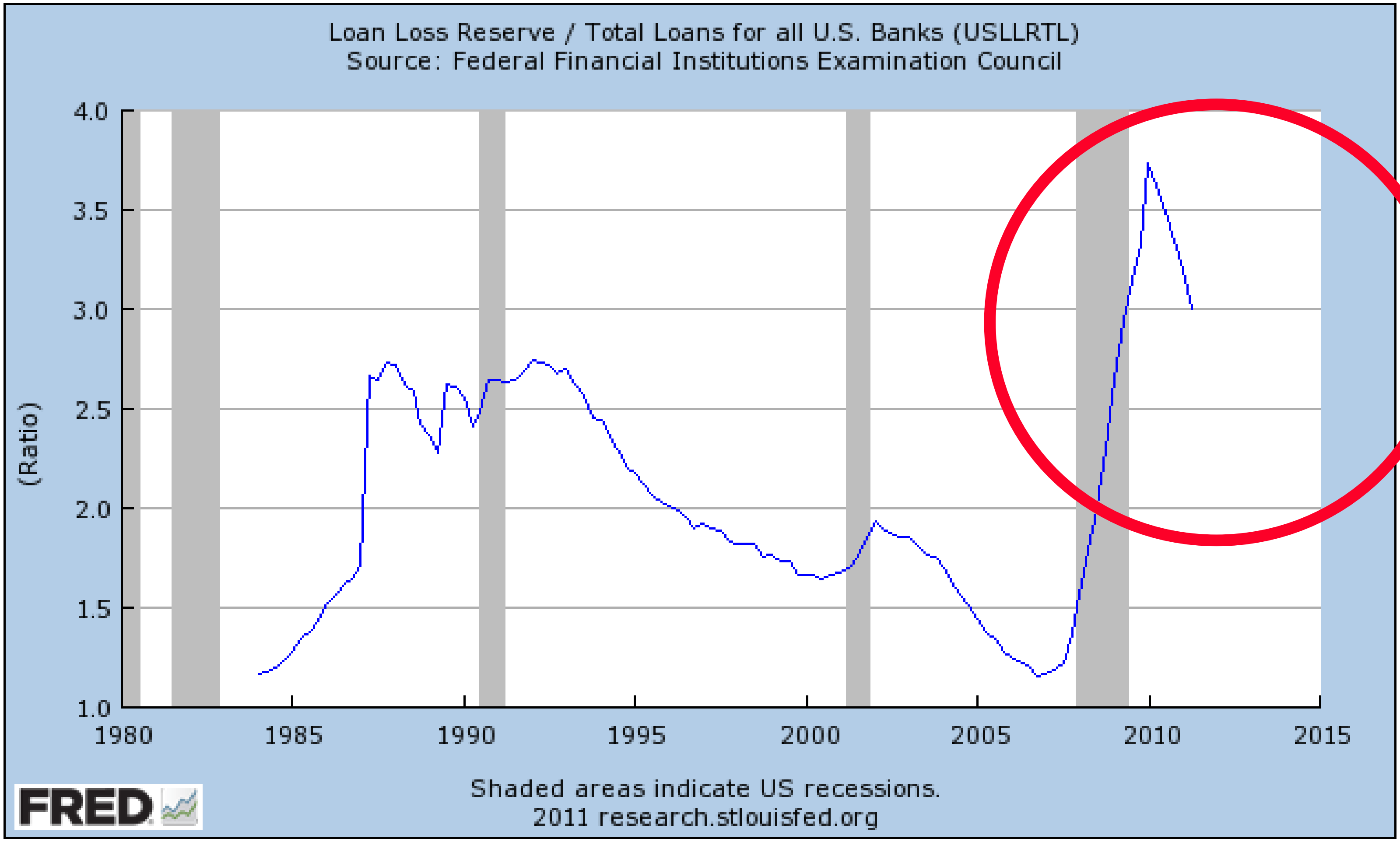


Loan Loss Reserves



Debt Held by Foreigners

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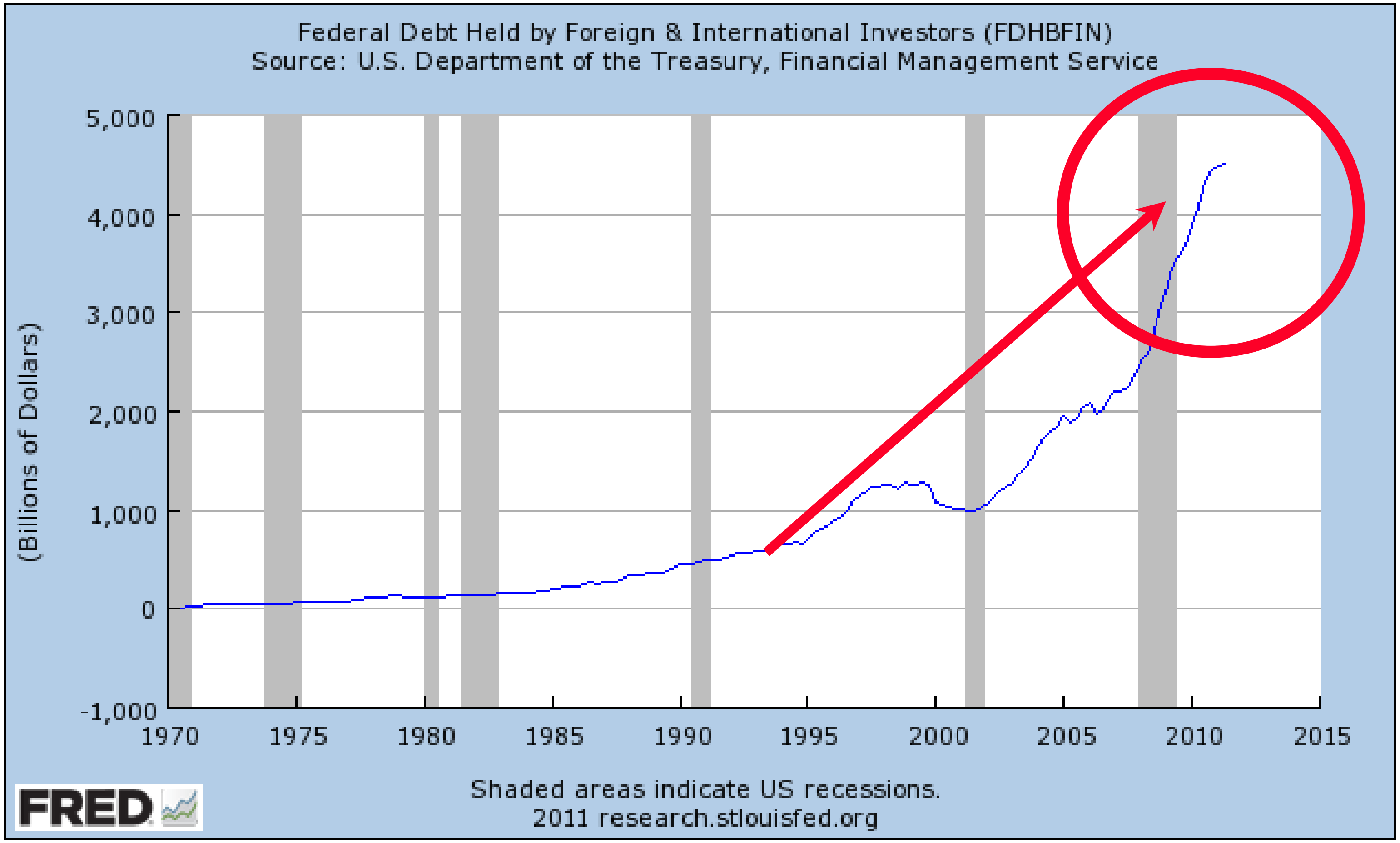

Monetary Base

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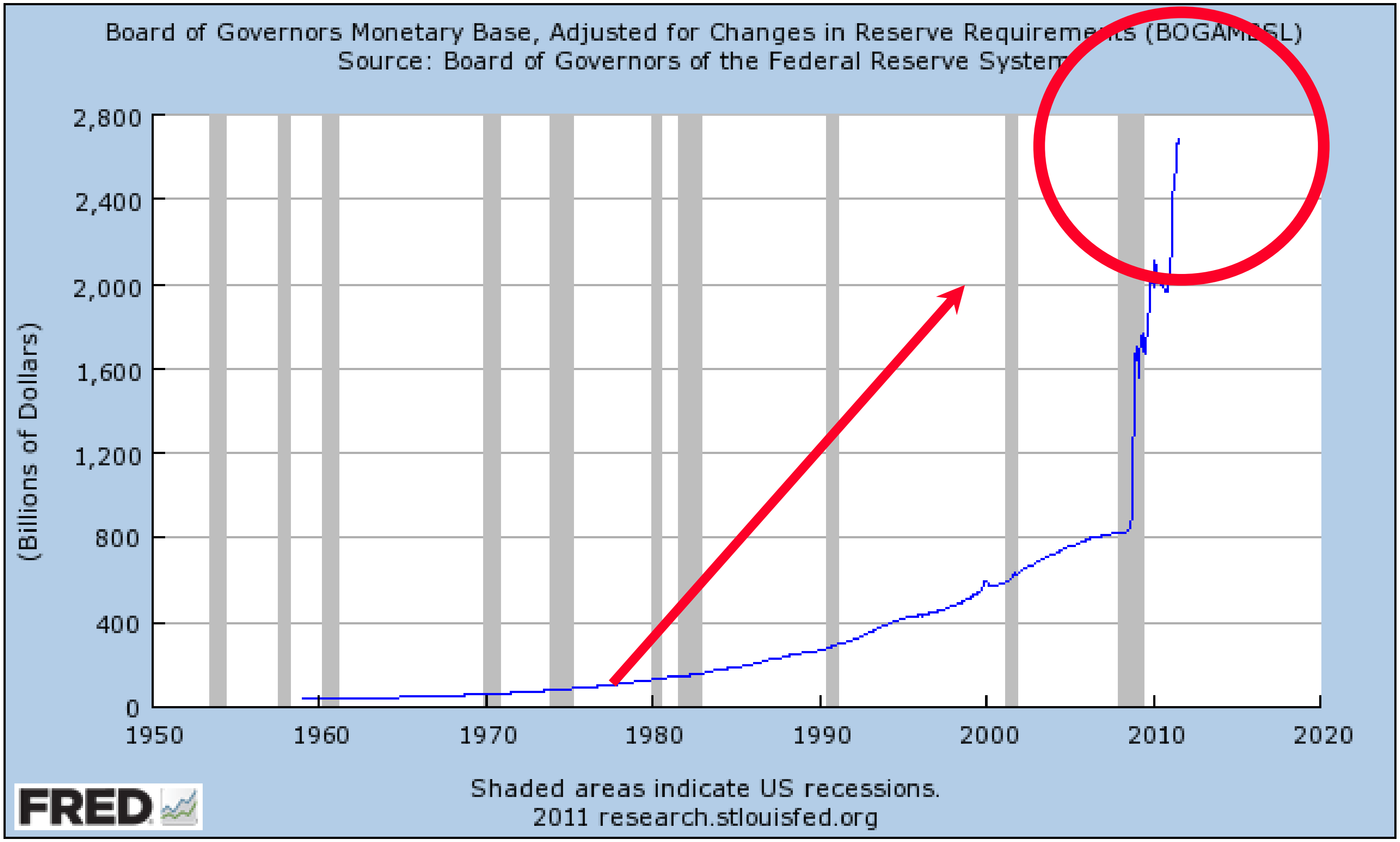

QE – Debt Held by The Fed

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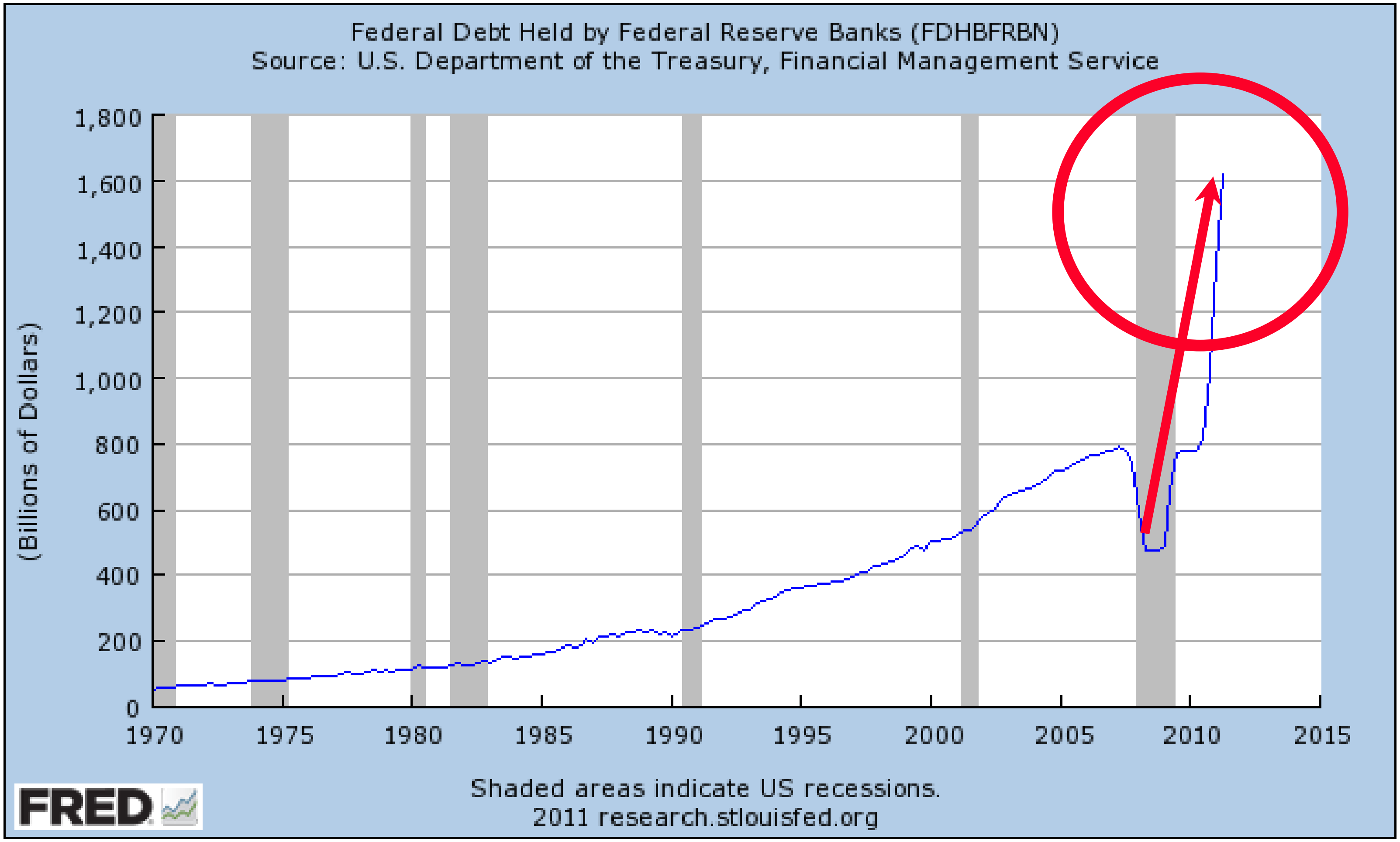

Gross Federal Debt

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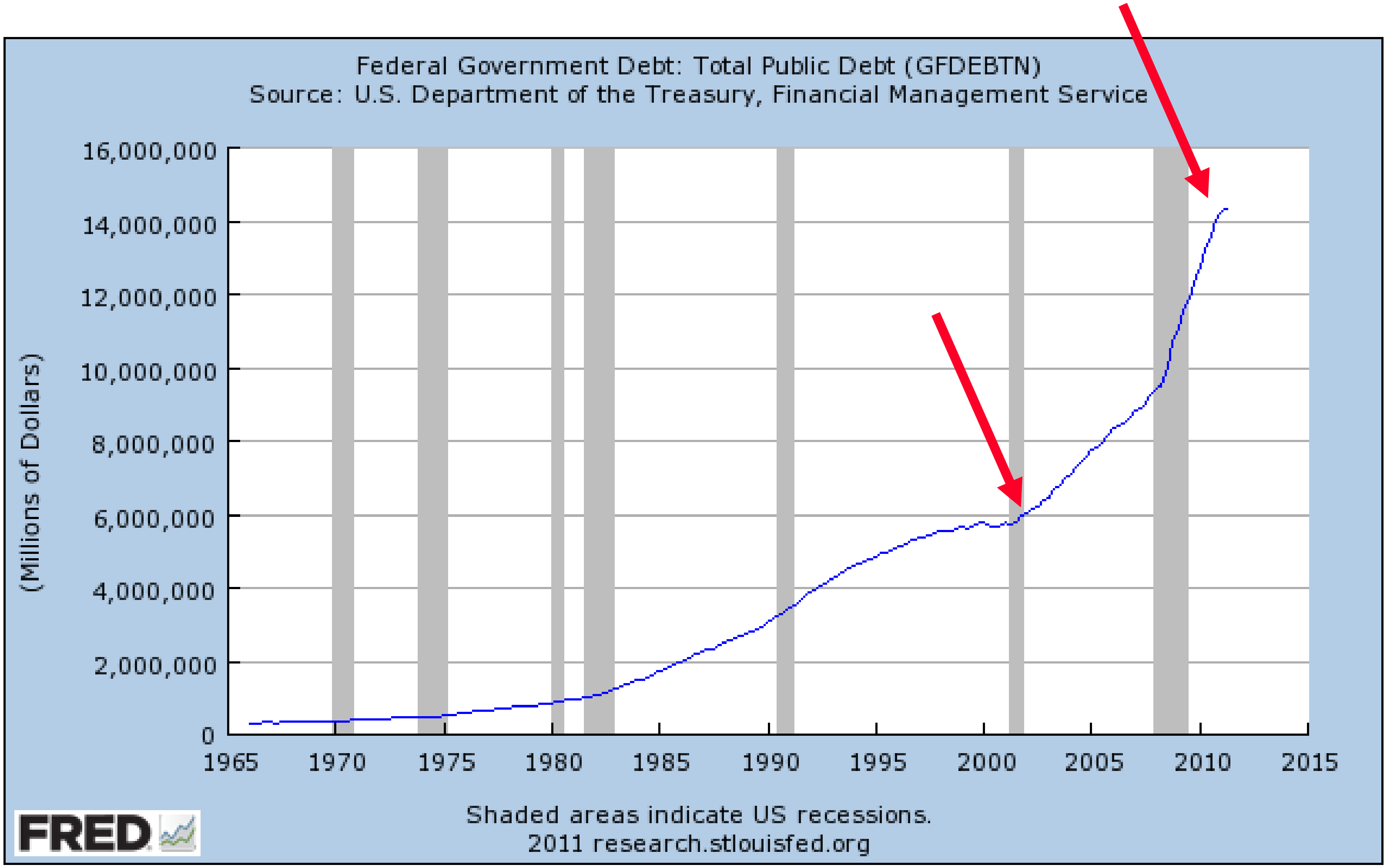
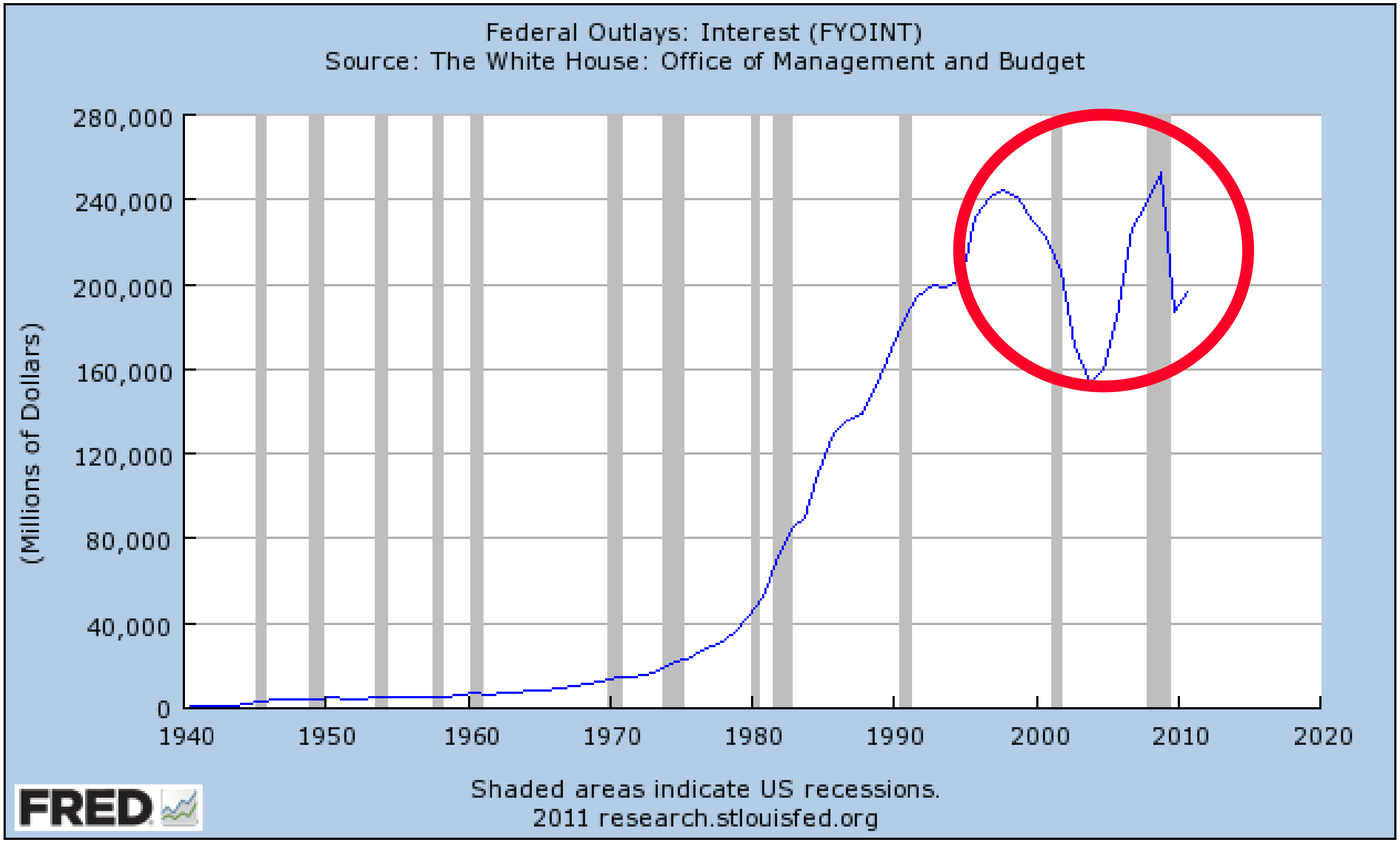


Federal Debt Service



MZM Velocity

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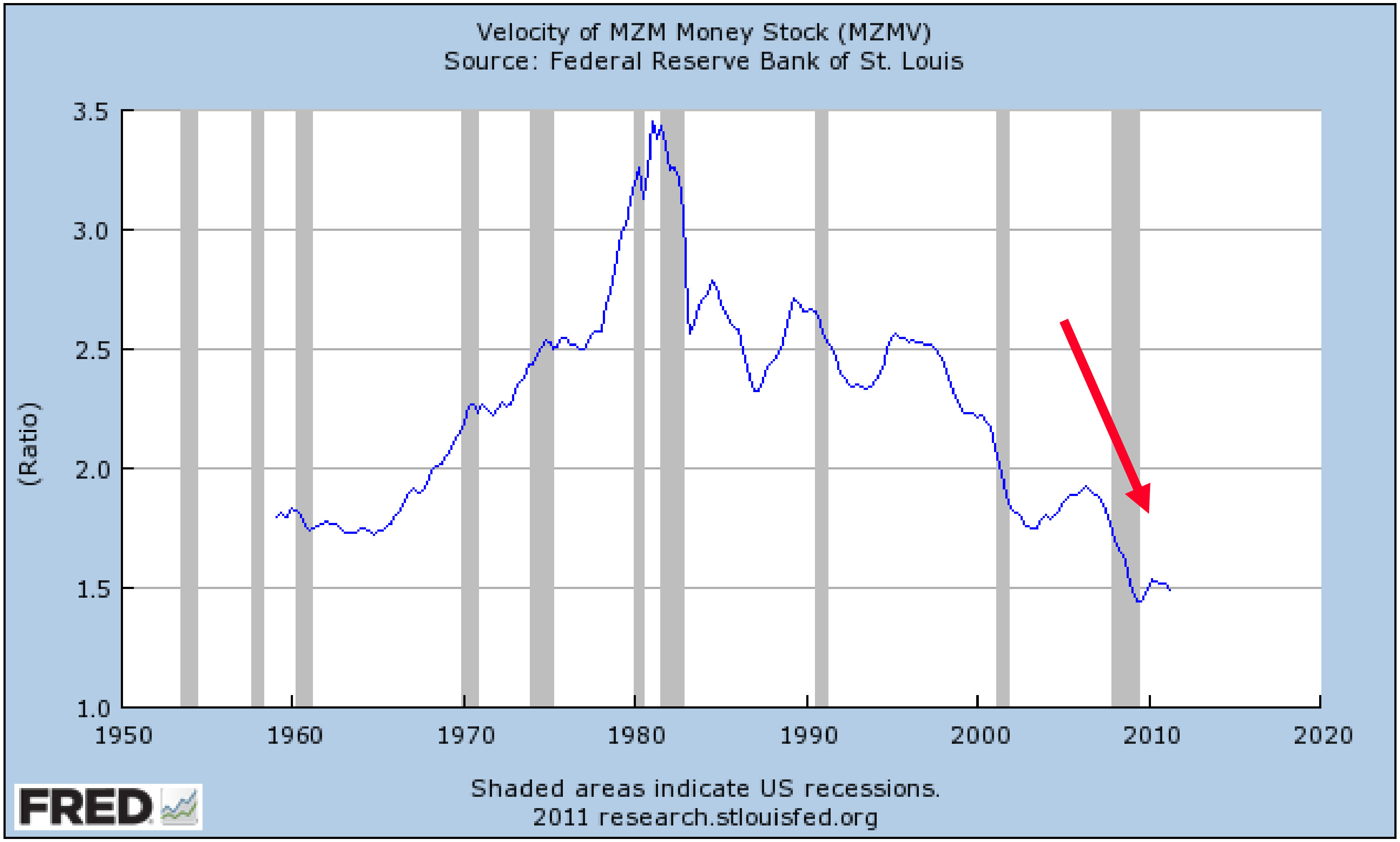

M2 Velocity

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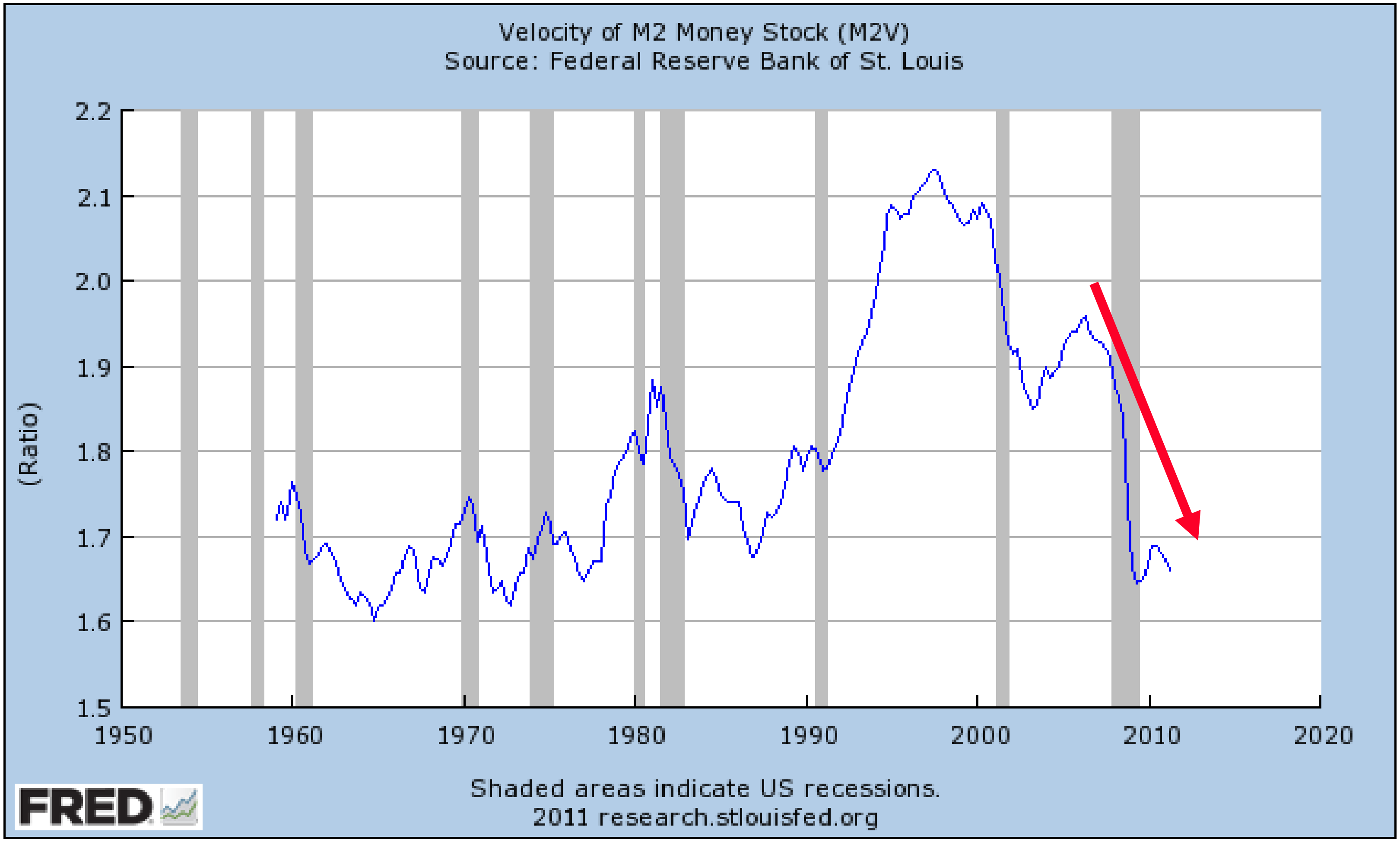

Total Consumer Credit

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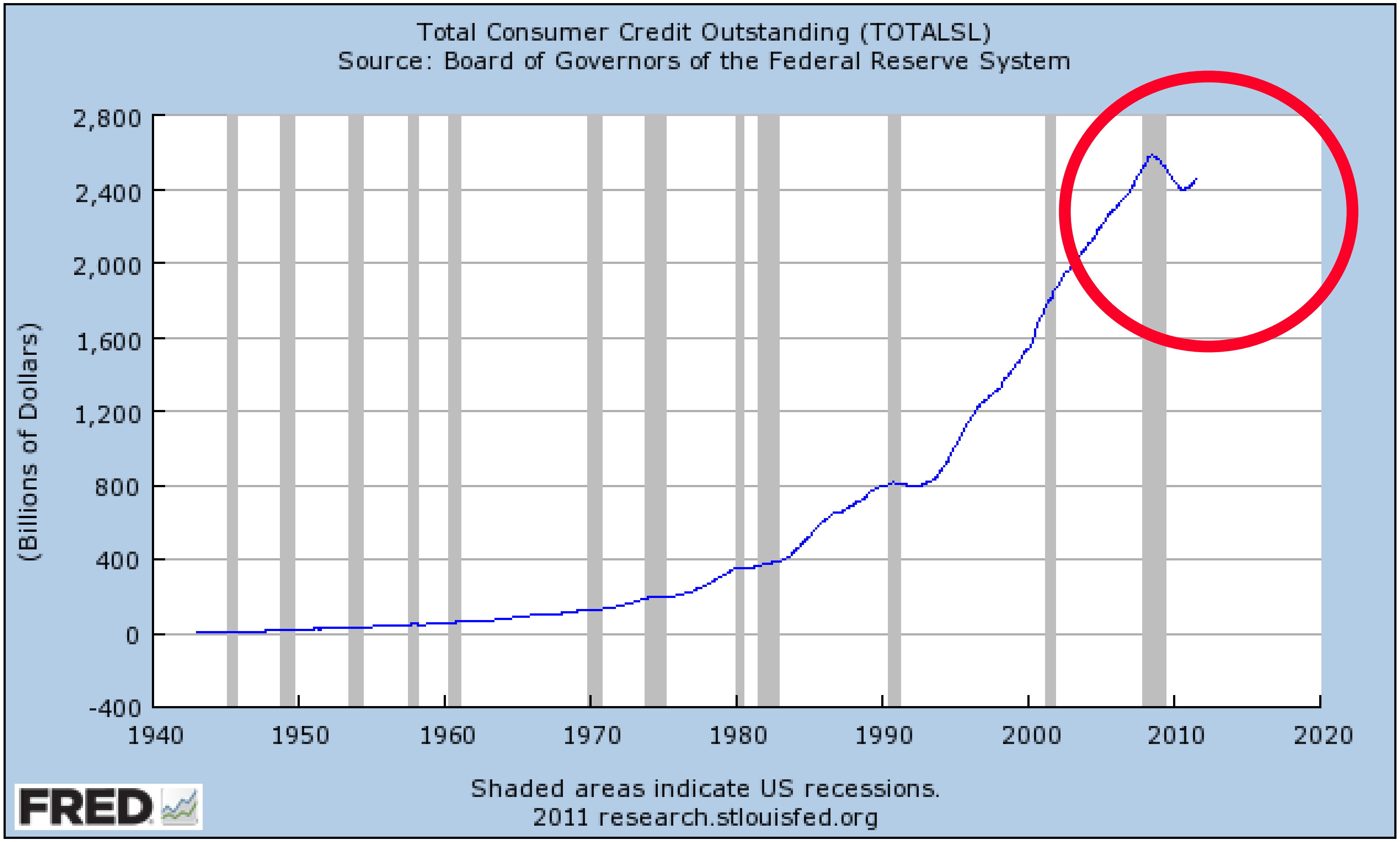

Inventory to Shipments

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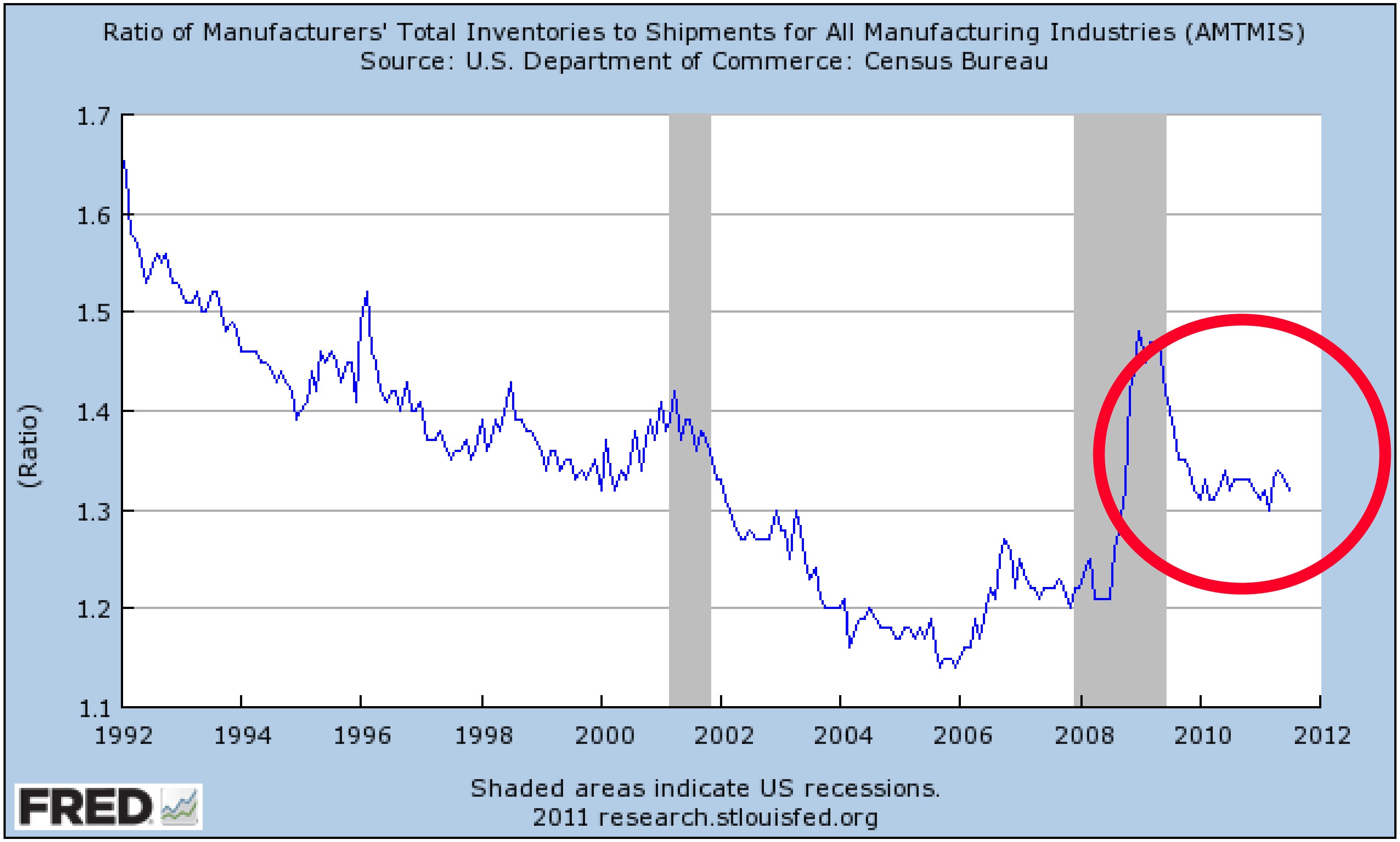

Industrial Production Index

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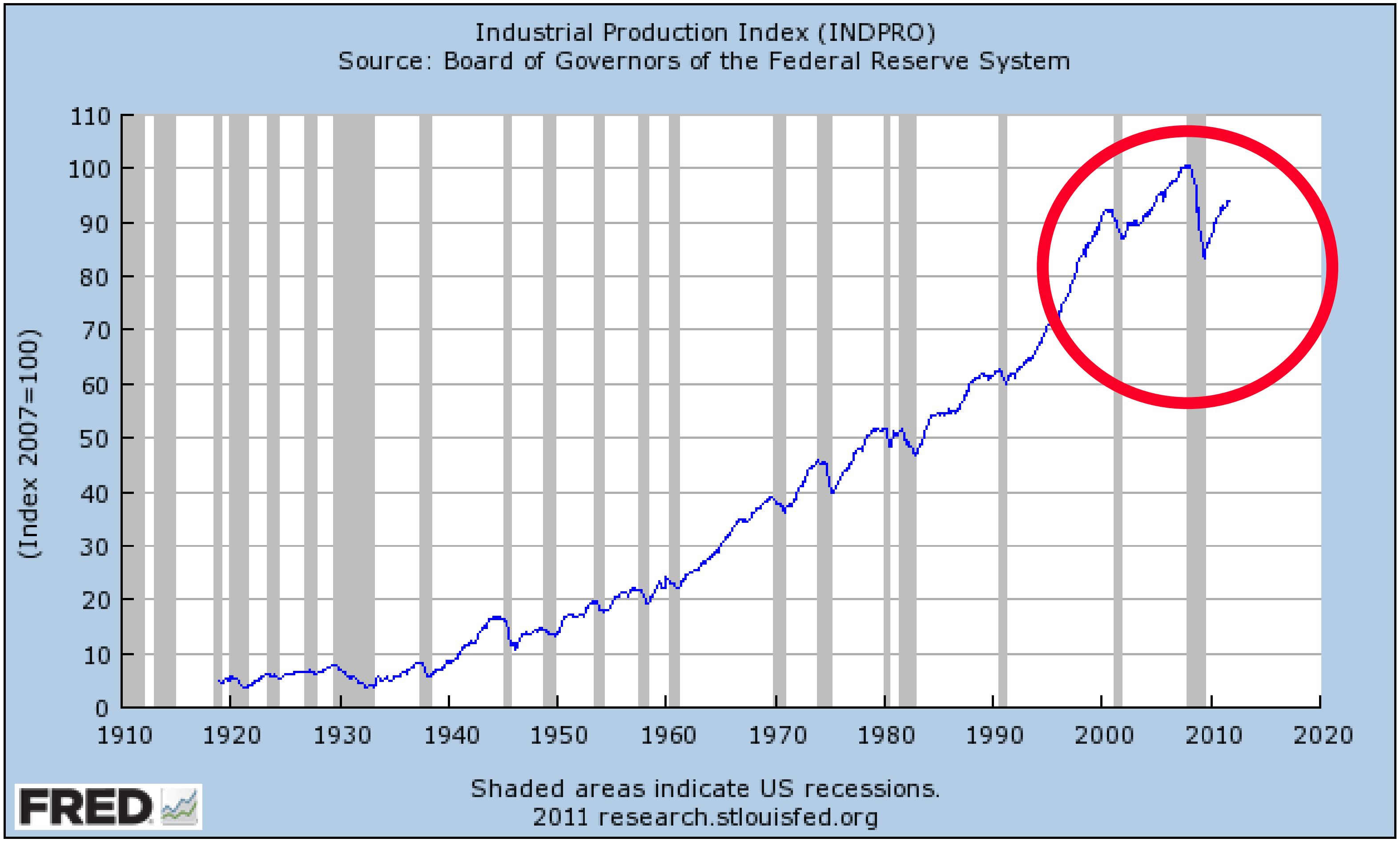

Job Openings

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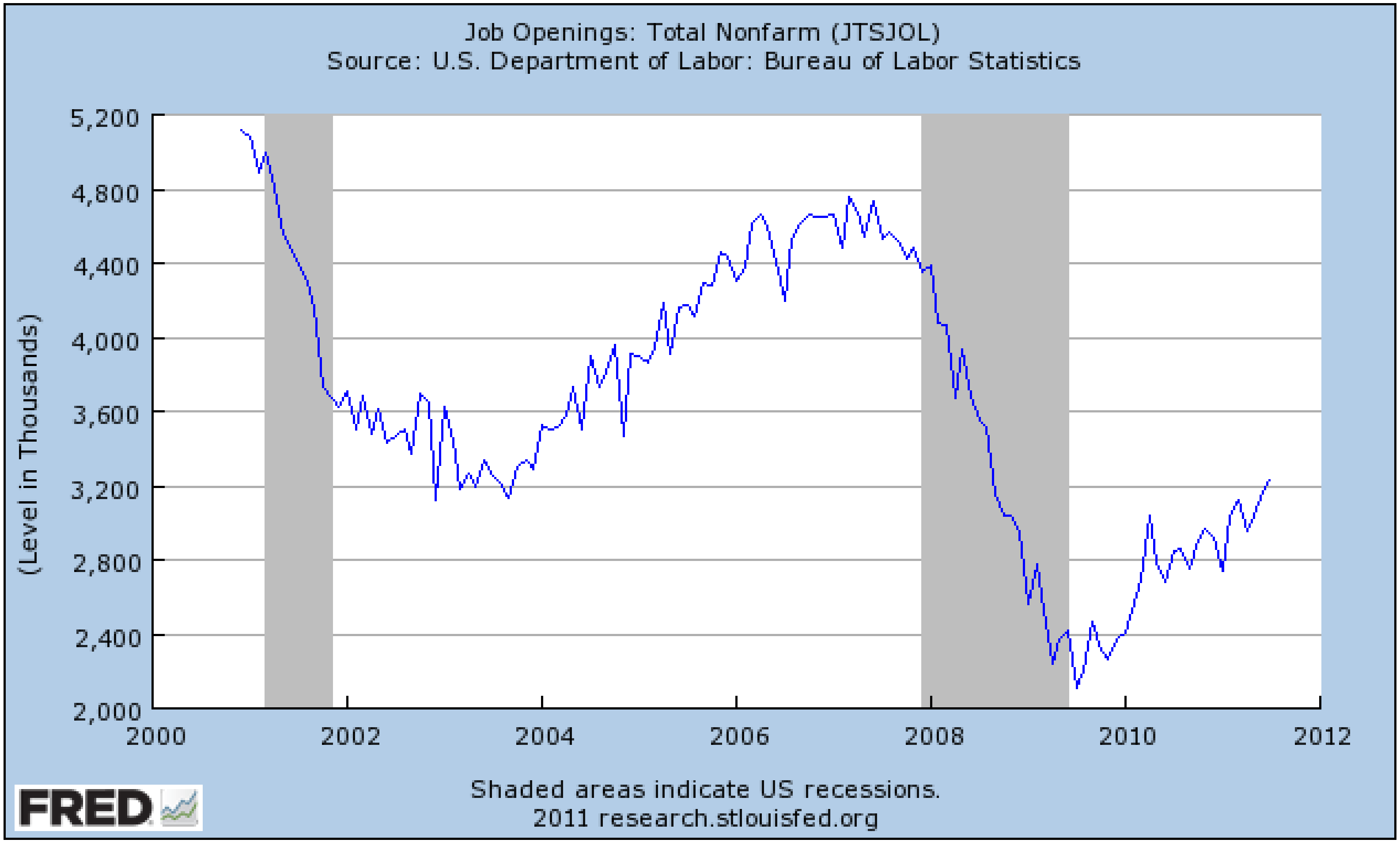

Unemployment – 27 Weeks or longer

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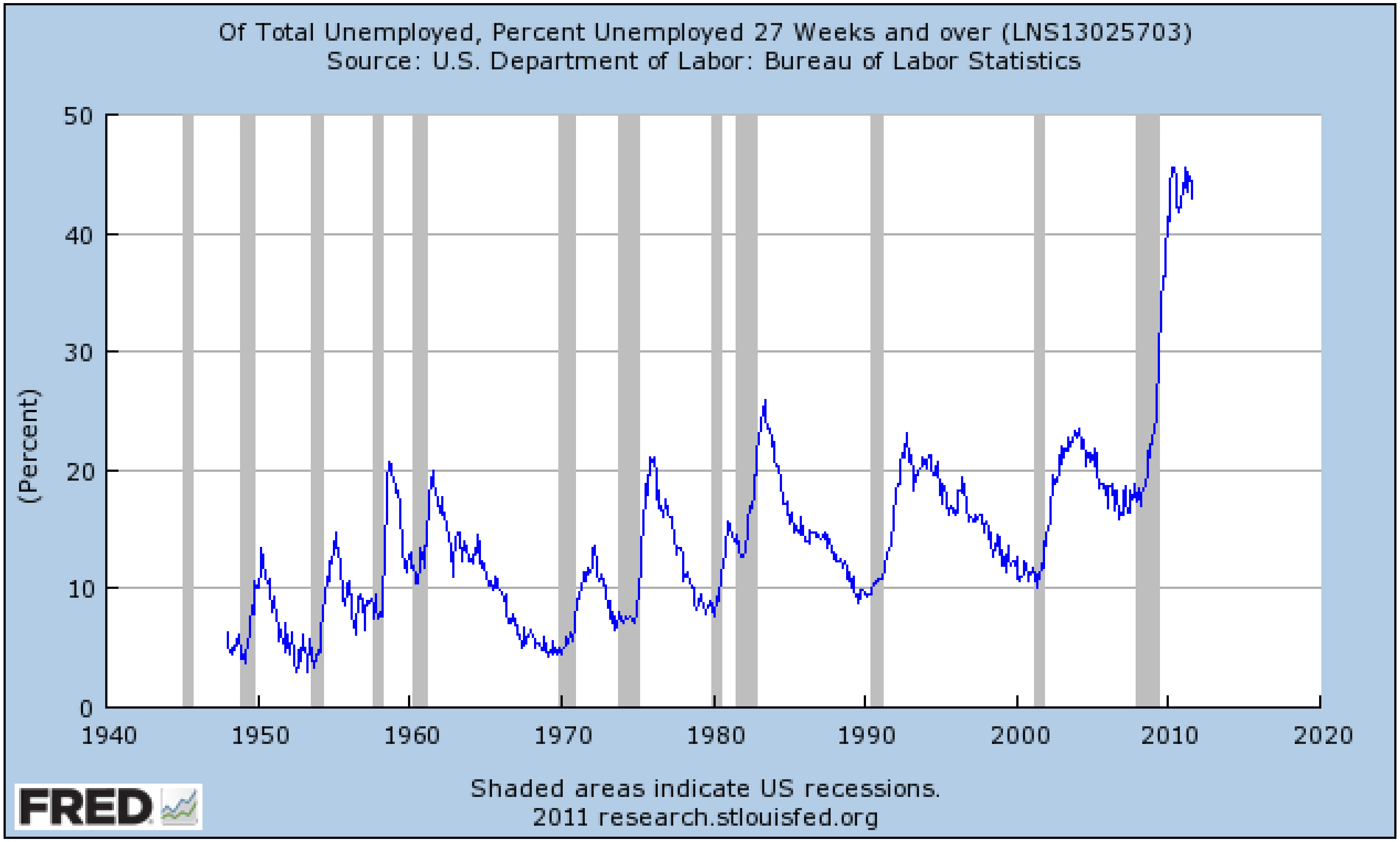
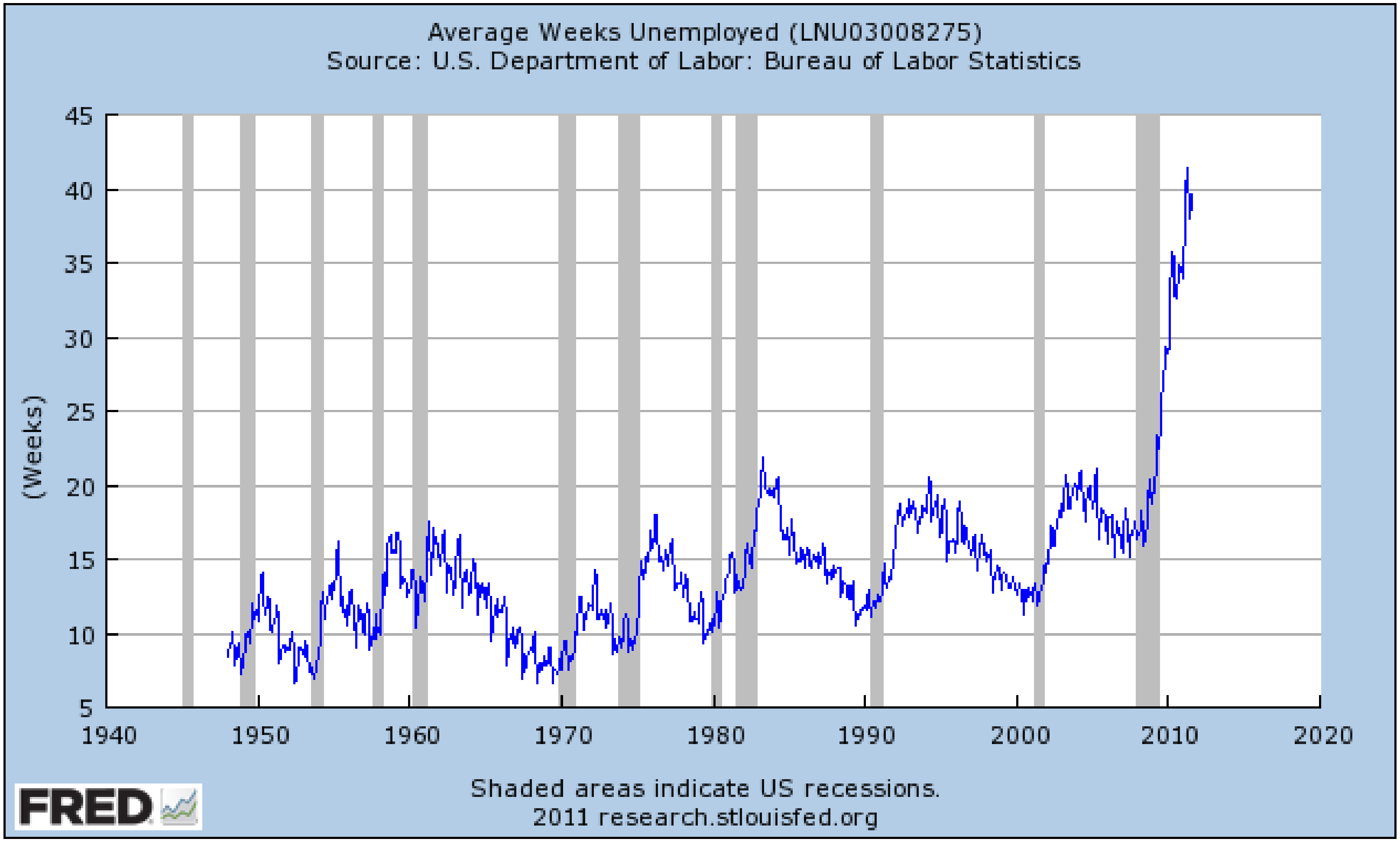
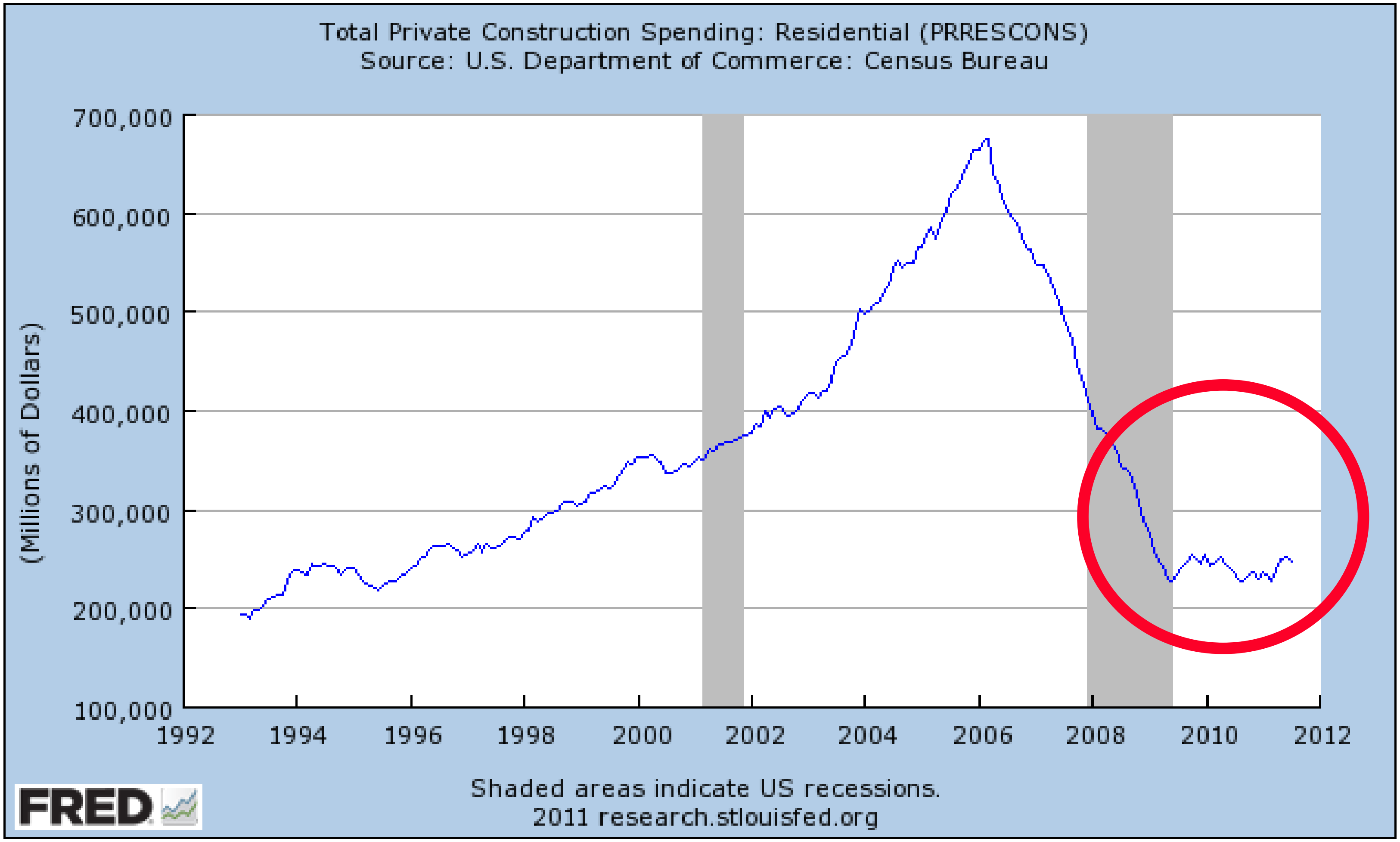


Average Duration of Unemployment



Residential Construction



Case Shiller Home Prices

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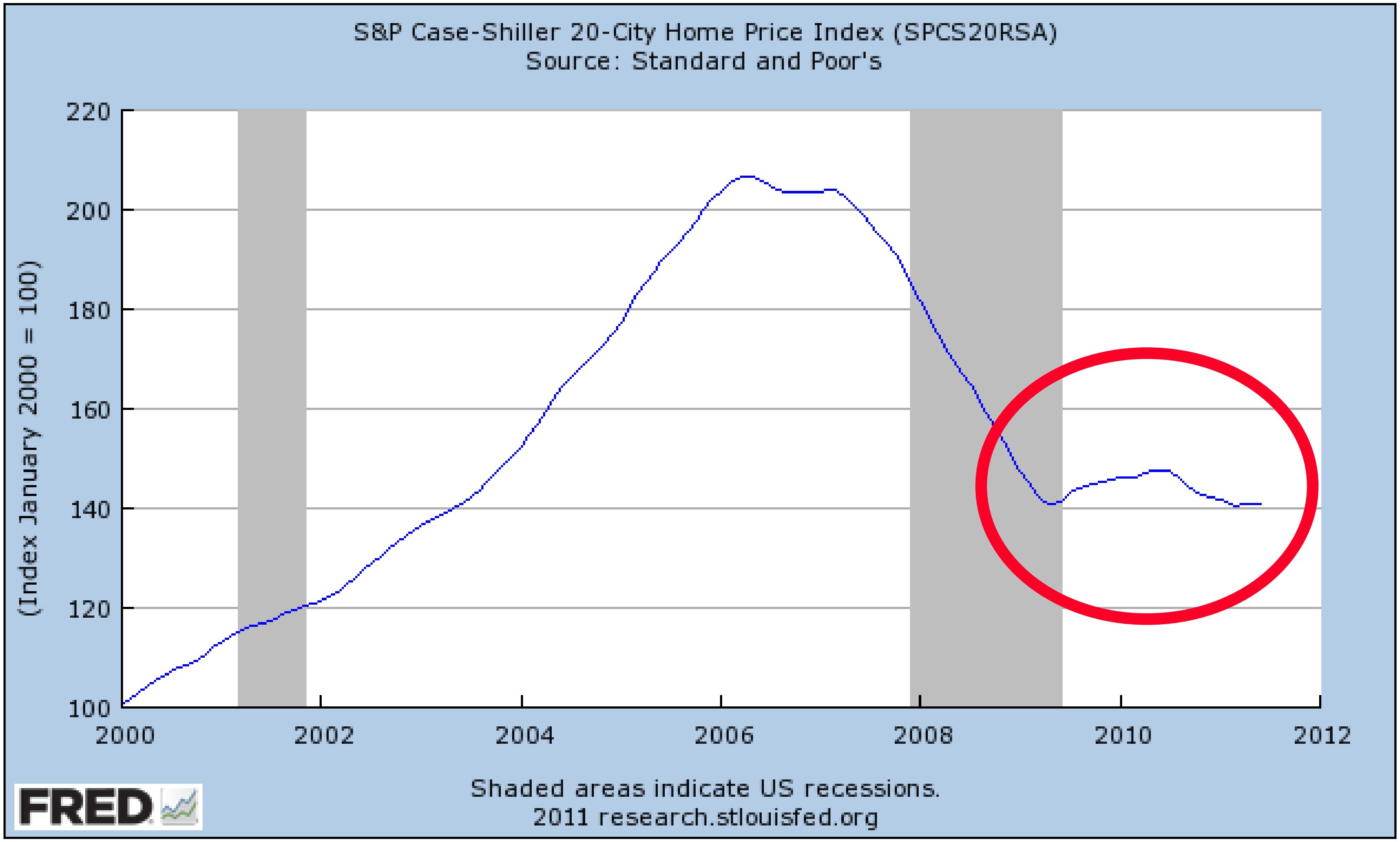

Capacity Utilization

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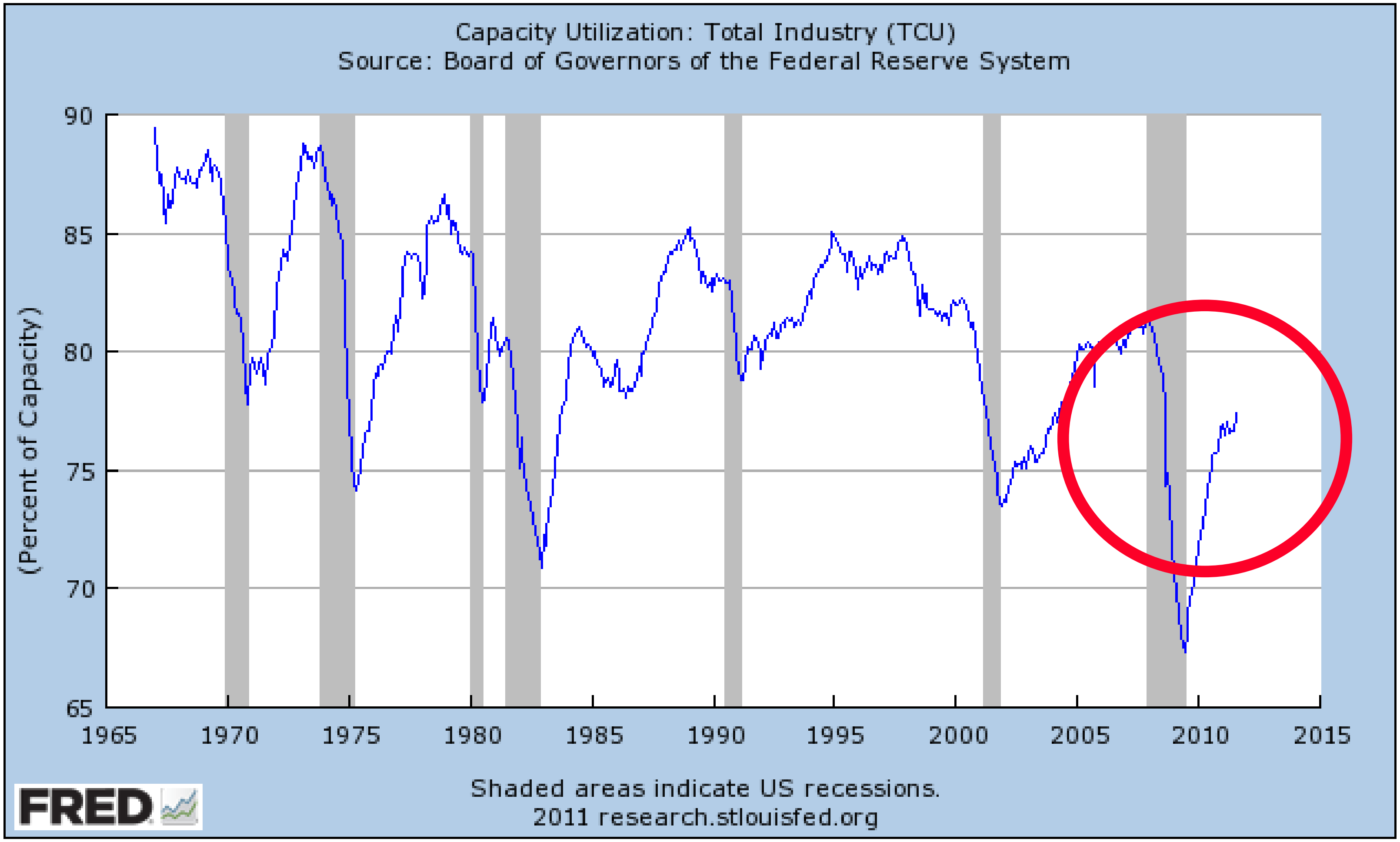
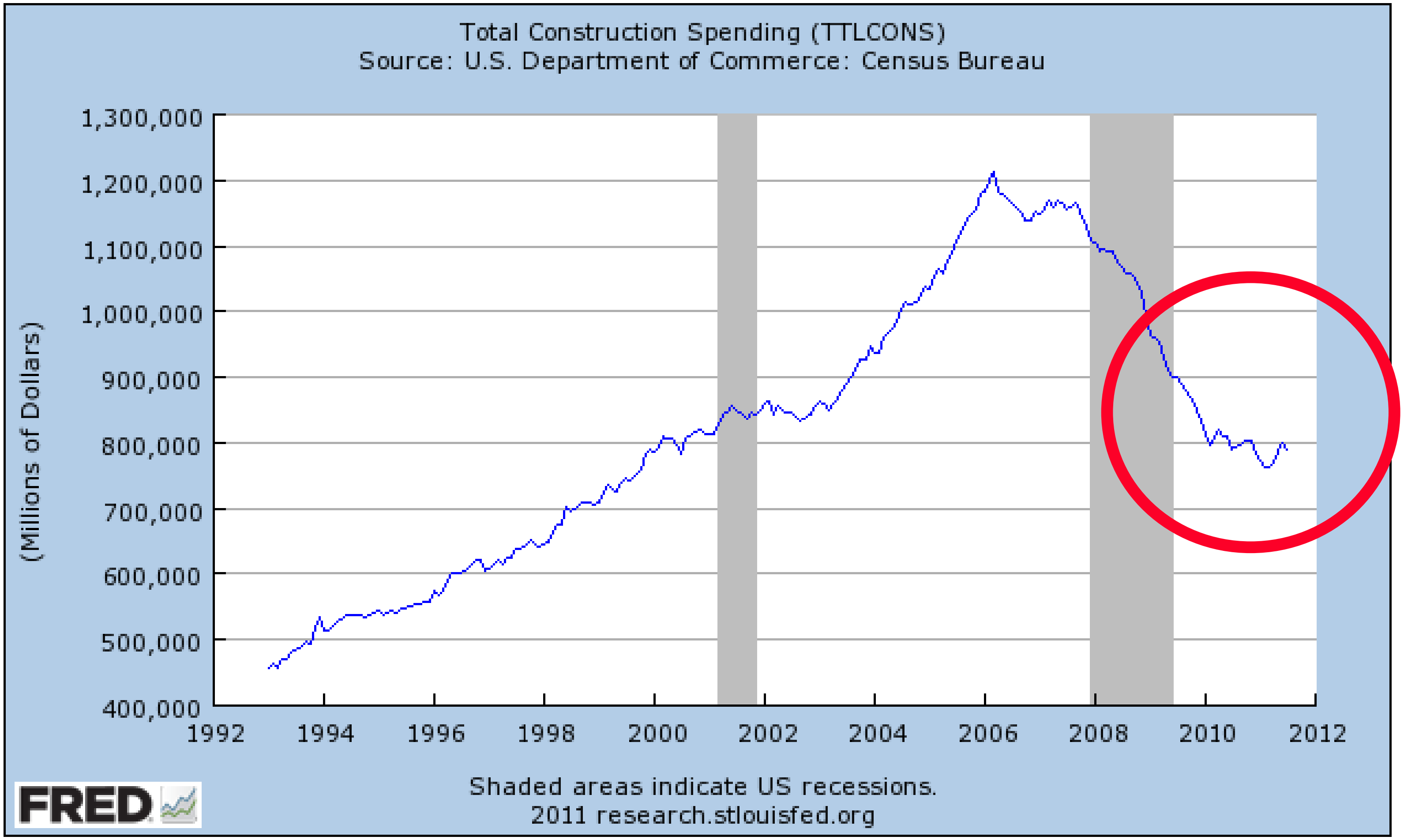


Total Construction Spending

Recovery Partners



Bank Failures and the FDIC

RECOVERY PARTNERS

Failures and Assistance Transactions

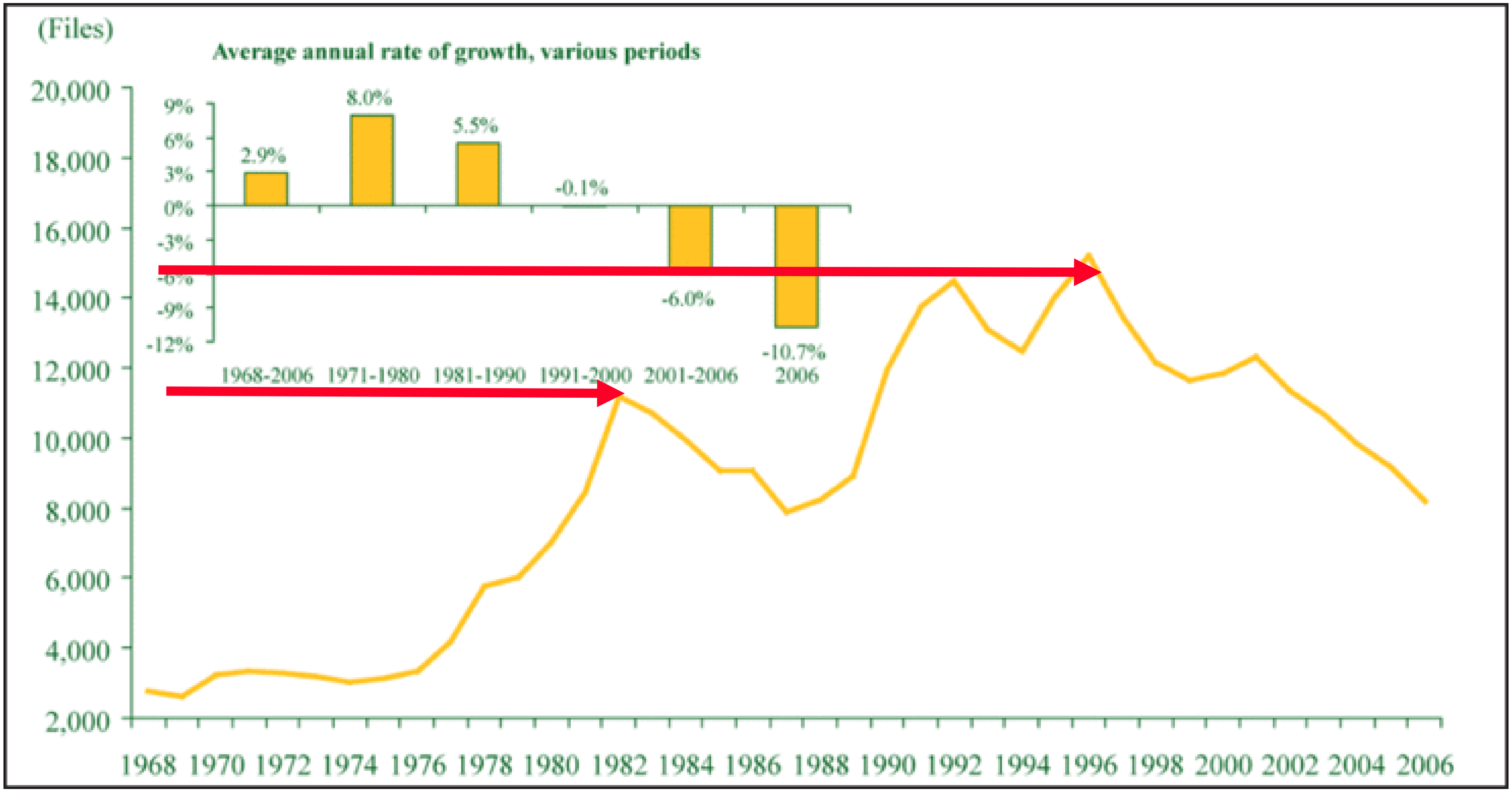
United States and Other Areas

(Dollar amounts in thousands)

	1990-2007	2008-2010
Number of Bank Failures	949	249
Nominal Value of Defaulted Assets	$403,130,565	$296,467,735
Average Size of Failed Bank	$424,795	$1,235,282
Losses to Insurance Fund(s)	$43,464,818	$73,462,832
Average Loss per Failure	$45,801	$304,825
Weighted Average Loss (%)	10.58%	26.29%
Annual Failure Rate (during Peak)	293	118

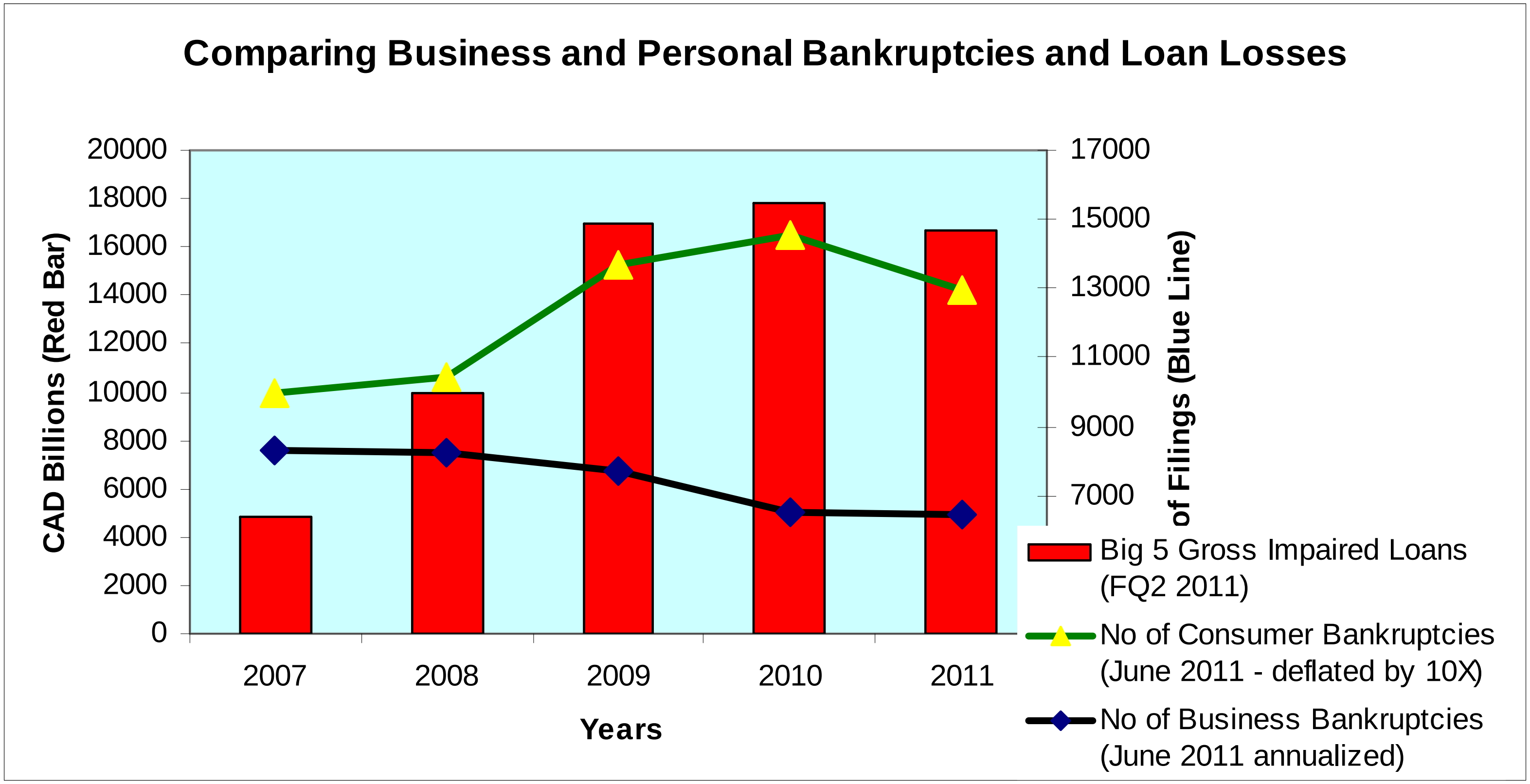
Canada – Bankruptcies

RECOVERY PARTNERS



Source : Superintendant of Bankruptcy

Canada – NPLs and Bankruptcies



Investment Implications

Keeping Investments safe will be difficult in a scenario where the public debt crisis spins further out of control, sovereign defaults and financial institution bankruptcies become a wide spread occurrence rather than a possibility and civil unrest ensues as populations lose whatever confidence they had left in their governments.

Buy-and-hold is definitely over; shorter-term trading is back. Absolute returns should be the yardstick, not market benchmarks.

- ✓ *Keep durations short to manage interest rate risk*
- ✓ *Use stop-loss parameters to manage equity risks*
- ✓ *Structured products (issuer assumes the risk of future shock while capping yields)*
- ✓ *Physical bullion or other forms of "Anti-Money"*
- ✓ *Alternatives: Farm Land, Silviculture Trusts; Commodities*
- ✓ *Exposure to emerging markets may well become a safer play than the NYSE, European Indices or the TSX*

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Notes: