GRANT'S
INTEREST RATE OBSERVER

Vol. 23, No. 5b | Two Wall Street, New York, New York 10005 • www.grantspub.com | MARCH 11, 2005

Now comes 'deconvergence'

On March 2, Greece sold 30-year bonds, the longest since Odysseus. Just as remarkable, it sold them at a price to yield 4.45%, just 26 basis points more than the yield on 30-year German government debt. Germany is a triple-A-rated sovereign borrower, two full rating notches better than the sponsor of the 2004 Summer Olympics. "It should attract demand from real money investors who are looking for yield," a European bond investor speculated about the deal in a conversation with Reuters. Sure enough, it did.

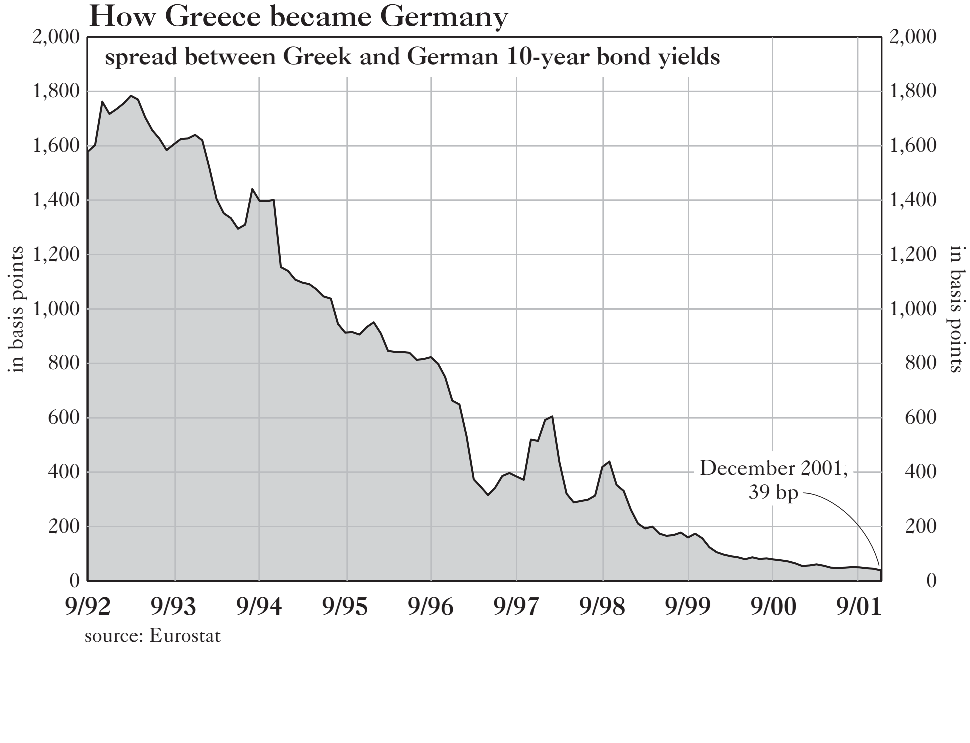
The page-one essay in the February 25 *Grant's* made the case against the euro. Now comes the sequel. Euro-denominated credit spreads will widen, we are about to contend, if only because they could hardly tighten.

Unfortunately, only institutional investors can easily implement the trade we intend to propose. To stewards of their own capital, we offer apologies and consolation. Credit spreads are unreasonably tight the world over. One day, they will widen, not by a little but by a lot. They will not stop widening until they become absurdly wide, at which exact point the readers of *Grant's* will pounce (will they please notify the editor when they do?). Most global credit markets exhibit bubble-like characteristics. What makes Europe particularly attractive is that its bubble, arguably, is biggest. Putting up a little, you won't lose a lot if you're wrong, and could make a bundle if you're right.

The background to the fabulously low borrowing costs available to Greece is the yield convergence of the 1990s. The sages of Europe ruled that countries intending to adopt the euro had to align their sovereign yields with Germany's. Thus, in 1995, Spanish and Italian 10-year bonds traded at a spread in excess of 525 and 600 basis points, respectively, to German bunds. By 1998, the gap had narrowed to 100 basis points; by the time the euro came into electronic existence on Jan. 1, 1999, the spreads were inside 25 basis points. Today, Spain trades at just one basis point over Germany, Italy at nine.

Sovereign credit risk encompasses currency risk and repayment risk. Promoters of the European project insist that the euro has neutralized both. Before convergence, investors willingly paid a premium to hold a superior currency. But the euro displaced the deutschmark (there aren't enough Swiss francs to go around), while the stability and growth pact supposedly inculcated fiscal discipline in even the most profligate Continental spendthrifts. Ergo, the market has been led to conclude, one European sovereign borrower is as good as another. The euro, we said one issue ago, is not yet irrevocably rooted. It could still be uprooted—by a constitutional crisis, by an economic crisis or by the centrifugal force of a dozen bickering European parliaments. However, we believe, credit spreads will eventually spring open, with or without monetary upheaval. Not every euro-zone borrower deserves to pay the same low rate. Greece may be many things, but it is not 26 basis points removed from triple-A quality.

How Greece became Germany



source: Eurostat

Not that triple-A quality is anything to own at prevailing prices, spreads and monetary arrangements. The self-selected company of buyers of the new French 4s of 2055 may profess to believe that the euro is for the ages. But, we think, that is not the reason they invested. They—and the buyers of the new Greek 4½s—invested because they fear the world is running out of long-duration assets. Isn't that just like Mr. Market? Back in 1981, when the U.S. Treasury was paying 15% to borrow for 30 years, the old goat worried about a glut of bonds, or, he was wont to sneer, "certificates of confiscation." Now, at 4%, he's wringing his hands about a shortage.

No respectable corporation borrows money with the expectation of defaulting, but default is a contingency provided for in the fine print of corporate debt covenants. How is the risk of monetary failure dealt with in the prospectuses of euro borrowers? We put the question to our friends at a global fixed-income investment firm.

"Apparently, there are no contingencies or provisions for the failure of the EUR in any bond prospectus," the answer came back. "The assumption of European governments is that the EUR is permanent; therefore, no contingencies are necessary. To plan for the contingency would imply a lack of belief in the permanency of the currency, which no government is willing to do." In other words, our friends advise, "the absence of any way to deal with a breakup of EMU in a prospectus is deliberate."

Probably, if the euro zone broke up, and if the euro were scuttled, holders of the euro-denominated debt would receive legacy currencies at market-determined exchange rates. Holders of Greek debt would get drachma, a currency not easily confused with the deutschmark in the early 1990s, when Greek sovereign debt yielded 1,700 basis points more than the equivalent German bunds.

Yes, a skeptic might say, but these are the mid-'00s. Like it or not, the euro is established, and Greece is in the euro zone. Yes, we say, but the Greek public finances look just as bad as they did before Greece entered (that was in 2001). Actually, just before it was voted into the club, Greek finances looked pretty rosy: In the make-or-break year of 1999, the deficit supposedly totaled just 1.8% of Greek GDP. But that was before a wholesale revision of the national accounts lifted the 1999 deficit all the way to 3.4% of GDP, which happens to be 40 basis points over the limit. "Greece would not have joined the euro with the figures we now have," is how a spokeswoman for the European Commission diplomatically put it in December.

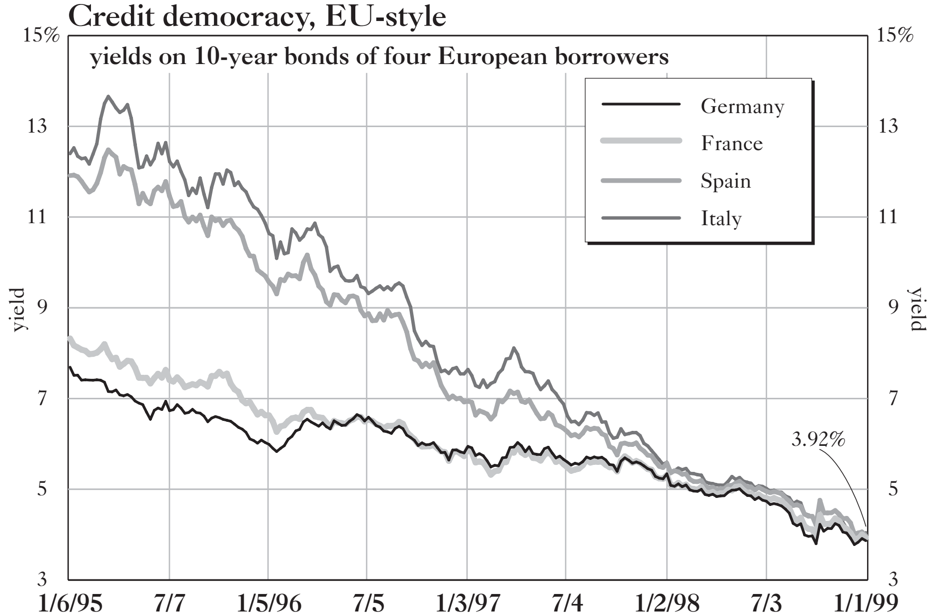
Yet, to repeat, Greece has contrived to float a 30-year bond at just 26 basis points over the virtuous Germans—or, perhaps, the not-so-virtuous Germans. They, too, are in breach of EU fiscal guidelines, and they, like the French, are seeking relief from the rigors of the so-called stability and growth pact. But whereas France has nuclear weapons and Germany has the biggest Continental economy, Greece is a relative cipher. And in its infinite insignificance, Athens must bear the brunt of euro-zone moralizing. Jean-Claude Trichet, president of the European Central Bank, was beside himself when told that the European finance ministers had given the Greek government yet more time to put its finances in order. Such leniency, Trichet declared the other day, stretches the rules of the stability and growth pact "to the limit."

The success of the bet we are about to describe in no way requires that the rules must be stretched beyond the breaking point. A winning outcome is only contingent on the market taking a less sanguine view of the monetary and fiscal risks (it could hardly take a more sanguine view). Trouble could come from an unexpected "No" vote in one of the looming EU constitutional referendums, a worrying downturn in the chronically weak Continental economy, or—most contrary—an unpredicted upturn in a Continental economy that turns out to be not so moribund after all. In this most unauthorized scenario, credit spreads could open as interest rates rose.

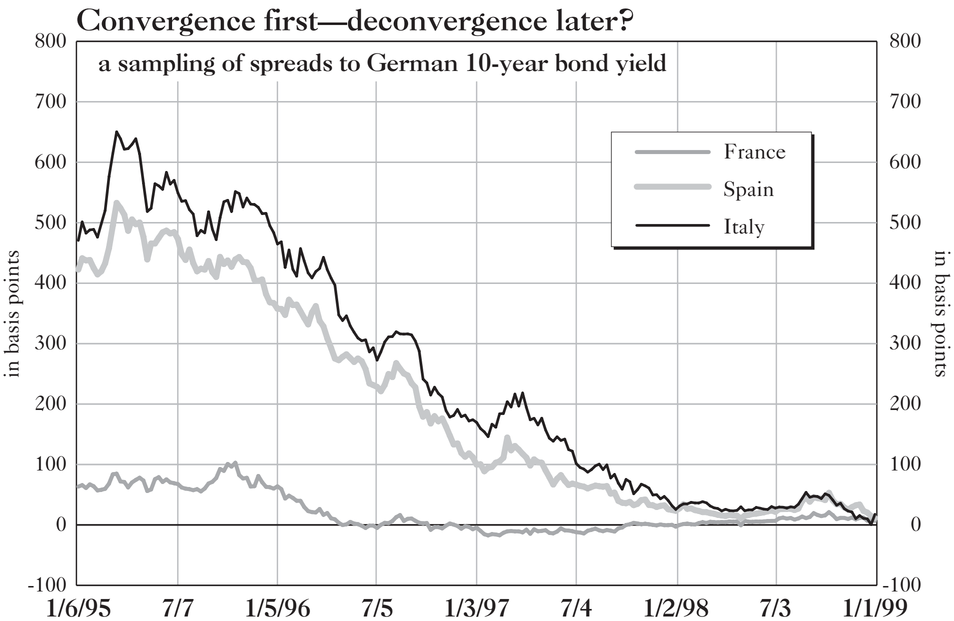
To profit from widening spreads, an institutional investor can buy credit default swaps (CDS), bespoke derivative contracts between a buyer and seller, with no interposing clearinghouse. The defined terms are the notional value of the contract, the premium and the credit events. At the end of the day, the buyer of protection must deliver to the seller of protection the face amount of the bonds being insured. For the buyer, an ideal outcome would be a complete and utter wipeout; gladly would he deliver worthless paper to the insuring party in exchange for the par amount in cash. It follows that the most a buyer can gain in a CDS transaction is par.

Start with Greece. Bloomberg quotes 10-year Greek CDS at around 14 basis points—that's $14,000 a year on $10 million of face exposure. You, the buyer, must annually remit that sum to the seller. For reference, as colleague Ian McCulley points out, CDS on South Korean 10-year bonds are quoted at around 42 basis points.

Credit democracy, EU-style



sources: The Bloomberg, Bank of Italy



source: The Bloomberg, Bank of Italy

It's true that South Korea shares a border with a nation dictated to by Kim Jong Il. On the other hand, Seoul, rated double-A-minus on won-denominated debt and single-A on dollar debt, is, by the numbers, a slightly better credit than Athens. And if, within a year of purchase, Greek CDS widened to match South Korea's 42 basis points, you, the CDS holder, would stand to cash in. By how much? Calculate first the difference between 42 basis points and the purchase price of 14 basis points; it comes to 28 basis points. The payday is the present value of those 28 basis points. Assume that there are nine years left to run on the CDS. Using a simplified model with a 5% discount rate, the present value of a single basis point would work out to be about seven basis points. Seven times 28 comes out to 196, and 1.96% times $10 million equals $196,000.

Or, you could invest in one of the better-rated, "core" euro-zone borrowers—France, for instance. A 10-year CDS on French debt with $10 million notional value is quoted at around five basis points. Say that, within a year, the CDS widened to 30 basis points. As before, one computes the profit by finding the present value of the gain, in this case 25 basis points. Seven times 25 is 175, and 1.75% of $10 million is $175,000.

Careful readers will observe that we have not yet mentioned losses. But they, too, are possible. An "absurd" and patently unsustainable 14 basis-point premium (as in the case of Greece) could always become even more absurd; it could prove to be sustainable. Even the five basis-point French premium could shrivel to nothing. The most an investor could lose is the annual premium payout over the length of the 10-year contract. In the case of Greece, it would be $140,000 (using a 0% discount rate); in the case of France, $50,000. Yet, we conclude, the prospective reward dwarfs the potential risk—assuming, that is, that the writer of the protection, one's counterparty, is around to make good on the bargain. Caveat emptor!

Colleague McCulley interviewed a trader who fondly recalls his experience with Korean CDS. "I remember 1997," our source relates. "I remember buying Korea protection on the sovereign at 40 basis points in the September/October time frame. And by the new year, the debt was trading at 50 cents on the dollar. And that was an A-rated OECD country. . . . You could buy something for 40 basis points, and you probably had to hold it for three months—let's say four months' time, so you pay one-third of a year. So if you bought $100 million, you would wind up paying $130,000 for something that was worth $50 million. That was a pretty good pick."

McCulley asked who the sellers are. "Guys that are taking sovereign risk through buying bonds," he replies. "They are saying this is free money. When is Germany ever going to go under?" European banks and insurance companies are among the sellers, our man goes on, as are hedge funds and the managers of collateralized debt obligations. And someone might sell Germany and buy Greece, using the German premium. "Kind of zero cost," our source explains. "Go long one thing so they have the money to go short something else."

Liquidity? No problem, the trader goes on: "If you come in and say, 'I want to buy $100 million, I don't think anybody blinks. . . . It's a real market. There's just way too much liquidity." And he winds up: "It's a joke, a freakin' joke. The road to hell is paved with positive carry. So if you sell CDS, it's the ultimate positive carry."

•

Subscribe to Grant's®

and get TWO FREE ISSUES added on to your subscription...

AND a signed copy of Jim Grant's latest book:*

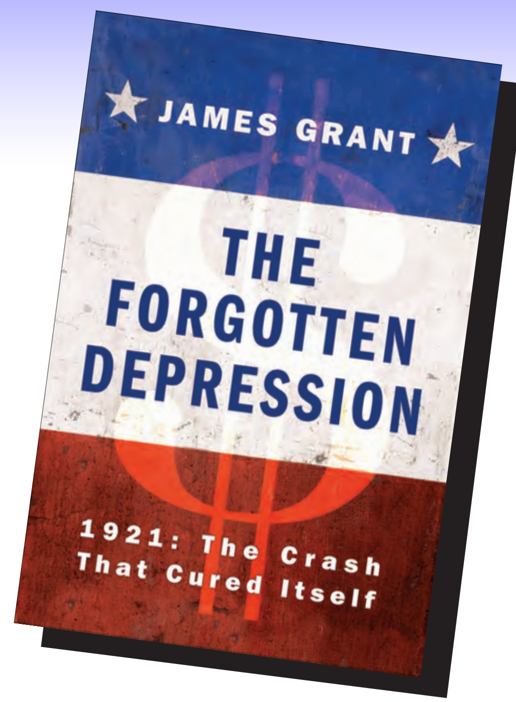

GRANT'S

INTEREST RATE OBSERVER®

Vol. 32, No. 22 Two Wall Street, New York, New York 10005 • www.grantspub.com NOVEMBER 14, 2014

Read the footnotes

"Hi, I'm rick. What's your name?"



*New subscribers only, as supplies last

Don't wait. Subscribe *NOW*.

Take us up on this offer and you'll recieve 26 hard-copy issues instead of 24 (a $230 value), complimentary online access to the current issue, the issue archive, AND Jim Grant's latest book, The Forgotten Depression: 1921 The Crash That Cured Itself."

Go to www.grantspub.com/subscribe. Use Offer Code: GPOD

❏ **Yes, I want to subscribe.** Enclosed is my payment (either check or credit card).

Subscribe now and we'll add two free issues onto your subscription. That's 26 issues instead of 24—a $230 value. We'll also send you a signed copy of Jim Grant's latest book, "The Forgotten Depression, 1921: The Crash That Cured Itself."

Understand that as a paid-up subscriber, you may cancel at any time for a prorated refund on the remainder of your subscription.
*New subscribers only, as supplies last

❏ 1 year (~~24 issues~~) **26 ISSUES for $1,175**

❏ 2 years (~~48 issues~~) **50 ISSUES for $2,125**

Group rates available upon request.

❏ Check enclosed (Payment to be made in U.S. funds drawn upon a U.S. bank made out to Grant's.)

______________________________ Exp. _______

Credit card number

Signature ______________________________

CV number __________ (3-digit code on back of VISA/MC/Disover; 4-digit code on front of AMEX)

Name ______________________________

Company ______________________________

Address ______________________________

____

____

____

Daytime Phone (required) ______________________________

E-mail ______________________________

GPOD0717

TWO WALL STREET • NEW YORK, NEW YORK 10005-2201 • P:212-809-7994 • F:212-809-8492 • WWW.GRANTSPUB.COM