PICK OF THE WEEK

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Sovereign default

"Dictum meum pactum?"

The world of high finance is full of charlatans; those who claim never to have been duped are lying or unaware. When clinching a deal, these fraudsters seize your hand in a manly but friendly grip, look you in the eye and utter the immortal phrase "my word is my bond". In olden times, the 1990s, the more professional crooks would often say "dictum meum pactum". This means the same thing but being in Latin shows great erudition, thus adding credibility. If a man (and usually it is a man) insists on telling you he is honest, something's seriously wrong. Today, more dubious people than ever are saying 'trust me', and investors are doing just that. Having lost millions to one group of hustlers – be they funds of hedge funds, SIVs or structured products - they are now fleeing by the billions of dollars to other fraudsters: central bankers selling the perceived safety of government bonds. Moreover, so great is the issuance of these IOUs that inevitably there is a giant crowding out effect on the private sector borrower. This ensures that bankruptcies accelerate, thus bond issuance must do so as well.*

Although objectively (sic) we are the greatest living authority on bank valuations and cycles (as the only firm in the world never to have held bank shares in the English speaking world), we make no claims as bond experts. Despite this caveat, we do understand when supply and demand are chronically out of balance. Such analysis on bonds suggests that financial markets are in for the worst shock of all – a series of Sovereign Defaults. 'Don't know where, don't know when,' as the Platters used to croon, but this time default will not just be a third world problem but will include some industrial nations.

Mankind is a natural herd animal. Criticising the status quo is never popular. Only when it has become blindingly obvious that the decision makers and leaders are unquestionably idiotic and their policies disastrous does the herd tear them to pieces. This is often when default occurs. Debt markets and politicians are not prepared for these events. Given the atrocious supply/demand dynamics, trusting in government issued paper is now one of the worst investments anyone can make.

What is a Government Bond?

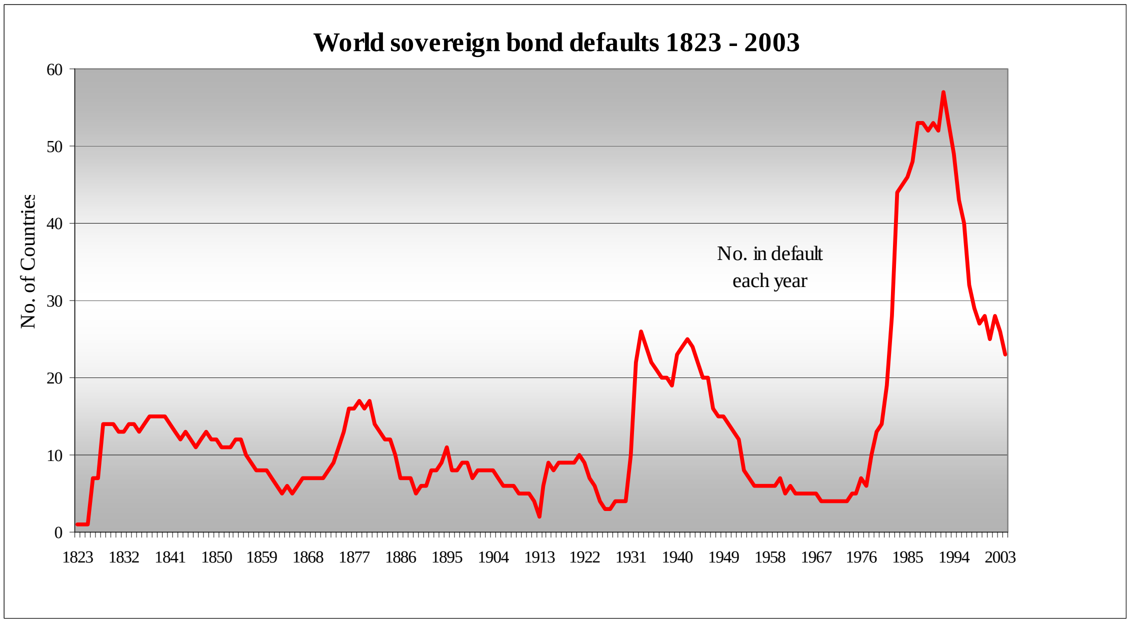
Until recently, none of us had ever read in full what is written on an American or British government bond or the offer documents. There are lots of words and caveats, not dissimilar to Bank of England bank notes with their lingering promise from the days when these notes could be redeemed in gold.

Government bonds are the standard benchmark for risk. Their yield sets the borrowing costs for everyone else. There is logic to this, as in theory the obligation to pay at some future date by issuing government paper in prudent quantities can always be met through changing tax rates or curbing government expenditure to raise the necessary funds. The promises are more explicit than bank notes and commit future governments to meet these liabilities even though their leaders may not yet have been born.

**Also the motto of the London Stock Exchange. Enough said.*

Default is normal

It is not widely realised that governments failing to meet their debt obligations are astonishingly normal. Indeed, it is utterly *abnormal* for a country to have a track record longer than three generations of paying back IOUs issued by dead people. The chart below shows the number of countries in default of their sovereign obligations in each year since 1823.



Source: C.Suter, Standard and Poor's, M.L.Wright

This chart understates the true extent of default; for at the sub-national level many states or cities - such as four American states in the 1830s (well before the civil war), or the City of Cleveland (Ohio) in 1978 - defaulted on their bonds. China created havoc in the late 1990s when several of its local state-owned investment companies defaulted. Beijing-based politicians and the central bank had always suggested they were government backed. When these investment companies gambled themselves into bankruptcy, bond holders hired translators and discovered they were not even backed by the regional governments which had issued them. Meanwhile the Politburo developed collective amnesia.

There is also a definition problem as to what constitutes a default. Not paying the interest in full, or replacing bonds on their due date with new bonds rather than the cash promised are not considered defaults, even though they are. But despite such a narrow definition, by the end of 2003 over 20 nations out of the 192 members of the UN were in some form of default.

The data on how often and which countries renege on their debt is also confusing. Some regions have an extraordinary history of, in practice, never paying. Many of the academic papers concentrate on quite recent events leading to some seemingly firm rules; such as if it speaks Spanish, beware. This was reinforced when virtually every country south of Texas entered default in the 1970s (leading to the Brady bond cover up/rescue); also by the amazing history of Argentina since then (see below) and by the 1997-8 emerging markets crisis. Although the latter commenced in Asia, it soon resulted in Latin America deciding to give up, again. This has resulted in an implicit assumption that sovereign default usually happens in fly-blown minor economies lacking an educated middle class or 'fair' political process. Nothing could be further from the truth.

Historically, many of the leading countries of their day had a higher propensity to renege on national obligations than smaller ones. Examples include Spain, France and Portugal, partially because smaller states simply could not obtain foreign credit. This list of defaulters reads rather like the proud medal table in every country's press around the time of the Olympics, although Spain (home to Europe's largest bank, Santander) probably prefers not to claim the all-comers prize over five centuries.

TABLE - SELECTED CASES OF SERIAL DEFAULT IN THE OLD AND NEW "EMERGING MARKETS": 1501-2002

Country	Number of default (or restructuring) episodes			
	1500-1800	**1801-1900**	**1901-2002**	**Total**
Spain	6	7	0	13
Ecuador	n.a.	3	6	9
Venezuela	n.a.	5	4	9
France	8	n.a.	0	8
Germany	1	5	2	8
Mexico	n.a.	5	3	8
Uruguay	n.a.	2	6	8
Brazil	n.a.	2	5	7
Colombia	n.a.	4	3	7
Liberia	n.a.	1	6	7
Peru	n.a.	2	5	7
Turkey/Ottoman Empire	n.a.	1	6	7
Portugal	1	5	0	6
Argentina	n.a.	2	3	5
Austria	n.a.	1	4	5
Bulgaria	n.a.	2	3	5
Greece	n.a.	4	1	5
Yugoslavia (former)	n.a.	1	4	5
Chile	n.a.	2	2	4
Russia	n.a.	1	3	4
Poland	n.a.	n.a.	3	3
China	n.a.	n.a.	2	2
Egypt	n.a.	1	1	2

Sources: Reinhart et al. (2003) and sources cited therein and Standard and Poor's Credit Week, various issues. Serial Default and the "Paradox" of Rich-to-Poor Capital Flows (2004), C. Reinhart and K. Rogoff.

Default is not a third world event. In the last century we have lost Germany and China twice and Russia three times, or one third of the G9 (the nine leading nations who like to meet a lot to ponder the world). Remember too the problem with what constitutes default. France did not pay its bonds during the last world war and so inflated away its currency afterwards: there was a 100 to one redenomination in 1960. In 1973 France issued 7% Rente Bonds (known as the 'Giscard') with redemption tied to the gold price; these were so expensive the government repeatedly changed the terms. That's three times in 70 years. Italy was similar - twice in less than a century. Japan hyper-inflated a bust in the 1930s and then all debt was wiped out after WWII. Thus six G9 countries have gone bust at least twice in less than 100 years. This is the group which is now expected to lead us to the bright uplands of economic recovery.

Send in the International Monetary Fund?

Most obviously missing from this table is the world's most serial defaulter from the late 1980s onwards, Pakistan. The main reason the country exists today is the IMF. Originally one of many accidental creations, as European nations were either forced out of or decided to give up on being empires, the sole reason for Pakistan's establishment was the desire of less than 100 middle class, educated Indian politicians to have their own theocratic state. Pakistan was never a real country. Earlier this year the US State Department was publicly worrying that it, and Mexico, have passed the tipping point of being nations. This is impressively behind the curve. Even by 1971 it had split into two - Pakistan and Bangladesh. Now it shows every sign of splitting into its four old tribal pieces. Certainly the 12 family groups which own over half the land and provide the ruling class are, by accident or design, accelerating this fracturing. Now there are only two organisations left holding it together: the highly corrupt army (with its attached and out of control ISI, or secret service), and the IMF.

It and its sister multi-national organisation, the World Bank, were post-war constructs to provide credit, infrastructure development and balance of payments advice when the world was trying to recover from years of fighting. Banks had no capital and exchange controls dominated. As banking and international financial systems developed, the roles of the multi-national overseers became unnecessary. So many papers have covered this we need not repeat them here. Although not in its original remit, by the early 1980s the IMF had morphed into the world's financial policeman, to help countries dig themselves out of debt holes and honour their international bond obligations. The underlying assumption was that if a country defaulted there could be a domino effect and thus financial chaos. The more cunning politicians, of which Pakistan has its fair share, realised early this weakness in the IMF structure. Thus Pakistan has a steady history of issuing bonds which it clearly has no intention of repaying, even if it had the ability. Yet it has never joined the list of defaulters because it has learnt to stare down the IMF and arranged emergency funding at three minutes to midnight five times during a 20 year period.

Pakistan is not alone in this. Turkey and its predecessor the Ottoman Empire has defaulted officially seven times since 1900. It is teetering on its eighth now. By 1998 these two and Russia in practice had been loaned half of the IMF's assets. Now it is looking to expand its asset base from $250bn to $500bn through new member subscriptions. Leaving aside obscure excuses used by many countries not to pay their dues (over $200bn unpaid) or the huge amounts of IMF loans in arrears, even if this sum were reached it is insufficient to meet just the British government's underwriting of the toxic debts of its two most recently supported banks. So compared with its glory days, the IMF today is a minnow. Its net new lending since mid 2008 has been around $55bn, less than the American government's third cash injection merely to help prop up a single 'insurance scheme' known as AIG.

In order to be an effective referee and saviour in the debt markets – should there be a problem – the IMF needs to be far more heavily funded by the major industrial countries, from America downwards. Yet these nations have shown an increasing distaste with the bureaucracy and efficiency of both it and the World Bank. That the chairman of each is an ethnically hereditary job (France and America respectively) indicates the depth of the torpor. The bond crisis may result in reform and a volte-face, but this is likely to be too little, too late. Moreover, the IMF simply lacks sufficient personnel.

The sovereign default jigsaw

Sovereign defaults are often avoided, because as country A wanders into a financial mess, country B meanwhile has enjoyed robust growth creating financial surpluses. As these need to be invested, B is often happy to buy A's bonds. This is precisely what China and Japan were doing supporting America's debt. Given Japan has produced its first current account deficit in 13 years and the savings rate has tumbled to 2%, that money pot has emptied. Meanwhile, China's exports have collapsed. Globalisation has ensured that all major countries are suffering huge fiscal deficits at the same time. The global property price bubble and collapse has created a uniform problem from Beijing to Jo'burg, Frankfurt to Washington. Every leading nation needs to borrow a lot more and there are simply far more government bonds to be issued than there are savings to buy them.

Each government is pursuing what they perceive to be a Keynesian response (it isn't, but why be picky?): print money, use massive budget deficits to rescue and nationalise local banks, subsidise politically sensitive industries and stimulate the economy through large capital projects. Bond issuance and deficits are rising to levels unseen save at the peak of WWII. The majority of the money in each nation must be raised locally. Many of these bonds will be sold to willing buyers but investors' pockets are insufficient. A record level of sovereign default is inevitable.

The facts on the ground do not yet support the theory. Consider the UK (or rather England). It hasn't done a decent default since Edward I (Hammer of the Scots etc.) in the 13th century. The Bank of England's base rate is now the lowest ever at 0.5% and bonds are selling like hot cakes. American investors have been gobbling up three month government paper with no yield at all. Such an appetite is surprising given many countries will suffer budget deficits in excess of 10% of GDP, before any contingent liabilities from bailing out local banks. President Obama has bravely forecast 12.3%. This may be correct but, understandably in politics, he is building in an impossible recovery rate thereafter. In the UK, sensible forecasts (i.e. not from government) are for net bond issuance in 2009 and 2010 of over £130bn in each year - 10% of GDP - and possibly higher still for 2011. In 1976, the IMF/OECD gave Britain a bail-out package when the deficit was only 60% of this level and the banking system in far better shape than now.

Other 10%+ budget deficit countries include China, Spain, Ireland, Portugal, Turkey, Italy, and every Eastern European nation including Russia. Denial or dirty data makes others look less bad although the lengthy list of those with the same problem will include India, Argentina and Kenya. No continent is immune. Yet the yields on leading 10-year government bonds are astonishingly low: 2.9%, 3.0% and 3.1% in America, Germany and the UK respectively. There have been warning shots of a 'buyers strike'. Six German bond auctions have not been fully subscribed since June last year. However, only the very weakest countries such as Latvia or Hungary have seen international borrowing costs rising.

That record issuance with such low yields is being bought by 'investors' reflects simple panic. They were amazed that banks could go bust. As credit availability was consequently reduced, they were then amazed again that other financial institutions from private equity to hedge funds could also go broke. They'll be amazed too when more insurance companies go pop, despite the demise of AIG (which at the start of last year was the largest insurance company in the world) or Munich Re, no minnow either. This flight to perceived safety may last throughout 2009, because looking at our own data on banks, further massive losses and government injections are inevitable. Soon, like Pakistan and Mexico, a tipping point will have been reached. The sovereign crisis is sure to run along similar lines to previous downturns, so at least there is a rough road map.

What governments will do

- Change the rules (or shutting the stable door). Most banks lacked liquid reserves even at the peak of the bull market, an extraordinary consequence of the Basel II accord reached by major governments to *improve* bank safety. Britain is doing this now. Current proposals mean that local banks may have to buy £100bn net of government bonds in the next two years.

- Quantitative easing. The central bank electronically prints money and then uses it to buy its home government's bonds. In a debt crisis there is something inherently fatuous in printing more money to create more debt.

- Encourage 'prudent' investing by state-controlled entities. Examples of this have included America, China, Ireland, Britain and Spain. Local authorities/provinces are at first advised and then regulated to buy safe government bonds. (We expect UK legislation on this in 2009; since many local authorities are financially inept and decision averse, they will happily comply without demur.)

- Overt pressure. History is littered with 'Recovery' and other patriotic bonds. Many countries still have them, such as Britain's irredeemable War Loan. No-one was ever forced to buy but the moral suasion in wartime to invest to save the nation made them an easy sell, especially when combined with a then high coupon (3.5%). It is always easy to squeeze the patriotic lemon. Perhaps this is why several western leaders are once again muttering ominously about 'economic migrants' stealing local jobs.

- Regulatory changes. Never has the state accounted for such a significant share of GDP globally. Even at the nadir of the great depression, non-communist government expenditure rarely accounted for more than a quarter of GDP: now it is always over 45% when adding back local authorities. At the core of budget deficits are state employee pensions. On current life expectancies, a typical state employee is likely to live longer on an index linked pension than in employment. The mathematics simply cannot work. This will be the big political battle. The solution was seen in the private sector in the 2003 slump; companies such as Rolls Royce unilaterally changed the pension benefits for employees from 1/40th to 1/80th, thereby solving their pension funding problem at a stroke.

- Demonise the poor, the ugly and the ill-educated to justify the removal of their welfare benefits. America's long-tradition of food stamps rather than cash was one response to its 1980s funding problems but this does not save much. Media criticism of large families on welfare (the 'six children by seven fathers' type headline) has commenced.

- Covert sequestration. Bribe the individual investor through a variety of tax breaks. This was part of the logic of America's 401k and Britain's PEPs (now ISAs) in the 1980s. At the corporate level, make taxes on funds held overseas greater than if held onshore.

- The last gasp is always compulsory sequestration: replacing savings in cash, in bank accounts, and elsewhere above a certain level with government paper on a "temporary basis", and limiting withdrawals or redemptions. In late 2008 some US legislators were muttering ominously about taking over individual 401k pension plans. It has happened before; it will happen again.

The fast and the furious

One interesting aspect of sovereign default is that those countries which try to repay their foreign creditors often suffer more than those which throw in the towel early, and which usually claim dramatically higher debts than the reality. This tactic is designed to negotiate the return of only a few cents in the dollar to lenders and increase new overseas aid. Winners default early. Paying what you owe is for wimps. This is because historically markets have mis-priced defaulting countries after the event. A good example is Argentina.* Following its 2001/2 default, (the fifth since independence), the world's lenders swore on their Grandmothers' honour never to touch the country again. This says little for their grandmothers' virtue; only 36 months later Argentina's sovereign bond spread (i.e. how much more it had to pay versus US bonds) quickly fell to a normal emerging market level.

**This is particularly well covered in a recent book by Harvard's Professor Niall Ferguson, "The Ascent of Money". It is should lie alongside J K Galbraith's "The Great Crash, 1929".*

In a way this is logical. All Argentina did was to stretch the rules. For despite many academic theses, if a country decides to give up on its foreign obligations it can cease draining the local economy to pay foreign bond holders and use tax receipts to stimulate economic activity.

Thus, using our earlier example, assume country A and B both have large deficits and identical economic attributes. Country A decides to tear up its debt obligations. Investors will assume that country B will soon follow, so will only lend to it at punitive rates. Country B must therefore raise taxes and cut welfare. Meanwhile country A is now enjoying an investment-led boom. Rapid economic growth makes it once again attractive to foreign lenders and investors. If history is a guide, having defaulted, then within five years country A will be able to borrow more cheaply than poor old country B, still bumbling along trying to be honest. Given this first mover advantage, the IMF, OECD, World Bank and the larger powers can unusually be relied upon to offer soft terms early. For if too many national leaders wake up to the real benefits of early default, chaos reigns. This allows a form of soft blackmail - the path used by Britain's labour government in 1976.

Who and when?

Which countries will renege? We have no idea. A matrix can be created to include savings, current and capital account deficits, government debt, the number of months of imports covered by foreign exchange reserves and so forth. This will highlight some obvious candidates but not necessarily those which will actually default. As is well documented, the so-called PIGS (Portugal, Ireland, Greece and Spain) are in the Premier League; of other large or advanced countries (so many Mickey Mouse ones fit the bill we will not give you a list), India, South Africa, Pakistan, Argentina, Ukraine and New Zealand must be up there. Before any inhabitants of these fair nations take offence, another name we have to put on the list is the United Kingdom.

As regards to when, we also have no idea. We cannot time how long this panic rush into government bonds will continue. In March 2007 the Great W. Buffett wrote scathingly on the fees charged by hedge funds and hedge 'fund of funds'. To paraphrase, they had to fail. Long term equity returns tend to be 3% or 4% p.a. more than the yield on government bonds. If a hedge fund manager charges 'two and twenty' (i.e. a 2% management fee and 20% of all profits) then the fees and other costs guarantee hedge funds will produce a lower return than bonds. This is multiplied in the case of funds of hedge funds, or similar fee structures such as private equity. Despite the blindingly clear mathematics, this did not stop investors - including the bluest of the blue institutions - from racing pell-mell into such investments. Hence we can no more judge how long this surge into absurdly mis-priced government bonds will continue. Our guess is that 2009 will see only a few fireworks. The real domino effect is more likely early in 2010 when that fiscal year's funding and deficit expectations are announced. Most people expect these large deficits will be short term. This cannot be the case until the welfare/pensions war is won. The first shots have not even been fired.

Ask Angela

The key player in Europe will be Germany's Chancellor Ms. Angela Merkel, because that country is the dominant funder of the EU. Female, right wing (in the context of her communist East German upbringing), protestant and a strong believer in the old fashioned virtues of savings and prudence, we're not quite sure how she views the hearty male catholic party scene in one Anglo-Saxon finance centre known as Dublin. Ireland is clearly a candidate for sovereign default. Ms Merkel's Finance Minister has been voluble in the need for euro-zone countries to support each other. This has caused much grinding of eurocrat's teeth in Brussels on what this means for the euro. It could be very good or very bad. Angela will decide.

Our ‘either or’ approach, depending on Angela’s views, is predicated thus: the legal structure of the euro actually encourages poor fiscal discipline amongst the member states. This has been true since its creation, especially for the newer members as they joined for more mercenary reasons than the earlier, idealistic founders. The structure has if anything encouraged countries to over-spend; the sanctions for rule-breaking are weak. By using Ireland, with its 4.1 million people, as an example ‘pour encourager les autres’ (there are 325m people in the euro zone and 495m in the EU), financial discipline would be restored. This need not involve the destruction of the euro as there are many options. One is that Ireland leaves the euro. Another is that the ECB honours Irish government bonds but makes Ireland pay indirectly through the withdrawal of all grants and subsidies, especially farming, and directly through a rise in sales taxes (VAT) payable to Brussels. Such action may well appeal to the bureaucrats and to Angela. They are all still smarting from Ireland’s kicking the new EU treaty into touch at the last referendum. Politically the impact on often lackadaisical financial discipline within the EU would be electric. In contrast, if there is a no-strings Irish rescue package, the risk is an immediate domino effect, first the other PIGS, then spreading to nations such as Belgium and Italy.

The three year view

In a recession it is worth asking which, taking a three year view, are the best investment choices; this gives a sense of perspective. Of the major asset classes available, property will have fallen a long way but might slowly be recovering. But now it is not a good place to park money. Offshore deposits are absurd. In default times, they are first in the queue to be sequestrated by foreign governments and also run the risk of controls on withdrawals (again there are many historical precedents). Worse still, national deposit insurance schemes rarely cover foreigners in a crisis.

As we have hopefully explained, government bonds are the new weapons of mass destruction. As default risks rise, so will yields, thus capital values must crumble. As the bull market in government bonds started in America in 1984, it is hardly a dramatic call to suggest a reversal is overdue. Gold does look good (maybe silver too), as a portable store of untraceable wealth; but most other ‘collectibles’ - from old Masters to wine, stamps or diamonds - far less so, since they depend on easy living and easy credit.

The odd conclusion is that the least bad home on this three-year view is to invest in businesses. Most of us lack the capacity or skill to take over manufacturing or other companies, but fortunately there is an equity market, which allows us to buy a share in them and their profits. Defining a decent business is easy. It is reasonably large, thus a consolidator gobbling up those smaller and weaker companies which are being strangled to death by a lack of credit. Prices will be absurdly low. It will have minimal debt – banks will only lend to those who do not need the money. It will pay a reasonable dividend. Over long term, between 25% and 100% of equity returns are the dividend yield. It will be in a sector where capacity is removed faster than the fall in demand (so excludes banking, autos, metals or consumption). There will be an ability to control pricing, such as pharmaceutical or telecom companies, and most important it will not depend on government support. Self-serving as this may appear, given we are an equity investment company, we remain certain that anyone buying newly minted 10 to 50-year government bonds and holding on to them, will long term be as disappointed as those patriots who in times of strife bought national war bonds.

Ever read the label?

Regards

Bedlam Asset Management plc

Quiz time

As usual, at least one bottle of France's finest bubbly (or for overseas readers, Niall Ferguson's oeuvre) will be despatched to the first correct reply received to this three part question. "Up to the later middle ages, all European accounting was in Roman numerals. Who introduced Arabic numerals, what was his main job and how many children did he have?"

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