11.5.2010

Pay your debt with More Debt will that solve the problem?

Sounds like a recipe for a prolonged financial crisis to me!

As promised in my last report the following is my more detailed look at government debt.

The leaders of the European Union huddled together over the weekend to devise a dramatic rescue plan for the euro. When they broke from their huddle they announced a $645 billion war chest (of borrowed money) with which to defend their 11-year old currency.

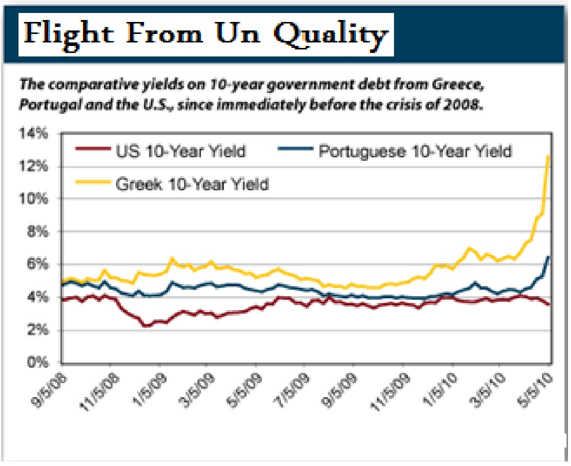
The massive rescue plans seems nearly certain to work for the moment and even perhaps the short term. But attempting to combat debt fears with a great big pile of additional debt is simply adding fuel to the fire which is already blazing. Such rescue plans rarely rescue much of anything in my opinion.

At the issue is simple it's a clear fact that most European governments are heavily indebted and are increasing their indebtedness at a catastrophic pace. Looking back it's an easy equation after decades of dispensing services and benefits that tax revenues failed to cover; the moment of truth has finally arrived this had to come! I would point out that it is too late for austerity measures or tax hikes to restore solvency and that's not a palatable message to be broadcasting. Therefore, without some combination of bailouts and money-printing, several governments might default and what then?

As this seemingly unthinkable possibility becomes "thinkable," if not likely, every heavily indebted sovereign borrower in the world is starting to wonder if they might be next. In many investment updates I have been warning members that this situation is very serious, very pervasive and very unlikely to be cured by the sort of rescue plan embarked on.

The panic of early 2009 may be gone and the "crisis mentality" resulting from the Lehman Bros. bankruptcy has vanished. In my view the seeds of the next crisis are germinating already. Excessive debt remains a very serious problem in almost every corner of the global economy. As for the US, consumers remain very highly leveraged and US banks continue to hold enterprise-threatening levels of impaired loans. Meanwhile, sovereign borrowers from Greece to Portugal to America are struggling with unsustainably large liabilities does that sound like the meltdown it abated is over.

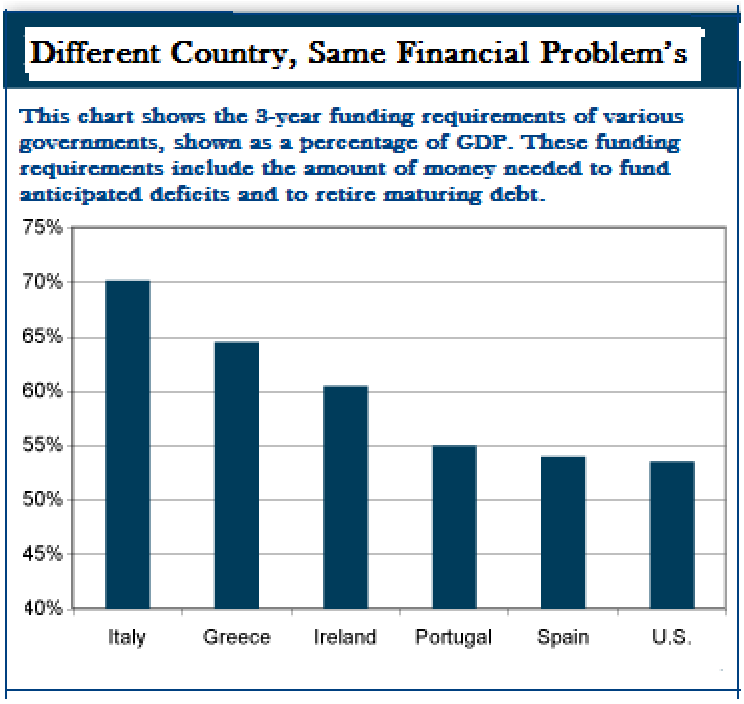
The Greek debt crisis has sparked substantial "flight to quality" buying of US Treasury securities. I would also draw member's attention to another fact that my research has uncovered; panic selling has become the norm in almost every other sovereign debt market.



My warning would be that "quality" may be in need of a re-definition in fact I will make my point clear and obvious.

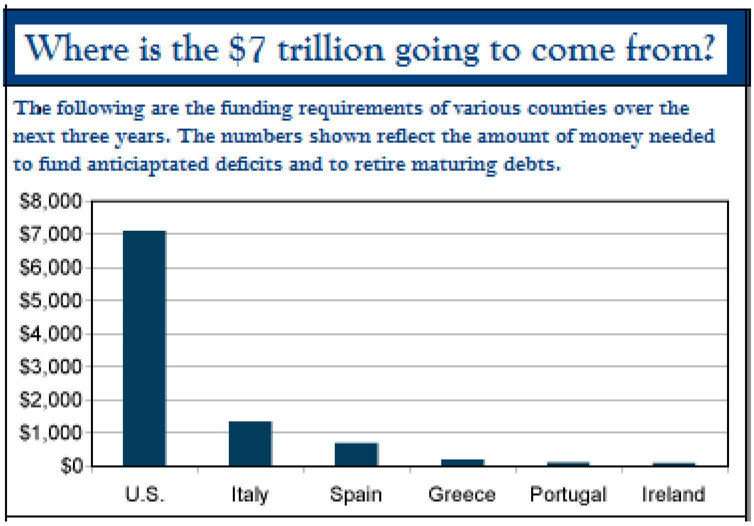
The US Congressional Budget Office's latest figures state that America's national indebtedness will increase by $9.7 trillion over the next 10 years. Further, the CBO projects the national debt will be 90% of GDP by the end of this decade. This projection seems very optimistic, as America's national debt has already reached 86% of GDP.

As I have said America's finances are not unique; they are emblematic. Sovereign borrowers throughout Europe are suffering from a toxic combination of sky-high debt and overly generous entitlement programs.



The charts above and below place the Greek crisis in a global context. The chart above shows the total "bare bones" funding requirement for various countries during the next three years. Specifically, this chart shows the amount of borrowing that would be required by each country to fund anticipated deficits during the next three years and to re-finance all government debt coming due in the next three years. The resulting sum is expressed as a percentage of annual GDP.

As expected, countries like Italy and Greece are high on the list. It may shock members that my research has unveiled the fact that, the US is on par with Spain and Portugal. The chart below depicts the exact same data in absolute terms, rather than as a percentage of GDP. America's three-year funding requirement seems much more ominous when viewed in absolute dollars. These charts clearly show that no indebted country is immune from the kind of investor scrutiny that could produce a debt crisis or a currency crisis.



Most central bankers of the world realize this fact. That's why they all wish to support Greece - not because they care about Greece, but more likely truth is that they very much care about avoiding close scrutiny of their own finances.

How long will it be before other investment houses, financial journals and TV news state the plane fact that runaway government borrowing creates a frightening context for any would-be buyer of government bonds? In my opinion long-dated government bonds may be some of the riskiest assets on the market at the moment. **I would warn that rising interest rates may become one of the most important investment influences over the next several years.**

Although near-term economic weakness, and/or "flight to quality" buying, may exert some downward pressure on US Treasury yields over the short term, runaway government deficits will exert upward pressure on Treasury yields over the long term.

In the car industry they sight white as the new black, in the financial markets I would be confident that that VOLITILITY is the new black! As such this is good news for those invested in RIOP Professional Investors Fund as this will give me opportunity to trade; in fact the fund has done well this month having seen my recent trades produce required result. Looking forward, I am very bullish about the next quarters trading opportunities and as such am likely to continue to outperform the funds bench mark returns set last year.

William Gray
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