The Issues

June 2010

MARKETS WILL FORCE THE OUTCOME

Greece's excessive fiscal debt, at over 120% of GDP in 2009 and expanding by 10% each year, has been a known factor for some months. What damaged investor confidence over recent weeks was the wobbly display of EU leaders, including the European Central Bank (ECB) and their respective ineffectual policies and statements. What began as an orderly decline in the euro evolved into a rather messy rout in May. Can this be an example of "sell in May and go away"?

The Underlying Issue

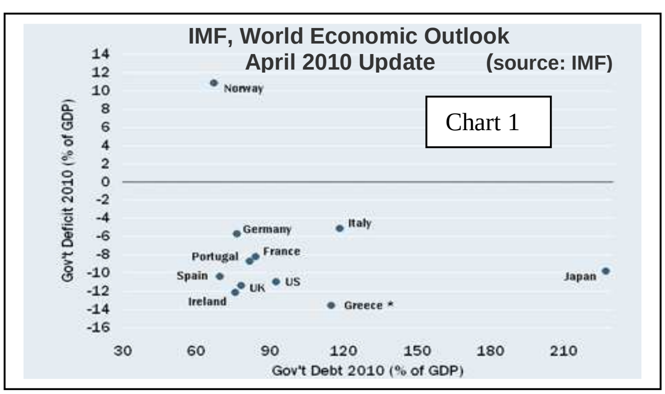
The problem with euroland's having a single currency is no different than Asia's dollar peg in the 1990s, which ended in the Asian financial crisis. Because of the currency peg, interest rates were mispriced, i.e., too low relative to inflation rates in certain economies due to different social/political systems. Low interest rates led to spending/investment booms and large current account deficits. Affected Asian economies devalued substantially then, restructured their debt, and used subsequent recoveries in the external sector to generate current account surpluses and rebuild savings. These moves helped them emerge from the 1997-98 financial crisis on a much stronger footing.

The current issue is the Euro Commission's refusal to allow Greece to drop the euro (politics of euroland unity) so Greece (with a 12% current account deficit) is denied the option of devaluing and restructuring its debt. At the same time, euroland leaders are prevented by domestic politics to use taxpayer monies to bail out another country. Of the €750 billion package announced to be made available to a Special Purpose Vehicle, only €60 billion is in hard cash-on-hand, which is too small relative to the sums involved (Table 1, below). Of that, €440 billion are "promises" with no details on how they'll be funded—taxpayer funds or money printing or some mixture of both.

And €250 billion from the IMF is conditional on undefined terms (probably dependent on what euroland's own €440 billion comprises). Despite a mounting crisis, euroland leaders have delivered rhetoric rather than clear, implementable policies. This is why confidence has plummeted and markets are forcing euroland to devalue *en bloc*. But even that will not help Greece because much of its trade deficit is with other EU members, particularly Germany. Therefore, euro devaluation alone will not solve Greece's problems.

The Germans have demanded that the Greeks (and all others) further tighten their fiscal belts in the middle of a recession as a pre-condition for assistance, which is economically implausible. Large cutbacks in fiscal expenditures when an economy is already weakening will deepen the recession, cause budget revenues to plunge even further, raise the risk of a spiral in bad debt, and hand the country a banking crisis. The Germans themselves took massive fiscal spending as medicine in 2009 to tackle the recessionary impact. No wonder markets have remained skeptical.

Key Problem Areas. How Big Is the Problem?



Greece and Portugal are at the center of the problem—but at 3.5% and 2% of EU GDP, respectively, they are too small to inflict systemic collateral damage on the remaining euroland banking system. Ireland is even smaller.

Foreign banks hold €106 billion and €44 billion of Greek and Portuguese government bonds respectively (details in Table 1, below, estimates by *The Economist*).

Spain is of concern, but not immediately. At ~70% of GDP, its public sector debt is the lowest in the EU. Thus, Spain, as a country, has room to borrow funds and buy needed time to restructure and reform its economy.

Italy's public sector debt as a percentage of GDP is high, at 120%, but most of that is funded by a high domestic savings rate, not foreign money, and its fiscal account maintains a primary surplus of 2% of GDP. Thus, Spain and Italy are not immediate systemic risk situations with flashing red signals. Markets will give them time to see if they can restructure. So the issue at this juncture is PIG (Portugal, Ireland and Greece), not PIIGS (+ Italy and Spain).

It's All about Cash Flow

Among PIG, over €20 billion of fiscal debt will be up for refinancing in 2H10 and €50 billion+ in 2011 (source: Bloomberg). On top of this cash flow need is funding for: 1) ongoing current account deficits at the rate of over €10 billion every quarter; and 2) rollovers of loans foreign banks have with PIG banks and other entities.

The Bank of International Settlements (BIS) estimates foreign banks' lending to government banks and private sector in Greece at end 2009 was €164 billion, and Portugal, €198 billion. Table 1 was constructed assuming banks own half of foreign holdings of government bonds held pro-rata to each country's bank holdings of Greek assets. Based on this assumption, the balance of assets other than government bonds held by foreign banks in Greece and Portugal is estimated to be a total of €210 billion, most probably credit lines that need to be rolled over regularly.

The size of bank loans foreign banks have with PIG entities that need to rolled over therefore dwarfs the size of PIG bonds maturing over the next few months. Thus, foreigners, i.e., the market, pulling money out of PIG is a much bigger issue than refinancing of sovereign debt in terms of cash flow impact. This cash drain has probably already begun.

Table 1

Foreign Banks' Holdings of Assets in:	Greece		Portugal	
	Gross Assets		Gross Assets	
(Euro billion, at end 09)	Govt. Bonds*	Others	Govt. Bonds*	Others
Euro Area	76	41	32	115
UK	7	3	4	13
Rest of World	24	13	8	27
Subtotal	106	58	44	154
(% of total outstanding)	25%		29%	
Total public bonds outstanding+	418		150	
Public bonds held by foreigners	213		88	

"Other assets" would mostly be loans extended by foreign banks to Greek and Portuguese banks, businesses and other entities to finance funding needs resulting from the two countries' cumulative trade deficits, which ballooned to ~€200 billion between 2005 and 2009.

Proportion of sovereign bonds outstanding held by foreign banks.

Sources: Bank of International Settlements (BIS); **The Economist* estimates and +Bloomberg,

IMF data showed net external debt at €176 billion for Greece and €165 billion for Portugal at end 2008 (2009 data not available). According to BIS, Portuguese banks' net foreign debt in 2009 was around €76 billion, or 46% of GDP.

In short, probably tens of billions of euros of interbank loans will need to be rolled over the coming months. The size of a potential run on PIG banks from the outflow of foreign funds could very quickly use up the €60 billion in standby credit lines. The sum also dwarfs the size of the ECB, which has said it will buy Greek bonds (meaning it will sell better-quality bonds and replace them with subpar bonds). Its equity base (contributed to by various eurozone members) was last reset on January 1, 2009, at €5.76 billion. And the bank has no power to print money.

Markets Will Force a Quick Ending

In the absence of a clear bailout policy by eurozone authorities, the market in subpar PIG government bonds will freeze up. But unlike the relapse of subprime ABS back onto global banks' balance sheets, which drove a slow water torture on credit markets and an ever-escalating global credit crunch, the end of the PIG sovereign debt crisis should be a quick one.

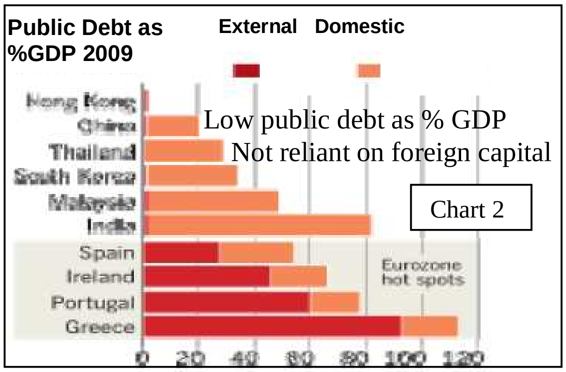
The end game will most likely be a private sector run on banks in Greece and Portugal, as foreign capital exits (much as foreign banks did that triggered the Asian financial crisis) and local depositors, in a flight to safety, transfer money out of local banks to global ones. Market forces will quickly drive a debt moratorium via a collapse of the banking system.

We see **two possible scenarios**: either 1) euroland's leaders will come up with hard cash for the €750 billion bailout package; or 2) market forces, i.e., bank runs will drive the banking systems of Greece and Portugal toward collapse, forcing a quick defacto country debt default and debt restructuring. Euroland would have to direct bailout funds to recapitalize the banking systems of Greece and Portugal, instead of buying hundreds of billions of PIG bonds that have little chance of being fully repaid for a long, long time. This would actually cost less and be a better solution for all.

Greece's dropping out of the euro currency and readopting its drachma with a big devaluation, plus debt restructuring, is probably the most likely outcome. Portugal, being more dependent on shorter-term foreign funds, is actually the most vulnerable. If the second scenario plays out, we expect Portuguese banks to fail first.

Conclusions

Whichever of the above two scenarios takes place, it should mark the end of current uncertainty. Under scenario two, some EU banks will take a hit from debt restructuring but, as discussed in the above analysis, the size involved is not big enough to cause systemic damage to euroland's banking system. As additional perspective, the European Union has a GDP of €11.8 trillion vs. a grand total for PIG net external debt of a little over €500 billion.



Source: Citigroup.

Markets always look ahead, and we expect a sharp rebound in Asia Pacific ex Japan stocks once the outcome is clear. The region remains one of the few superior growth areas globally, driven by internally funded domestic consumption and investment (Chart 2). The euroland episode will not derail these trends.

Last but not least, the "feel good factor" among the Asian public is very high (a major difference from the EU and the U.S.). Since the 1990s, they have endured *three* major crises—1997-98, the 2000 IT bubble and the 2008 meltdown—and emerged stronger each time with higher income and asset wealth. In behavioral finance, that spells confidence about the future.

Who's Buying?

For every seller there's a buyer, so who's buying shares in the Asia Pacific ex Japan region during this mini-meltdown? As far as bourses in this region are concerned, sellers have been mostly foreign momentum investors and relative performance-driven mutual funds. And the buyers? Not surprisingly, the locals.

It is no coincidence that Malaysia is the best relative performer (with low foreign ownership) and that those with the highest foreign institutional ownership fared the worst (e.g., Korea, Hong Kong, H-shares). This pattern reminds us of the conclusion of the global financial tsunami meltdown at end 2008. Then, stocks became so cheap that local individuals came out as major buyers. Now, too, the general sentiment of local investors is, "When would be a good time to buy some stocks?"

Investment Policy

Recent developments have had the effect of toning down global growth expectations, which is a healthy sign given that the risk of a growth scare was one of the overhanging issues we were concerned about following the sharp market gains of 2009. For fundamental reasons, as discussed above, we do not see a globally spreading credit crunch triggered by events in Europe. This correction is NOT the start of a global bear market.

One of our past *Issues* discussed the volatility factor taking on a life of its own. The wild magnitude of swings in today's markets are amplified by the use of geared instruments such as derivatives, options, short selling, etc., that facilitate market exposure at a multiple of the principal committed. We call them the steroids of the primeval herd instinct that fuel greed and fear. On the back of violent price swings, rationality is out the window as greed and fear self-feed.

We see the current plunge as another repeat of sharp, volatility-induced, fear-driven selling, i.e., a blip, albeit a big one. The sharper the fall, the greater the fear of more downside, which then self-feeds, especially with momentum funds and relative performance-benchmarked fund managers. Some of them capitulated in the middle of last week.

Our regional funds have 20% in cash. We believe markets will act as police and soon force the current unsustainable political impasse among euroland's leaders to unravel. Neither the German nor the French public will foot the bill to bail out PIG. A bank run driven by market forces and the risk of a total collapse of the problem economies' banking sectors would precipitate a defacto debt default, debt restructuring and resolution of the PIG issue. We should therefore be near the final chapter of the PIG financial crisis saga.

In a global environment where growth in all major developed economies is constrained by massive budget deficits, Asia Pacific ex Japan stands out as one of the few areas with good growth visibility. Further, sharp dips of bourses in this region will offer great buying opportunities in selected stocks, sectors and markets. Given the recent meltdown, some stocks in these sectors are once again offering very, very good value.

The Net Asset Values GSI Asian Capital Growth – US$21.99 & The Long Short Fund – US$20.39 (May 27, 2010)