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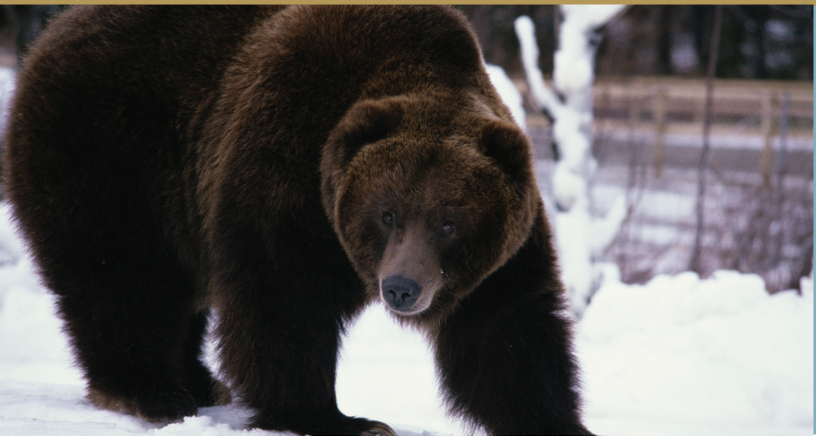
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



THE UNRAVELING OF DEBT

Not since the Great Depression of the 1930's has the world borne witness to so many sovereign credits, state and municipal governments, banking and financial institutions, as well as various corporate entities and individual consumers, trapped in the vice grip of demonic indebtedness.

In terms of sovereign debtors, the global community is now anticipating that Greece will become the first euro zone member to seek a rescheduling and restructuring of its outstanding debt. In the western hemisphere, the United States of America – the most indebted nation on the planet – soars inexorably, towards its statutory debt ceiling limit of $14.3 trillion (U.S.). Given that premise, we are focusing on the sovereign credits of Greece and America for this issue.

Lending to Sovereign Governments Has Always Been a Risky Busines

Banking in its modern form first developed in Italy during the Renaissance. Successful merchants in Florence discovered that they could lend out other people's money at a profit. As author Anthony Sampson describes in his book The Money Lenders, the nature of banking, then as now, is to accept risk at a price: "To these Italian bankers, England was a wild developing country on the edge of their world, a kind of medieval Zaire. Its exports of wool offered prospects of big profits: but with its despotic monarchs, its tribal wars and corrupt courtiers, it had a high sovereign risk." When King Edward III defaulted on his Italian debts in 1327, it caused the Florentine banks of Bardi and Peruzzi to collapse.

The Reconstruction of Sovereign Debt

"Sovereign debt restructuring means postponing the debt payments of a country and lengthening them out over a period of years, in the expectation that the borrower will be in a better position in the future to pay his loans. There are few explicit rules, except that creditors will not conclude a reconstruction until a country has reached an agreement with the International Monetary Fund (IMF) on an austerity program to put its balance of payments back in order. Debtor governments find it politically more palatable to accept terms from the IMF than from other sovereign states or the banks. Borrowers often object to the bankers' terms for rescheduling, but new loans make it possible for them to keep going. They live in the hope that falling interest rates and economic growth will enable them to meet rescheduled debt payments." – The Problem of International Debt, edited by Christopher A. Kojm, H.W. Wilson Co. 1984. Moreover, despite government denials, be not surprised to see government-mandated bondholder 'haircuts' creep into the process of any Greek sovereign debt reconstruction ; since it has already occurred to bank bondholders in Denmark and is now threatened in the Irish bond market. Wakeup call for the Irish and the Danes: Look not to Canadian investors to purchase your bonds!

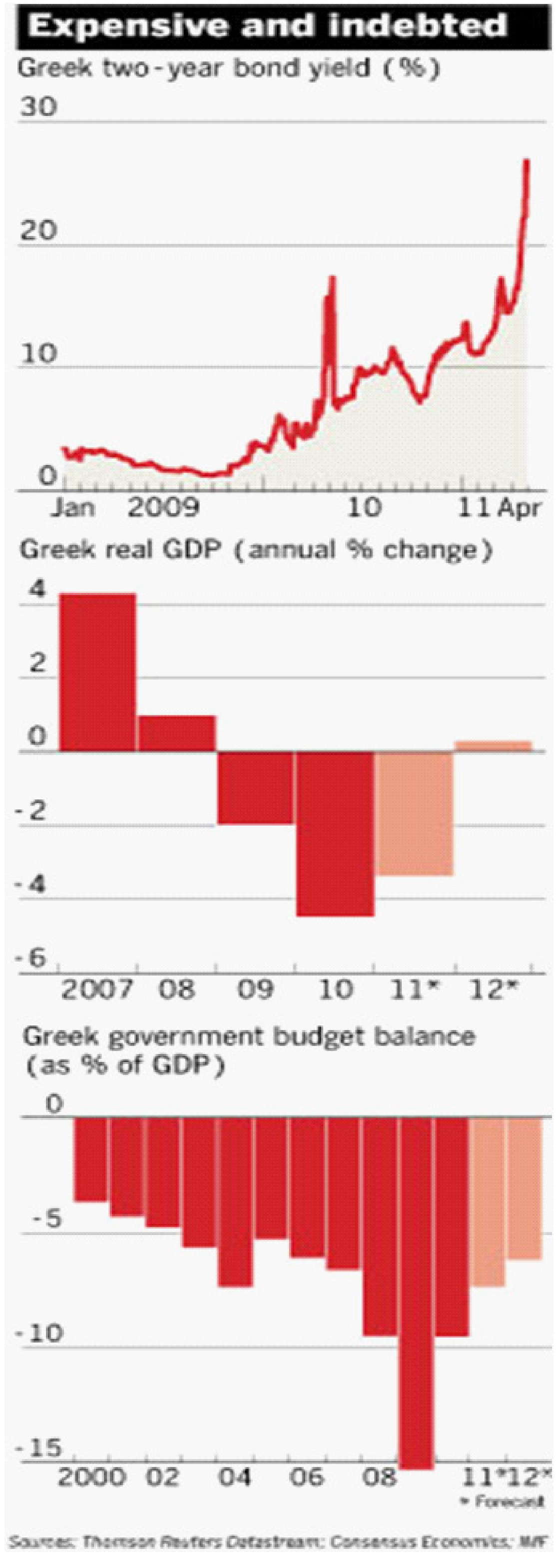
This Greek Tragedy Transcends Shakespeare

According to the Washington Post, holding fast to the EU party line, the European Union's Economic Affairs Commissioner, Olli Rehn, insists that a restructuring of Greece's massive debt "is not part of our strategy and will not be. Proponents of a debt restructuring, i.e. reducing the total amount of money Greece owes, or giving it more time to repay, appear to be unaware of the risks to overall financial stability that such a move would entail." Indeed, EU officials have warned that a restructuring of Greece's debt could lead to a panic on the financial markets. Accordingly, the European Central Bank (ECB) and the IMF are trying to save the banks of EU member states by bailing out other peripheral EU countries, such as Portugal and Ireland.

Simultaneously, Finance Minister George Papaconstantinou announces the Greek government's plan to raise an additional 11.8 billion euros through 2013, with a crackdown on tax evasion: "This is the first time ever that such a systematic effort has been undertaken. Tax evasion is a crime against the country, so the measures include tougher penalties for bribing tax officials, a radical reorganization of the tax office structure and increased use of online tax services." EU debt inspectors, due in Athens this week, have been warning that Greece needs to improve its taxation system, to curtail a weakness in state revenues that is threatening the country's fiscal rescue program.

According to the Financial Times, "Since late last year, the (Greek government's) reform agenda has lost momentum, raising the prospect that the progress made to date will be squandered. Fears of a repeat of violent street protests last summer that culminated in the deaths of three bank employees have prompted Mr. Papandreou's government to delay or dilute structural reforms. A deeper than expected recession – exacerbated by the squeeze on public finances – set back hopes of boosting tax revenues, although compliance appears to have improved a little. Local government spending has overshot targets. The result of all this was evident in figures released last week by Eurostat, the EU's statistical office, which showed the 2010 public sector deficit was worse than forecast at 10.5% of gross domestic product (GDP)."

However, the most serious problem for Greece has been its bloated public sector. Over the last two weeks and under heavy pressure, Athens has outlined a new medium-term financial plan to overhaul the public sector and its funding with a 50 billion euro ($74 billion U.S.) privatization program – enough to reduce debt by the equivalent of 18% of GDP by 2020. Placed on the auction block would be the government's stakes in crown corporations, concessions on airports, marinas, ports and land leases. Privatization experts are skeptical, however, whether formidable technical and legal chal-



lenges will allow progress anytime soon – given the program of prospective sales has divided Mr. Papandreou's cabinet and mobilized the trade unions. A prime example is the power workers' union, which provided strong support for his leadership of the socialist party, has threatened a national blackout over plans to sell the government's stake in the PPC state electricity utility.

Since Greece has lost financial credibility on an international basis, Greek banks are dependent upon the European Central Bank (ECB) for liquidity, currently borrowing about 90 billion euros in short-term loans on reasonable terms. Athens had hoped to regain access to the fixed income markets in 2012, when according to projected requirements, it must raise 25 billion – 30 billion euros. With yields on 2-year Greek maturities currently setting a record high at 25% in the secondary bond market, the timetable for next year is most certainly unsustainable. On the other hand, accessing additional bailout funds from the European Union (EU) seems highly unlikely.

Just one month ago, the International Monetary Fund (IMF) was urging the Greek government to restructure its debt soon, since it no longer believes that the austerity measures introduced in Greece will be sufficient to solve its debt problem, currently 150% of gross domestic product (GDP). Rescheduling possibilities include forgiving some of the debt, extending the maturity dates of sovereign bonds or lower interest payments. Naturally, all three of these alternatives would result in Greek bondholders receiving reduced rates of return. Moreover, at the same time, Standard and Poors downgraded Greece's sovereign debt rating to 'BB' (Low) – three levels below investment grade, citing "concerns that Greece may be forced to restructure its debt, wherein either governments will be repaid before other creditors, or the country may eventually renege on its debt obligations."

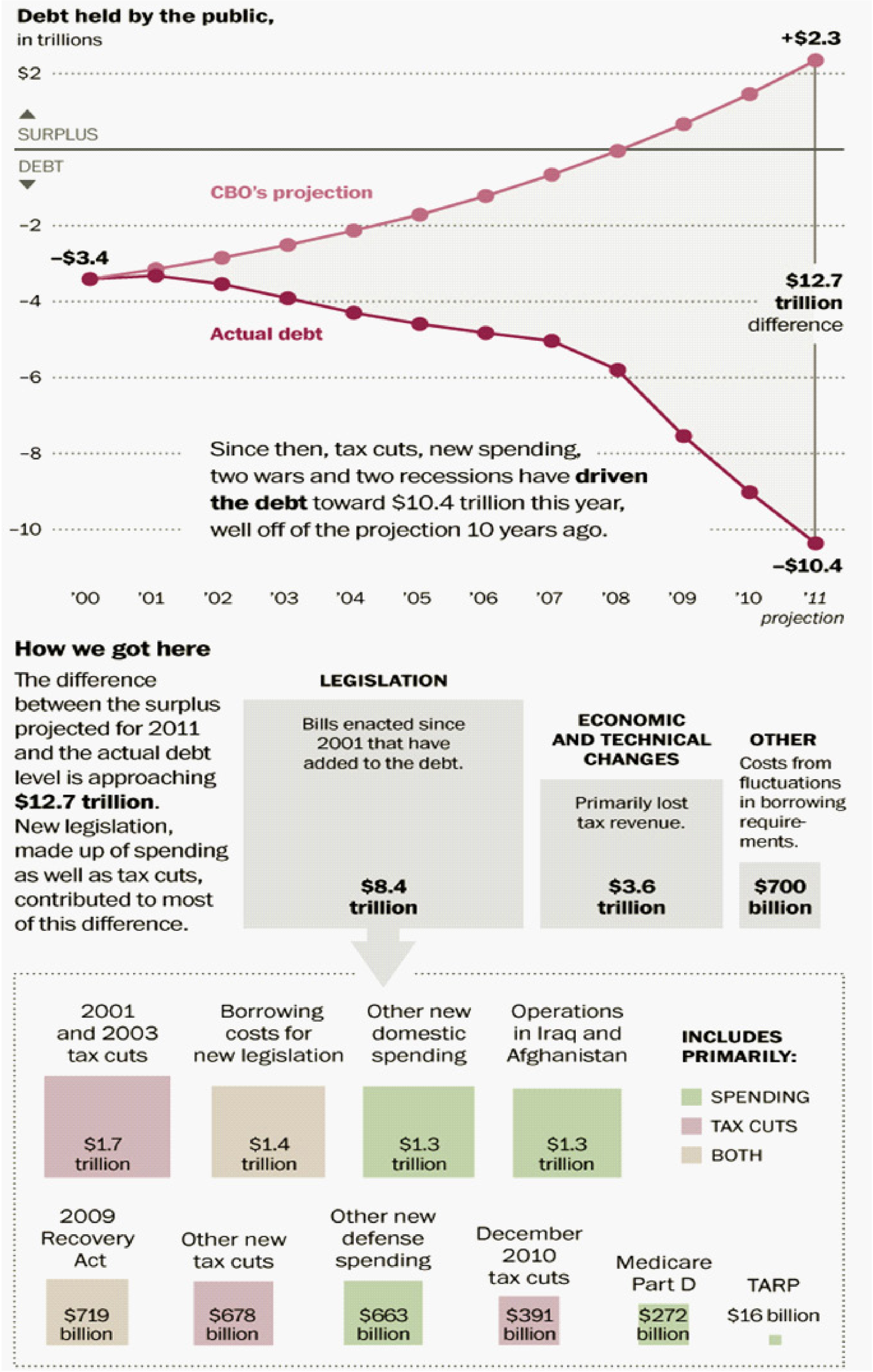
European Summary

At Longwave Analytics, we place great credibility in long-term economic cycle anniversaries, as pioneered by W.D. Gann. We are currently marking the 80th. anniversary of the collapse of Austria's Boden-Kredit Anstalt Bank in May 1931 because of unsustainable debt levels and which followed the 3rd. Kondratieff autumn stock bull market of 1921-1929. The bank's collapse precipitated the banking crisis in Austria, Germany, Great Britain and the United States – where almost 10,000 banks closed their doors – during the Great Depression. It is also the 40th. anniversary of U.S. President Nixon's abandonment of America's quasi-gold standard in 1971, creating the harbinger of additional debt. Since Greek 2-year bond yields have already soared above the 20% level, it seems inevitable that the next global economic downturn will be triggered by the default of that European Union member on its sovereign debt. The year 2011 could well record the beginning of the end for Greece's dalliance with the euro and the end of the beginning of the restoration of the drachma. Indeed, it also marks the beginning of the end of the world's fiat monetary system. See also, Winter Warning, January 26, 2011 – The Economic and Financial Outlook for 2011.

The United States of America Approaches the Fork in the Road

There is a classic saying attributed to former New York Yankee baseball Hall of Famer Yogi Berra: "And when you get to the fork in the road – take it!" Were the American debt and deficit problems not so dire, indeed not so serious, this anecdote would prove much more amusing. The fact remains that the U.S. has dug itself into a deep dungeon of debt, from which its ultimate extrication will prove arduous, if not downright impossible; particularly if economic growth proves to be unsustainable, due to the great expansion of debt on many levels. For the current fiscal year ending September 30th. the U.S. government's deficit is expected to reach at least $1.5 trillion (U.S.). In the meantime, the U.S. Treasury expects the country to confront the statutory debt ceiling limit of $14.3 trillion (U.S.) by early August. Failure of Congress to vote to raise the debt ceiling in a timely manner would preclude the U.S. Department of the Treasury from borrowing any more money.

In a recent online article entitled "U.S. Debt Ceiling – Cost and Consequences," the Council on Foreign Relations (CFR) noted if President Obama's proposed 2012 budget is followed, it would "require a $US 2.2 trillion hike in the debt ceiling just to meet the government's spending obligations for the next (fiscal) year. If the rival Republican plan was implemented, the figure would be a slightly lower $US 1.9 trillion."


Debt held by the public,
in trillions
$2
SURPLUS
DEBT
-2
-4
-6
-8
-10
+$2.3
CBO's projection
–$3.4
Actual debt
$12.7 trillion difference
–$10.4
Since then, tax cuts, new spending, two wars and two recessions have **driven the debt** toward $10.4 trillion this year, well off of the projection 10 years ago.
'00
'01
'02
'03
'04
'05
'06
'07
'08
'09
'10
'11
projection
How we got here
The difference between the surplus projected for 2011 and the actual debt level is approaching **$12.7 trillion.** New legislation, made up of spending as well as tax cuts, contributed to most of this difference.
LEGISLATION
Bills enacted since 2001 that have added to the debt.
$8.4 trillion
ECONOMIC AND TECHNICAL CHANGES
Primarily lost tax revenue.
$3.6 trillion
OTHER
Costs from fluctuations in borrowing require-ments.
$700 billion
2001 and 2003 tax cuts
$1.7 trillion
Borrowing costs for new legislation
$1.4 trillion
Other new domestic spending
$1.3 trillion
Operations in Iraq and Afghanistan
$1.3 trillion
INCLUDES PRIMARILY:
SPENDING
TAX CUTS
BOTH
2009 Recovery Act
$719 billion
Other new tax cuts
$678 billion
Other new defense spending
$663 billion
December 2010 tax cuts
$391 billion
Medicare Part D
$272 billion
TARP
$16 billion

According to The Privateer, “the most recent debt limit hike of $US 1.9 trillion, was signed into law on February 12, 2010. The previous one of $US 290 billion, was signed into law six weeks earlier on December 28, 2009. If Treasury Secretary Geithner’s latest projection that the limit will be hit on or before August 8th. proves accurate, that (combined) $US 2.19 trillion hike will have lasted the Treasury and the U.S. government for 16.5 months. Add that same 16.5 months to a debt limit rise in early August 2011 and you arrive at the end of November 2012. President Obama’s latest 2012 budget plan claims to cut cumulative deficits by ‘$US 4 trillion plus’ over 12 years. The rival Republican plan presented by Paul Ryan claims $US 6.2 trillion in deficit cuts over a decade – by tampering with Medicare.” According to the CFR, neither plan would make a discernable dent in deficit spending for fiscal 2012.

Notwithstanding the above, Republicans remain adamant that they want to take advantage of the debt limit debate, in order to extract additional budget cuts and impose stringent fiscal rules on government spending over the long term. John Boehner, Republican Speaker of the House, recently remarked to Politico: “If the President doesn’t get serious about the need to address our fiscal nightmare, there’s a chance a debt ceiling vote may not happen, but that’s not my goal.” On the other side of the aisle, in recent days more Democrats have threatened to vote against raising the debt ceiling on an unconditional basis. In a statement released by his office this week, Senator Mark Udall (D-Colo.) warned: “As catastrophic as it would be to fail to raise our debt ceiling, it’s even more irresponsible not to take this opportunity to own up to our unsustainable spending path. If we don’t take action to reduce our deficit spending, Congress will be facing this same debt ceiling vote in the near term – still with no end to our deficits in sight.” Last week, White House spokeswoman Amy Brundage commented: “Legislative leaders in both parties have been clear that the debt ceiling must and will be raised to prevent another economic meltdown. If members of Congress act responsibly and try to reach common ground, we can agree to significant deficit reduction without playing reckless politics with our economy.” The chart on the previous page, U.S. Treasury ‘Debt held by the public,’ reflects the Congressional Budget Office’s 2001 projection for a surplus in 2011 and the actual debt level incurred over the decade.

What Happens if the U.S. Statutory Debt Ceiling Isn’t Raised?

Outlined below are the highlights of a letter penned on April 25th. last, by Matthew E. Zames to U.S. Treasury Secretary Timothy Geithner. Mr. Zames is a managing director at JP Morgan Chase and Chairman of the Treasury Board Advisory Committee, which meets on a quarterly basis with the Treasury Department. The letter includes five salient points which analysts think may affect the U.S. economy if the debt limit isn’t raised.

Dear Mr. Secretary,

As Chairman of the Treasury Board Advisory Committee, I am writing to express my concerns regarding the urgent need to increase the statutory debt limit. A considerable degree of uncertainty already exists among market participants given the severe and long-lasting impact that even a technical default would have on the U.S. economy. Any delay in making an interest or principal payment by Treasury, even for a very short period of time, would put the U.S. Treasury and overall financial markets in unchartered territory and could trigger another catastrophic financial crisis. It is impossible to know the full impact of such a crisis on overall economic growth and on Treasury’s financing costs. However, the lessons from the recent crisis suggest that several damaging consequences will likely result, ultimately raising Treasury’s long-term funding costs and increasing the burden on the American taxpayer. These consequences stem from five developments that could likely occur if Treasury were to default on its obligations as a result of a failure to raise the debt limit in a timely manner.

Firstly, foreign investors, who hold nearly half of outstanding Treasury debt, could reduce their purchases of Treasuries on a permanent basis and potentially even sell some of their existing holdings. A worrisome precedent is the sharp decline in foreign sponsorship of government sponsored enterprise (GSE) debt, since Fannie Mae and Freddie Mac were placed under conservatorship … If foreigners began curtailing their investment in Treasurys as a result of a default, Treasury yields, thus treasury borrowing costs (coupon rates) would undoubtedly rise. A sustained 50 basis point increase in Treasury yields would eventually cost U.S. taxpayers an additional $75 billion (U.S.) each year.

Secondly, a default by the U.S. Treasury, or even an extended delay in raising the debt ceiling, could lead to a downgrade of the U.S. 'AAA' sovereign credit rating. Indeed, Standard & Poors' decision to change the U.S. ratings outlook from stable to negative this week indicates a one-in-three chance that Standard and Poors will downgrade the U.S. rating within the next two years. One reason cited for the change in the outlook is a material risk that U.S. policymakers might not reach an agreement on how to address medium-term and long-term budgetary challenges. It is possible that a default, or even a delay in acting on the debt ceiling, will be perceived as an increased indication of the political inability to forge a compromise on essential long-term fiscal reforms. The consequences of a ratings downgrade would be significant, with the potential for Treasury yields to rise by 100 basis points (one percentage point) for each one-level downgrade.

Thirdly, the financial crisis you warned about in your April 4th. letter to Congress could trigger a run on money market funds, as was the case in September 2008 after the Lehman Brothers failure … Such a run would spark a severe (financial) crisis, disrupting markets and ultimately necessitating the same kind of backstops that Treasury and the Federal Reserve initiated in the aftermath of the 2008 crisis. Such further increases in Treasury's off-balance-sheet commitments are likely to be viewed negatively by investors and rating agencies, which will potentially put further downgrade pressure on U.S. 'AAA' sovereign ratings.

Fourthly, A Treasury default could severely disrupt the $4 trillion (U.S.) Treasury financing auction market, which could sharply raise coupon rates (borrowing costs) for some market participants and possibly lead to another acute deleveraging event … A default could trigger a wave of margin calls and a widening of 'haircuts' on collateral, which in turn could lead to deleveraging and a sharp drop in lending.

Fifth, the rise in coupon rates (borrowing costs) and contraction of credit that would occur as a result of this deleveraging event, would have damaging consequences for the still-fragile recovery of our economy. In 2008, placing the GSEs in conservatorship, combined with a tightening of credit standards, caused mortgage rate spreads to widen by 1.5%, ultimately raising mortgage rates for consumers. A similar rise in mortgage rates and Treasury yields would adversely impact economic growth, potentially pushing the U.S. economy back into depression.

Finally, I would emphasize that because the long-term risks from a default are so large, a prolonged delay in raising the debt ceiling may negatively impact markets well before a default actually occurs. This is because investors will likely undertake risk-management actions in preparation for a potential default …Notwithstanding your significant efforts to date, your continued attention to this important issue is greatly appreciated.

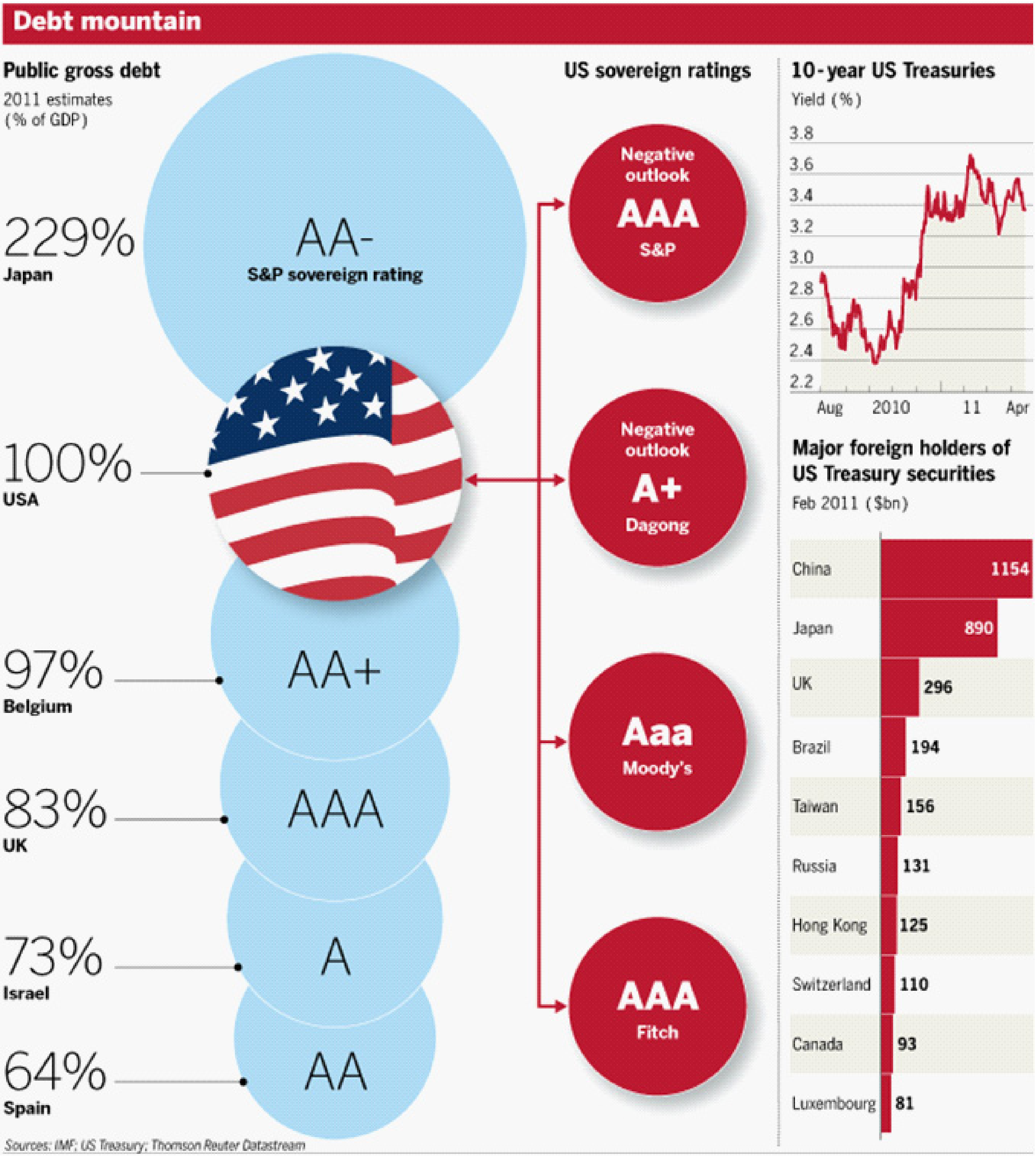
Sincerely,

Matthew E. Zames, Chairman

At Longwave Analytics, we would include two additional points of related importance on this subject:

Sixth, a U.S. Treasury default would, not only have the effect of raising the prevailing level of interest rates and bond yields in the fixed income market, but also, serve to steepen the yield curve from the relatively narrow spreads prevalent in today's bond market. For example, the yield spread between 10-year and 30-year Treasurys could widen from the current 115 basis points to 200 basis points quite easily.

Seventh, a U.S. Treasury default and credit rating downgrade would certainly place the U.S. dollar at great risk of losing its status as the world's reserve currency, sooner rather than later.


Debt mountain
Public gross debt
2011 estimates
(% of GDP)
229%
Japan
AA-
S&P sovereign rating
100%
USA
97%
Belgium
AA+
83%
UK
AAA
73%
Israel
A
64%
Spain
AA
US sovereign ratings
Negative outlook
AAA
S&P
Negative outlook
A+
Dagong
Aaa
Moody's
AAA
Fitch
10-year US Treasuries
Yield (%)
3.8
3.6
3.4
3.2
3.0
2.8
2.6
2.4
2.2
Aug
2010
11
Apr
Major foreign holders of US Treasury securities
Feb 2011 ($bn)
China 1154
Japan 890
UK 296
Brazil 194
Taiwan 156
Russia 131
Hong Kong 125
Switzerland 110
Canada 93
Luxembourg 81
Sources: IMF; US Treasury; Thomson Reuter Datastream

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North American Summary

At Longwave Analytics, for over a decade we have been forecasting a global economic collapse into a depression, because of the enormous expansion of the worldwide debt bubble and its ultimate unraveling. In a Long Wave Analyst Special Edition of April 2001, we referred to the collapse of the gold exchange standard system in Britain in 1931: "Given the fragility of the U.S. dollar, based as it is on a mountain of debt, it can be confidently predicted that this system will also fail. As the Kondratieff winter really gets underway, U.S. stocks and bonds will fall further and the image of the almighty U.S. dollar will vanish. Foreigners will dump their U.S. dollars and with the uncertainty of the world monetary system, they will place a goodly portion of their U.S. dollar holdings into gold. This is what they did after 1931."

The high stakes Debate of the Statutory Debt Limit, framed in partisan gridlock and cloaked in the guise of political brinkmanship, began last week in Washington under the chairmanship of U.S. Vice President Joe Biden. According to the Wall Street Journal, six House members and Senators, hand-picked by party leaders at the behest of President Barack Obama, include figures who seem resistant to moving off their parties' core positions on taxes and spending. Among them are two of the Republicans' most conservative leaders, two liberal lieutenants to House Minority Leader Nancy Pelosi and two committee chairmen known for guarding their own turf.

Simultaneously, Republican leaders and the White House are discussing a compromise agreement that would enact strict deficit targets and some spending cuts . The deal would defer contentious decisions about Medicare, Medicaid, Social Security and tax reform until after the 2012 elections. If such an agreement were reached, it would allow both sides to assure financial markets and the public of their commitment to reducing the deficit and then use next year's presidential campaign to outline their competing visions for the future of major government programs. Rep. Paul Ryan (R.-Wis.), chairman of the House Budget Committee, recently told reporters: "We're not going to get a grand slam agreement. We're not going to get a big comprehensive agreement because of the political parameters. My hope at this moment is to get a single or a double."

Addendum

Late-breaking news just prior to publication has Standard & Poors (mentioned above) again downgrading Greece's sovereign debt rating; this time by two levels from 'BB' (Low) to 'B' with a negative outlook citing: "In our view, there is increased risk that Greece will take steps to restructure the terms of its commercial debt , including its previously-issued government bonds. Euro zone countries will likely want private holders of Greek government debt to extend bond maturity dates, as governments consider easing terms on the bailout (package) that saved Greece from (declaring) bankruptcy last year. S&P's projections suggest that principal reductions of 50% or more, known as a 'haircut' (mentioned above), could be needed to restore Greece's debt burden to a sustainable level."

Addendum 2

In a Monday evening address to the Economic Club of New York, House Speaker John Boehner (R-Ohio) reveals that amid negotiations over the raising of the federal statutory debt limit, he is demanding that President Obama and Senate Democrats agree to at least $2 trillion (U.S.) in spending cuts: "The cuts should be greater than the accompanying increase in debt authority the President is given. We should be talking about cuts in trillions, not just billions. They should be actual cuts and program reforms, not broad deficit or debt targets that punt the tough questions into the future. If we're serious about balancing the budget and getting our economy back to creating jobs, tax hikes should be off the table."

The political gridlock game of Washington hardball brinkmanship is well under way.

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Written By: Christopher Funston

"Those who cannot remember the past are condemned to repeat it". Santayana