PFP Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4FP
020 7400 1860

www.pfpg.co.uk

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Ireland is no Island

"A Budget tells us what we can't afford, but it doesn't keep us from buying it."

- William Feather.

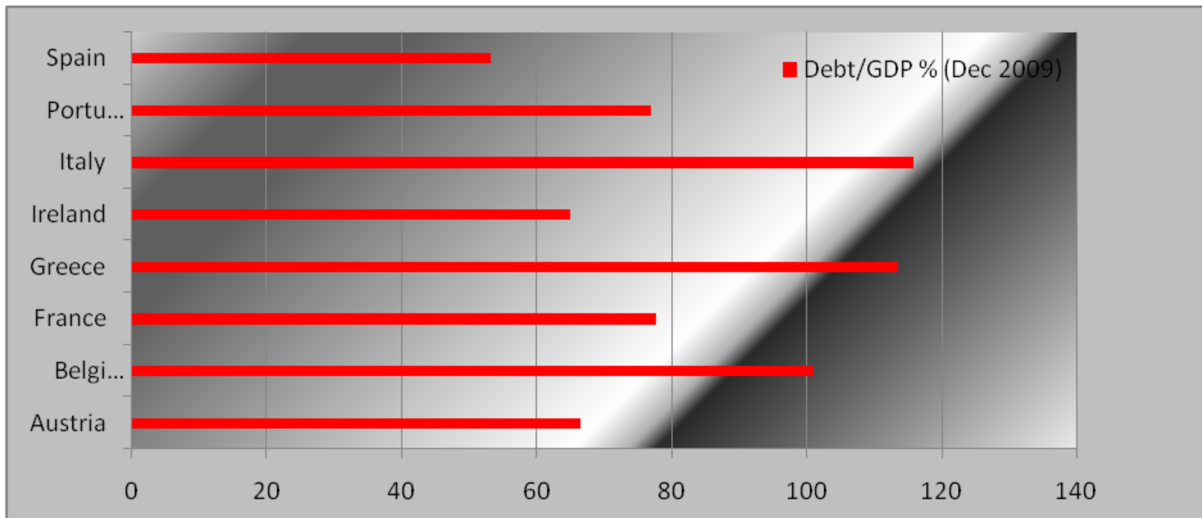
"In emerging economies, public debt of more than 40% of GDP is considered dangerous. That is less than half the ratio in much of the euro zone."

- The Economist Magazine, 4th December 2010.

Last week, the Financial Times confirmed that the EU, with support from the IMF, had finalised the latest, and almost certainly not the last, European sovereign bail-out. Ireland will receive external financing of €67.5bn from her fellow EU members, a figure that includes bilateral loans from Norway, Sweden, Denmark and her erstwhile foe Britain. Her sovereign wealth fund is being forced to liquidate a well balanced, diversified portfolio and make around €10bn (41% of its assets) available should the Irish government continue its reckless spending. The remainder will be sourced from "other domestic cash resources". The misallocation of thousands of workers' savings, which will leave the funds' participants with an irresponsible level of exposure to their government's debts, is strangely apt. The National Pension Reserve Fund, like the Irish state, is no longer either sovereign, nor wealthy.

It is surprising that a nation of only 4.6 million people, annually producing goods and services worth €160bn, has found itself on the front pages of the international press for the last two weeks. It is even more startling when viewed through the prism of the chart below. The Irish national debt had grown to over 65% of GDP by the end of 2009. The unnecessary bailout of bank bondholders was behind much of this increased issuance. The recession swelled both the current and capital expenditure of the state and in total added €37.3 billion to the credit card bill of Ireland plc. This boosted the national debt from a modest and manageable €38bn to a dangerously high €75.2bn at the end of 2009.

Debt to GDP ratios for various members of the euro zone



Data: Bloomberg LLP

As the chart shows, at the end of 2009 Ireland was not the most indebted country in the Eurozone; the Irish state stood up favourably against other debt-troubled euro zone members such as Italy, Portugal and even France.

This year saw an increase in both the national debt and general government debt levels of Ireland. National debt only measures sovereign credit outstanding, whilst general government debt includes credit that has government backed guarantees. Such credits include instruments issued by local governments and special purpose vehicles such as the now infamous National Asset Management Agency. The numbers are certainly scary. The national debt level at the end of 2009 was €75.2bn. Government ministers recently confirmed that the 2010 government deficit will be lower than previously advised. According to the Department of Finance, the deficit looks set to come in at €15bn forcing the national debt up to €90bn by the end of the year.

The Irish government recently released the details of their four year economic plan. They have forecasted that by 2014, through cuts of €15bn, the budget deficit will have been reduced to only 3% of GDP. We'll let other commentators argue about whether the current government or the one elected in the New Year will have the political will to implement these cuts. We use current government estimates in our model, whilst acknowledging that these are on the "optimistic" side of most economic forecasts.

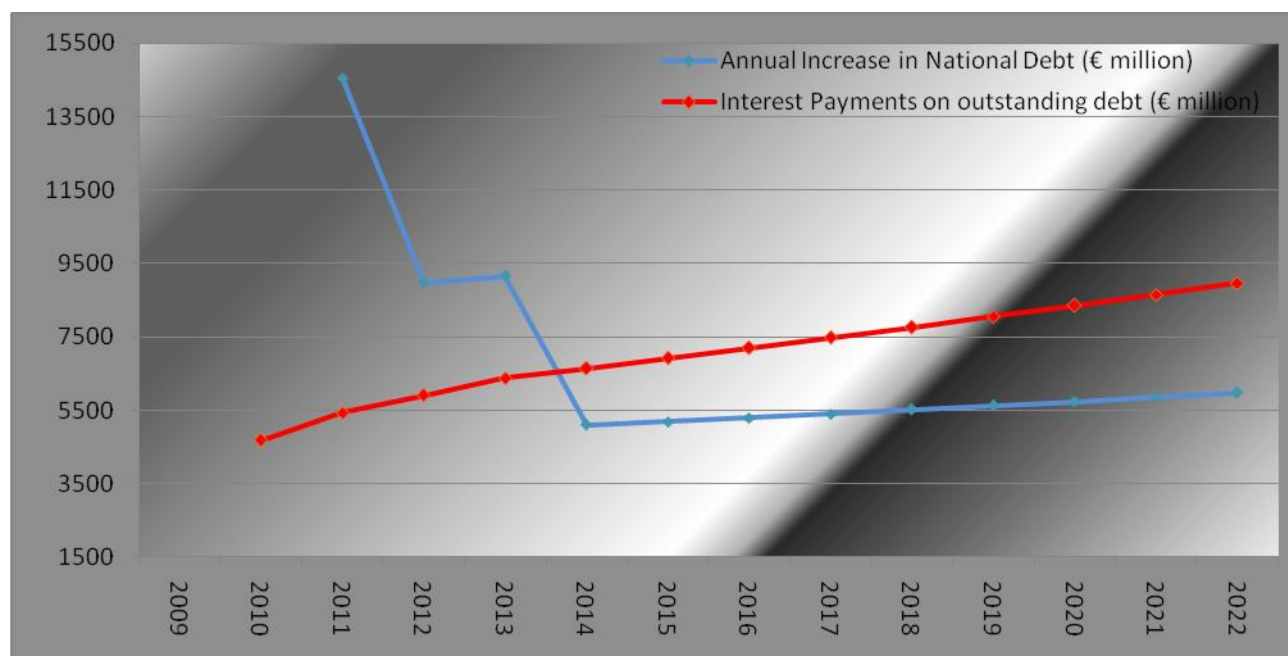
For the purposes of this analysis, we are agnostic as to how much fat will be trimmed off the state. We are also agnostic as to whether the state cuts current or capital expenditure. We focus on the deficit – since that is the rate of growth of the national debt. In order to make some conclusions and investment decisions, we have to add some pesky assumptions. Mindful of the adage "garbage in, garbage out", we have erred on the "conservative" side of assumptions. Those assumptions are:

- Nominal 5.2% interest rate on outstanding sovereign debt
- Annual real GDP growth rate of 2% from 2011-2014 (inclusive)
- Deficits of 5.5% for 2012 and 2013.

The interest rate has been calculated using a weighted average of the coupons offered on outstanding Irish debt (4.64%) and the interest applied to the bailout package (5.8%).

The chart below is instructive.

Ireland: increase in national debt versus interest payments on existing debt



Data: Bloomberg LLP

The bail-out will buy the government three more years. In 2014, there will be a shortfall of €1.5bn that will have to be plugged. The Irish government will then be faced with a choice – increase the deficit, or get the scissors out again and start cutting. The former will only kick the can down the asphalt. The latter will be difficult to explain away to a public sector that will have been squeezed of €10bn between 2011 and 2013. Perhaps the Irish economy will be back booming in three years and the government can increase the tax burden on a newly affluent society. This is possible, but not exactly plausible.

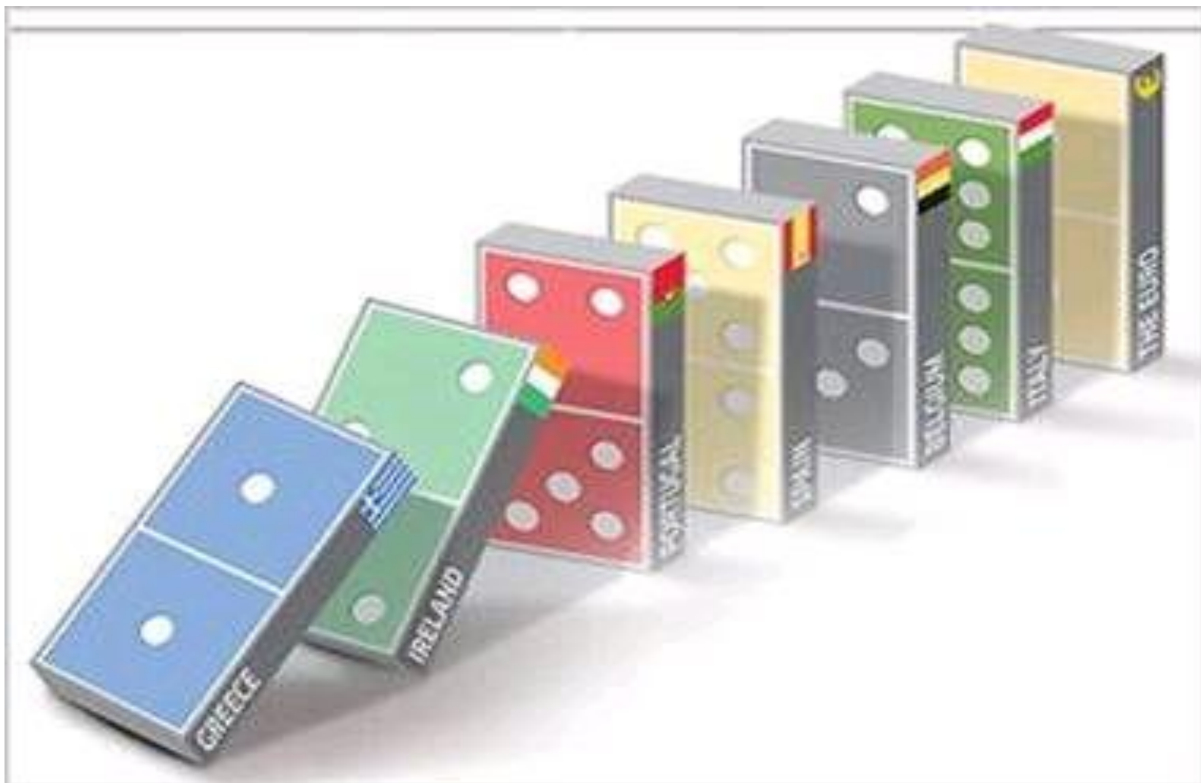
European politicians seem to have already worked out the date of this inflection point. Ironically enough, it was the airing of this date that led to the speeding up of the Irish bail-out. At the October summit in Seoul, EU ministers released plans to impose haircuts on sovereign bonds issued after mid-2013. That aligns perfectly with what our model is saying. Bail-out funding, along with related austerity measures, will only plug the deficit gap for a short while. In the end, these governments are going to have to trim expenditure annually, through ongoing austerity plans, or they are going to have to restructure outstanding debt. That is a polite word for default.

As discussed, our analysis is agnostic as to how the state is trimmed. Recent articles have focused on the assets side of Ireland's balance sheet. Indeed, the state could raise funds through the privatisation of its transport infrastructure (port and airport authorities), its utility companies (Bord Gais and the Electricity Supply Board) and its mineral wealth (National Oil Reserves Agency). We think such disposals would unlock significant amounts of wealth for the country. It would also force a lot of public sector employees into the private sector, thereby decreasing expenditure and increasing revenue. We're not policy advisors. We have no political agenda. We're simply looking at the upcoming proposed deficits and the subsequent debt levels. The current Irish government has gained approval from its recent creditors (the IMF and the EU) to

run a budget deficit of 9.1% in 2011. It has agreed to bring the deficit down to 3% by 2014. We have to question what would be the impetus of any government, especially one including a staunchly nationalist Sinn Fein, in disposing of enough national assets in order to run government surpluses.

A glance back at the chart of the most indebted nations in the euro zone offers little comfort for those investors exposed to the debts of Spain, Portugal, Italy, Belgium and France. Dylan Grice, strategist at Société Générale recently quipped, "There is no such thing as toxic assets, only toxic prices". There is a price at which these assets become attractive. However, with French 5 year paper offering a nominal yield of 2.10%, that price is still not right. With French national debt approaching €1,300bn, only a euro zone politician could describe this return as risk-free.

Who's next ? And where does it end ?

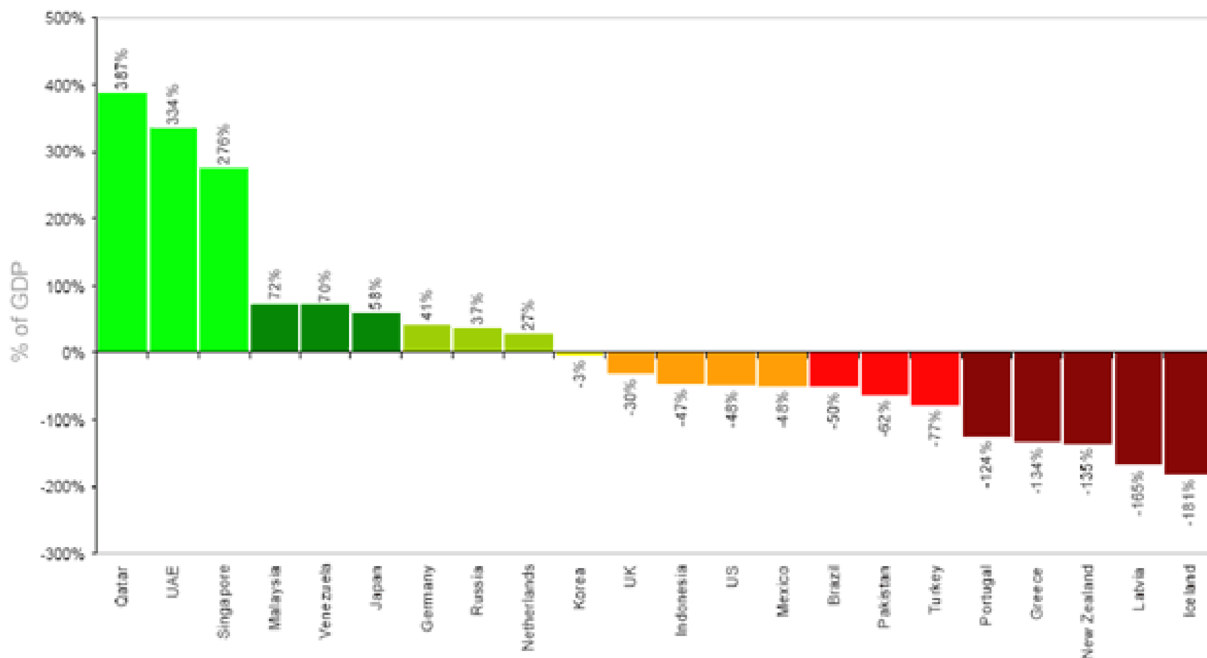


Volatility in the bond market over the next few years is going to create massive gains and losses for speculative investors. For those charged with preserving their clients' wealth, things will be volatile enough, even without direct exposure to these toxic credits. The most sensible approach will surely be to diversify across multiple asset classes and currencies, in each case attempting to identify investments that offer value on a fundamental (that is, risk-adjusted) basis. The principle of avoiding capital loss, both incidental and catastrophic, must surely be paramount.

The book value of a nation's equity

When allocating capital to sovereign credit investments we analyse the net foreign assets of the issuer to determine its creditworthiness. This is a measure of the liabilities issued by a nation against its financial assets. This metric favours countries that have a modest level of debt and substantial financial assets following years of current account surpluses. The chart below highlights the sovereigns that we believe have the best fundamentals. Green = Good; Yellow and Orange = Mediocre; and Red = Bad (too dangerous for us to consider investing).

Net foreign assets of various countries as a percentage of their GDP



Source: IMF data, Stratton Street Capital LLP; data as at August 2009

Net foreign assets include the assets and liabilities of the whole country: the sovereign entity, private corporations and domestic households. The recent problems of the euro zone, and in particular Ireland, highlight the rationale for aggregating across these three sectors. Following the creation of the euro zone, capital flooded into Ireland and its commercial banks as investors took advantage of higher projected rates of return. The capital was then loaned out to pernicious property developers where it would be grossly misallocated. Asset prices continued to rise for so long as credit continued to expand. Banks are only as creditworthy as those to whom they lend capital, and as Bank of Ireland, Allied Irish Bank and other poorly governed institutions came to appreciate, the loans were not made to the most creditworthy. Whether out of ignorance or corruption, rather than let the banks fail, as would have been morally and legally justified, the Irish state assumed their liabilities. A nation's net foreign asset score allows us and our preferred bond fund managers to analyse the leverage inherent in a given country, highlighting those sovereign entities that have the best ability to repay their creditors. This is the ***sine qua non*** of fixed income investing. The fact that many of these wealthy sovereigns also yield more than bonds issued by overly indebted and supposedly ***developed*** nations is an added bonus. To get a higher return from what we genuinely consider to be lower risk investments is a wonderful anomaly that is unlikely to last forever. This is why we consider the New Capital Wealthy Nations Bond Fund the most compelling bond investment – from the perspective of both capital and risk management, and prospective return – in an environment of acute stress for government bonds as a whole.

Killian Connolly, Tim Price
PFP Wealth Management

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Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

Group homepage: http://www.pfpg.co.uk

Bloomberg homepage: PFPG <GO>

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