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THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING

Beware of the Ides of March

In William Shakespeare's play Henry V, published in the year 1600, the English king dispatches his uncle, the Duke of Exeter, to the court of King Charles VI of France demanding the French king's surrender prior to the Battle of Agincourt in October, 1415.

Duke of Exeter: From his most fam'd of famous ancestors,
Edward III, His Majesty bids you then resign
Your crown and kingdom, indirectly held
From him the native and true challenger.

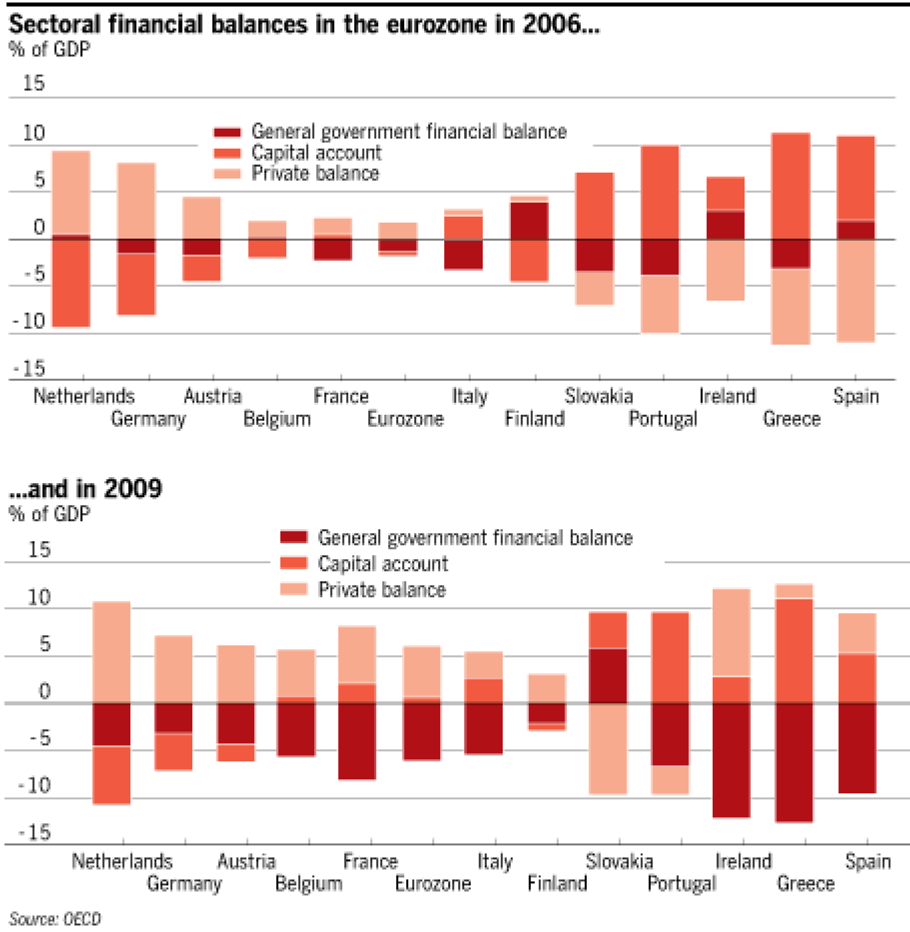
King Charles VI: Or else what follows?

Duke of Exeter: Bloody constraint ; for if you hide the crown
Even in your hearts, there will he rake for it :
Therefore in fierce tempest he is coming,
In thunder, and in earthquake, like a Jove ;
That, if requiring fail, he will compel ;

The world's fixed income markets worry Greece could be to the sovereign debt market, what sub-prime mortgages were to the American housing market and spreading a new bout of financial contagion, affecting heavily indebted countries on a broad scale. Of course, only countries with serious deficit and national debt problems, threatened with sovereign rating downgrades, are in danger of experiencing limited borrowing access to global bond markets. In recent weeks, Greece's Prime Minister George Papandreou could likely identify, at least in an emotional sense, with Shakespeare's Charles VI, as many of his fellow European Union members laid siege to Athens to take stringent measures and reduce Greece's burgeoning deficit and national debt. In 2009, Greece's budget deficit amounted to 12.7% of its gross domestic product (GDP) which is the broadest measure of a nation's economic output and its national debt reached 113% of GDP. In order to avert financial Armageddon, Mr. Papandreou vowed to cut his country's deficit to 3% of GDP by 2012: "I've told the Greek people that 2010, this year, must be and will be a year of drastic reforms across all levels of government, changes in our tax system, our social security system, our public administration, our education system, our health system and our development model."

While investors continue to pour money into sovereign government debt issues around the world, perceiving them as a safe investment, that is only true on a relative basis and there are no guarantees. Indeed, sovereign debt investors have helped maintain the general level of global interest rates at historically low levels. The Greek debt problem emanates from, not only free-spending federal governments, but also, from some very creative accounting practices perfected by its Department of Finance. Moreover, by the Prime Minister's own admission, graft and corruption virtually permeate throughout the Greek government bureaucracy. Adding to its financial woes and as a consequence of decades of bargains struck between strong unions and weak governments, Greece has promised early retirement to about 700,000 employees, or 14% of its work force; enabling an average retirement age of 61, one of the lowest in Europe. According to research by Jagadeesh Gokhale, an economist at the Cato Institute in Washington, bringing Greece's pension obligations onto its balance sheet would show that the government's debt is in reality equal to 875% of its gross domestic product, definitely, the highest debt level among the 16 euro zone nations. Naturally, any default or near default by Greece could cause investors to question their perceptions of

safety, raising doubts about the credit worthiness of other nations, including Spain, Italy and even the United Kingdom. For the present, it would appear that sovereign fixed-income investors are confident that Greece's debt problems will remain confined to Greece. Faced with the prospect of refinancing over $50 billion (U.S.) of maturing bonds in April and May, the proof will be in the pudding.



Be that as it may, today the euro zone governments announced that they stood ready to assist Greece manage its debt crisis by establishing an emergency financial support facility for the first time since the euro's creation in 1999. According to the Financial Times, after a meeting of finance ministers of the 16-nation eurogroup in Brussels, Jean-Claude Juncker, Luxembourg's Premier stated: "The member states of the euro area will take co-ordinated action, if such action turns out to be necessary. There are still some technical points. We agreed that the final decision will be taken by the European Council." While few details of the plan were unveiled, it appears that the plan will involve bilateral loans to Greece from other euro zone governments, led by Germany and France. Jan Kees de Jager, Finance Minister of the Netherlands, noted that all euro zone governments would make a contribution, but they would require the Greek government to pay a premium for its loans, in order to provide it with an incentive to refinance its debt through the financial markets.

In the meantime, Standard & Poors affirmed Greece's investment-grade 'BBB' (High) sovereign debt rating and removed the country's outlook from "credit watch negative," citing the 4.8 billion euros ($6.6 billion U.S.) of budget cuts passed earlier this month "were appropriate to achieve" the goal of cutting its budget deficit to 8.7% of GDP this year, from the current 12.7%. Standard & Poor's revised opinion, notwithstanding, we believe that given Greece's financial track record and lack of credibility in the past, there is neither any hope of the

country achieving this year's promise, nor, Mr. Papandreou's vow to cut the budget deficit to 3% by 2012.

In a new report, Moody's Investors Service warns that the world's five biggest 'AAA' rated states are all at risk of soaring debt costs and that economic "growth alone will not resolve an increasingly complicated debt equation." The U.S. debt rating agency noted that the United States, the United Kingdom, Germany, France and Spain are walking a tightrope as they try to bring public finances under control without impeding any potential economic recovery. It warned of "substantial execution risk" in the withdrawal of stimulus packages. Pierre Cailleteau, Moody's chief economist, comments: "Preserving debt affordability at levels consistent with 'AAA' ratings will invariably require fiscal adjustments of a magnitude that, in some cases, will test social cohesion. We are not talking about revolution, but the severity of the crisis will force governments to make painful choices that expose weaknesses in society." If countries tighten monetary policy too soon, they risk stifling economic recovery and making matters worse by eroding tax revenues; yet waiting too long is "no less risky" since it would test the market's patience. "At the current elevated debt levels, a rise in the government's cost of funding can very quickly render debt much less affordable." Moody's stated that Britain has been slower than Spain to "rise to the challenge" and it may be at a greater risk of losing its 'AAA' credibility should interest rates suddenly move higher.

According to Reuters, in a new report the European Commission (EC) criticizes Britain for failing to guarantee that it will meet the Maastricht limit for budget deficits of 3% of gross domestic product by fiscal 2015. The EC states: "The overall conclusion is that the fiscal strategy in the convergence program is not sufficiently ambitious and need to be significantly reinforced. A credible time frame for restoring public finances to a sustainable position requires additional fiscal tightening measures beyond those currently planned." The EC also urges the U.K. Treasury to publish "the detailed departmental spending limits underlying the overall expenditure projections" for the coming years. However, U.K. Chancellor Alistair Darling has indicated that next week's budget will not include a detailed spending plan.

The bottom line is that no country can solve its debt problems through the issuance of more debt. In a fiat monetary system, the relentless printing of more paper money simply adds to a nation's debt load and debases the purchasing power of its currency. The leading credit rating agencies, Moody's, Standard & Poors and Fitch are well aware of the fact that countries don't like to hear bad news about their creditworthiness. As mentioned above, when Moody's issues a sovereign debt warning, many factors are considered in the determination of whether a country's 'AAA' credit status can be maintained. The potential for economic growth; the current monetary policy being employed by the central bank; the trend of the government's taxation revenues in terms of its fiscal budget deficit; the government's financial vulnerability to unforeseen economic shocks; the country's accumulated national debt level in relation to its gross domestic product (GDP) and by no means the least, a government's interest payments on the national debt as a proportion of government revenues. History has well documented the cases of countless governments, who when their budget deficits exceed 10% of GDP and/or their national debt exceeds 100% of GDP and/or their debt interest payments exceed 10% of their revenues; they will face increasing difficulties and challenges in the management of the public's finances.

Moreover, rating agencies must also take into consideration the question of contingent government liabilities, such as pension plan obligations; as mentioned above in reference to Greece. According to Mr. Cailleteau, "The state of public finance accounting is extremely rudimentary relative to private sector accounting." As the cost of these contingent entitlements escalates, rating agencies will be obliged to include these obligations in their periodic rating reviews, thereby, raising the overall level of government debt and making government budget-balancing acts increasingly difficult.

Long Wave Analytics has long predicted that a global economic depression would unfold within this time frame, as a result of the massive and still growing debt bubble. For most of the past decade, Ian Gordon, Long Wave President, has accurately forecast that excessive U.S. consumer debt levels would not only, result in the crash of the American housing market and stock market, but also, cause irreparable damage to corporate and private pension plan industries. Moreover, Mr. Gordon has accurately predicted that the consumer debt contagion would spread all the way to the sovereign arena, as is now evident in Greece, Ireland, Spain and Great Britain.

Let me conclude by emphasizing that what the media and the politicians are presently terming "the great recession" is rather, only the first leg of the second great economic depression. In the past, every bursting of a major debt bubble has resulted in an economic depression. Today, the world is witnessing the bursting of a debt bubble of unprecedented magnitude. The current economic situation of the world being virtually, overwhelmed by debt is a historic event and cannot be rectified by the creation of additional debt. In point of fact, more debt creation will only make matters considerably worse. Already, Britain's debt interest payments have reached a dangerous 7% of its budgeted annual revenue. When this ratio arrives at 10%, the U.K.'s coveted 'AAA' sovereign debt rating will be history. There can be no global economic recovery until global debt is purged from the landscape.

In an economic depression, government debt rises exponentially, because GDP crashes (In the last depression US GDP dropped by 45%), and at the same time government revenues plummet. That's all well and good, when governments have the cash to try and contain the effects of the depression, as the US did in the 1930s. But where's the money going to come from, this time, when the next shoe drops?

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