Infomail

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The Tip of The Iceberg?

It seems that as soon as the Greek issue got a band aid bail out, Italy became the next on the crisis list, bypassing Portugal and Spain who were supposed to be next in line.

Is Greece the tip of the Iceberg for the Euro zone? In the last week both Irish and Portuguese debt spreads hit all time highs, indicating they are likely right behind Greece. The prospects for Spain and Italy, who collectively carry 4 x the debt load of Greece, Ireland and Portugal combined, are beginning to raise questions.

If the entire periphery were to default, it would be the equivalent of the 1994 Mexican crises, the 1998 Russian Crisis and the 2002 Argentina crisis, occurring <u>five times over</u> - would not be pretty.

But it also raises the question of why the ECB has decided to contract the monetary base three times since 2009 by raising interest rates?

It would seem as if the ECB has sabotaged the fiscal austerity efforts of the periphery nations and by continuing to talk higher rates, they seem to be making the same policy error as the US in 1936-1937 which did not end well. Seventy-five years later the Euro zone could have the same results.

But not all Euro nations have gotten it wrong. Sweden seems to have gotten it right:
GDP Q4 2010: 7.3% Year over Year
Public Debt to GDP: 40%
Unemployment April 2011: 7.4%

The largest Scandinavian economy is enjoying record breaking success since 2006, when Fredrik Reinfeldt's right of center coalition took over. His focus is on "reinforcing the work ethic" as a way of making pay work, which is much different than sending checks to people who don't work or don't pay federal taxes. In Sweden, lower taxes and smaller welfare benefits has allowed the private sector to take off. The retirement age was lifted to 67 and inheritance and wealth taxes were eliminated. His conservative modernist party is set to become the biggest political party in Sweden, which would be the first time in 90 years the Social Democrats did not hold that position. Sweden has not fought in a war since 1814 and the borders have remained the same since 1905.

While Greece may have avoided a default for now, world attention has moved to the USA and their huge debt problem and the debt ceiling debate.

The USA is the wealthiest country in the world, so logically its credit limit would be the biggest. However, the spending and bills run up in recent years has created gridlock in Congress and the Democrats want to continue taxing and spending and the Republicans want to cut spending and start paying down the debt.

The USA is at its credit limit of $14.3 trillion. The largest economy in the world needs Congress to allow it to go to the financial markets for more cash to pay obligations due in the next few months. Those payments add up to about $500 billion. Credit agencies are threatening to cut the prestigious AAA rating the USA currently enjoys if Congress decides not to raise the debt ceiling. For the record, the debt ceiling limit has been raised thirty times since WWII.

While high debt is always a concern, it isn't always a cause for alarm as many media types would lead one to believe. Some of the nation's most successful businesses run not only a high debt level, they actually consider it good business.

The USA GDP is approximately $15 trillion per year and carries $14.3 trillion in debt, for a debt to income ratio of roughly 1:1. Consider the following levels:
IBM 2:1
Dupont 3:1
United Technologies 3:1
Boeing 4:1
Caterpillar 14:1
JP Morgan 50:1

In other words, IBM borrows $2 dollars from lenders for every dollar made and JP Morgan $50 dollars for each dollar.

Most of the US debt is held overseas and so a US debt crisis would have global implications. Almost a quarter is held by China, 20% by Japan and 7% with the UK. If the USA's credit rating was cut it would most likely send yields sky high and the value of that debt would also tumble. Investors would be hit twice on their holdings.

In the end, I believe the US Congress will reach an 11th hour agreement, both sides having concessions, both sides claiming victory. I believe a Greek default is inevitable and a withdrawal from the EM. The USA will pay its bills, but no country is entirely free from default risk, even one as rich as the United States. I would guess going forward the political posturing on Capitol Hill has eroded the USA's reputation as a risk free investment and may make it more expensive for the US to borrow in the future.

We know the tide has turned globally to fiscal responsibility and both investors and voters have a low tolerance for excessive debt loads or the mismanagement of them. We've seen it locally in recent Canadian Federal elections and the city of Toronto. This fall we will see it provincially.

I have always had a fondness for Sweden.

Stay Tuned

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