RUSSELL CLARK
INVESTMENT MANAGEMENT

SOVERIGN DEBT

Russell Clark's
Market Views

"Forget about Politicians and Eurobonds – it's all about Trade!"

For many years developed market investors have not had to consider sovereign defaults when investing, other than perhaps any sales exposure that the companies they invested in had to possible defaults in Emerging markets. Alas, with Greece likely to default and increasing numbers of European nations being shunned by the markets this is no longer the case. This newsletter is meant to help investors understand how debt crises emerge, and how they are solved.

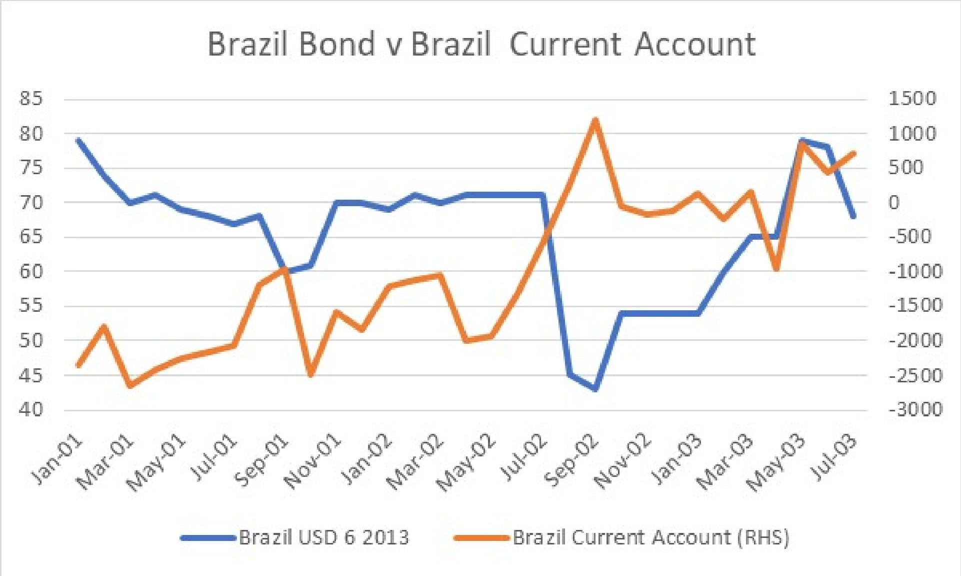
Typically debt crises occur when a country consumes more than it produces, and it requires foreigners to lend to them to finance this consumption. If foreigners begin to lose confidence in a country's ability to repay its debt, they will often sell the debt and the currency. If the country has issued debt in a foreign currency, this can cause the debt problem to escalate, as the debt will increase in size as the currency devalues. If investors sell the debt, the interest rate at which the government has to borrow increases, making debt levels unsustainable. Hence, often debt crises descend into vicious cycles, from which it is very difficult for countries to escape. But in many cases, markets' concern on debt has proven unfounded, and this created very attractive opportunities for investors. At lows, sovereign debt offer equity like returns with only sovereign debt risk.

In my opinion, the time to buy distressed sovereign debt is when its current account moves from deficit to surplus. This shows that the nation can now fund its consumption through its own exports, rather than running down savings or increasing debt. To make an analogy, lenders much rather make a loan to a household that is able to save at least some of its income, than to a household that persistently spends more than it earns. For nations, this point occurs when the current account moves positive.

This year we have seen Ireland move to a current account surplus, with Irish debt subsequently performing well. Recent data suggests we may see Spain and possibly Italy moving to current account surplus in 2012, which to me suggests that market concerns over European debt look overstated.

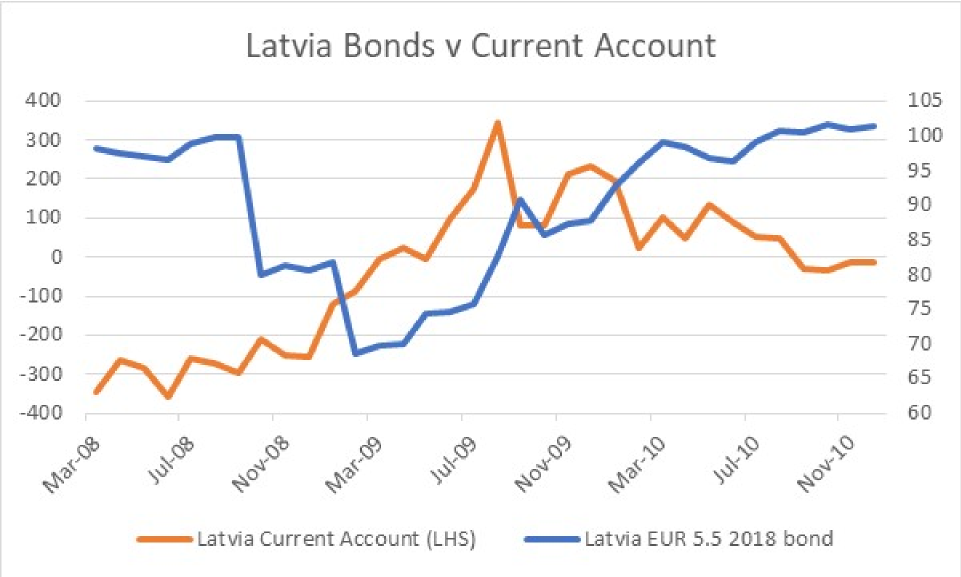
Recent history of sovereign debt crises
Below I show the movement in yields with movement in trade balances of various countries that have had sovereign debt crises over the last 10 years:

Brazil 2002
Concerns over the possible default of Brazilian USD debt with the election of a left wing government caused a significant sell off in both the debt and currency markets. We can see that both the currency and bond markets bottomed when Brazil moved to current account surplus.



Eastern Europe 2008

In the 2008 financial crisis, the market began to price in devaluation and default in many eastern European countries. A representative country of the region is Latvia. Its bond market and current account are represented below. Latvia pegs its currency to the Euro, and hence we have seen no devaluation in its currency.

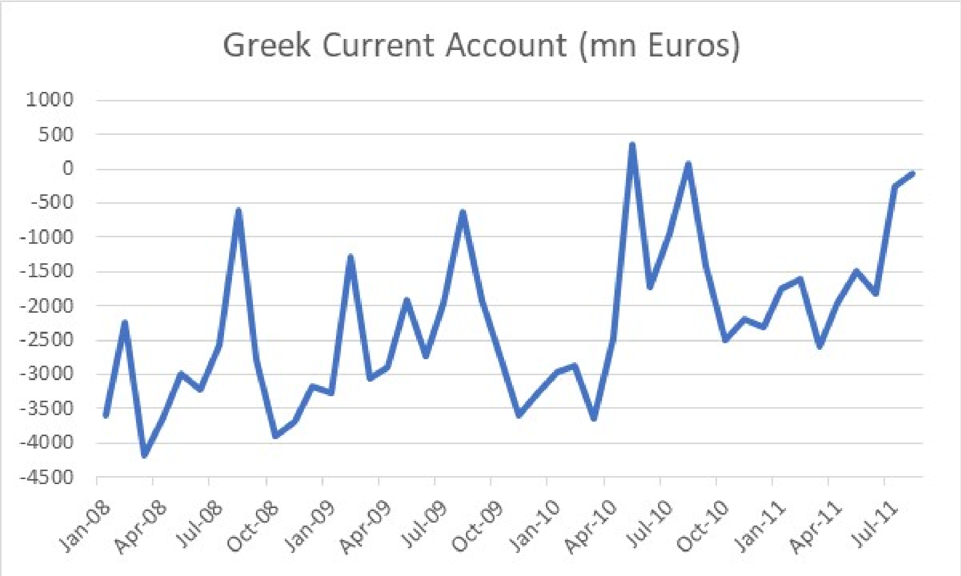


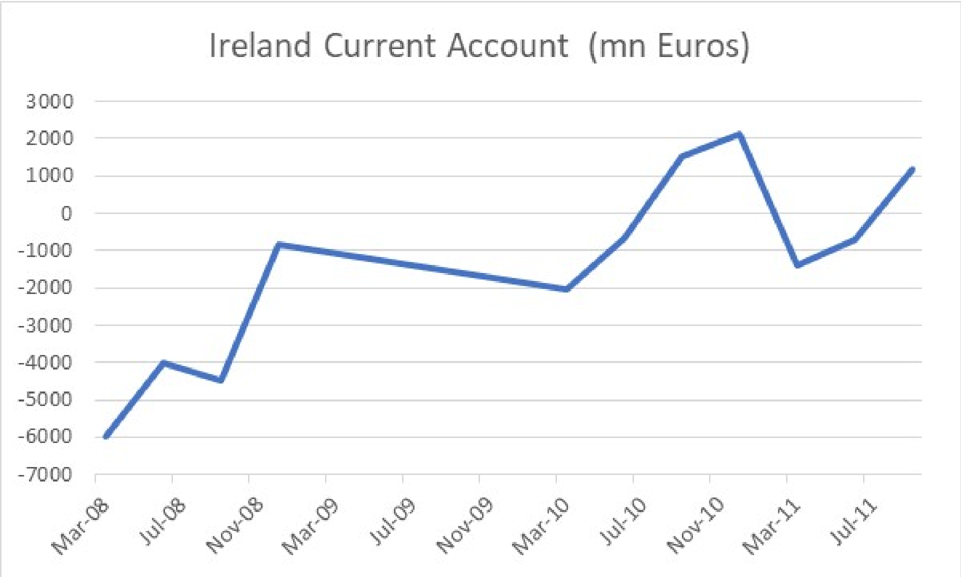
Once again the move to current account surplus proved the decisive point in the debt crisis. This experience was also repeated in Iceland, Estonia, Lithuania, Ukraine and Hungary.

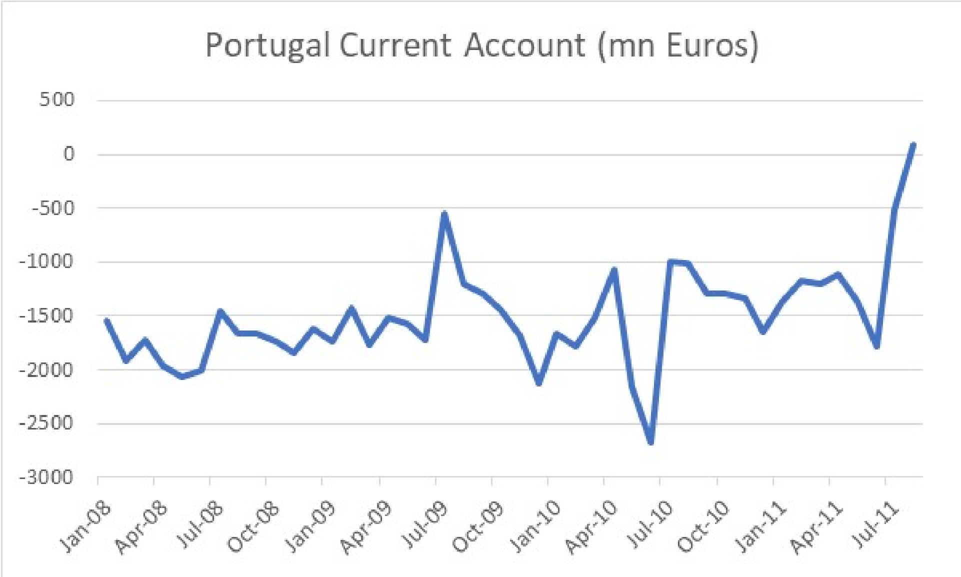
The Current European Debt Crisis

The current European debt crisis is putting extreme pressure on the bonds of large European governments. The lesson from other countries is that we need to track the performance of the current account balances of the countries affected to get an idea of when, or if, this crisis can be solved.

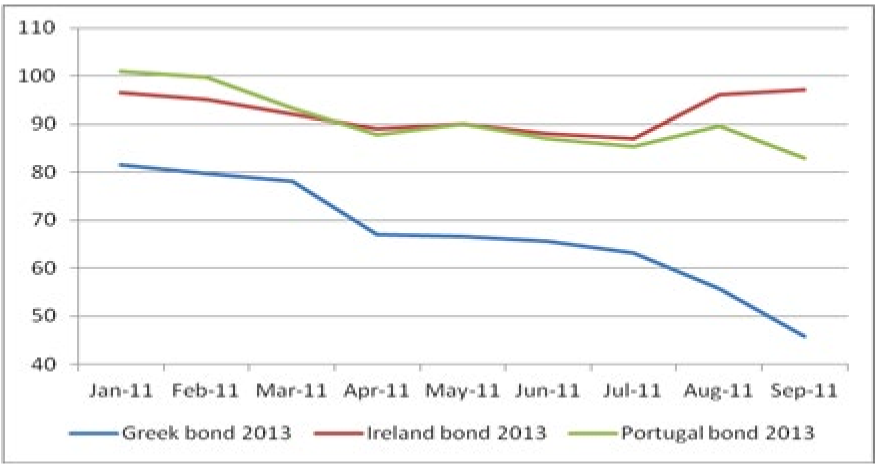
Below is the current account performance of Greece, Ireland and Portugal.



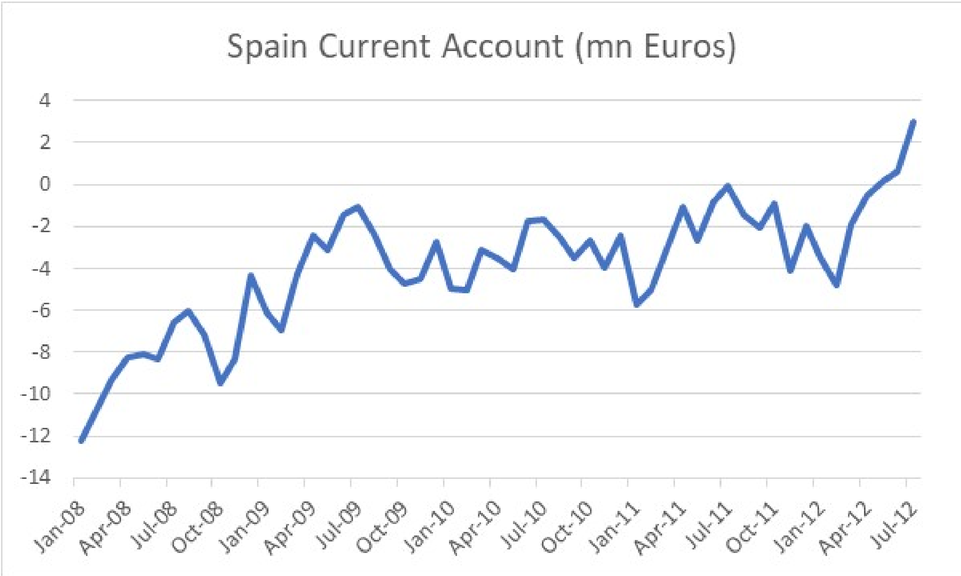


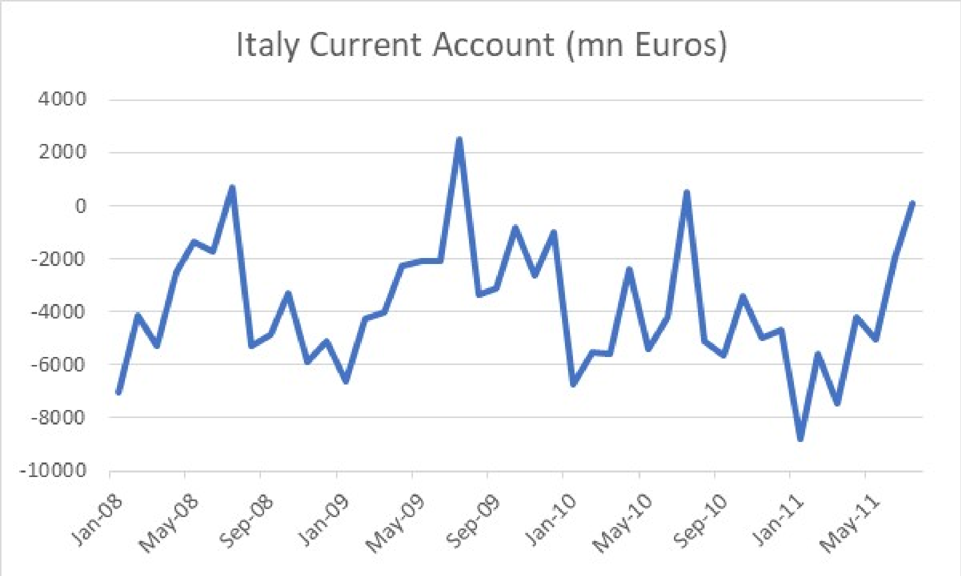


As we can see, only Ireland has managed to achieve current account surplus. In my view this had been the main driver in the outperformance of Irish bonds.



Currently the market is worried about Italy and Spain, two much larger European countries, and Italy possesses the third largest bond market in the world. Their current account performance is presented below.





Spain has seen a huge improvement in its current account, and if current trends continue, could move to surplus next year. Italy has not run a large current account deficit, but markets will need a decisive move to current account surplus in my view. Export growth has been reasonable, but this has not been enough to counteract higher energy costs, which is Italy's main import. Should we see lower energy prices, both Spain and Italy would move to current account surplus, and the bonds of these countries should rally significantly.

Conclusion

While investors' concern over Greece seems totally justified, and investors are right to price in a spread between the yields of German bonds to other less secure economies, the risk reward now looks extremely poor in pursuing a further spread widening. The future holds three possible outcomes for European bond markets. One is the breakup of the Euro. The second is the creation of some form of Eurobond or fiscal union. The third is that Spain and Italy move to current account surplus, and become self financing. Given that Spain and Italy now offer some of the highest real yields globally while German bonds offer negative real yields, the risk reward in my view favours Spanish and Italian bonds. This is particularly true if energy costs continue to fall.

INFORMATION

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