Helvetic Investments Pte. Ltd.
6 Battery Road, #23-04, Singapore 049909
DID: +65 6438 0383, Fax: +65 6438 3430
Reg. No. 200912670W

"Point of no return" - the sovereign debt crisis **October 2012**

Every pilot sitting in a cockpit – whichever aircraft in question, from a F/A-18 fighter jet to the more humble and slow moving Cessna 152 – all have one thing in common: they know their "point of no return" pretty precisely.

This is the point where an aircraft has not enough fuel to make it back (safely) – or more generally defined as the point "beyond which one must continue on his or her current course of action because turning back is physically impossible, prohibitively expensive or dangerous". http://en.wikipedia.org/wiki/Point_of_no_return

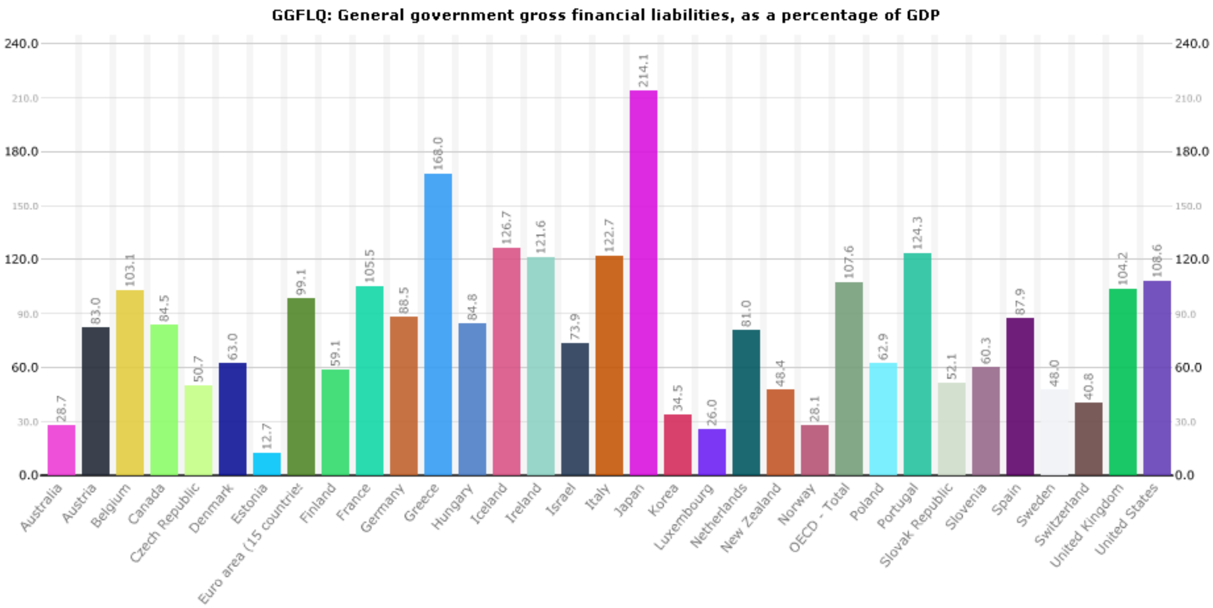
Regarding the exploding public debt most nations have faced since the market collapse of late 2008, some market observers question whether some countries have reached a level of public debt that in fact creates a "point of no return", especially in democracies, where governments simply cannot make it "back to the starting point" however hard they try. And where either a full or part default of government obligations, or a repayment of debt in a debased currency, could possibly occur.

In conjunction with the crisis, the public debt exploded, either due to private sector debt accumulating on the public balance sheet in order to release the pressure on the private sector (being busy deleveraging – and getting rid of the junk the governments took over) or simply due to increasing social costs and falling tax revenues.

The debt situation

In 2007, on the eve of the financial crisis, debt-to-GDP ratio in the OECD area was around 75%. At the beginning of 2012 it was 107% and estimated by the OECD to reach 109% at the end of 2012. Even though the debt is growing slower now, it is still growing – and levels have reached an alarming plateau – despite rates being close to zero, many observers cannot see how to get out of the dead-lock, unless a robust and long-lasting growth is emerging. Whether this is plausible is anyone's guess.

As can be seen in the following chart from OECD, a number of nations have reached crucial levels for government indebtedness, where the level of 100% is generally seen as the ultimate wall. The Euro area 15 countries are close to the limit of 100% (seen as a group), and not only do we find the "usual suspects" like Greece, Ireland, Italy and Portugal here, but we can also find major industrialized heavyweights like France, the UK and the US close – while Japan is in a league of its own – among the potential "no return" candidates.



Source: OECD.StatExtracts 2012

One might argue that sovereigns also hold assets which are not included in these gross figures shown above, like loans to 3rd parties, cash and deposits, other financial assets, land, railways, ports, highways and other infrastructure assets – that certainly being an issue an indebted nation should address immediately – and plan orderly privatizations of such assets, if it has not already done so (like in the UK).

The flip side of the coin being that this is surely not an easy task in democracies. And that the off-balance sheet obligations of unfunded future promises, like pensions etc. are based on coming generations' contributions which again are often based on way too high growth assumptions or not based on anything at all. Yet these obligations could easily be higher than the value of government owned assets, which varies significantly between nations.

According to Rogoff and Reinhart's gigantic study of financial crisis in the last 200 years, covering 60 nations representing over 90% of GDP (This Time Is Different), a government debt ratio of 90% is rare, and one of 120% is extremely rare for a safe landing to be expected. In fact safe landings are not very likely once such debt levels have been accumulated. http://www.reinhartandrogoff.com/

As Rogoff and Reinhart described, defaulting nations are very natural events throughout history and not a novum at all. We just tend to forget, or simply believed such devastating mistakes only happens in faraway destinations like post junta Argentina and post communist Russia etc. Of course there are examples of nations having had hard-times and a high debt ratio, finally making it safe back to the runway - like the UK after WWII. http://en.wikipedia.org/wiki/United_Kingdom_national_debt

Default by nations

Looking at past defaults by nations since 1800, it is pretty chocking to see not only which nations defaulted or partly did, but also how frequently it actually happened. http://en.wikipedia.org/wiki/Sovereign_default

That Greece qualifies for a gold medal in the sense of default record is generally known, but names like Spain, Austria, France etc. also appear on the list.

So one might argue that these nations defaulted due to overspending by out-of-touch Royal Dynasties without any democratic check-and-balances. But this raises yet another and really interesting question: is a functioning (at least half way) democracy able to do better? And the sad answer is: most probably not – in peacetimes. And in a much more interconnected world, the final consequence of a default or partial default is having greater implications – as could be seen in relation to Greece and mainly most big European banks.

When the US Republican Party's nominee for presidency, Mitt Romney, at a private meeting said that he could not reach the 47% of the population living off public benefits, he might have been perfectly right, even it may not have been a smart thing to state.

One of the problems with the democracies simply is that a government doing what it has to do in order to be fiscal prudent – with no present enemy at its gate – might get rejected by the electorate, precisely as it happened to Arnold Schwarzenegger in California, as described in Michael Lewis' excellent book – Boomerang.
http://www.guardian.co.uk/books/2012/sep/23/boomerang-michael-lewis-review

So there is no guarantee that such defaults as those we have seen plenty of in the past would not happen again today. Earlier time's kings and princelings are equal to today's substituted companies and citizens living off government welfare – and we could include private sector selling mainly to the governments. So this probably takes Romney's figure somehow higher.

Tailwind or headwind - where is the travel supposed to take us?

Governments basically have 5 options – or a combination thereof:

> Create growth and stop the creation of new debt – and let the relative importance of old debt diminish over time. This might work well in special situations where it worked well before. Condition being that the creation of growth is possible. In the current situation is it hard to imagine this solution being generally successful, as it would also

normally in addition require a devaluation of the currency – simply due to the fact that too many nations are facing the same problem at the same time.

Austerity; reduce spending, increase taxation. And by this action risking to reduce or completely eliminate growth – making it ever more impossible to reach the set goal – an effort of "anti Keynesian policy". It seems that the interconnection between austerity and falling or negative growth is much higher than anticipated, as we see daily in places like Greece and Portugal – it is simply too late to fine-tune and adjust, while trying to be fiscal prudent, once things are spiraling down.

Devaluate and increase competitiveness and thus increase economic activity and the tax base. Difficult as many countries have the same problem. But currency wise the "race to the bottom" has begun – and it's most likely really only the beginning.

Be bailed-out by your bigger neighbor; might work for smaller nations in the European Union. But at some point a painful regaining of competitiveness must be achieved – either through internal or external devaluation – as is required when IMF is bailing out countries. http://en.wikipedia.org/wiki/Internal_devaluation

And as we see daily in Greece, an internal devaluation is not socially easy, as more or less all labor cost have to be adjusted, and most probably the project won't succeed, or if it succeed – only at very high social cost, and a culprit to point fingers at can easily be found. Less so if the currency floats and the adjustments are done by the market. The process is painful as well – but it's harder to point fingers, and as such easier to digest socially.

Quantitative Easing "QE"; where central banks buy assets (government debt and also other assets) with freshly created central bank money – out of thin air. In fact most major central banks have implemented some kind of QE.

In the theory the extended central bank's balance sheet can be reverted and scaled down at the central banks' discretion (but an increasing number of independent "out-of-the-box" analysts doubt this is ever going to happen). Government intervention will become more and more significant – not only with regard to short dated yields, but also on the whole yield curve – the latest with FED's open ended QE3, enabling the FED to buy (long dated) mortgage backed securities for USD 40 billion monthly. In 2011 the US Federal Reserve bought above 75% of the debt issued by the Treasury Department.

And when we soon come close to the end of the runway – to the "fiscal cliff" – we shall see whether this heading can be substantially reversed. We wouldn't bank on it, though we wouldn't fear an outright default in a major nation either (besides the countries not able to manage their own money supply).

So how should investors set their bearing?

Basically things might still end well for indebted nations. In an ideal world one would expect governments to do the right things, and citizens to stand close together and support one another, like in wartimes. The problem just seems to be that we came too far in the wrong direction already in the western industrialized world, together with Japan, and there just isn't any big foreign army at the gate, making citizens accept endless sacrifices. More likely will there be more government intervention, where citizens and companies will be facing more regulatory framework and limitations, with a potential drag on growth – the "Japanese fever".

Now add a few herbs to the soup – like demography, interests at levels where the downside is very limited but the upside is open, and a few more, and one might begin understanding the pessimist – those who believe that the QE we have seen so far might only be the beginning of something more to come – regardless whoever wins the November US election.

Even the debt-to-GDP is far less a problem in most emerging countries including many ASEAN countries which are not in any significant way changing the overall dark picture.

According to page 62 of The Economist October 20th 2012, low interest historically isn't good for equity, especially if it comes with sluggish growth, and two significant measures: – the cyclical adjusted P/E ratio and the dividend yield the US market offers – does not look that appealing.

Investors might run into a kind of a trap when buying stocks paying seemingly nice dividends – at least compared to bond yields. But it just might not be enough as bond yields are artificially low. When going for dividend stocks, look carefully at the companies pricing power and general competitive situation forward going.

Government bonds might for some time to come make investors feel well – yielding a bit, while being supposedly safe – but the potential for most (western + Japan) government bonds is very limited, and big managers like Bill Gross at Pimco recently lost his appetite for government bonds. Company bonds still offer some yield, but it is limited, and we sense that the counterparty risk is not being compensated appropriately. Asian bonds seem more appealing to us.

It is worth noticing that a bond manager like Pimco's Bill Gross – co-managing one of the world's biggest bond funds – just until a few months ago argued in favor of US government bonds and described them as being "the cleanest dirty shirt in the laundry". Now he has changed his mind and talks about a "ring of fire". He mentions that the debt-to-GDP gap should be closed or the ratio will continue to rise – the FED would have to print even more money and monetize the debt, with the inevitably implication that inflation will follow; followed by a falling dollar (the level and speed of a falling dollar will be a function of how far and fast trading partners will act in a similar way as well).

In our article dated May 2010, and after some discussions with clients about how and if to implement a gold strategy, we at Helvetic Investments have consequently argued that investors should hold a fraction of their savings in gold – in fact by now we opine it as being almost grossly negligent not to hold some gold. http://helvetic-investments.sg/image/Gold.pdf

The fraction will depend on individual circumstances and would need to be analyzed and determined in greater detail.

Farmland and some raw materials could partly provide a similar diversification – but such a strategy is complicated to implement for mainstream investors.

The discussion about gold and the lack of intrinsic value is a real interesting one and all arguments are quite reasonable and understandable – with gold not yielding and supposed being costly to store.

But given the current situation many nations find themselves in, many arguments against this diversification are just not all that relevant, to our understanding.

In our article of May 2010 we recommended clients to hold some gold at USD 1215 per ounce, even the price seemed high at that time.

Traditionally October is a weaker month for gold, and in early October 2012 gold was overbought, with a big number of long interest positions. Lately it came down to the level of USD 1700. Being aware of a great numbers of pros and cons, and that bigger corrections are possible, we hold our breath and reiterate our suggestion: to hold some gold in a portfolio in most cases.

We would be delighted to discuss the issue further and would be pleased to be of support to implement an investment strategy – please do not hesitate to contact us.

Your Helvetic team/JW

Disclaimer

The opinions expressed herein should not be considered to be a recommendation by Helvetic Investments Pte. Ltd. to any reader of this material to buy or sell securities, commodities, currencies or other investments referred to herein.

The past performance of any portfolio and the manager and any economic and market trends/forecast are not necessarily indicative of the future or likely performance. Value of investment may go down as well as up, and the investor may not get back the original sum invested. Changes in rates of currency exchange may affect significantly the value of the investment.

Helvetic Investments Pte. Ltd. has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Helvetic Investments Pte. Ltd. and its affiliated companies make no guarantees, representations or warranties and accept no responsibility or liability as to its accuracy or completeness. Information in this report is subject to change without notice.

Helvetic Investments Pte. Ltd. and its affiliated companies, clients, directors and/or staff may, at anytime, have a position in the markets referred herein, and may buy or sell securities, currencies, or any other financial instruments in such markets.