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Athens' Second Sin

2000 years ago, a local schoolteacher for noble children named Socrates was condemned to death in Athens for speaking the truth. Under similar threat, his disciple, Aristotle, chose self-imposed exile. On his way out the door to Macedonia, he reasoned, 'Athens shall not sin against philosophy twice.' Athens has now sinned against economics, a close enough approximation of philosophy for government work. Greece borrowed >1x GDP in a hard currency it cannot print. Default is the only possible outcome. Its 13+% deficit proved the ultimate liar loan - the liquidity of Euro financing under a fictitious fiscal premise. The Germans do not want to throw good money after bad, but having accepted accounts they should have known to be murky, their leaders are nervous. As Germany publicly talks of kicking Greece out of the Euro, it's government is reconciled to absorbing the bank debt portion of any default by rolling over at below market levels, amortized over oh, say 50 years.

The default, whether exercised as a legality or not, is about to teach the Greeks finance. Permanently. Unfortunately, when a country's bonds trade at the equity risk premium expected from Microsoft, functionally, it no longer issues debt. Its citizens no longer face bondholders, they face the sovereign equivalent of a market for corporate control. And the consequences will be no less meaningful than Aristotle's arrival in Macedonia. As a refresher, he then taught a young prince named Alexander, who ran his armies all the way into India, opening trade routes that lasted until Robert Clive planted the flag of the East India Company in Calcutta using naval capability. The Greeks will learn to file tax returns that begin to resemble the truth, and the collapse of their welfare state will reverberate throughout Europe. Others may also find Brussels' auditors somewhat more unpleasant than local ones. This time, the chain reaction from Spanish beach resorts, through Dubai, all the way to Pune, India will be of condo defaults. Everyone I know in India owns 2 empty apartments in Pune already, or is scheming to buy a second one.

In 2008, the final straw in the markets came from the ECB, which raised rates in the midst of the start of a US Great Recession. The same people are now considered smart enough to solve for the ongoing Depression of Europe. They will be forced to print money when Spanish regional bank balance sheets are found to be as optimistic as Greek fiscal accounts. With any good sense, they would start now. In any case, a QE program by the ECB is now all but unforeseeable. Its failure would dissolve the Euro.

Why print? In Barcelona, on Las Ramblas, their main drag, I had a late night snack in July 2008, when Lehman still breathed, and the bartender thought it fit to charge USD 11 for a draft beer, a price which the Monkey Bar in New York dare not set. The per capita income of Manhattan residents is a touch higher than Barcelona's central districts, and any society setting a 100% price / productivity premium on its services is an accident waiting to happen. The rule of thumb, per Barton Biggs, is 40+% decline in currency and 40+% in asset price, for a total of 80%. That would set a target rate below parity vs. USD for the Euro, while prime property is cut almost in half. As for beachfront, a hat is tipped to the late John Templeton, who, commenting on Miami, said, 'Take the highest price paid, divide by 10, and start bidding.'

As for those who are printing as if there were no tomorrow, India just raised its reverse repo rate to 3.5%, while inflation approaches 10%. This is about to blow up in their faces. If this is 'tightening', what on earth is loose policy? Negative nominal rates? What are they thinking? Of course they are competing with China, which claims 2.6% inflation. I will be shocked, shocked to find out that Chinese inflation estimates proved optimistic. If China printed 10x-20x the money India did, how is such low inflation even possible given their real growth cannot now keep up with India's, which is at a far lower per capita base, and their property values are accelerating while Indian asset values are flat from 2 years ago (though at ridiculous levels)? In India, a Volckeresque tightening is required to bring the genie back in the bottle; a parallel step in China would reveal trend growth to be 5%, at which rate export oriented employment growth stalls, which implies reducing regulation in the domestic economy to achieve further improvement in standards of living. This is something both governments are loath to do for different reasons.

There is a dispute between the Chinese central bank, which would like to end the 'special' hold in the rise of the Yuan in response to the recession, and the commerce ministry, which is captured by the export lobby and would like the Yuan frozen permanently, inflation be damned. The implication for the Yuan of a rational monetary policy may be a melt-up in the currency, a reverse of the crisis after which the Pound left the European Exchange Rate Mechanism. Of course, such an outcome bankrupts all the nephews of the leadership who are partners in the export zones, just as positive real rates in India would bankrupt the regional party leaders who are now real estate developers. The trigger of the next crisis is likely not a US or European double dip, painful as that would be, but a blowup of Asian macroeconomic policy, which was 51% of the root of the recession to begin with.

Back to the US. The FDIC needs a trillion dollar rescue from the banks' commercial real estate holdings, another 'surprise' in the works. California needs a constitutional convention to avoid bankruptcy. It's after tax yield is even higher than Greece's, if that were possible. From incredibly generous unemployment benefits, to government employees scamming the pension system by spiking retirement incomes, the stories floating out of state governments border on the incredible. California is now a banana republic, and sadly, nowhere near unique for a US state. Forgive me for quoting Lenin, but the state is a reflection of society, and municipal bond yields are suggesting that many societies in the US need to take Socrates' advice and re-examine their lives. The leverage offered by the savings of newly minted Asian industrial workers corrupted an entire society - from the dishwasher with an 500k mortgage to the CEO expecting $50 mm a year as a product of 50x leverage. The final straw, of course, is a Federal government obsessed with spending another $1 trillion of other people's money.

So when does all this affect the S&P? It feels like 2007 redux, a new equity bubble with a variety of accidents waiting to happen. By year end, higher taxes kick in, the stimulus ends, Asian interest rates rise to fight inflation, and the mathematical recovery of inventory rebuild wraps up. Double dip, anyone? The macro narrative of our times is one of over-indebted western governments sobering up and switching gears to regain control over their fiscal situations, before they lose their right to issue reserve currencies, and undemocratic governments become equity holders in their societies. It might then take 2000 years to regain the truth as a currency. Just ask the Athenians. The US Congressional elections should mark the decision point for markets. I believe the voters get it, as demonstrated in NJ, VA, and MA, and with time, they will recruit politicians who do, too.

Until then, Treasury and municipal bond yields remain suspect, with ghastly consequences to markets if they widen say, another 1%. It would prove to be the Treasury buying opportunity of the decade, though, given inflation just might require Bernanke's threatened helicopter drops of cash to create, with unemployment stuck at 10%,; meanwhile voters are incredibly unlikely to keep asking for trillion dollar deficits to fund 'stimulus' and 'bailout', words which one recoils viscerally from merely while typing them.

http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(PPP)_per_capita