Risk-Free In Name Only

One of the sillier promises made during the recent presidential campaign was to review the federal budget line-by-line. What a Zen-like experience that would be. It recalls two similar efforts, Jimmy Carter's zero-based budgeting and Ronald Reagan's war against "waste, fraud and abuse," as if those were line items in the budget.

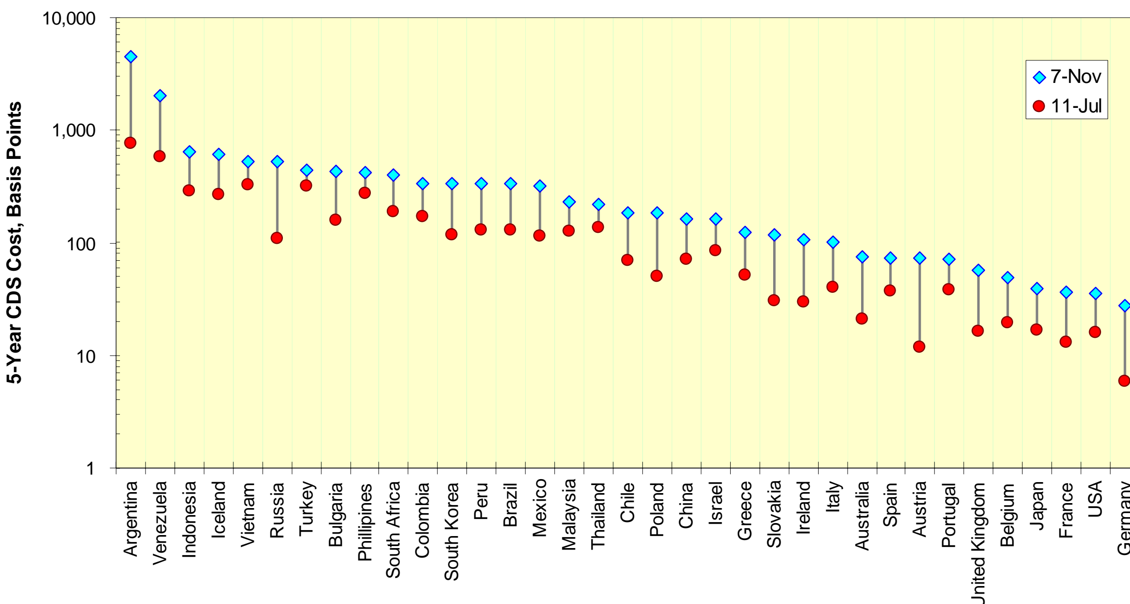
Speaking of abuse, let's turn our attention to what governments around the world have been doing to their sovereign credit ratings since the mid-July backstopping of Fannie Mae and Freddie Mac by the U.S. government. This is in addition to a much longer history of governments trying to meet their spending desires and those of key constituencies by debauching their own currencies. The sad history in the U.S. includes the 1933 suspension of the dollar's convertibility into gold, the closure of the gold window in 1968 and the move to floating exchange rates with the 1971 Smithsonian Agreement.

Those green pieces of paper in your pocket are nothing more than Treasury debt, a weak link to reality given the almost unbelievable expansion of government credit obligations since July. And we are not alone in official abuse of credit; as we shall see below, the full faith and credit of Uncle Sam ranks high on the world scale. But the last time there was such an explosion of global liquidity, the 1969-1970 episode corresponding to the creation of Special Drawing Rights at the International Monetary Fund, we had a decade of runaway global inflation soon thereafter.

Sovereign Credit Risk

Let's return to a topic visited here in September, credit default swaps (CDS) on U.S. Treasuries and extend the analysis across a range of other governments' five-year notes. The chart below sorts these CDS costs in descending order of last Friday's values, marked in blue, in comparison to the values from Friday, July 11, 2008, marked in red. The CDS costs for the U.S. are expressed in euros, not in dollars, on the charming theory that if the U.S. government defaults those euros you receive in recompense will be worth something.

Change In National 5-Year CDS Costs After De Facto GSE Nationalization

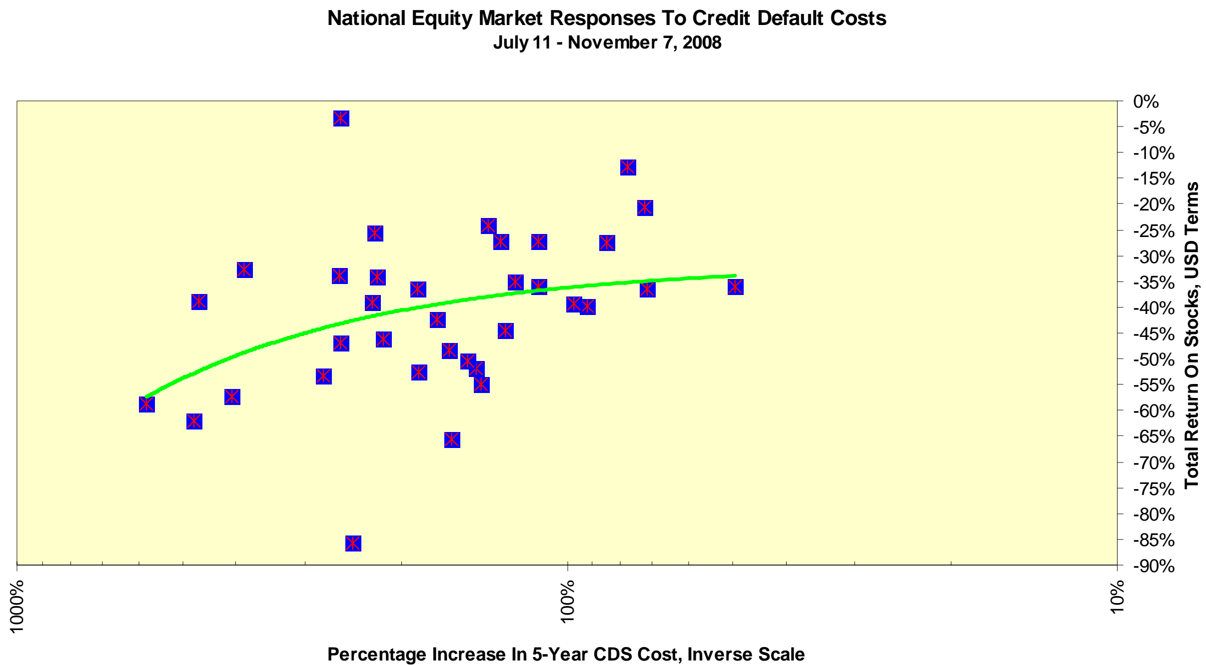


The Y-axis (that's the one running up and down, Gov. Palin) is logarithmic, which means the vertical range represents percentage change. All sovereign CDS costs rose over the four-month period; not one government's credit risk fell. Some of the largest percentage increases were seen in low-risk countries such as Germany and Austria; other large percentage increases were seen in weak credits such as Russia, Iceland, Venezuela and Argentina. A few weak credits, such as Vietnam, Turkey and the Philippines, had small percentage increases.

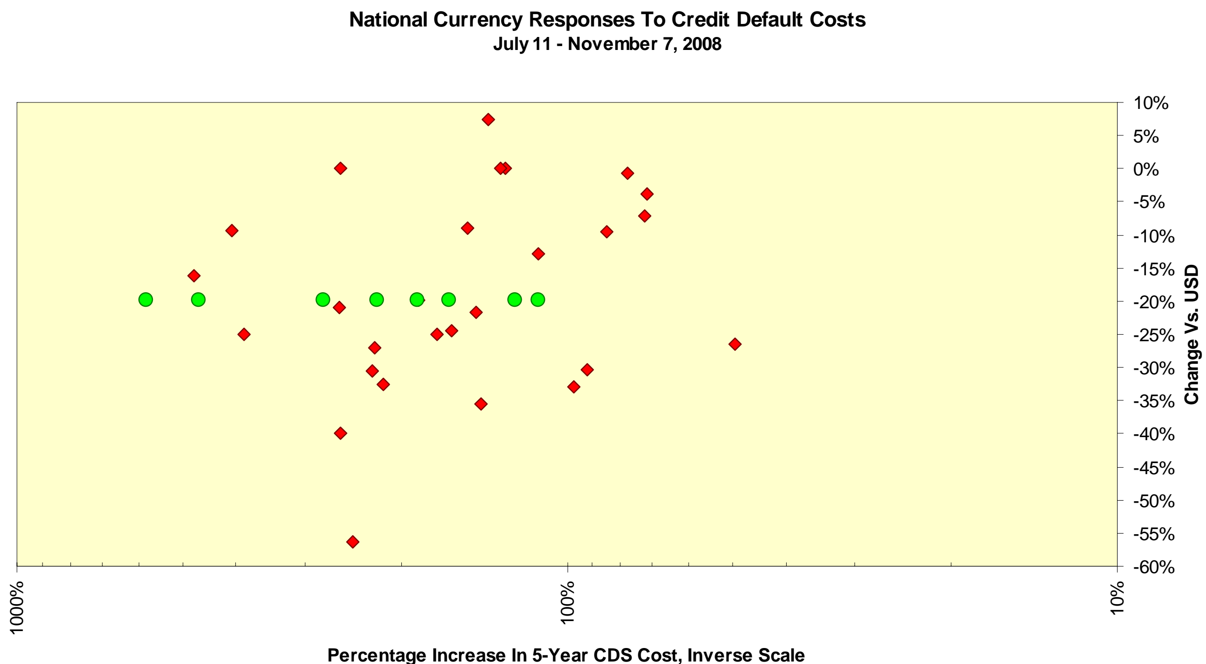
Equity And Currency Responses

Does deteriorating credit quality affect the total return expressed in U.S. dollars for each country's stock market? The unsurprising answer is, "Yes." If we plot the total returns against the percentage increases in CDS costs

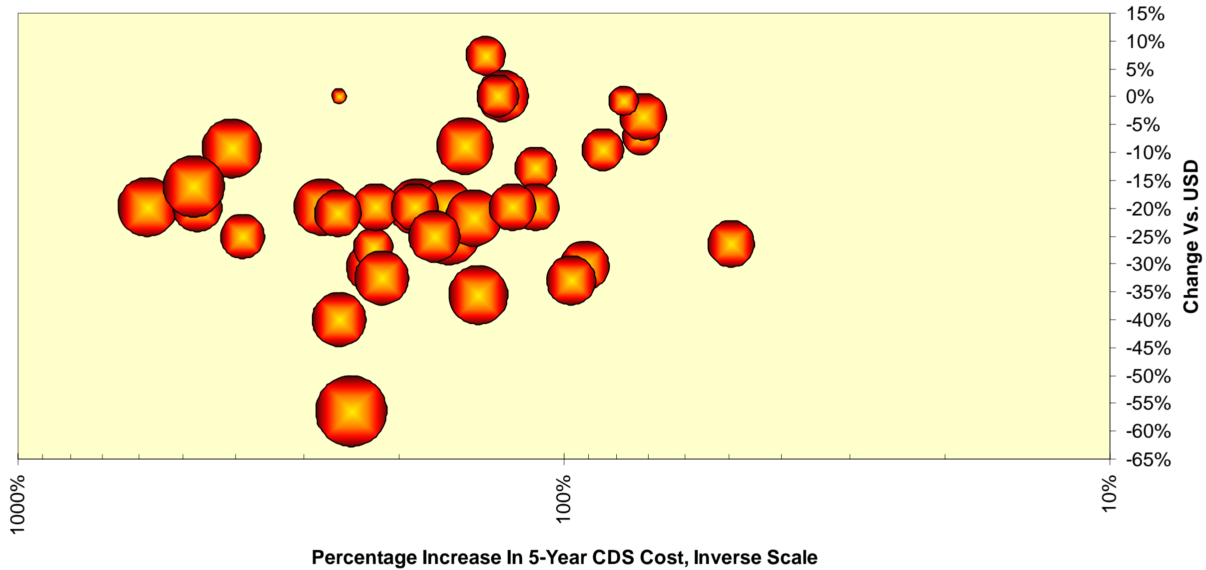
extracted from the chart above, plotted inversely on a logarithmic scale, we see a definite trend toward rising credit risk leading to poorer stock market performance.



Can we do the same plot for changes in each country's currency? No; here the relationship is far more random than we might expect, but for a very interesting reason. As a country's credit quality deteriorates, it often has to raise its short-term interest rates to forestall capital outflows. Those higher short-term interest rates tend to support a country's currency, all else held equal. As the euro supports eight different national stock markets in the sample, the Eurozone percentage changes in CDS are marked with green in the chart below.



As higher short-term interest rates should, all else held equal, drag equity returns lower, we should see a definite pattern in equity returns mapped against currency changes and percentage changes in CDS costs: The greater the CDS percentage increase and the worse the change in the currency are, the poorer the performance of the equity market should be. If we use bubbles to represent the magnitude of the equity market decline, with larger bubbles corresponding to worse performance, we should see larger bubbles in the southwest corner of the chart below, and we do.



The message is clear and once again is unsurprising: If governments believe they can solve long-term economic problems by over-extending their faith and credit up to and past the breaking point, they will do so at the cost of higher interest rates. Restated, governments will have to bribe investors with higher interest rates to support borrowing and to support currencies. Long-term economic growth and profitability – those positive stock market returns we all remember and would like to see again one day – will suffer as future investment is diverted into current consumption.

We have been living the nightmare of a burst credit bubble in the private sector. Do we really want to replace it with a global public sector finance nightmare?