Sovereign Debt And Your Lying Eyes

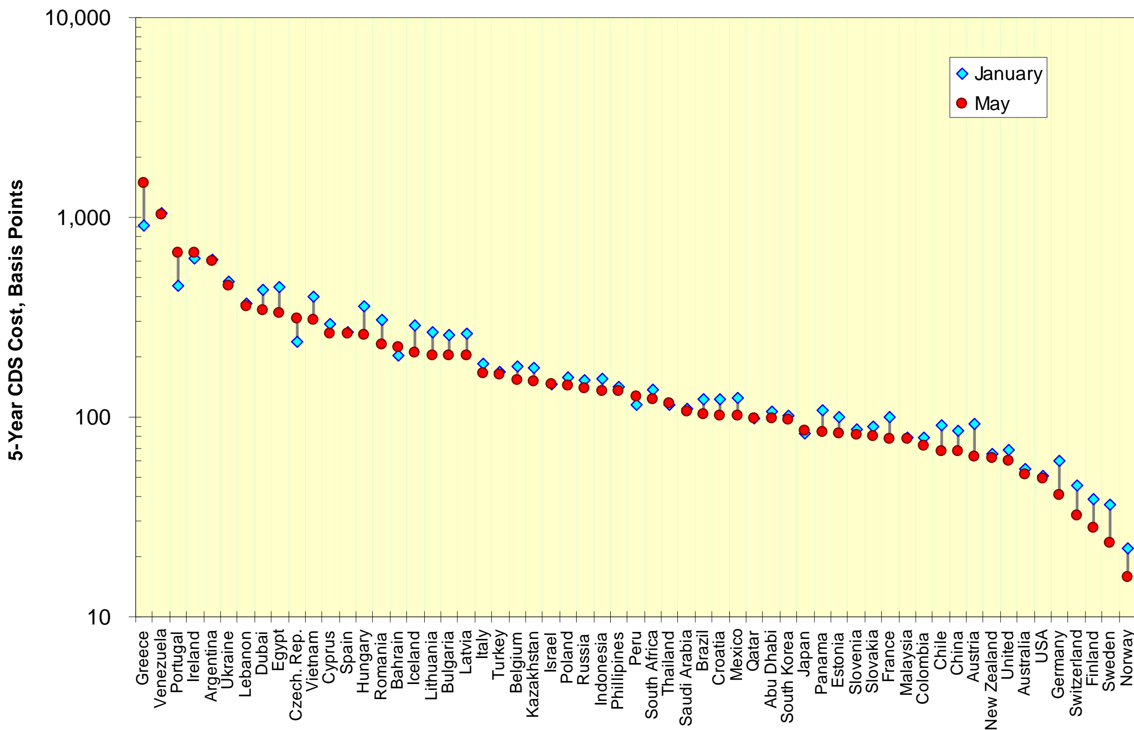
There is an old joke about a statistician who drowns in a river averaging three inches in depth. If we have learned anything over the past quarter-century of ever-greater quantitative disasters, and we have not, it should have been the Devil has fat tails: The extreme events matter far more in reality than anyone thought they would.

So saying, the remarkable aspect of sovereign credit default swap (CDS) costs is they have been declining since late January with the exception of a few prominent but potentially dangerous countries such as Greece, Portugal and the Czech Republic. This includes the U.S., the subject of a recent negative credit outlook from Standard & Poor's an outfit last seen slapping AAA credit ratings on all manner of mortgage offal, and Japan, where the debt to GDP ratio is somewhere north of 200%.

As an aside, once this ratio gets this large, does it matter anymore? As Ellen DeGeneres once observed about having your airplane seat upright and locked on landing, will it matter if the plane hits the runway at the wrong angle?

I might add the five-year CDS costs displayed below are priced in USD except for those on U.S. debt. Here they are priced in euros. If anyone believes the U.S. is going to go "poof" and disappear into the mists of time while the euro remains a functioning currency, please see me immediately. Alternatively, I should hire the salesman who first put that over on a customer; that is the sort of "talent" that made this country great.

Change In National 5-Year CDS Costs Since January 28, 2011

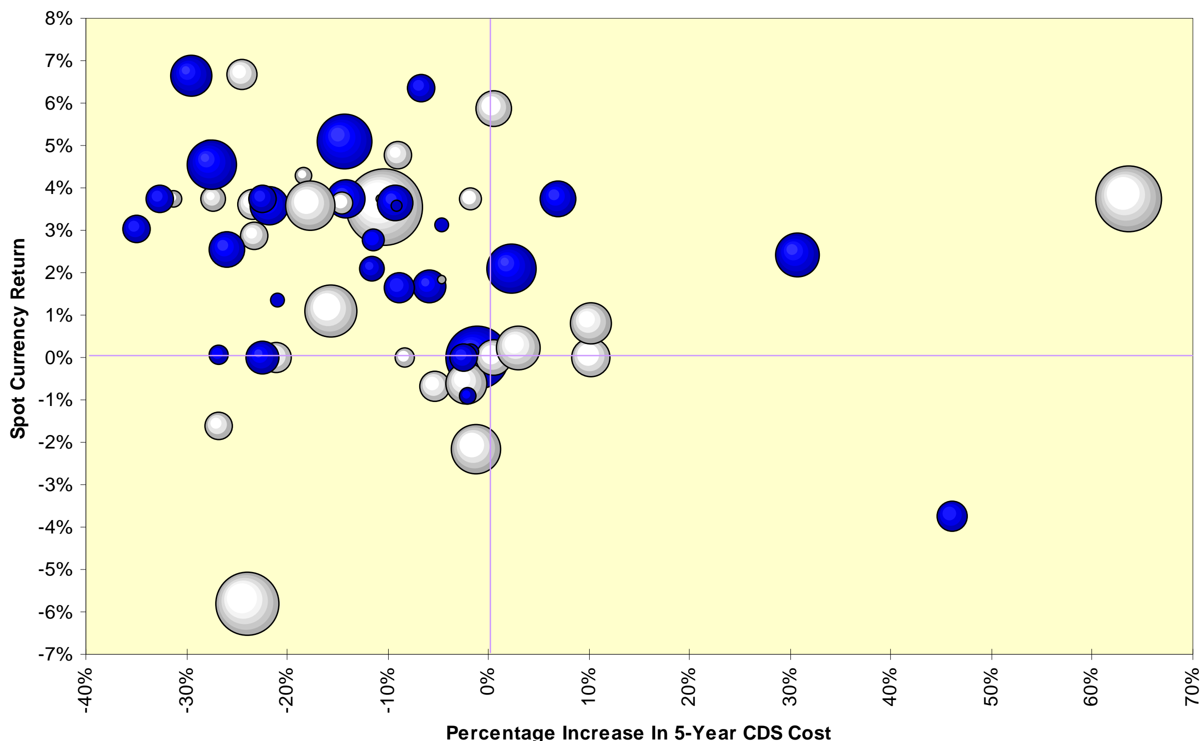


Credit, Currencies And Stocks

Prior to the latest go-around on the European sovereign debt carousel, the one beginning with the Irish bailout in November 2010, there was no discernible relationship worldwide between CDS costs, currency exchange rates and stock market returns. As the Irish bailout came right on the heels of QE2, (Queen Elizabeth II was just in Ireland. Do you really think this is just a coincidence?) and the deliberate and simultaneous attempts to drive the dollar lower and stocks higher, the emerging relationship may be a short-lived affair.

The chart below depicts national equity market returns in USD terms since January as a function of currency returns and percentage changes in CDS costs. Please note how the positive returns, the blue bubbles, are in the northwest

corner of the chart: Perhaps coincidentally, countries with improved sovereign credit quality and stronger currencies have enjoyed higher stock market returns.



Of course, there are those deeper parts of the river. The lowest return here belongs to Cyprus, an island that has been described as the "Delaware of the Mediterranean" for its, um, liberal approach to financial registration. If would want a stock to avoid, here is one: The Apollo Investment Fund, presumably named after the Greek god and not the theatre in Harlem, has lost 17.65% in 2011. Yes, we have to compare that to a 21.63% loss for the benchmark Cyprus General Market index, which itself is dominated by the Bank of Cyprus and Marfin Popular Bank. These two financial firms account for 54.06% and 26.97% of the index; we might as well refer to it as the Cyprus 2.

This is why quantitative analysis is so hard and should be left to professionals if you want to lose breathtaking amounts of money for no good reason whatsoever: The Cypriot pound gained against the dollar (Really!) and CDS costs for protecting Cyprus' debt have declined. If you thought that spelled "I w-i-n," you "l-o-s-t."