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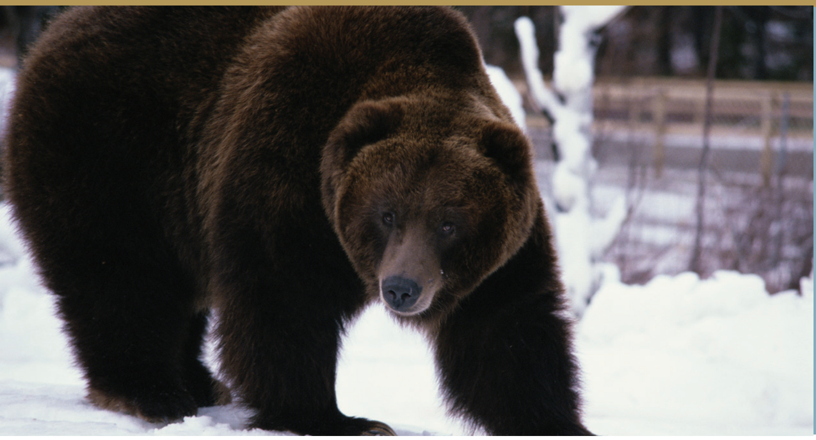
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER



The Ongoing Saga of the European Sovereign Debt Crisis

Greece – The Beginning of the End

Despite the ability of Greece's former coalition government – comprised of the mainstream parties New Democracy and Pasok – to negotiate a second bailout agreement with the European Union (EU) the European Central Bank (ECB) and the International Monetary Fund (IMF) in order to remain a member of the European Monetary Union (EMU), the Greek electorate chose the recent elections to vent their anger at the incumbent politicians, over the newly imposed austerity measures. Indeed, the electoral platform included far-left and far-right splinter parties such as Golden Dawn. Incredibly, this party of neo-Nazi, anti-immigrant "army of brave boys in black" actually garnered 7% of the vote. As a result of the failure of the New Democracy, Pasok or Syriza parties to form a new coalition government, Greek President Karolas Papoulias will likely announce another election date of June 17th. Elsa Lignos, a currency strategist at RBC in London recently commented: "Greece's 436 million euro bond maturity on May 15th. is looming. Since there is a 30-day grace period, effectively, Greece could hard default just days ahead of a new election. While that would open the way to litigation, the real story would still be what fresh election results might mean for Greece's chances of a euro exit."

As reported in the Financial Times, the European Union/International Monetary Fund bailout requires Greece to cut wages, raise taxes, fire state employees, sell off state assets and reform labour laws. EU leaders emphasize it is needed if Athens is ever to become solvent. However, opponents argue that the harsh medicine is self-defeating, making it impossible for Greece to grow its economy and emerge from the depths of the euro zone's worst recession, which has ground on relentlessly for five years. European leaders insist the next tranche of bailout loans, due to Greece in late June, is in jeopardy if Greece does not emerge with a government committed to the bailout agreement.

Indeed, as reported in the Daily Telegraph U.K., government ministers in Berlin warn they will withhold international aid to Greece in a move which could trigger a new, damaging countdown to default in Athens. Amid escalating anger in Berlin over the anti-euro backlash following elections in Athens … Germany's Foreign Minister Guido Westerwelle has noted: "Greece must recognize what's going to happen if it repeals agreements that have already been made. If Greece were to terminate the reform process that it has undertaken, then I can't see how the respective tranches of financial aid can be paid out. Wolfgang Schaeuble, Germany's Finance Minister has suggested: "While we want Greece to remain in the euro zone, it also must want this and to fulfill its obligations. We cannot force anyone, but Europe will not sink that easily. We have learned a lot and built in protective mechanisms. The risks of potential effects on other countries have been reduced and the euro zone as a whole has become more resistant."

Editor's Note: The Daily Telegraph understands that the German government is increasingly resigned to the prospect that Greece will crash out of the euro over the summer and that the euro zone is prepared. Diplomats point to over a trillion euros in cheap European Central Bank loans since December and new powers for the euro zone's bailout fund (EFSF) to protect Spanish and Italian domestic banks and government bonds from contagion.

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France – The End of the Beginning

France's new socialist President Francois Hollande based his election campaign on two main issues: to renegotiate the two-month old euro bailout pact and to avert economic focus away from austerity measures back to government spending and gross domestic product (GDP) growth. Indeed, Mr. Hollande proposes to cut France's deficit by raising corporate taxes, financial-transaction taxes, the wealth tax, inheritance taxes and income taxes on those earning more than one million euros a year. Mr. Hollande believes he can accomplish all of the above without any offsets to business confidence. Not only, are his future projections of economic growth too optimistic, but he also proposes to reduce the unemployment rate by creating more public sector jobs, instead of providing hiring incentives for the private sector. Naturally, Mr. Hollande would postpone any deficit cutting plans until the French economy had recovered to a better state. Suffice to say, were Mr. Hollande to embark on some unilateral fiscal initiative away from the euro pact, he could well find France's 'AA' sovereign rating on credit watch.

Table I.1:

Overview - the spring 2012 forecast

	Real GDP						Inflation					
		Spring 2012 forecast			*Difference Autumn 2011*			Spring 2012 forecast			*Difference Autumn 2011*	
	2010	2011	2012	2013	*2012*	*2013*	2010	2011	2012	2013	*2012*	*2013*
Belgium	2.3	1.9	0.0	1.2	-0.9	-0.3	2.3	3.5	2.9	1.8	0.9	-0.1
Germany	3.7	3.0	0.7	1.7	-0.1	0.2	1.2	2.5	2.3	1.8	0.6	0.0
Estonia	2.3	7.6	1.6	3.8	-1.6	-0.2	2.7	5.1	3.9	3.4	0.6	0.6
Ireland	-0.4	0.7	0.5	1.9	-0.6	-0.4	-1.6	1.2	1.7	1.2	1.0	0.0
Greece	-3.5	-6.9	-4.7	0.0	-1.9	-0.7	4.7	3.1	-0.5	-0.3	-1.3	-1.1
Spain	-0.1	0.7	-1.8	-0.3	-2.5	-1.7	2.0	3.1	1.9	1.1	0.8	-0.2
France	1.5	1.7	0.5	1.3	-0.1	-0.1	1.7	2.3	2.1	1.9	0.6	0.5
Italy	1.8	0.4	-1.4	0.4	-1.5	-0.3	1.6	2.9	3.2	2.3	1.2	0.4
Cyprus	1.1	0.5	-0.8	0.3	-0.8	-1.5	2.6	3.5	3.4	2.5	0.6	0.2
Luxembourg	2.7	1.6	1.1	2.1	0.1	-0.2	2.8	3.7	3.0	2.0	0.9	-0.5
Malta	2.3	2.1	1.2	1.9	-0.1	-0.1	2.0	2.4	2.0	2.2	-0.2	-0.1
Netherlands	1.7	1.2	-0.9	0.7	-1.4	-0.6	0.9	2.5	2.5	1.8	0.6	0.5
Austria	2.3	3.1	0.8	1.7	-0.1	-0.2	1.7	3.6	2.4	2.0	0.2	-0.1
Portugal	1.4	-1.6	-3.3	0.3	-0.3	-0.8	1.4	3.6	3.0	1.1	0.0	-0.4
Slovenia	1.4	-0.2	-1.4	0.7	-2.4	-0.8	2.1	2.1	2.2	1.7	0.9	0.5
Slovakia	4.2	3.3	1.8	2.9	0.7	0.0	0.7	4.1	2.9	1.9	1.2	-0.2
Finland	3.7	2.9	0.8	1.6	-0.6	-0.1	1.7	3.3	3.0	2.5	0.4	0.7
Euro area	**1.9**	**1.5**	**-0.3**	**1.0**	**-0.8**	**-0.3**	**1.6**	**2.7**	**2.4**	**1.8**	**0.7**	**0.2**
Bulgaria	0.4	1.7	0.5	1.9	-1.8	-1.1	3.0	3.4	2.6	2.7	-0.5	-0.3
Czech Republic	2.7	1.7	0.0	1.5	-0.7	-0.2	1.2	2.1	3.3	2.2	0.6	0.6
Denmark	1.3	1.0	1.1	1.4	-0.3	-0.3	2.2	2.7	2.6	1.5	0.9	-0.3
Latvia	-0.3	5.5	2.2	3.6	-0.3	-0.4	-1.2	4.2	2.6	2.1	0.2	0.1
Lithuania	1.4	5.9	2.4	3.5	-1.0	-0.3	1.2	4.1	3.1	2.9	0.4	0.1
Hungary	1.3	1.7	-0.3	1.0	-0.8	-0.4	4.7	3.9	5.5	3.9	1.0	-0.2
Poland	3.9	4.3	2.7	2.6	0.2	-0.2	2.7	3.9	3.7	2.9	1.0	0.0
Romania	-1.6	2.5	1.4	2.9	-0.7	-0.5	6.1	5.8	3.1	3.4	-0.3	0.0
Sweden	6.1	3.9	0.3	2.1	-1.1	0.0	1.9	1.4	1.1	1.5	-0.2	-0.1
United Kingdom	2.1	0.7	0.5	1.7	-0.1	0.2	3.3	4.5	2.9	2.0	0.0	0.0
EU	2.0	1.5	0.0	1.3	-0.6	-0.2	2.1	3.1	2.6	1.9	0.6	0.1
Croatia	-1.2	0.0	-1.2	0.8	-2.0	-0.4	1.1	2.2	2.4	2.0	0.9	0.3
USA	3.0	1.7	2.0	2.1	0.5	0.8	1.6	3.2	2.5	2.0	0.6	-0.2
Japan	4.4	-0.7	1.9	1.7	0.1	0.7	-0.7	-0.3	-0.3	0.8	-0.2	0.0
China	10.3	9.2	8.4	8.2	-0.2	0.0	3.3	:	:	:	:	:
World	5.1	3.7	3.3	3.7	-0.2	0.1	:	:	:	:	:	:

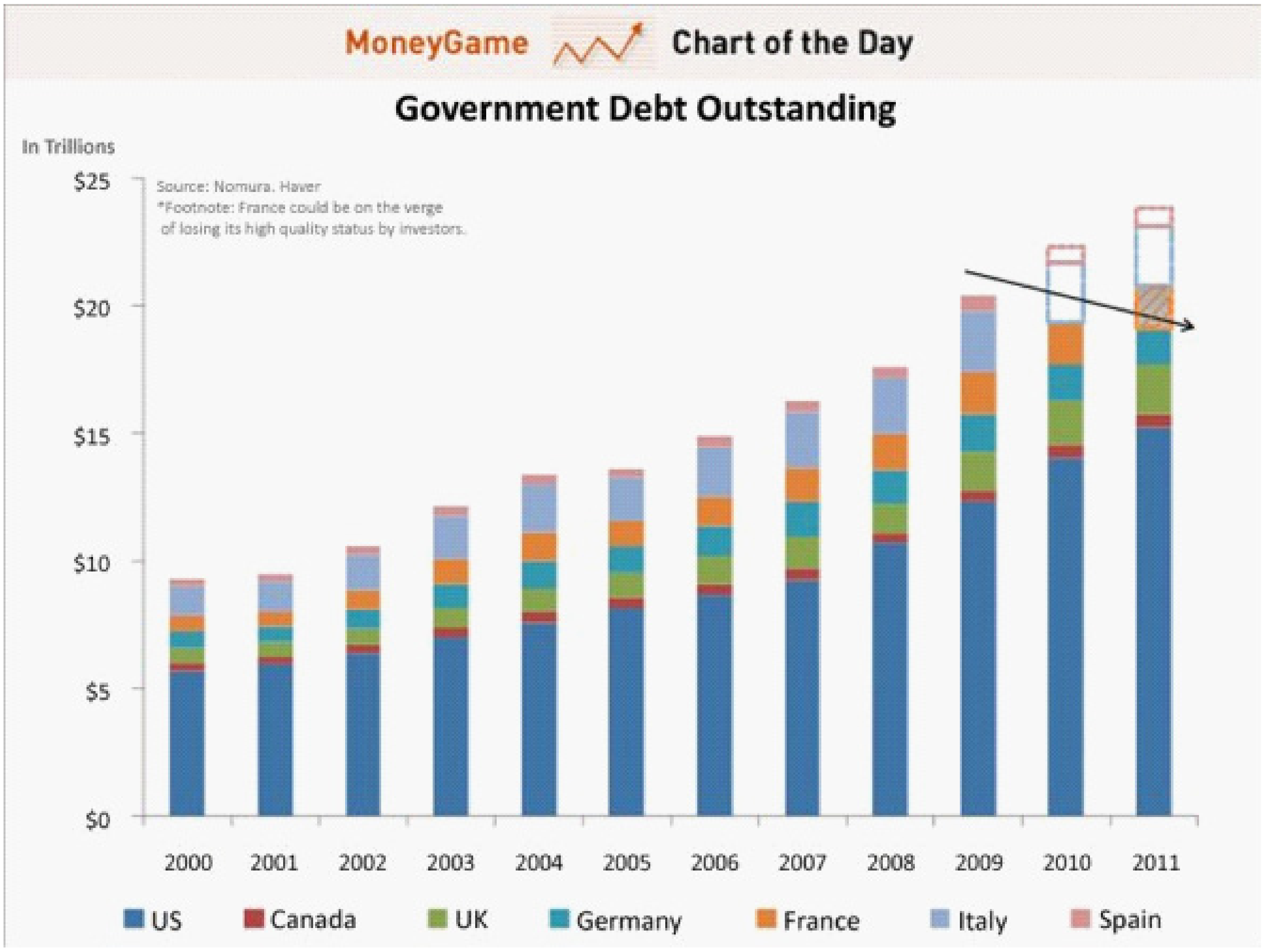
Real GDP and Inflation Data for the Euro Zone, USA, Japan and China. Source: European Commission

The International Monetary Fund (IMF) has recently reported the state's share of GDP reached 56.8% in 2010 and will still be 55.2% this year, higher than in Scandinavia. The IMF stated: "France has one of the rich world's highest life expectancies, but one of the earliest retirement ages at 62, a costly mix. Only 40% of those aged 55 to 64 are working, compared with 56.7% in Britain and 57.7% in Germany. French workers spend the longest time in retirement among advanced countries, as a result of generous pre-retirement benefits. The minimum wage of 9 euros an hour is 0.6% of the median wage, much higher than most OECD states. The result is an entry barrier for youths and chronic long-term unemployment. These rigidities have led to loss of efficiency, inability to break through in new markets and loss of technological edge."

Marc Touati with Global Equities in Paris recently warned: "It will soon be clear that France is drifting into a deep recession. The Government must absolutely cut public spending and control the debt. If they don't act quickly, interest rates will spike up and we will have a catastrophe by September. France must deal with the reality that it lacks the credibility go for growth alone under the constraints of the monetary union. It is trapped. Certainly, I blame the European Central Bank for making matters far worse, by pushing the whole euro zone system into an economic slump out of blind ideology. If Mr. Hollande strays too far from virtue, French interest rates will go through the roof and France will not be able to borrow." Historian Nicolas Baverez notes: "The French are in a national sulk, idealizing a mythical past and retreating behind a new Maginot Line. Europe has become a great scapegoat. I am convinced that France will stand at the center of the next euro zone crisis."

As can be perceived from the above chart, the European Commission (EC) only expects France's gross domestic product (GDP) to expand by 0.5% this year and by just 1.3% in 2013. Weak as these predictions may seem at first glance, they will likely prove to be quite optimistic. France's deficit is expected to be 4.5% of GDP this year and only marginally lower at 4.2% in 2013. The fact of the matter is that due to the excessive debt levels of many euro zone countries, Britain, China, Australia and the United States, the EC's average GDP global growth expectation of 3.5% for the next two years will also prove to be overly optimistic by a significant margin. In sooth, there are no quick fixes to the European sovereign debt problem, which may have several years to completely play out. As a recent issue of the Privateer aptly notes: "Europe is the cradle of the modern welfare state. It is also the region singled out by the markets to 'prove' that this welfare state is viable. How is it to do this? By abandoning any remaining pretense that it can solve a debt problem without throwing more debt at it. The task is impossible. However, just like everywhere else, the European leaders and their 'voters' won't face up to the fact."

The bar chart below delineating the sovereign debt for seven of the world's most developed economies illustrates that even as the total outstanding debt grows, the amount of debt which is still considered to be 'safe' by investors – excluding Italy, Spain and now threatening France – is actually on the decline. There are only a dozen countries whose sovereign debt credit rating is currently 'AAA' with all three of the leading rating agencies; Moody's Investors Service, Standard and Poor's and Fitch, namely: Australia, Canada, Denmark, Finland, Germany, Luxembourg, Netherlands, Norway, Singapore, Sweden, Switzerland and the United Kingdom.



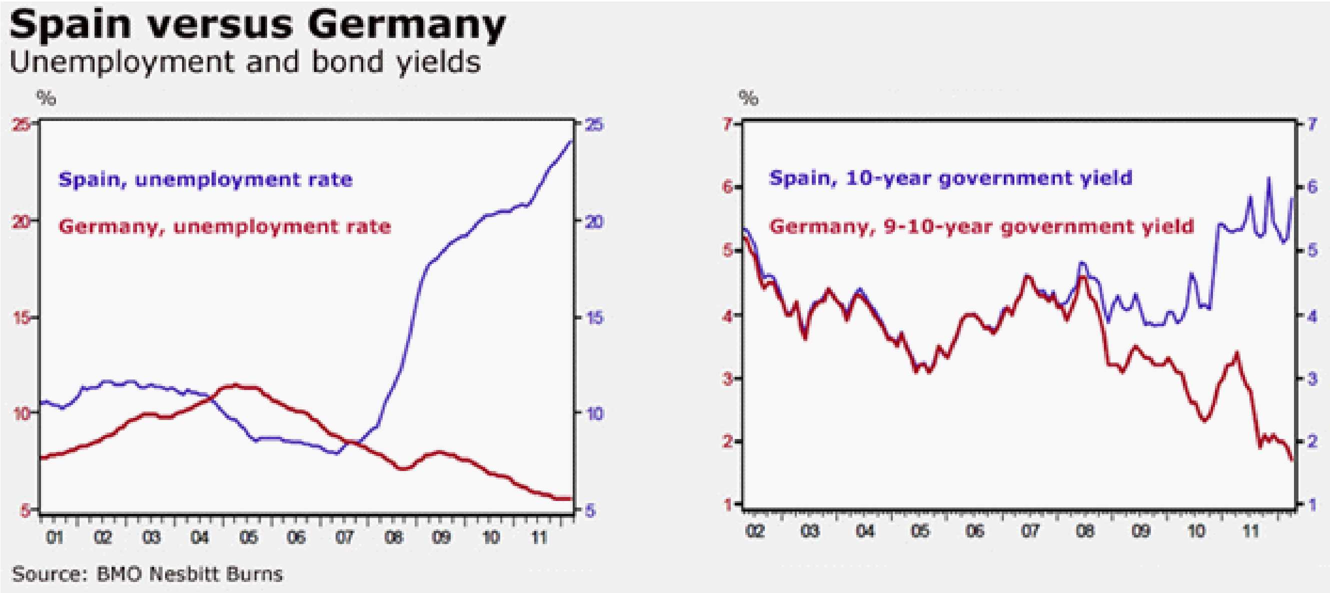
Source: Normura, Haver

The Pain in Spain Is Far From on the Wane

As a result of the bursting of its real estate and housing bubble in 2008, Spain's unemployment rate has soared to nearly 25%, while its youth unemployment rate is nearing 50%. According to the European Commission's spring economic forecasts, Spain's government budget deficit projection for the current fiscal year is now 6.45 of gross domestic product (GDP) and likely to remain the same for 2013. This rate is more than double the 3% level mandated by the European Union. The EC also forecast that Spain will be the only euro zone nation remaining in recession next year; the country's introduction of 27 billion euros of austerity measures, notwithstanding.

EU Monetary and Economic Affairs Commissioner Olli Rehn recently informed reporters: "For Spain, the key to restoring (investor) confidence and (economic) growth is to tackle the immediate fiscal and financial challenges with full determination. This calls for a very firm grip to curb the excessive spending of regional governments. The economic situation remains fragile and (economic) growth could remain low for a prolonged period. That (economic) weakness is combined with the prospect of continued high levels of joblessness over the next two years." Nicholas Spiro, Managing Director of Spiro Sovereign Strategy – a London consulting firm which specializes in sovereign debt credit risk – bluntly stated: 'Spain stands out like a sore thumb. This is the strongest indication yet that austerity measures are failing in Spain." Last week, Spanish Premier Mariano Rajoy ordered the nationalization of the troubled lender Bankia SA, after auditors Deloitte Touche refused to accredit the bank's books, amid allegations of 3.5 billion euros of inflated assets. Half of Bankia's 37 billion euros of property exposure is deemed problematic by regulators.

Spain also ordered its banks to increase their capital tier by 30 billion euros ($39 billion U.S.) – in addition to the 54 billion euros ordered in February – against mounting losses from toxic real estate loans and mortgages. Moreover, Spain's Finance Minister Luis de Guindos announced that banks have until the end of 2012 to transfer their property holdings into asset management firms in order to expedite their sale. For banks unable to raise the necessary funds, the government will purchase 5-year bonds – convertible into bank shares – at a yield basis double that of an equivalent government 5-year bond. The government also ordered an independent audit on loans and real estate assets across the banking sector, as the European Union had requested.



In reaction to the European Commission's forecast, Ricardo Santos, a European economist at BNP Paribas, warned: "The deterioration of the Spanish housing market will lead to even greater losses than expected, so the government should also demand added (capital) provisions by the banks for construction related loans. Because of its funding constraints, Spain cannot issue enough sovereign debt to recapitalize the banking system in order to reassure the markets. Spain must turn to some of the precautionary facilities now on offer under the European Financial Stability Fund (EFSF)." Indeed, the yield on Spanish 10-year bonds has reached 6.25% this week.

Since their peak in 2007, Spanish home prices have declined by more than 25% and remain under pressure, to the point where an increasing number of debt-laden Spaniards – many of whom have most of their assets invested in real estate, can no longer meet the monthly payments on their mortgages. Whereas, a rising portion of Spain's 663 billion euros ($876 billion U.S.) of residential mortgages are at risk of default, Spain's banks and the Spanish government may not have the ability to raise enough capital to halt the real estate slide; the recent takeover of Bankia SA, notwithstanding. Moreover, similar to bankers in the United States during the American housing bubble, Spanish banks sold mortgages to finance companies which repackaged them into bundles of securitized mortgages, which high-yielding securities, in turn were purchased by insurance companies, European pension funds and other institutional investors. In Spain, the mortgages used as collateral for securitized issues were considered to be prime credits – loans made only to creditworthy borrowers. Predictably, as was the case in the U.S., many of these securitized mortgage issues are falling in price, with the numbers worsening every quarter.

In his recent book, "The Truth about the Spanish Real Estate Market", author Borja Mateo relates: "On the plain below the central walled city of Avila – a world heritage site and a popular tourist destination – the province with a population of 171,680 has about 19,000 apartments and villas empty or unfinished." Figures from Spain's Ministry of Infrastructure disclose 23,419 homes were constructed in the decade through 2007, while another 11,000 homes have been built there since 2008. The sprawling developments are dotted with thousands of empty parking spaces, while streets have makeshift barriers where the money has run out and others simply end in fields. Mr. Mateo continues: “There are now 1.9 million housing units for sale in Spain and about 3.9 million that could go on the market in the coming years. Since current housing demand is now at about 175,000 units a year, the glut would cause home prices eventually to fall by 60%. What we are witnessing is a massive impoverishment of a country.”

According to the Financial Times, Spain may be offered more time to hit the budget target deficits it agreed with the European Union (EU), but only if Madrid meets new conditions, including an independent audit of the restructuring plan for its troubled banks. The European Commission, the EU’s executive branch, has insisted on the extra conditions – which include ensuring more fiscal control over Spain’s profligate regional governments – before allowing Madrid to delay its 2013 deficit target by a year.

Summation

In an effort to avoid a new round of elections, Greek President Karolos Papoulias hopes to resume government coalition talks with the leaders of the three fractious political parties, which together control an overall majority in Greece’s parliament. However, hopes of averting another general election are rapidly fading since Alexis Tsipris, leader of the left-wing Syriza Party, has refused to participate in any meetings flatly stating: “We’re not going to join in selective meetings of political leaders … The circle of contacts provided for by the constitution has been completed.” Last weekend’s talks, chaired by President Papoulias, stalled amid mutual recriminations from Mr. Tsipris, Antonis Samaras, leader of the center-right New Democracy Party and Evangelos Venizelos, leader of the PanHellenic Socialist Movement (Pasok). According to the Financial Times, amid mounting tension, the three politicians failed to approve the proposed repayment in full of a 436 million euro bond maturing on May 15th. – which was not included in Greece’s partial debt restructuring in March – as outlined in a letter from Greece’s Prime Minister Lucas Papademos.

Realistically, the most likely outcome to emerge from the current meetings is for President Papoulias to set a new election date for June 17th. Having vented their anger about the tough austerity measures at the incumbent political leaders and parties in the May general election, surely the Greek electorate will come to its senses by voting to remain in the European Monetary Union (EMU) in another election. The alternative would represent bankruptcy, social unrest and financial chaos by a return to the drachma, with its attendant likely drop of 50% to 60% in purchasing power in comparison to the euro. According to the Privateer, ‘The U.S. ratings agency Fitch has made the entire situation crystal clear. It has formally announced that if whatever Greek government is finally cobbled together decides to leave the euro, it will immediately move to review and probably downgrade the sovereign debt ratings of ALL the euro bloc nations.”

In France, Mr. Hollande’s rallying electoral cry – an “end of imposing austerity everywhere, austerity that brought desperation to people throughout Europe” – resonated across the euro region. However, Germany’s Chancellor Angela Merkel has already declared that the fiscal agreement reached in March will not be reopened. Mr. Hollande claims that France’s economic problems are the result of “finance and the previous Sarkozy administration.” According to the Globe and Mail, at the core of France’s problems lies its failure to have a reckoning with the (economic) policies it chose during the 1980s. Mr. Hollande’s political mentor was Francois Mitterrand, the well-intentioned architect of structural unemployment and intergenerational inequality. Mr. Mitterrand’s vision was fulfilled with the 35-hour work week law, which increased business costs and reduced wages, even as the Socialists promised this would not happen. Within Mr. Hollande’s election manifesto, there appears no reference to international competitiveness or structural reform. Perhaps, Mr. Hollande should bide his time and commit to doing some real work, before issuing any more unilateral pie-in-the-sky declarations with any Napoleonic verve.

In Spain, the government and banking community are belatedly recognizing a multi-billion euro funding gap in the financial system, linked to the 2008 property crash, heightening fears the country may need an international bailout. Spain’s banks, already trying to write down 54billion euros of losses on real estate investments, are unlikely to obtain an additional 30 billion euros without public assistance. Even strong Spanish international lenders like Groupo BBVA and Santander are already posting big profit declines as they write off losses on real estate investments. However, BBVA Chairman and CEO Francisco Gonzalez recently and confidently declared: “We will exit the (sovereign debt) crisis through greater fiscal, financial and economic integration in Europe.”

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At Longwave Analytics, we have long forecast the eventual failure of the current monetary system due to excessive sovereign debt levels and the similarities to the international monetary crisis of the previous Kondratieff economic winter cycle of 1931- 1933. Once the euro succumbs to the present fiat monetary crisis, investor attention will shift to other high debtor sovereign credits, such as are manifest in the United Kingdom and the United States of America.

Written By: Christopher Funston