EUROPEAN DEBT DANGERS:
SELLING SOLUTIONS, BUYING TIME…YIELDING RESULTS?
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"I know not the difference between a moment of performance and a moment of honesty." "It is my destiny to exist halfway between reality and fantasy at all times." Are these statements by a political leader or financial player during the worldwide economic disaster that erupted in 2007? No. The performing artist Lady Gaga uttered them in July 2011 (V Magazine, "Gaga Memorandum No.2").

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CONCLUSION

In the ongoing economic crisis, central banks in Europe, the United States, Japan, China, and elsewhere have fought persistent financial forest fires with a deluge of accommodative monetary policies such as low interest rates, money printing, and liquidity-enhancing measures. These central bank strategies, like massive deficit spending, do not ensure a long-lasting genuine economic recovery. Just look around the globe at slowing economic growth in many key countries. Also, European sovereign debt (fiscal troubles) and banking problems burn on. America's major fiscal problems are not evaporating. As the United States 2012 election campaign heats up, and despite the likelihood of windy rhetoric, little decisive productive action by President and Congress on the deficit front is likely. Unemployment remains very high in America and Europe. The US household balance sheet and real estate marketplaces are still badly damaged. These central bank and fiscal campaigns do, however, buy time so that political leaders and economic guardians can attack and overcome substantial problems. Is currency depreciation necessarily a satisfactory solution for a given nation in today's interconnected world? Many nations would like a fairly weak currency to bolster growth, but not everyone can devalue at once.

Though global marketplaces and their problems intertwine, let's concentrate on recent European debt developments and related statements alongside a review of several European interest rate spread relationships. This inquiry underlines that the heated efforts by European (and American and other) economic (political) generals have yielded only partial progress in vanquishing the challenges of the worldwide international crisis. So the worldwide international economic crisis probably will march onward for quite some time. And there is more than a little chance that it will worsen.

TALKING THE TALK, CONTINUED

"Brother, Can You Spare a Dime" (1931 song; lyrics by Yip Harburg, music by Jay Gorney): "Why don't you remember, I'm your pal? Buddy, can you spare a dime?"

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The cascade of European summit meetings over many months at best has made only modest progress in solving sovereign debt and banking issues.

At various points in recent months, there frequently has been much optimistic wordplay. On 12/9/11, the European Council proclaimed an agreement to move to a stronger economic union. The German Chancellor remarked there is a good chance of reaching an agreement by end January 2012 regarding a fresh European treaty that will reinforce Eurozone budget discipline (Financial Times, 1/10/12, p4). Wizards have devised creative rescue vehicles such as the

European Financial Stability Facility ("EFSF") and the European Stability Mechanism ("ESM"). On 1/23/12, Eurozone finance ministers convene to discuss Greek bailout plans and Eurozone crisis management mechanisms. The European Union gathers at the beginning of March to approve a treaty on fiscal rules.

However, much of this supposed December 2011 European solution arguably will produce little new substance. As a prelude, keep in mind that the EU stability and growth pact, with its ceiling of 60pc of GDP on public debt and annual budget deficits of three percent, has been in place for many years. Thus far it has not resulted in the imposition of significant sanctions.

Economic firefighters need more than a few buckets of water to put out widespread fiscal and other financial flames. **What does the European Central Bank say regarding the December 2011 European Council decision?** The ECB speaks of this "fundamental restatement of the fiscal rules". The wording "fundamental restatement" implies that there really is not much new of note yet. After all, the ECB adds: "The wording of the rules needs to be unambiguous and effective." (ECB Press Conference, 1/12/12).

The ECB supplemented this somewhat veiled warning with a devastating criticism. Regarding revisions to the draft fiscal treaty of December 2011 aiming to create Eurozone fiscal discipline, a member of the ECB executive board wrote a letter (dated 1/12/12) to treaty negotiators. The Financial Times (1/14-15/12, p2) reports: "revisions to the draft amounted to a 'substantial watering down' of the pact's strictures intended to force down debt levels within the single currency." According to the FT, the ECB board member also said "provisions in the treaty which would allow highly indebted eurozone countries to breach budge deficit limits 'in periods of severe economic downturn' amounted to an 'escape clause' that could lead to 'easy circumvention of the rule'". "'These revisions in my view clearly run against the spirit of the initial general agreement on an ambitious fiscal compact'". "The treaty must 'move toward a deeper and more effective co-ordination of fiscal policies'".

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As European leaders continue to talk, borrowing requirements and debt levels for many of its nations remain substantial. Estimates for Eurozone sovereign debt refinancing are lofty. For 2012 alone, it is about Euro 794 billion (the long run average is about E670bb). Italy has E220bb, France E197bb, Germany E178bb, and Spain E81bb (Financial Times, 1/4/12, p21, citing Barclays Capital).

The OECD's "Overview OECD Sovereign Borrowing Outlook 4" (December 2011) offers details on the OECD and its subdivisions. Its sobering comments contrast with sunny optimism spouted by those bullish regarding further economic recovery. "OECD governments are facing unprecedented challenges in the markets for government securities as a result of continued strong borrowing amid a highly uncertain environment with growing concerns about the pace of recovery, surging borrowing costs, sovereign risk and contagion pressures." "Higher than anticipated gross borrowing needs of OECD governments are expected to reach USD 10.4 trillion in 2011 and USD 10.5 trillion in 2012, including a strong increase in longer-term redemptions in 2012. Against this backdrop government debt ratios are expected to remain at high levels." (p1).

This OECD "Overview" remarks the general government deficit for the OECD as whole of 6.6 percent of GDP in 2011 (about $2.9tr) will ebb to 5.9pc in 2012. Yet for 2012, "deficits are still standing at near historical record levels" (p4). The OECD projects that the general government debt to GDP level will reach 105.7pc in 2012. In addition, the average long term OECD interest

rate will climb to 4.7pc in 2012, up from 2009's 3.7pc. Rate trends are important, for they influence government funding operations and projected borrowing needs (p4).

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Although experts declared a worldwide recovery began in mid-2009, Europe (and elsewhere) still battle sovereign debt and banking problems (and struggle to sustain economic growth). Yet not only has the European war on deficits and debt (or at least "excessive" ones) and other evils continued during this recovery. In addition, difficulties from the so-called periphery of Greece, Ireland, and Portugal have engulfed the Eurozone and most of the rest of Europe. And as noted above, many European leaders spin tales of progress. In this context, the very recent sovereign rating downgrades and their potential consequences are significant.

Standard & Poor's slashed ratings on 1/13/12 for nine European nations using the Euro FX currency. These cuts included the once AAA-blessed France and Austria, as well as Spain and Italy. S+P also kept a negative outlook on France. This lowering of French and Austrian credit ratings may reduce the Eurozone's European Financial Stability Facility's effectiveness. Of the EFSF's E440 billion in guarantees, only E250bb probably remained available prior to the downgrades (Portugal, Ireland, Greece bailouts, plus recapitalization of European banks reduced the sum). France's and Austria's loss of their AAA rating may endanger the EFSF's AAA rating and the availability of its remaining guarantees. For the EFSF, France's guarantee is about E159bb, Austria's E22bb. It will be interesting to see how creative central banks, finance ministers, and politicians handle this rating development.

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Greece's debt disaster has not run out of theatrics. Remember the private bondholder haircut discussions that have dragged on for many months, sometimes loudly on stage, usually discreetly behind the scenes. Now there has been a breakdown in negotiations between Greece and commercial banks (and the official sector). Therefore the risk of a default (a real, actual, genuine, involuntary one; credit event) has jumped. See the NYTimes (1/14/12, pB6) and the Financial Times (1/14-15/12, p2).

The FT notes the "International Monetary Fund… has concluded that bondholder losses must be boosted significantly or a second Greek bail-out would have to be bigger than the E130bn agreed in October." Is the clock running out for Greece? The FT stresses the Greek debt restructuring talk breakdown makes it "increasingly likely that Athens will become the first government of a developed country in more than 60 years to suffer a full-scale default on its debt." If a Greek default activates credit default swap payoffs, dangers of contagion are not minimal. There also has been a run on Greek banks. The Greek finance minister says Greek depositors have withdrawn about one-third of total deposits over the past two years.

SPREADING THE WORD

L7 sings in "Bad Things":
"But something out there's messing with me
A strange dose of reality"

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A review of yield spreads between the 10 year government debt of Germany and the key Eurozone nations of Spain and Italy over the past year or so underlines the gradually growing sovereign debt and banking stresses on Europe (and therefore on other territories

and marketplaces). In addition, these widening European spread trends, especially when reviewed in the context of stock marketplace, currency, and commodity ones, point out the limited (merely partial) successes of efforts to solve the European sovereign debt and banking crisis in particular (and the worldwide economic disaster in general). These spreads warn of dangers to European (and global) economic growth.

Although Spanish and Italian 10 year yields have slipped a bit from recent pinnacles, they gradually have increased since the depths of the financial crisis, and especially since spring 2011. During the global financial crisis, there have been frequent "flights to quality", with government debt of Germany, the United States, and even Japan offering refuge. This has helped to lower government yields in these "safe haven" countries. However, government yields in riskier nations sometimes have risen and sometimes spiked.

Quite importantly, the yield spread for Spanish 10 year government debt over the German Bund has steadily widened since the 45bp bottom of 8/10/09, and it has done so on balance over recent months. Admittedly the Spain less Germany spread has sagged from the 469bp plateau on 11/22/11, and it is below 8/4/11's 398. Yet at around 348bp at the end of last week, it still hovered quite a bit above 11/30/10's 283bp high and the recent (12/5/11) 291bp low. Significantly, since mid-2010, noteworthy spread lows have edged higher steadily. Suppose one starts with the climb from the low of 139bp on 7/27/10 to that on 4/11/11 of 174 basis points. Then see the higher bottoms of 266bp on 8/12/11 and 291bp on 12/5/11. In addition, the current level soars over the 130bp spread peak achieved on 2/17/09 during the depths of the global crisis (and not long before the S+P 500 major low on 3/6/09 at 667).

What about the relationship between 10 year Italian and German government debt? The picture rather closely resembles that of the Spain/Germany government debt relationship. The yield spread has widened, especially since spring 2011.

At the end of last week, Italian yields exceeded German ones by about 497 basis points. Indeed this is a bit under the pinnacle of about 551 basis points attained 11/9/11 and that of 531bp on 1/9/12. But it is not too far from these elevations. Recall the much lower spread top in the dreadful days of about three years ago; a mere 159 basis points on 1/27/09 (close in time to the 2/17/09 Spain/German government spread top). On 8/10/09, the Italian/German spread made a key low around 67 basis points. After moving sideways for about a year, the spread ascended, reaching 200bp on 11/30/10. As was the case for the Spanish/German government spread, the Italian/German crucial lows during 2011 moved higher and higher. Note the bottoms of 122bp on 4/12/11 (compare the timing with the Spain versus Germany spread), 267bp on 8/16/11 (see date of the Spanish/German differential), 348bp on 10/10/11, and 368bp on 12/6/11 (see the Spanish case here as well). The current level not only skyrockets over the January 2009 peak, but remains over the 12/6/11 low as well as 8/4/11's top at 389bp and 9/22/11 399bp high.

Those with an appetite for further European government yield spread analysis may choose to compare Hungary with Germany. Hungarian 10 year government yields towered around 770 basis points over German ones near the end of last week. Though they reside below the 1/4/12 height of 890bp (which was close to the 954bp crisis level peak of 3/6/09), they remain very high, and well above the 11/30/10 top at 576bp. The spread lows have voyaged higher and higher since the key one at 345bp on 4/11/11. Recall the 10/12/11 low at 547bp and that on 12/5/11 at 618bp. **Note the timing of these 2011 Hungary/Germany lows in relation to those of Spain and Italy government spreads against Germany.**

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The German 10 year government note closed last Friday at 1.77pc, not much above its 9/23/11 low at 1.64 percent. The US Treasury 10 year low likewise was on 9/23/11, at 1.67pc.

Compare the timing of the German 10 year's high on 4/11/11 at 3.51pc with the April 2011 lows in the German 10 year's spread against Spanish, Italian, and Hungarian government debt. Keep in mind the pattern of higher lows in the Spanish/German and Italian/German spreads since mid-April 2011. For this mid-April 2011 timing perspective and its aftermath, remember the S+P 500's high around then (on 5/12/11 at 1371) and that in the broad Goldman Sachs Commodity Index (4/11/11 and 5/2/11 at 762).

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Euro FX weakness also reflects the Eurozone (European) crisis. Note the rough parallel since spring 2011 between the declining Euro currency (peak versus the US dollar 5/4/11 at 1.4940) and the gradual widening of the Spanish/German and Italian/German 10 year government spreads. Last week's Euro FX low around 1.2625 versus the dollar is only slightly above the key 8/24/10 trough of 1.2588 (recall the timing of the Federal Reserve's unveiling of its second round of money printing, QE2). The Euro currency's recent lows also neighbor the bottoms achieved during the financial crisis (1.233 on 10/28/08 and 1.2457 on 3/4/09).