

Volume 5 No 6
15 February 2010

JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE BETWEEN DIRE AND DISASTROUS

In this week's *Thoughts from the Frontline* John Mauldin explains the choices Greece has in terms of managing its budget and paying off government debt. With no easy choices available, it will be interesting to see which plan of action is followed. He also mentions that other economies with high levels of debt and increasing budget deficits could be in a similar position if corrective steps are not taken before the situation deteriorates.

Enjoy the read.

The news is somewhat "All Greece, All the Time," but most of the pieces miss the more critical elements, and in today's letter we will look at what I think those are, as well as at the important point that Greece is a precursor of a new era of sovereign risk. Plus, we glance at a few rather silly recent comments from economists. It will make for a very interesting discussion.

A few weeks ago I mentioned my friend Sir Walt Ratterman, who was in Haiti at the time of the earthquake. Long-time readers know that every Christmas I ask you to make a donation to Knightsbridge and projects that Walt runs. You have been very generous over the years. Tragically, they have found Walt's body. For those interested, I will provide a few details about this true hero, toward the conclusion of the letter.

Before we get into the meat of the letter, I want to give you a chance to register for my 6th (where do the years go?!) annual Strategic Investment Conference, cosponsored with my friends at Altegris Investments. The conference will be held April 22-24 and, as always, in La Jolla, California. The speaker lineup is powerful. Already committed are Dr. Gary Shilling, David Rosenberg, Dr. Lacy Hunt, Dr. Niall Ferguson, and George Friedman, as well as your humble analyst. We are talking with several other equally exciting speakers and expect those to firm up shortly.

Look at that lineup. These are the guys who got the calls right over the past few years. They called the housing crisis, the credit bubble, and the recession. And, in my opinion, these are some of the best in the world at giving us ideas about where we are headed.

Comments from those who attend the annual affair generally run along the lines of "This is the best conference we have ever been to." And each year it seems to get better. This year we are going to focus on "The End Game," that is, on the paths the various nations are likely to take as they try to solve their various deficit problems, and how that will affect the world and local economies and our investments. We make sure you have access to our speakers and get your questions answered, and you'll come away with excellent, practical investment ideas.

This conference sells out every year, and you do not want to miss it. There is a physical limit to the space. Every year I have to tell people, including good friends, that there is no more room. Don't wait to sign up. There is an early-bird discount of \$200. And while it pains me to say it, you must be an accredited investor to attend the conference, as there are regulations we must follow in order to offer specific advice and ideas. Click on the link and sign up now.
<https://hedge-fund-conference.com/2010/invitation.aspx?ref=mauldin>

A Path-Dependent World

Path dependence explains how the set of decisions one faces for any given circumstance is limited by the decisions one has made in the past, even though past circumstances may no longer be relevant. In essence, history matters.

With regard to the future, the choices we make determine the paths we will take. As I have been writing for a long time, we have made a series of bad choices, often the easy choices, all over the developed world. We are now entering an era in which our choices are being limited by the nature of the markets. Not only are we in a path-dependent world, but the number of paths from which we may choose are becoming fewer with each passing year.

Our economic future is more and more a product of the political choices we make, and those are increasingly difficult. We have no good choices. We are left with choosing the best of bad options. Some countries, like Greece, are now down to choices that are either dire or disastrous. There is no "easy" button.

Let's look at how Greece came to its current rather dismal predicament. And we will look at why it may be even worse than many pundits think.

First, we need to go back to the creation of the euro. Most of the Mediterranean countries that are now in trouble were allowed into the union with an exchange rate that overvalued their currencies relative to the northern countries, but especially to Germany. That meant that Greek consumers could buy products and services that previously may have been out of their reach. Plus, with government debt at low rates, the Greek government could borrow more to finance deficit spending, without the threat of higher interest rates. And Greece began to increase its debt with abandon.

Additionally, as it now turns out, Greece basically lied about its finances in order to gain admission to the union. It never complied with the fiscal discipline that was required for entrance.

With the high exchange rate, however, came the consequence of higher labor costs relative to, above all, Germany. While reviewing some economic facts about Greece, I came across the factoid that Greek workers had the second highest level of actual hours worked. But even with that, Greece was running a trade deficit that is currently 12.7% of its GDP.

And with the onset of the current recession, their fiscal deficit went from bad to worse. Their total debt is now €254 billion, and they need to finance another €64 billion this year, €30 billion of it in the next few months.

Bottom line, without some help or a bailout, they simply will not be able to borrow that money. And since a lot of that money is for "rollover" debt, that means a potential for default if they cannot borrow it.

European leaders said today that Greece will not be allowed to fail, hinting of a bailout. But there are a lot of "buts" and conditions.

Between Dire and Disastrous

While German Chancellor Merkel has indicated a willingness to help, the German finance minister and other politicians are suggesting German cooperation will either not be forthcoming or only be there at a very high price; and the price is a severe round of "austerity measures," otherwise known as budget cuts. Greece is being told that it must cut its budget to an 8.7% deficit this year and down to 3% within three years.

For my American readers, let's put that into perspective. That is the equivalent of a \$560-billion-dollar US budget cut this year and another such cut next year. That would mean huge cuts in entitlements, Social Security, defense, education, wages, subsidies, and on and on. And repealing the Bush tax cuts? That would just be for starters. No "let's freeze the budget" and try and grow our way out of it, as we effectively did in the '90s, or gradually cutting the budget a few hundred billion a year while raising taxes. That combination of tax increases and budget cuts would guarantee a

US recession. Unemployment, already high, would climb higher.

And yet, that is what the Greek government is being asked to do as the price for a bailout.

A few facts about Greece. Some 30% of its economy is underground, meaning it is not taxed. In a country of 10 million people, only 6 (!!!!) people filed tax returns showing in excess of €1 million in income. Yet over 50% of GDP is government spending, and Greece has one of the highest public employee levels as a percentage of population in Europe. And its unions are very powerful. Nearly all of them have gone on strike over this proposal.

A National Suicide Pact

Now, here is where it actually gets worse. If Greece bites the bullet and makes the budget cuts, that means that nominal GDP will decline by (at least) 4-5% over the next 3 years. And tax revenues will also decline, even with tax increases, meaning that it will take even further cuts, over and above the ones contemplated to get to that magic 3% fiscal deficit to GDP that is required by the Maastricht Treaty. Anyone care to vote for depression?

And add into the equation that borrowing another €100 billion (at a minimum) over the next few years, while in the midst of that recession, will only add to the already huge debt and interest costs. It all amounts to what my friend Marshall Auerback calls a "national suicide pact."

Normally, a country in such a situation would allow its currency to devalue, which would make its relative labor costs go down. But Greece is in a currency union, and can't devalue. Or it would restructure its debt (think Brady bonds) to try and resolve the problem.

The *dire* predicament is the one where Greece cuts its budgets and more or less willingly enters into a rather long and deep recession/depression. The *disastrous* predicament is where they do not make the cuts and are allowed to default. That means the government is plunged into a situation where it has to cut the entire deficit to what it can get in the form of taxes and fees, immediately. As in right now. And defaulting on the interest on the current bonds wouldn't be enough, although it would help.

Why not just let Greece go under? Part of the argument has to do with moral hazard. If Germany bails out Greece, Ireland, which is actually making such cuts to its budget, can legitimately ask, "Why not us?" And will Portugal be next? And Spain is too big for even Germany to bail out. At almost 20% unemployment, Spain has severe problems. Its banks are in bad shape, with large amounts of overvalued real estate on their books (sound familiar?) and a government fiscal deficit of almost 10%. While Spanish authorities say they can work this out, deficits will remain high.

The fear is one of contagion. Some argue that Greece is only 2.7% of European GDP. But Bear Stearns held less than 2% of US banking assets, and look what happened.

I have been trading emails with Lisa Hintz of Moody's, and she sent me the following note:

"It turns out from the BIS [Bank of International Settlements] numbers, that the largest holders of Greek debt are French, followed by the Swiss, although my guess is that a lot of that is hedged, and I don't know that the BIS picks that up, and then the Germans. The numbers as of last June were France €86 billion, Switzerland €60bn, and Germany €44 billion. I have seen more recent numbers of France €73b, Switzerland €59b, and Germany €39b. In terms of GDP, for Germany it is minimal - just over 1%. Of more concern, for France it is nearly 3%, and for Belgium 2.5%. For Germany, the debts of Ireland, Portugal and Spain are much bigger problems. They may, however, worry that if there is a contagion, they will have to take marks on that debt. That would be a real problem - nearly 15x the size of the Greek issue."

The recent credit crisis was over a few trillion in bad, mostly US, mortgage debts, with most of that at US banks. Greek debt is \$350 billion, with about \$270 billion of that spread among just three European countries and their banks. Make no mistake, a Greek default is another potential credit crisis in the making. As noted above, it is not just the writedown

of Greek debt; it is the mark-to-market of other sovereign debt.

That would bankrupt the bulk of the European banking system, which is why it is unlikely to be allowed to happen. Just as the Fed (under Volker!) allowed US banks to mark up Latin American debt that had defaulted to its original loan value (and only slowly did they write it down; it took many years), I think the same thing will happen in Europe. Or the ECB will provide liquidity. Or there may be any of several other measures to keep things moving along. But real mark-to-market? Unlikely.

The entire EU is faced with no good choices. It is coming down to that moment of crisis predicted by Milton Friedman so many years ago. And there is no agreement on what to do.

As Ambrose Evans-Pritchard wrote yesterday:

<http://www.telegraph.co.uk/finance/financetopics/financialcrisis/7216363/Will-markets-call-EU-bluff-on-Greek-rescue.html> :

"The 27 leaders never even discussed how they might shore up Greece or the rest of Club Med. German Chancellor Angela Merkel said she was not willing to broach the subject at all. The only relevant topic was whether Greece was complying with Treaty obligations, and how the country would slash its budget deficit from 12.7pc to 8.7pc this year - in a slump.

"They offered nothing,' said Jochen Felsenheimer, a credit expert at Assenagon in Frankfurt. 'It was just words without any concrete measures, hoping to buy time.'

"Whether the EU has time is an open question. Credit Suisse says Greece must raise €30bn in debt by mid-year, mostly in April and May. Greek banks have been shut out of Europe's inter-dealer markets, forcing them to raise money at killer rates. They are suffering an erosion of deposits as rich Greeks shift money abroad. This could come to a head long before April.

"Economically, we are in a very risky situation. Greece is close to default. We face systemic risk like the Lehman collapse and unless there is a bail-out for Greece, there will have to be a bail-out for the whole European banking system within two or three months,' he said.

"Yet they are damned if they don't, and damned if they do. 'A Greek bail-out increases the risk of EMU break-up, because monetary union can only work if everybody sticks to the rules,' Mr Felsenheimer said."

There is talk among some in Europe of a more centralized control of some countries that do not stay within guidelines, which means that Greece might be asked to give up some of its sovereign freedoms in exchange for bailout funds. French President Sarkozy emphatically stated that no member of the EU would be allowed to default. But he did not bring a checkbook to the press conference. Selling this to a variety of national parliaments will not be easy, when they have their own problems.

And Merkel has problems on the home front. There are reports she is putting the brakes on a bailout, as she is getting pushback from her constituency. The *Frankfurter Allgemeine Zeitung* warned the chancellor yesterday that offering Greece any kind of bailout would be a betrayal of the trust of the Germans who so reluctantly traded in their marks for the euro. "If the no-bailout clause of the Maastricht Treaty is going to be abandoned, then the last anchor of a stable euro will be destroyed," warned the front-page editorial in the conservative newspaper. "Chancellor Merkel has to be hard now so that the euro doesn't become soft."

Ultimately, this is a political decision for the Greek people. They have roughly four options. They can accept the austerity measures and sink into a depression for a few years. This would mean the total amount of debt would go up rather significantly, putting a very large crimp on future budgets. Debt is a constraint on growth. Debt-to-GDP is already over 100%. A recent paper by Reinhart and Rogoff (authors of the book *This Time It's Different*) shows that when government debt-to-GDP goes over 90%, it reduces future potential GDP by over 1%. That locks in a slow-growth,

high-unemployment future in an economy already saddled with government spending at 50% of GDP, which is by definition a drag on GDP growth.

The second option is that they can simply default and go into a depression for more than a few years. This would have the advantage of reducing the debt burden, depending on what terms the government settled on. Would bond holders get 50 cents on the euro? 25 cents? Stay tuned. But it would also most assuredly mean they would not be able to get new debt for some time to come, forcing, as noted above, severe cuts in government spending. From one perspective, it has the potential advantage of reducing government's share of the economy, which is a long-term good but a short-term nightmare. But it also keeps Greece in the euro zone, which does have advantages. However, it does little to deal with the labor-cost differentials.

The third option is that they could vote to leave the European Union. While this is unthinkable to most Europeans, it is an option that may appeal to some Greeks. They could create their own currency and effectively devalue their debt. It would make their labor and exports cheaper. They would still be shut out of debt markets for some time. Any savings left in Greece would be devalued overnight. Those on pensions would find their buying power cut by a great deal. It is likely that inflation would become an issue. And it would be a full-employment act for legions of attorneys.

Most people scoff at this notion, but money is flying out of Greek banks into non-Greek ones, and to my way of thinking that is a suggestion that some Greeks think secession might be a possibility. It is also causing severe stress at Greek banks.

The final option is to promise to make the budget cuts, get some form of guarantee on their bonds, and borrow enough to make it another year - but not actually cut as much as promised; just make some cuts and then promise more next year if you will just bail us out some more. That just kicks the problem down the road for another year or two, until European voters (mostly German) get tired of taking on Greek debt.

The market is not going to let Greece continue to borrow without showing some serious efforts at cutting their deficit, and probably not even then without some external guarantees. The history of Greek debt is not a good one. They have been in default 105 years out of the last 200.

There are some optimists, however. Good friend and fishing buddy David Kotok thinks that this will all turn out OK. Writing this week, he said, "Lastly, it is important to understand the territory of this issue. The 27 members of the EU and the 16 of them that are in the euro zone, and most of the other 11 that want to be in the euro zone, will coalesce and deal with Greek debt in the fiscal policy arena. Budget deficits will decline, although they may not decline as fast as projections. Economic growth will occur, although it may not be as fast as projected. Taxes will rise. Public sector employment benefits and compensation will be pressured to compress, and the workers will resist but eventually compromise. By the way, that will also happen at the federal level in the United States and with the 50 sovereign state debtors that make up our country. Think of us as a US dollar zone, just as we think of them as a euro zone. They are new at it. We have had a century of practice and need only another few hundred years to get it right."

My objection to that is, US states generally have a mandate to balance their budgets, so that the "debt-to-GDP" of a state is comparatively rather small. And a US citizen is ten times more likely to move from one state to another to find a job than a European will move to another country. As one person I read commented about unemployed Spanish workers in Madrid, "They won't even move to Barcelona!"

It's More than Just Greece

The lesson here? This is not just a Greek problem. Debt and out of control deficits are a problem all over the developed world. The Greeks are just the first. As Niall Ferguson wrote this week in the *Financial Times*, the contagion is headed to US shores unless we get our budget house in order. You cannot spend your way out of a fiscal crisis. The current path is simply unsustainable. At some point, we can become Greece. Yes, we have the advantage of having our debt denominated in dollars, but that is only an advantage up to a certain point.

The Nobel Prize economists (who will go nameless here) who say the US cannot default because our debt is in dollars miss the point. Being the world's reserve currency just means we can run up bigger bills, but if we go the route of printing money to pay those bills, that is devaluation and fraud, as the value of a dollar will diminish; and that is tantamount to default.

Whether it is Japan or Portugal or the US or (pick a country), the body of evidence clearly shows that there is a limit to the amount of debt a sovereign country can handle without a crisis developing. That limit is different for each country, but there is a limit that the bond market will impose. And there are many countries in the developed world that are approaching that limit.

We are in the fullness of time approaching the End Game. In country after country, the choices that have been made over the last decades will yield a Greek situation, where there are no good choices. And the longer the hard choices are put off, the more difficult they will become.

For some countries it could mean deflation. For others, it will look like inflation on steroids. Countries with sensible budgets and policies will thrive.

For most of the last two decades, investors have ignored country risk in the developed world. That is no longer a safe option. We will explore the consequences in later letters.

R.I.P., Walt Ratterman

A few weeks ago I wrote about my friend Walt Ratterman, who was at the Hotel Montana in Haiti when the earthquake hit. Walt's wife Jeanne received an email only 10 minutes before the quake, which placed him in the courtyard, where he would have been OK. After the quake there was an eerie silence. We all assumed that Walt was helping those injured in the quake and that he and his friends would surface when they got a break. Those who knew Walt understand the passion he brought to many relief operations. Walt was known for sneaking into Myanmar in the bottom of a boat where, if discovered, he would have been summarily executed. Walt was the subject of the documentary *Beyond the Call*, which showed him braving Afghanistan a month after 9/11, Myanmar, and the most dangerous region of the Philippines.

Walt's love of helping people who, for no fault of their own, couldn't help themselves caused him to relocate his family to the West Coast, to be better able to continue his work. Walt traveled the world to help the needy, visiting Asia, Africa, South America, and Central America. Each time he brought food, medical relief, and solar power, and had a sustaining impact on all the lives he touched. Walt was part of a team brought into Haiti by USAID (United States Agency for International Development) to bring solar power to Haiti. Walt was working there on several projects, including a few hospitals where electricity brought them out of the dark ages, allowing them to perform surgeries and other treatments that were unavailable in Haiti previously. Many of the projects were completed prior to the quake and provided much-needed support for the injured, saving countless lives.

The great irony is that Walt almost never stayed in nice hotels. He stayed with those he helped.

The men and women who loved Walt mobilized to raise money and travel to Haiti. My own readers have been very generous. Six teams made their way at various times throughout the search and rescue phase of the operation. Each of those teams brought much-needed food, water, or medical relief. Dr. Sir James Laws hired a bus in the Dominican Republic and loaded it with bottled water that was given to many who were thirsty in Haiti. Sir Edward Artis loaded a 20-foot truck with food and braved the road from the Dominican Republic as well, in spite of reports of looting and hijacking of other vehicles on the road. The first team was given the emotional task of handling the morgue at the Hotel Montana. Without complaining, each member of that team stepped up and did what was asked of them. Each night this team cried themselves to sleep from the emotional toll of dealing with the dead that day. Each of the Knights and friends of Walt reached out to their entire networks and brought awareness to the search for Walt and the hundreds of others trapped in the rubble at the Hotel Montana.

As time wore on it became obvious that a miracle wasn't meant to be. Hope gave way to preparation for the inevitable. Walt's backpack and laptop were found a few days before his body was discovered. And then there was a wait for positive identification, before dental records confirmed that Walt was a casualty of the devastating earthquake. He was one of more than two hundred thousand souls separated from their bodies in that quake. No doubt Walt was busy in the spirit world, calming and organizing this mass of men, women, and children for their trek to meet their maker.

Each of us who has been involved in the life of Walt, and now with his untimely death, knows that he lived a life of honor and that he died doing the work that he loved. His death was certain to be a death of honor because of the way he chose to live his life. Each of us has the opportunity to rededicate ourselves to living our lives in a manner more aligned with the values that Walt applied every day he was here. Walt stared death in the face so many times and lived, that we all expected him to be immortal. Each of us has limited time on this planet, and we can use Walt's example to make that time count.

You, gentle reader, have given generously to make a great deal of difference in Haiti and over the years to Knightsbridge. Would you join me one more time to honor the life and work of our fallen hero Walt Ratterman? The world does not have enough Walts, and he will be sorely missed. Rest in Peace, my friend.

Please make your generous donations today, by sending a check made out to "Steps for Recovery" but clearly marked "FOR KNIGHTSBRIDGE / HAITI" to:

Steps For Recovery
P.O. Box 67522
Century City, CA 90067

(A California 501(c) 3 Tax Exempt Corporation
Federal ID # 95.4472343)

Or you can make an immediate ONLINE donation via PayPal, by going to the Knightsbridge website, located at: <http://www.kbi.org/> and hitting the Donate icon found there.

There will be two memorials. Click here for details.

<https://app.e2ma.net/app/view:CampaignPublic/id:1403664.6599887325/rid:c59296f8c03405402c1abafdccace3fc>

The NBA, Snow, and No Power

I note, for the (now almost 10,000) readers of the Chinese language version of this letter, that there is a very interesting conference in Shanghai this spring. I wish I could go, but I have a conflict, though next year I am planning on speaking. You (and others around the world who are interested) can learn more at http://www.halterconferences.com/hfs2010_ticket.asp. Use promo code "MAULDIN" for a discount on tickets.

This weekend I take most of my kids and their spouses and friends to the NBA All-Star Game, as well as my friend of longest standing, Randy Scroggins (I am not allowed to say oldest friend). We went to the first grade together and have remained close for all these years. It will be a fun evening. My last All-Star Game was some 25 years ago, here in Dallas. I remember Isaiah Thomas getting the tip-off and missing his first shot. Kareem pulled down the board, jumped up and baseball-passed the ball to Magic Johnson running down the left side, near half-court. Magic caught the pass, dribbled once, and then passed the ball behind his back all the way down court to James Worthy, who was streaking down the far side. Worthy dribbled once and then dunked. All in the first few seconds of the game. At least that's the way I remember it, from the very top row in the corner. My tickets are better this time, but I can only hope we see something like that.

I write this letter from a friend's house. Thursday we woke to snow, and it continued all day and into the evening. We had almost a foot of snow, which is not a lot for the north of the country but quite a lot for here. It has been decades since we had that much. Trees are down everywhere under weight they had not grown accustomed to, as are power

lines. My power went out yesterday afternoon and will probably be out until Sunday sometime.

Just like a financial crisis, these things sneak up on you. It was only supposed to be a light dusting of snow. The problem would be "contained." We had a system that was not prepared for the weight of this much snow. Oh well. We figure out how to Muddle Through. There are some facts and figures on my computer that did not make it into this week's letter, but it is long enough as is.

Have a great week, and remember to enjoy your friends and family while you have them.

Your meditating on how quickly life can pass analyst,

John Mauldin

Copyright 2006 John Mauldin. All Rights Reserved

Plexus. Independent Insight in an Uncertain World.

Tel: +27 (0) 21 970 2400 • Fax: +27 (0) 21 975 2248 • E-mail: info@plexus.co.za • Web: <http://www.plexus.co.za>

DISCLAIMER

This e-mail transmission contains confidential information that is the property of the sender and which is legally privileged. The information is intended only for the use of the addressee. If you are not the intended recipient, you are hereby notified that any disclosure, copying or distribution of the contents of this e-mail transmission, or the taking of any action in reliance thereon or pursuant thereto, is strictly prohibited. Should you have received this e-mail in error, please notify us immediately by telephone to arrange for the return of the documents comprising this transmission. In no event will Plexus Mauldin Alternative Investments (Pty) Limited, Plexus Asset Management (Pty) Limited or the sender of this e-mail be liable to any party for any direct, indirect, special or other consequential damages for any use of this e-mail, or on any other hyper-linked web site, including, without limitation, any lost profits, business interruption, loss of programs or other data on your information handling system or otherwise, even if we are expressly advised of the possibility of such damages.