



28th February 2011

Common currency

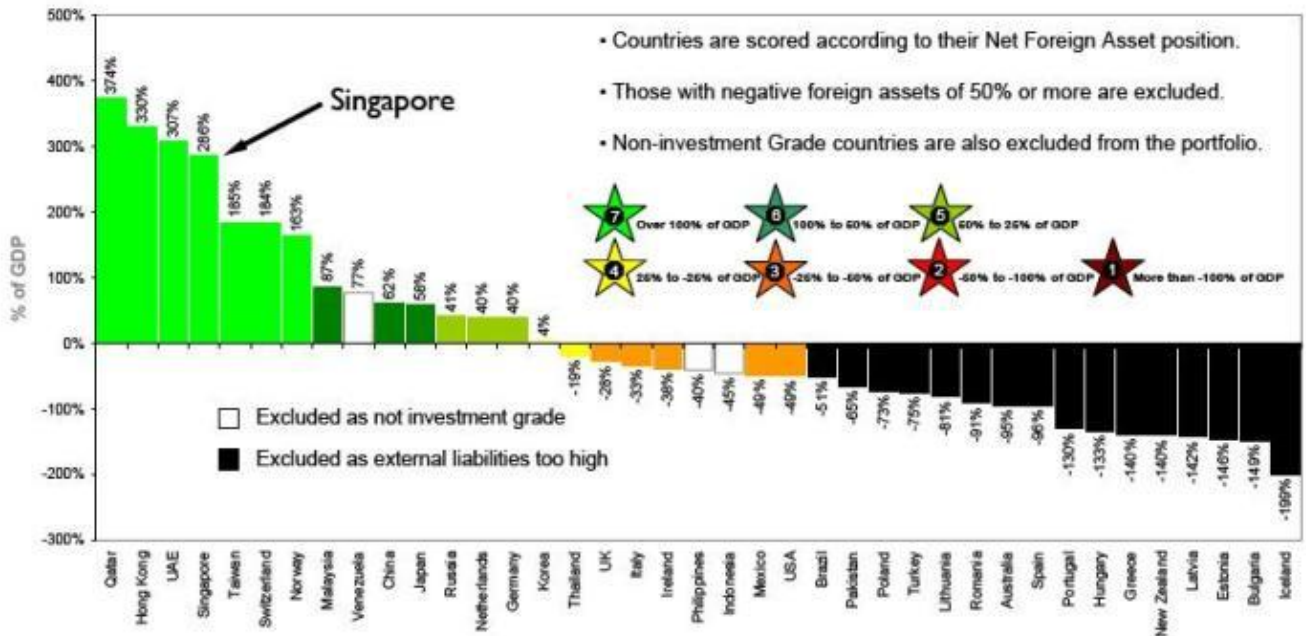
“It was vintage Muammar Qaddafi. After a blood-soaked week of unrest, Libya’s leader delivered a rambling, hectoring, fist-pounding speech on February 22nd. He blasted the popular uprising that has left hundreds dead and torn much of the vast north African nation from his grasp as the work of drug addicts and agents of al-Qaeda and America. He shouted that he would never surrender and ordered his men to hunt these “greasy rats” from house to house, without mercy, and take what they wanted. Then he drove off in an electric golf buggy.”

- The Economist magazine, 24th February 2011.

Events in North Africa and in other Arab states are evidently unsettling not just for their own people but for investors globally. But compared to the other elephants in the room, even the likes of Libya is ultimately a distraction. (Awkward questions will undoubtedly be asked about the support of western governments for those autocrats now being messily if democratically removed from office by their own people.) Peak oil deniers will doubtless point to the anticipated post-crisis abatement in Brent and WTI prices; provided there is something approaching resolution to these local uprisings, equity markets may regain a sense of poise. But there are huge and unresolved problems out there that haven’t gone away, even if they may have been temporarily blown off the front pages – or the business sections – by rising tensions in the Maghreb and elsewhere. The banking sector is still sick, as evinced by the hypothetical that Lloyds, one of the UK market’s bigger basket cases, at the current level of statutory profits, would not be paying tax for more than [50 years](#). And largely unreconstructed banks still look suspiciously too big to save, as opposed to fail. Fears (or hopes) of further quantitative easing continue to buoy multiple asset markets behind an explicitly inflationary magic veil. The biggest problem of all is that the supposedly developed world is drowning in debt, and in many western democracies the problem is getting worse, not better. With governments and central banks busily engaging in currency depreciation masquerading as putative export competitiveness, fiat currencies are engaging in a race to the bottom. No surprise to see gold and silver testing new highs. But to return to the current flashpoints – North Africa and the Gulf – how are the current uprisings affecting the prices of debt there, given that as investors we and our clients have meaningful exposure to parts of the region ?

The answer is, perhaps surprisingly to outsiders, very little. According to the thesis of Stratton Street Capital, advisers to the New Capital Wealthy Nations Bond Fund, in a deleveraging world, money will seep away from debtor nations toward healthier creditor countries, and this process will likely take a period of some years. This, in turn, should mean higher borrowing costs for the debtors, alongside weaker exchange rates. They point out that since 2007, when the financial crisis

started to bite, the Yen, Swiss Franc, Singapore Dollar and Chinese Renminbi have been among the five strongest currencies against the US Dollar. These countries are all creditor nations. Amongst the weakest currencies have been the Romanian Leu, Vietnamese Dong, Turkish Lira and Icelandic Krona – and these are all large debtors. Both the credit logic and the currency logic can be seen in the table below, a longstanding favourite of ours provided by Stratton Street, and which shows the net foreign assets as % of GDP for selected countries as at January 2011:



The most attractive credit risks are shown in green at the far left of the table. Investors should be comfortable lending their money to these countries (i.e. buying their bonds), because they have objectively the greatest wherewithal to pay it back. Investors should seriously reconsider lending their money to those countries toward the right of the table (in black), because those countries are approaching technical insolvency. Of course, countries can always print local currency to service their debts – but by definition they cannot legally print foreign currencies, hence the usefulness of this specific measure, net foreign assets as % of GDP. And in printing ever more local currency, they run the risk of a domestic currency collapse – so it should come as no surprise that the currencies of the ‘black’ countries in the table are typically faring poorly in comparison to those of the ‘greens’. Many of the Gulf states have currencies pegged to the US Dollar. The table shows conclusively why we believe the Singapore Dollar to be such an attractive currency from the perspective of soggy western currencies (take your pick between \$, £ or €) – not ignoring the fact that Singapore is also a gateway to, and representative of, the faster growing Asian economies.

To return to North Africa and the Gulf. Stratton Street point out that Bahrain credit spreads suffered during February and their 5 year CDS (credit default swaps) widened from 215 vs US Treasuries to 297. The price of the bonds issued by the sovereign wealth fund of Bahrain, Mumtalakat 2015's, fell from roughly par at the end of the month to a low of 92.75 at the start of last week. In Stratton Street's view, the risks in Bahrain are political rather than economic and so the chances of the current turmoil leading to sovereign default they consider more or less negligible. Political risk is, however, a subjective assessment; provided credit ratings are sensible (admittedly a more debatable point now), credit risk amounts to a straightforward mathematical comparison. If two countries have identical ratings and identical maturities for their debt, the higher yielding country, all things being equal, is objectively cheap. Mumtalakat 2015's now stand 3 points above Monday's lows and arguably continue to offer value at a spread of 425 bp over for the A- rated name. Elsewhere in the region, CDS spreads for Abu Dhabi (rated Aa2, spread @

117), Dubai (not rated, spread @ 452), and Qatar (rated Aa2, spread @ 117) are all roughly 10 basis points wider as is emerging market favourite Turkey (rated Ba2, spread @ 180). The average credit spread of the Wealthy Nations Bond portfolio is +380 bps over government bonds. This is extremely wide for investment grade credit and compares favourably against Emerging Markets debt (JPM EMBI+) at + 279 bps, Eurodollars (ML) at +104, Euro-Sterling (ML) at +179 and Europe (ML EMU corp.) at + 169 bps. In conclusion, like the Dubai property wobble of late 2009, the current tensions may prove to be an excellent buying opportunity for the better credits in the region. These are in many cases, by any objective assessment, extremely wealthy countries, not poor ones. In the style of Goldman Sachs, we would coin our own trendy acronym for the supposedly riskless sovereigns of the “wealthy” west:

Citizens Rich; Administrations Poor.

Within Wealthy Nations the major Middle East allocations are to Qatar and the UAE. The fund's Qatari quasi-sovereign selections are typically rated AA **and yet are trading at the same spread as BB rated Emerging Debt**. In the UAE meanwhile, Dubai Sovereign and Dubai Electricity and Water (100% owned by Dubai Sovereign) trade at T+450 bps - **over five times the spread of similarly rated Emerging Debt**. The Abu Dhabi quasi-sovereigns, single A rated, are typically priced wider than BB rated Emerging Debt, such as Turkey.

Take another look at the table above. Within the Wealthy Nations Bond Fund, the managers draw the line where countries are either sub-investment grade, or where their external debt liabilities are too high. On this latter point, they define net foreign liabilities beyond 50% of GDP as the point of exclusion. Note that the US, which is conventionally regarded as the safest sovereign credit in the world, hovers perilously close to this 'line of no return'. **US Treasuries themselves are very close to being non-permissible assets**, too insubstantial for consideration within the fund. Then ask yourself why the major credit ratings agencies are still even in business.

Stratton Street point out that the World Bank considers the following countries to be too wealthy to be considered emerging markets in debt terms; Hong Kong, Singapore, South Korea, Taiwan, Qatar, UAE, Kuwait and Saudi Arabia. These countries are likely to have no problem paying their debts. In a dramatically deleveraging world, it is rational to expect problems to arise in several countries. Besides those countries Stratton Street identified two years ago as vulnerable (Iceland, Estonia, Hungary, Latvia, Bulgaria, Portugal, Greece, Lithuania, Poland, Romania, Australia and Spain), it would not be a huge surprise to see the likes of Vietnam, Turkey, Ecuador, Sri Lanka, Lebanon and Georgia getting into financial difficulty. The common denominator is that they are indebted and poor. Forget the Gulf. For a UK or even US bond market investor, the real default / devaluation risks are altogether much closer to home.

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