



The Greek Comedy

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June 21, 2011

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“Comedy is tragedy plus time.”

Woody Allen

It is no longer prudent to dismiss the possibility of a worst-case outcome for the Greek debt crisis. Greece is not only laying bare the flawed structure of the European Union, but the fragility of the global financial system. Monetary union without political union is increasingly untenable and leaves global financial authorities with one hand tied behind their back. Furthermore, three years after the financial crisis, little has been done to reduce systemic leverage or strengthen regulation where it is most needed. Inexcusably, derivatives remain unregulated – the latest news is that the CFTC will delay the implementation of derivatives rules until the end of 2011. The failure to impose meaningful reforms on derivatives is largely due to the intense efforts of the financial sector to fight regulation. Moreover, the interconnected nature of global financial markets render Europe’s problems the world’s problems. What happens in Europe – or anywhere for that matter – can no longer stay in Europe. And what happens in even a minor player in the European Union – Greece accounts for a mere 2.6 percent of the European Union’s GDP – can no longer stay in Europe. An interconnected and networked global economy cannot ignore problems on its so-called periphery because there is no longer any periphery. Derivatives and other counterparty relationships have seen to that.

Accordingly, investors should hope for the best but plan for the worst. While there are signs this morning that Greece will receive the funds needed to avoid an imminent default, nothing has been done to solve Greece’s or Europe’s long-term problems. Of greater concern is what is happening on the political front in Europe. *The New York Times* described the political headwinds gathering force in Europe in this morning’s edition (“As Europeans Wince at Austerity, Markets Fear Turmoil,” June 16, 2011, p. A1):

“European officials are also worried that if Greece’s politicians bow to popular anger and reject the austerity route, other countries might follow, with potentially dire consequences for Europe’s banks and the common currency. So concerned were European Union officials about the potential for trouble that the bloc’s top financial



official, Olli Rehn, hinted in Brussels on Thursday that Greece might get the new financial aid even if European finance ministers failed to approve the loan at a meeting this weekend.

In recent months, the governments of Ireland and Portugal have been ousted over efforts to cut budgets and benefits. Students have rioted to protest tuition increases in Britain, and young people who feel shut out of their own futures have held nationwide sit-ins in Spain, where the governing Socialists are in trouble in the polls. Rightwing political parties are gaining strength, tapping, in part, the populist rejection of austerity plans.”

So it seems we may be moving from an Arab Spring to a European Summer of dramatic political changes as the European populace revolts against the hegemonic powers that have guided their failed economic union.

The example of Iceland also looms large (at least to us). Iceland took over the domestic units of its broken banks and left private creditors to take their losses. The country saw its currency collapse by 80 percent against the Euro (which led to a trade surplus) and instituted budget cuts to rein in its budget. It also asserted its sovereignty as a reason for refusing to repay creditors of its broken banks. Iceland returned to the global debt markets last week, raising 5-year debt at slightly more than 3 percent. If weaker nations are forced out of the European Union, what is to stop them from following a similar route? This scenario is not as outrageous as it may seem. After all, the route that Europe is taking offers little hope for Greece or other countries of a light at the end of the tunnel.

What happens if the Greek government stops functioning effectively?

Greece appears to be falling into political chaos and there is a genuine possibility that it may become incapable of operating as a sovereign nation. The mounting number of resignations of Greek MPs will render it increasingly difficult to pass any kind of austerity plan, and the odds of meeting the demands of Germany, the IMF and others are long. Deutsche Bank’s Jim Neil has pointed out that there is a complex group of institutions and individuals that need to come to an agreement in order to avoid a Greek default. While most commentators believe that these parties – despite their differing views and ideologies – will eventually agree to fund Greece’s July refinancing, such an outcome is far from a certainty. But even if the outside parties can be persuaded to fund Greece’s short-term maturities, which seems likely, there has to be a functioning Greek government to offer these parties a colorable austerity plan.

Can we truly be confident that another functioning parliamentary majority can be formed if the Prime Minister George Papandreou fails? Mr. Papandreou has called for a vote of confidence in his government that is expected to occur at an unspecified date in the coming days. According to *The Wall Street Journal*, Mr. Papandreou’s Socialist Party only enjoys a four-seat majority, but additional resignations may erode that further. There is no



way to handicap the outcome of this vote; one can only hope that Greece's MPs will peer over the precipice and then step back. Forming a new government during a crisis is a tall order. Forming one that is capable of meeting the demands of Greece's creditors is even taller. *The Credit Strategist* would not dismiss the possibility that Greece could become a political zombie, just as it is already an economic zombie. That scenario would leave the other Eurozone nations, the IMF and the European Central Bank (ECB) facing the choice of funding into a black hole or letting the entire edifice collapse. As noted above by *The New York Times*, Europe's top financial officials appear poised to do that. Where that would leave things is anybody's guess.

Can a Greek default/restructuring/credit event be confined?

As noted above, any financial crisis on a sovereign scale (even a tiny sovereign) cannot be isolated from the rest of the global economy. While Greece is a relatively small nation, the magic of financial engineering has swelled its importance to a dangerous level. A Greek default cannot be fenced off from the rest of the global financial system because derivatives and other financial transactions have linked Greece and its banks to the rest of the world. In some ways, the very concept of "Greece" (or any nation) as a singular financial entity is misguided since its funding and fate are deeply entwined with the rest of global economy.

The connections between Greece and other financial entities are extensive. European banks have enormous direct exposure to Greek debt. At the end of 2010, the holdings were as follows: French banks - \$53 billion; German banks - \$34 billion; UK banks - \$13 billion; and Portugal - \$10.2 billion. While Moody's Investors Service placed BNP Paribas, Credit Agricole and Societe Generale on review for a possible credit downgrade based on their exposure to Greece, some experts like Sean Egan of Egan Jones Rating Company suggest that the UK's banks may be the most vulnerable to a Greek default. While in the kingdom of the blind the one-eyed man is king, we should not forget that the king still has only one eye. It should also be noted that European banks are not carrying their Greek and other dubious sovereign debt holdings at their current market value. This has two consequences. First, their financial statements overstate their financial health. Second, they are going to be loathe to sell any of these holdings since doing so would force them to come clean on the value of their holdings and trigger large losses that would erode their already flimsy capital bases.

As an aside, this is an example of the costs of delaying the imposition of stronger capital requirements on banks. Regulators, politicians and bank lobbyists have spent the last couple of years debating Basel III, which certainly moves bank capital to more reasonable (i.e. higher) levels. But while jaws were flapping, banks were busy lending to Greece (and its weak sisters Ireland and Portugal) to an extent that has significantly weakened their balance sheets. The result is that the powers-that-be are left with little choice but to do the wrong thing (kick the can down the road) rather than start taking the tough steps necessary to solve the European sovereign debt problem.



The ECB is also up to its eyeballs in Greek debt. Starting in May 2010, the central bank began buying up Greek debt in the secondary market as part of the first bailout plan. Today the bank reportedly owns more than €80 billion of this paper. Leaving aside for the moment the value of this paper (the bank is obviously sitting on significant losses on these holdings), a default would impose a legal prohibition on the ECB taking any additional Greek paper as collateral.

But direct ownership of Greek debt is only the tip of the iceberg (an analogy that is particularly apt in view of the reality that virtually any short-term bailout plan is tantamount to shuffling deck chairs on the Titanic). For example, as of May 31, the three banks named by Moody's plus another French bank, Natixis SA, had borrowed about \$91 billion from U.S. money funds (about 12 percent of those funds' assets according to Fitch Ratings). Troubles at these French banks from their Greek holdings could impact these money funds negatively. These funds required a bailout from the U.S. government during the financial crisis three years ago and have started to see higher outflows in recent days that may or may not be attributable to concerns about Greece.

Unsurprisingly, American banks also got into the action. Wherever there is financial profligacy, U.S. banks can't be far away. U.S. banks have written \$34.1 billion of CDS protection on Greek debt (as well as \$54.0 billion on Ireland and \$41.2 billion on Portugal). A "credit event" – which in layman's terms means a default or restructuring of Greek debt – would require these banks to pay out on these insurance contracts. Avoiding just such a credit event is one of the principles guiding the precise form that the Greek bailout will assume.

The list of interconnections goes on and on, and one can be sure that global regulators are trying to monitor these relationships but have no real sense of what type of contagion effect would occur if Greek were to default. No doubt they believe it is significant enough that they are willing to do virtually anything humanly possible to prevent this scenario from unfolding.

Does any prospective plan really solve the problem?

Leaving aside the worst-case scenario, even the best-case scenario doesn't solve the problem. All of the proposals beg the question of how to solve the European debt problem rather than delay an inevitable default and restructuring (and therefore render the next crisis even more severe than today's). Even if the Greek government continues to function and a Greek default is avoided this time, the world economy is still left with a hopelessly insolvent country with no chance of meeting its obligations. And Greece is hardly the only European country in that situation. Ireland is not only hopelessly insolvent but increasingly insisting on private bondholder taking significant losses (a position *The Credit Strategist* wholeheartedly endorses). Paul Krugman, with whom I never agree, has suggested that Ireland follow the route of Iceland and bankrupt itself into recovery. I still don't agree with



Professor Krugman but would not dismiss the possibility of what he is proposing from occurring. Portugal is not far behind Greece or Ireland. After these three terminal cases sit Spain, Italy, and Belgium, a set of larger overleveraged countries whose default or restructuring would make Greece look like a day on the beach. In recent days, Spain's borrowing rates have risen to record levels that the country cannot sustain. It is widely acknowledged that even if Europe were able to handle Ireland, Portugal and Greece, a Spanish default would be a breaking point. There appears to be no end in sight to sovereign debt problems and the havoc they can wreak on the global financial markets.

What should investors do?

This is no time to be a hero, and it appears that there are fewer heroes out there with each passing day. While *The Credit Strategist* often writes about investor complacency, we are coming to believe that this complacency is turning into fear as the reality of global economic problems become undeniable. The intellectual case for being long risk assets is a difficult one to make in the face not only of the European crisis but the flood of negative U.S. economic data. It is no crime to be holding cash (even a lot of cash) at this point in time.

Just two weeks ago, *The Credit Strategist* recommended that investors go long volatility through options on the VIX index. While the VIX has jumped by over 40 percent since we gave that advice, we continue to think that volatility is priced too cheaply. Other ways to express a view on volatility and hedge long portfolios (or potentially profit outright) is to sell puts on the S&P or one of the small cap stock indices such as the Russell 600 (either through options on the index or on ETFs such as IWM).

Treasuries will continue to catch a bid as investors seek safety in a larger bankrupt sovereign. We do not recommend Treasuries because, despite the likelihood that they will continue to rally in the face of weak U.S. economic news and the European crisis, it makes little sense to lend to this government at 3 percent.

Many analysts argue that the stock market is inexpensive. In a crisis, however, valuations are irrelevant. All that matters is liquidity. Moreover, in a crisis atmosphere, stocks cannot be looked at as an isolated asset class but as subject to what is happening in the currency and debt markets. The strategies run by the largest investors often cross asset class boundaries. Accordingly, investing in large cap dividend paying stocks with great balance sheets makes the most sense *for long-term holders*; in the short-term, anything can happen and today that "anything" could easily generate losses.



Finally, European banks are a long-term structural short. It is difficult to short a basket of these stocks. SX7E, a European bank ETF, is illiquid. It is probably most effective to short a number of these stocks individually.

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The Credit Strategist June 16, 2011

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The Credit Strategist
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