# B | Blackstone Financial Group, LLC

*An Independent Firm*

132 Riverview Drive, Suite D Flowood, MS 39232
769.216.3150 Office 769.216.3153 Fax

bheadley@blackstonefg.net
lpeeples@blackstonefg.net
trussell@blackstonefg.net
jchar@blackstonefg.net



## REMEMBERING THE FUTURE

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**Living with the Risks of the D's: From the Fear of Depression, to Defaults, Deleveraging, and Deflation**


***John E. Charalambakis Ph.D., Professor of Economics, Asbury College***


**Introduction**

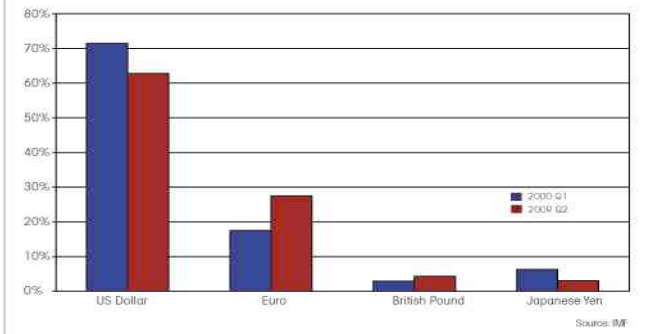
In the last few issues we have touched upon three issues that we believe are characteristic of financial crises, namely: Crises come in twins; deflation may hit; and nations may default. The center of gravity for a financial crisis is debt. The latter is like a black hole that sucks everything in. The current gyrations in the markets reflect fear, uncertainty, and the lack of proper understanding of the risks that surround economies, financial markets, and the balance sheets of corporations and households. The global monetary system is driven by debt. The explosion of debt (corporate and sovereign) has been dramatic since the 1970s, when the Bretton Woods system of dollar convertibility to gold was suspended. The fiat monies that nations produce could potentially be sustained through a generation or two, as long as the collateral that backs up that debt is unquestionable and at least is based on some reasonable valuations. However, when the valuations become absurd and unreal (like tulips in 1630, railroad mania in 1870s, internet stocks in late 1990s, and the housing sector in the beginning of the previous decade) asset prices deflate, especially when the assets used for credit creation were camouflaged into surreal valuation territory. In this issue, we have chosen to concentrate on the default risks that surround the current stage of the economic evolution. However, we cannot discuss that risk without linking it to the financial crisis and to credit creation.

**On Credit Mechanisms, Debt, and Crises**

Since the middle of the previous decade, we have been on record advocating the position that we need to allow hard assets to drive the credit creation mechanism. The global debt/bond market (operating without an anchor) was denominated in greenbacks for almost a generation. To be sustained without the introduction of an anchor – similar to the role that gold played for centuries – it had to be supplemented by a new debt market denominated in a different currency. Thus, the introduction of the Euro, and the Eurobond market was necessary (among many reasons) in order to minimize systemic risks in the global economy, as well to sustain somehow the value of fiat money and the options for growth (via leverage) and development in other countries. Thus, the Euro was born on January 1, 1999 (as an electronic currency for the first two years) and the bond/debt/fiat currency markets enjoyed revitalization and an extension of life.

Thus, the Euro became the front face of a debt resurgence whose goal was to perpetuate economic happenings based on fiat currencies. Obviously, central banks that play the most important role in the debt instruments markets were given opportunities to diversify their assets by diversifying their debt-denominated holdings. The figure below shows that diversification.

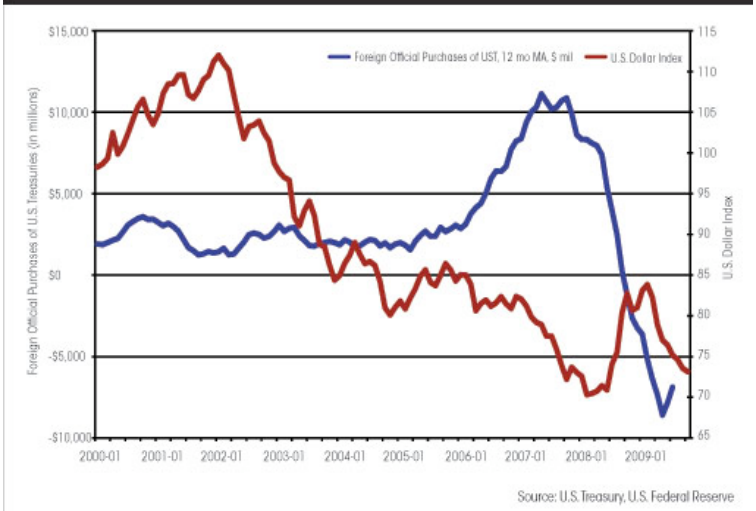
**FIGURE 1:** Changing Composition of Allocated Currency Reserves



The global credit mechanism has limits. Think of it as a family sedan. Overburden it with too much (like a 5.0 liter engine) and it will collapse. Pack it with too little (a 500 cc engine) and it will go nowhere. The bigger engine needs a car with a bigger body. The latter is the collateral for the engine. Now of course, you could cook the books and present on paper a bigger body (collateral) in order to get a bigger engine. Thus, the problem of collateralization. What backs up the debt issuance? Good collateral lowers risks, affords/guarantees re-payment of debts, enhances incomes, and - assuming that productivity grows in a healthy manner - can readjust balance of payments problems (not exactly like in the old days where gold transfers automatically re-adjusted nations currencies and settled debts, but in a way that could approximate that old practice.)

The central banks seem to have been moving away from dollar-denominated reserves. If that trend continues it could create problems for the Fed and its enlarged balance sheet, for the Treasury and the need to refinance our debt at low rates, and for the government and her need for some budget flexibility, while it would shake confidence in the dollar at a time when the global credit mechanism is not ready yet for a dramatic change in the currency that denominates assets and global financial instruments. The second figure below shows those trends that may require a reversal.

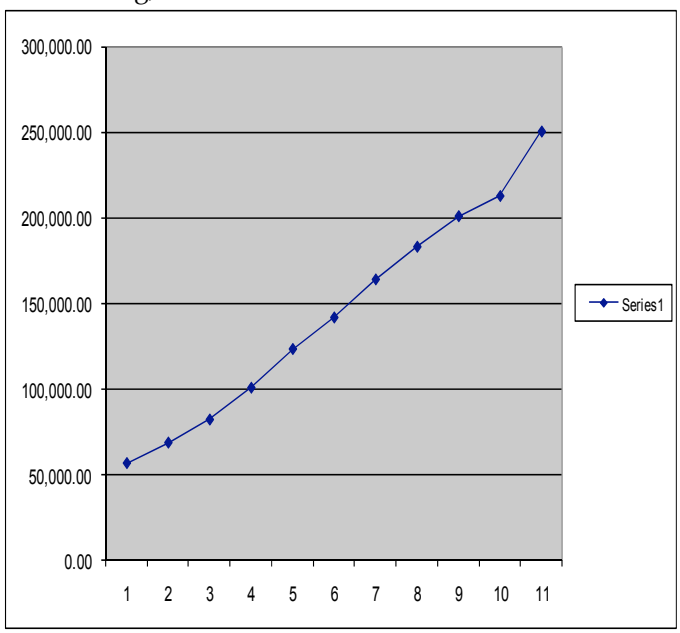
**FIGURE 2:** Central Bank Purchases of U.S. Treasuries Have Waffled Along with the Dollar




The explosion of the derivatives market – especially from 2003 to 2007 – coincides with the explosion of debt instruments and the explosion of credit. Thus, in our estimates, the housing problem (read subprime mortgages bundled together with other financial instruments that few understood) is nothing but a symptom of a greater cause: the explosion of debt and credit. The bad/camouflaged collateral was exposed as overvalued in the best case and as worthless (toxic) in the worst case, and thus things imploded.

The figure below is from a presentation that I made in October 2006 and shows clearly the explosion of the derivatives market that in turn supported credit creation.

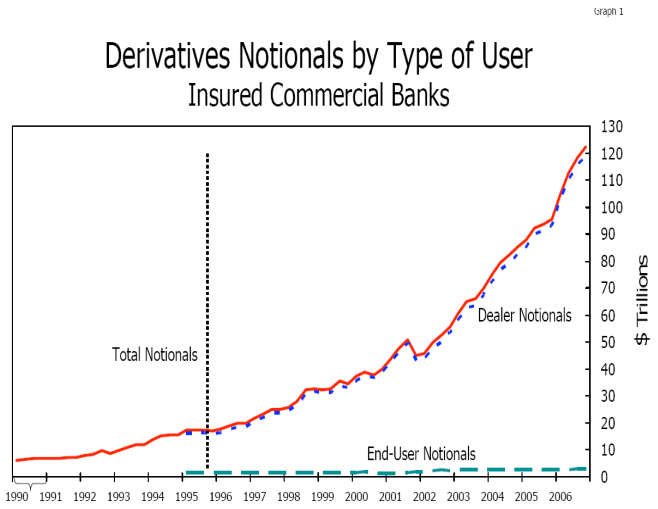
Figure 3: Semi-annual Credit Default Swaps (in millions) Outstanding, 2001-2006




Source: International Swaps and Derivatives Association

As we pointed out back then, the explosion of these derivatives could bring down the whole market. Unfortunately, it turned out that they did. We could look at the same picture through the data provided by the Comptroller of the Currency, as the following figure does.

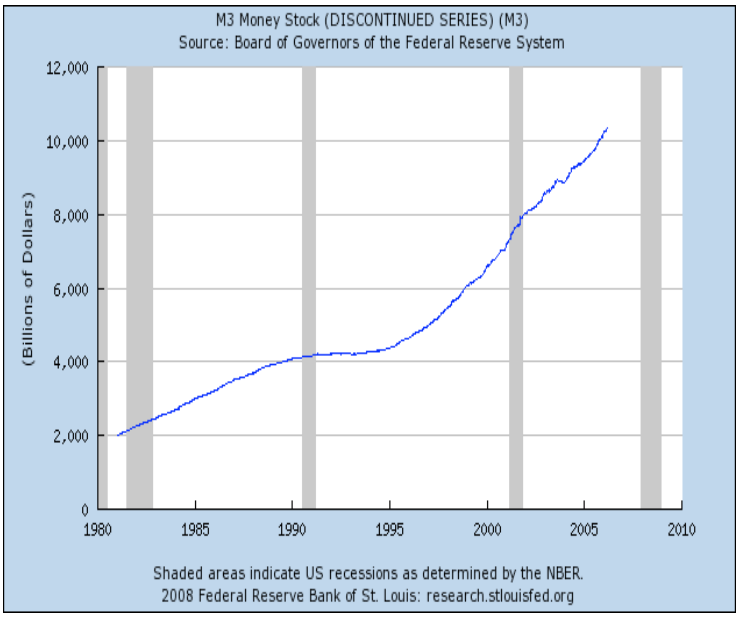
Figure 4: Derivatives Trading 1990-2006




Source: Comptroller of the Currency

Now, let's look at the explosion of the money supply (M3 a measure that unfortunately the Fed ceased publishing since 2006.)

Figure 5: Money Supply Growth




Any similarities between the exponential growth of the derivatives market and that of the money supply could merely be a simple coincidence…

The collateral used in credit creation proved to be of questionable quality, and the first signs of that were seen in June 2007 when two hedge funds (hedge funds and private equity groups were among the top traders of toxic paper) of Bear Stearns went down. By August of that year it had become obvious that we were headed for trouble (despite the assurances given by high places and top officials.) In the first two months of 2008 Bear Stearns denied the fact that it was headed for bankruptcy (some countries' unsustainable programs are endorsed by bureaucrats, in a similar manner to the assurances given to the US markets in the spring and summer of 2008 that the worst is behind us.) The collateral was no good and thus the house had to implode, as other houses did later that year (Lehman Brothers, Wachovia, Merrill Lynch, etc.) The fact that some survived (Morgan Stanley, Goldman Sachs, Citi, UBS, etc.) could only be attributed to the Fed's unprecedented measures and to the government's handouts and bailouts.

Now, let's return our attention to the composition of international reserves around the world (Figure 1.) Without a doubt the role of the Euro increased significantly in the first decade of this century (as much as 50%, in terms of international composition of reserves a.k.a. debt instruments that central banks hold as assets.) In the last few days/weeks we have been observing the Euro losing ground in a significant way. The reason is that the markets are afraid of possible default by countries such as Greece, Portugal, and even Spain, and Italy. Why is it that all of a sudden these peripheral countries suffer from such sickness? Were their banks holding toxic assets? All evidence suggests that they had very few toxic assets on their balance sheets. The reason is hidden debt i.e. paper sold (in Euros) that was unaccounted for. It seems that the junior partner in the global credit mechanism has violated the debt covenant among the partners, and has circulated more paper than was allocated to her. What did that partner post as collateral? Possibly nothing i.e. the paper in Euros was backed by the word of the respective governments.

If the latter cannot make the payments on those debt instruments, their ratings will decline (as they were, which could be interpreted as the warning sign similar to the downfall of the two Bear Stearns funds in June 2007) which in turn won't allow them to post their

bonds as collateral to the ECB (European Central Bank) for liquidity/loan purposes. Needless to say, this isolation from ECB credit will freeze those economies and will drive nations and local corporations into default with potential significant consequences for all markets around the world. More on the fate of those peripheral countries in a moment.

Our prediction is that a portion of the junior's share in the debt markets will be replaced by two other junior partners in Asia (China & Australia) along with a junior partner from N. America (Canada), where global bonds denominated in the respective currencies (RMB, Australian and Canadian dollars) will start being traded, which inevitably leads to the yuan's revaluation and the others' appreciation. The former enhances the Chinese people's spending power, while the tradable bonds' expansion reduces global trade imbalances, restores competitiveness in both European and US-based markets, while allowing the debt market to extend its life while it discovers (hopefully through a new Bretton Woods agreement) again the necessity of anchors for credit creation and proper market valuations.

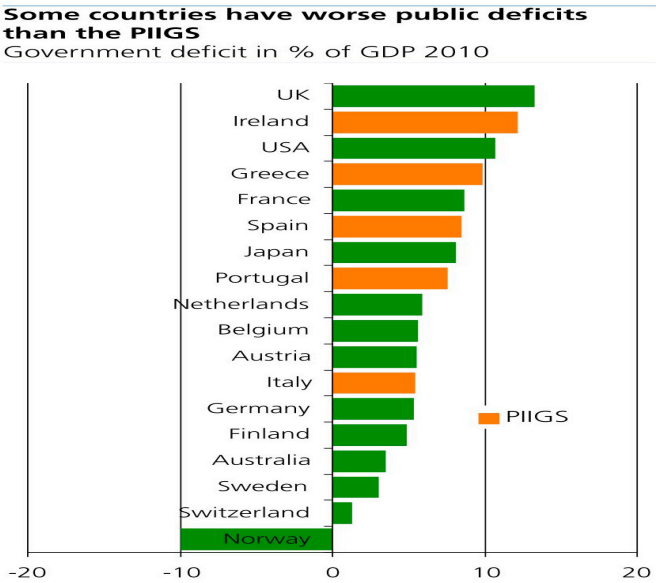
**Will PIIGS fly or fry?**

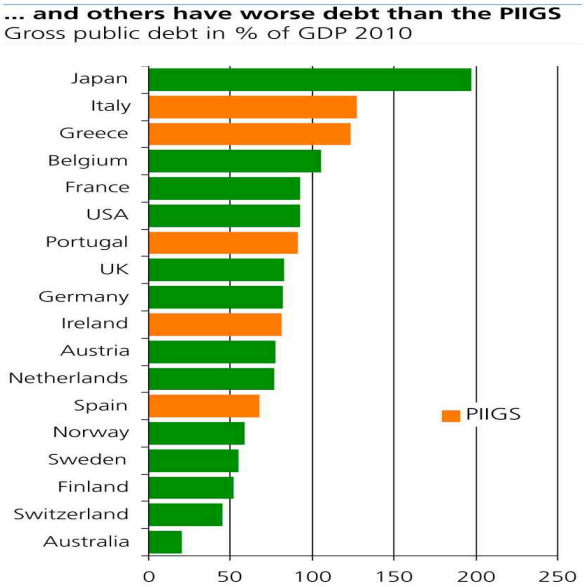
Citicorp used to have a famous phrase: "Countries don't go bust." Yet with the current status of economic and financial fragility gripping the European continent, that old saying can be thrown out the window. The probability and concern of default on sovereign debt rises each day for a number of Euro economies. The "PIIGS" as they have been labeled (Portugal, Italy, Ireland, Greece, and Spain) – please do not read any negative or derogatory implication in the acronym - represent merely the cusp of what could be a tumultuous stretch of downturn for the continent.

While the economies of the PIIGS represent some of the smaller and less developed economies of Europe, the repercussions of their collapse could be staggering. Just like a bank closure in one town leads to a run on other banks in the surrounding area, should one sovereign domino fall others are likely to follow. The concerns have been focused on Greece and Portugal; however, the cases of Spain and Italy represent tremendous risks.

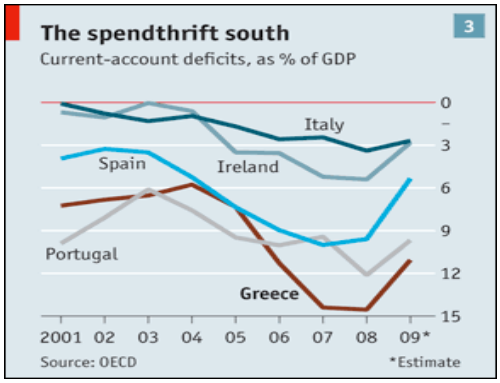
The graphs below provided by the OECD demonstrate the severity of fiscal pressure on a number of economies. For smaller economies, history has shown that circumstances such as these would call for a devaluation of the currency and then a repayment of debts with inflated paper as one possible prescription. However, with the economies of the PIIGS under a common currency, devaluation is impossible without first dropping use of the Euro.

**Figure 6: Foreign Debt Levels (OECD)**



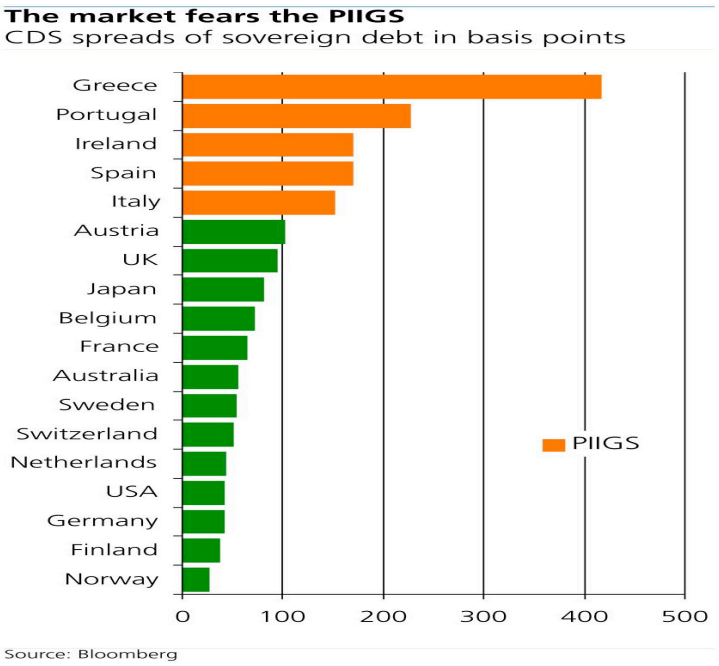
Greece's troubles have been brewing for nearly a decade, many economists argue. It's admittance into the Euro zone, despite indicators which suggested the country was not ready, gave the country access to cheap credit and widened its current account deficit to over 14%. Relieving such an imbalance pushed Greece deeply into bond markets in order to finance such deficits. With its bond rating lowered to BB-, the ability for the country to roll over its debt is highly unlikely given its huge total debt (112% of GDP) and the fact the EU plans to return to a "grade A collateral only" policy in exchange for liquidity. Despite raising 8 billion Euros from bonds last month Greece will not be able to look to the bond market for help. Portugal meanwhile held a 500 million Euro auction but could only find buyers for 300 million, raising major alarms about its ability to roll over debt.




Greece has announced certain policy measures aimed at tightening the weak economy's belt. Tax raises, frozen wages, and spending cuts in the public sector –with the private sector most likely to follow- have been declared in the hopes of maintaining faith in the countries sovereign debt. These austerity measures will sink Greece further into quicksand since the people will stop spending and put further deflationary pressure on wages, employment, and the economy as a whole.

Greece is unable to address its financial hurdles on its own however and default grows more likely each and every day, evident by the high rates of insuring Greek and other countries' debt as figure 7 shows in a graph that demonstrates that credit default swaps (a.k.a. insurance against debt) have increased substantially for the PIIGS. Carmen Reinhart and Kenneth Rogoff point out that Greece has been in default half the time in the last sixty years. An IMF intervention is out of the question as it runs contrary to any notion of a political or monetary union. The Maastricht Treaty of the EU monetary Union, does not include any provisions for a bailout. Of course, that demonstrates that monetary union in isolation from a fiscal and political union might be impossible. The Growth and Stability Act of the EU, has been unable to restrain fiscal imbalances since it lacks the political repercussions of a true union of states. An IMF (International Monetary Fund) intervention may be perceived as a humiliating act for the EU. The EU has been dancing around a commitment to assist. However, issues of moral hazard arise as well as political costs for the rescuers in their homeland. Moreover, such a rescue does not know the exact limits if Italy's and Spain's debt and becomes the football of the speculators. Should Greece or any other of the troubled economies collapse, capital would immediately flood out of the other PIIGS as well as distressed countries such as Latvia, Hungary, and Romania (these latter countries do not use the Euro), while countries that barely survived the 2008-'09 turmoil such as Ukraine will experience massive capital outflows as well. Banks exposed to these economies (from the countries shown in charts later) would incur huge losses, spreading capital withdrawals from smaller, less developed European economies to the greater European financial powers such as France, Germany, and Switzerland. The Euro would further fall and the dollar would stand as a benefactor.

Figure 7: CDS Spreads (Bloomberg)




The figures below, reflect extraordinary amounts of debt (over $1.5 trillion) circulated by Spain, Portugal, and Greece. If we add Italy to the list, then we

could see that the picture is tragic and it is an accident waiting to happen.

Figure 8: Exposure to Portugal, Spain, and Greece

| Foreign banks claims to Portugal ($bn) at end Sep09 | |
|---|---|
| Country | Claim amount |
| Spain | 88.5 |
| Germany | 47.3 |
| France | 35.5 |
| UK | 24.5 |
| Netherlands | 11.8 |
| Total (not only sum of above) | 286.7 |

*Source:BNP Paribas, BIS*

| Foreign banks claims to Spain ($bn) at end Sep09 | |
|---|---|
| Country | Claim amount |
| Germany | 240.3 |
| France | 195.8 |
| Netherlands | 126.6 |
| UK | 119.5 |
| US | 52.8 |
| Belgium | 46.4 |
| Ireland | 31.9 |
| Italy | 31.1 |
| Portugal | 29 |
| Total (not only sum of above) | 1,153.9 |

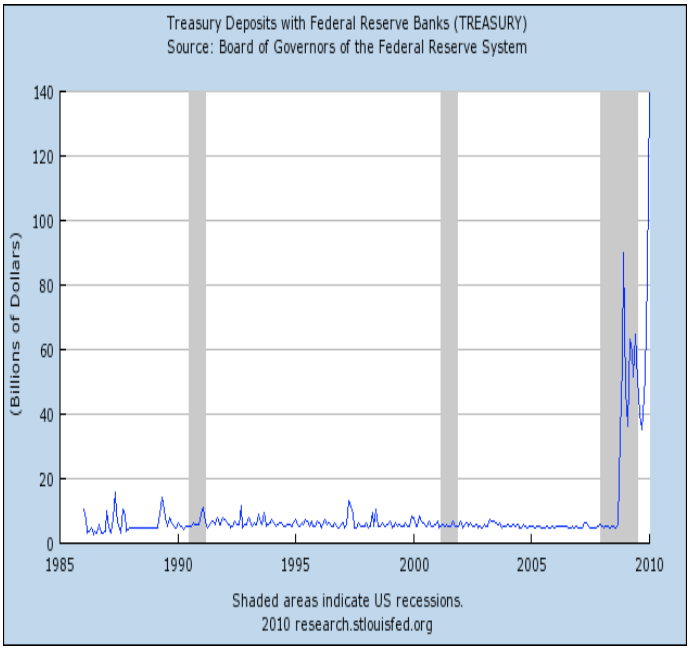
*Source:BNP Paribas, BIS*

| Foreign banks claims to Greece ($bn) at end Sep09 | |
|---|---|
| Country | Claim amount |
| France | 75.5 |
| Switzerland | 64 |
| Germany | 43.2 |
| US | 16.4 |
| UK | 12.3 |
| Netherlands | 11.8 |
| Portugal | 10.3 |
| Ireland | 8.5 |
| Italy | 8.4 |
| Belgium | 7.5 |
| Austria | 6.2 |
| Total (not only sum of above) | 302.5 |

*Source:BNP Paribas, BIS*

Who are the counterparties to the above debt holdings? The list contains many well-known global banks, and thus the dangers are spread in both debt and equities markets. Overall, we could say that the warnings given and quantified in spreads (differences between yields of those economies and that of Germany) constitute the signals that were visible in 2007 prior to the collapse of Bear Stearns. It seems that some weak links will be let go i.e. some form of default will take place (possibly similar to the Russian default of 1998), which strengthens the US dollar, the Fed's balance sheet is enhanced (which has suffered in quality since it acquired paper other than Treasuries), debt-refinancing for the US becomes easier, while interest payments on the debt become lighter and more affordable for the Treasury Department, which in times of crises is able to sell more paper and the proceeds to be deposited with the Fed (see graph below.)

Figure 9: Treasury Deposits with Federal Reserve Banks




Certainly such a scenario also implies a lower appetite for yield, which may be accompanied by less capital infusion and capital appreciation of the funds directed and invested in the emerging markets. We should state that something like that may be needed in order to avoid bubbles building up in those markets. At the same time such an occurrence indirectly assists those emerging markets' governments by lessening the need for sterilization (which in turn could undermine a healthy growth) and simultaneously advances the need for a balance into the global picture of risk/reward which overshot in the aftermath of the recent financial collapse where emerging markets' returns skyrocketed

out of proportion, threatening their own recoveries with excesses.

There are many concerns that jump out of the above scenario. First, the default of sovereign nations could shake the debt and equities markets (through the counterparties that hold those instruments) around the world, and thus the bull market of March 2009-December 2009 would prove to be nothing but a bull within a larger bear. Second, some form of default of a sovereign nation within the European Union (EU) and the corresponding drop in the value of the Euro, would lead to tremendous austerity measures throughout the EU, which would lead to deflationary scenarios that could spread around the world. Third, those deflationary pressures and the corresponding drop in the Euro's velocity – we could possibly even assign the temporary drop of gold to those scenarios - would require households and corporations to hold significant amounts of cash. Cash is the anchor against deflation. Thus, the extraordinary amounts that the Fed has printed can be put to good use around the world (someone could call that the new Marshall Plan.) Fourth, the instability generated by the above scenario (namely deflation) may be the collateral damage to be paid if high inflation is to be avoided until proper mechanisms to sustain credit creation are ready to be put into place.

**The Risks of Sovereign Default**

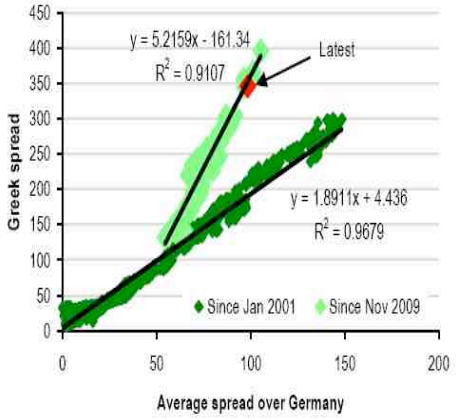
The February 8, 2010 issue of Forbes magazine elaborates on the possibility of Japanese debt default. Unimaginable, even by today's facts, the author makes a plausible case that the declining Japanese savings in collaboration with its declining competiveness, demographic issues, rising interest rates, and unproductive deficits, may force Japan to default on its obligations in the course of the next five-seven years. The fact is that Japan has already far-exceeded the threshold 90-100% level of debt/GDP ratio, which is regarded as the metric of sustainable debt. The new book by Rogoff and Reinhart entitled "This Time is Different" makes an excellent case of this point.

In a rerun of Secretary Connaly's classic ("the dollar is our currency but your problem") we should say that the Euro is the EU's currency and their problem. However, there are global consequences in hasty moves. Allowed defaults could potentially threaten historic economies whose fiscal position seems to be worse than that of those peripheral countries (Greece, Portugal, Spain, and Ireland.)

The shifting sands of central bank reserves (see Figures 1 & 2) will reverse to deep and liquid markets/instruments given the shaky fiscal positions of several countries around the world. We do not imply that the hegemony of the dollar will continue without question in the years to come. We can take it as a given that a new regime (with the dollar still playing the most important role) is at work. This regime is needed, given the structural and fiscal imbalances of the US, as well as the dynamism of the rising Asian powers.

We ascertain that some form of default will take place; most analysts and commentators do not subscribe to this view, pointing out that a bailout will occur. However, the effect on the Euro will not be significant. The risks will be contained and that idiosyncratic nature of risk can be seen in the next figure which, from an econometrics standpoint, shows that more than 90% of the risk involved corresponds to the particular market and the risks of spillovers are not that great.

Figure 10: No Significant Spillover Effects from a Greek Default

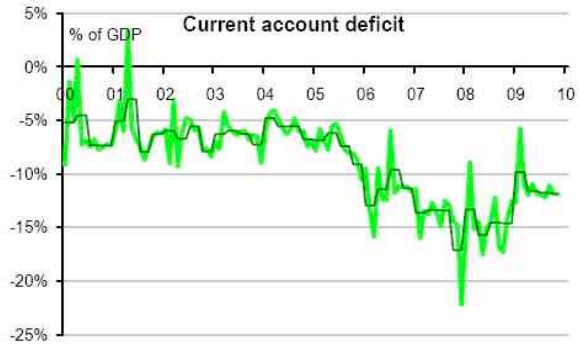



Source: Bloomberg

That form of limited default seems to be unavoidable for three basic reasons: First, it will demonstrate a mechanism of discipline without creating a domino effect. Second, it will minimize moral hazard concerns. Third, it will force fiscal and current account treatments (see figure 11 below where Greece's – among other EU countries – current account deficit exceeds 10%

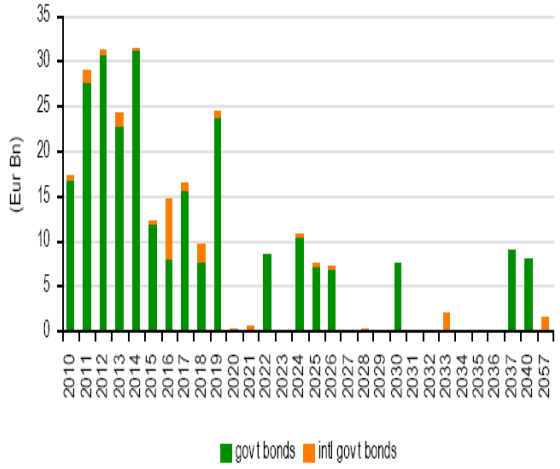
of GDP, a level which by all standards is unsustainable.) Fourth, the redemptions in 2011 are almost double of those this year (see figure 12 below.) When markets discount the reality, the form of default that we subscribe to becomes even more real. Finally, we believe that it fulfills the role of twin crises that financial history has taught us and as we wrote earlier, the PIIGS situation is a warning sign similar to those that preceded the collapse of 2008.

Figure11: Greek Current Account Deficit




Source: Eurostat, UBS

Figure 12: Timeline of Greek Bonds Redemptions




Source: Bloomberg

Our position is that the form of default chosen will not affect the other countries, will not create reciprocal and domino effects, contagion to other countries' markets will be limited, and the European Pact will demonstrate its stamina by strengthening in the aftermath her credibility proving that once in the Eurozone a country needs to take care of her own house (fiscal discipline) and that its "partying" cannot threaten to bring the whole house down, since disciplinary rules can contain local crises in a similar manner that a default in one of the states in the US (especially the smaller ones) cannot threaten the whole US economy and her currency. A Eurozone country cannot be forced to go back to her original currency (drachma, lira, peseta, etc.) since there are no such clauses in the monetary union treaty. At the same time, the country itself would never choose such an option, simply because the costs outweigh the benefits by several multiples. Therefore, we subscribe to the position that in the short term following the form of default that will be chosen, the Euro may lose some ground, but in the medium and long-term it will gain ground.

Epilogue: Investment Alternatives under Deleveraging and Deflationary Scenarios

First of all, let us reiterate our long-standing position that when suitable, a good percentage of a portfolio needs to be in hard assets. We live in an era of uncertainty and hard assets are the ultimate tangible investment. Temporarily they may experience substantial volatility (that's part of their nature), however we feel their prospects in 2010 and beyond is promising.

From the discussion above, we have pointed out that in the short term Euro markets may experience vibrations. As always, if you call the offices, Blackstone Financial Group would be happy to discuss potential strategies.

We also believe that emerging markets will be vindicated based on the analysis above. Emerging markets will re-balance their growth prospects (e.g. recent Chinese monetary measures point to that) and thus any drop in prices in those respective markets could be perceived as buying opportunities. Another example is India. India's reported growth on February 8 is very healthy and promising. If we take into account its central bank's reserve position (acquired 200 tons of gold recently) as well as its emerging middle class, we could state that India as part of the emerging market should may be appropriate in some portfolios. At the same time, diversification in the debt and equities markets of Canada and Australia could be advantageous if their global position in the bond market advances.

As countries, households, and corporations go through the process of debt reduction and deleveraging[1], potential deflationary threats may emerge (hence a source of a short-lived instability in hard assets) which may be approximated by the increase in corporate bond spreads (the latter of course signifies risk aversion inspired partially by the EU perceived instability.) Our position is that historically the unwinding of debt could last a few years and could affect specific debt-burdened sectors but also the whole economy, thus the threats of deflation. Since the Great Depression we have had 45 episodes of deleveraging[2]. From those 45 episodes, 32 took place after a financial crisis. At the same time those episodes are related to austerity programs (a.k.a. tightening the belt), credit slowdown, defaults, and in some instances falling prices (deflation.) Historical records show that when deleveraging starts, the economy and credit growth slowdown, ultimately leading to an economic contraction.

The projected deleveraging (the McKinsey study has painted the household and commercial real estate sectors in the US, UK, and Spain as having a high chance of entering the deleveraging cycle) could be postponed (or its results lessened) through government spending, increased exports (as we wrote earlier that currency crises could assist economies in their efforts to fix their current account imbalances), and the ability to re-finance debt at lower rates.

Finally, in an environment of post-crisis recovery characterized by deleveraging and credit slowdown, the deflationary forces generated through a slowdown in demand will stimulate savings (thus further advancing the cause of fixing balance of payments problems), while it will increase real debt levels (thus the need to deleverage, i.e. it's a two-way street when one reinforces the other.)

These phenomena have consequences for all asset classes. For consumers, their debt level will become larger while their home prices may decline for example. Thus, paying off debt becomes a top priority. For fixed-income investors, the declining yields (due to declining inflationary expectations) will increase their values and thus their capital gains. The equities markets have dismal returns during deflationary times (except for those companies whose products consumers need and cannot postpone purchasing.) Thus the potential strategy of diversifying into emerging markets where deflationary pressures are weak and possibly non-existent.

The real estate sector – assuming as we do that deflation will only last for a short period of time (less than 18-24 months) – could be used as a hedge due to declining interest rates and due to the expected reflation. This in turn may assist the struggling housing and real estate sectors in general. The Government's interest obligations could potentially decline and re-financing could become easier. The yield curve would be inverted which would imply that fixed-income investors may need to hold longer-term maturities (in the current environment short term bonds pay almost nothing), which could advance the goal for lower payments on the debt.

On the other hand, corporate bonds may be perceived as riskier assets (thus the increase in the spread between them and government bonds), especially for corporations that do not have enough cash and substantial long-term debts. On the contrary, the bonds of those corporations whose demand is inelastic (situation in which the supply and demand for a good are unaffected when the price of that good or service changes) and which enjoy price power should experience gains (e.g. health care, utilities.)

The deflationary pressures may temporarily attract capital to the safest places (i.e. long-term US bonds), thus advancing the balancing act where Asian savings are placed into US-denominated assets. The exit should be the reflation of the economy in which case the Fed could potentially also find an exit strategy for the huge reserves it has accumulated over the course of the recent crisis. In that case, the currency will be depreciated sharply and hard assets would be sought even more. In the short-term, gold may suffer from

[1] Under that light, the fear of default by the PIIGS is part of the deleveraging process.

[2] See C. Reinhart and K. Rogoff, This Time is Different, Princeton University Press, 2009. Also McKinsey Global Institute's study, Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences, January 2010.

volatility, however we estimate that it will remain at or above the current prices for four reasons: First, because its industrial usage is low; second, because of its potential revaluation that should advance the goal of lower long-term debt to GDP ratio if we desire to lower the risks of another meltdown; third, because emerging markets and central banks should continue their purchases; and fourthly, because the deflationary pressures are expected to be low, thus the negative impact on commodities may be outweighed by the positive impact by the emerging economies.

It promises to be an interesting ride. We hope you enjoy it!