Default: Not Dead, Only Resting

How different would your lifestyle be if you were a billionaire who suddenly went a billion into the hole? The answer, not all that surprising when you think about it, is it should not make much of a difference. Either way, you do not have to worry about paying your bills. This perhaps explains why some very illustrious personages in American history, such as Thomas Jefferson, departed the scene in debt.

On a smaller scale, a cottage industry had emerged prior to the most recent credit crisis to lend to people who had filed for bankruptcy; perversely, they were considered to be good credit risks as they could not file again for another seven years and therefore creditors had access to whatever personal resources were not protected by law.

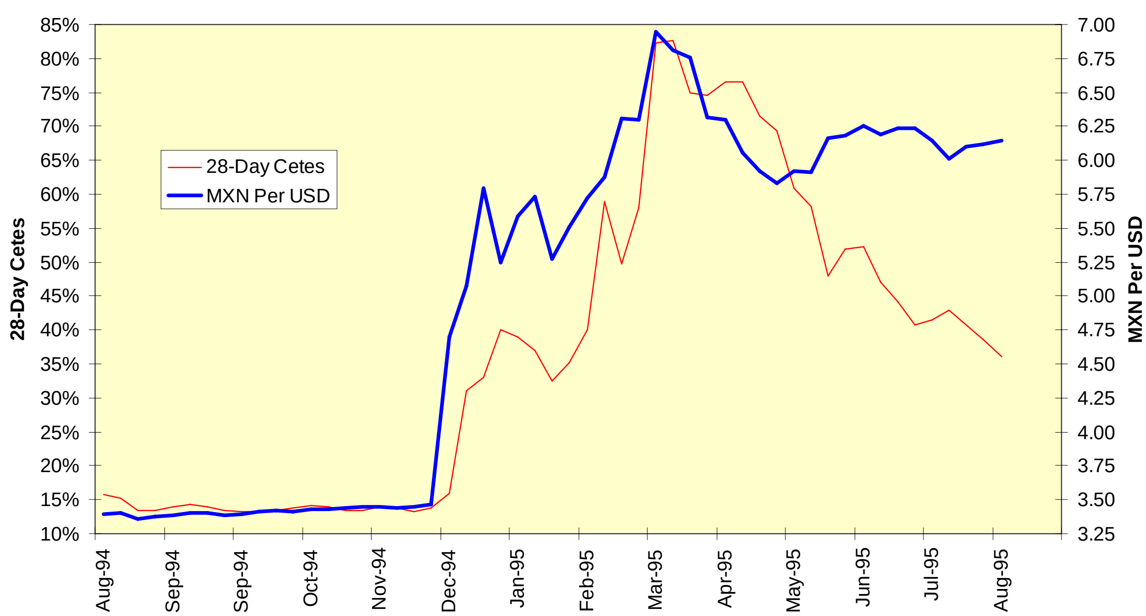
As we face another round of the European sovereign credit difficulties (I am trying to avoid using the word "crisis" all of the time. That, and "legendary." Unless, of course, there is a crisis of legendary proportions, and then I will make an exception) and more municipal debt problems, let's take a look back at a few actual defaults or major devaluations on the global scene and see whether the fear of the unknown is greater than the actual consequences of the adverse event occurring.

The Mexican Peso In 1994

One of the most common responses to a massive currency devaluation, such as the peso's December 1994 collapse, is a surge in short-term interest rates as foreign investors are bribed to keep their money in that currency. As an aside, this response was underway in Europe before it was short-circuited by the European Central Bank over the weekend of May 9th.

If we map the peso against 28-day Mexican Cetes rates before, during and after the devaluation, we see how effective 80% short-term interest rates can be in retaining capital. These rates were effective at squelching the Mexican economy while they were in place.

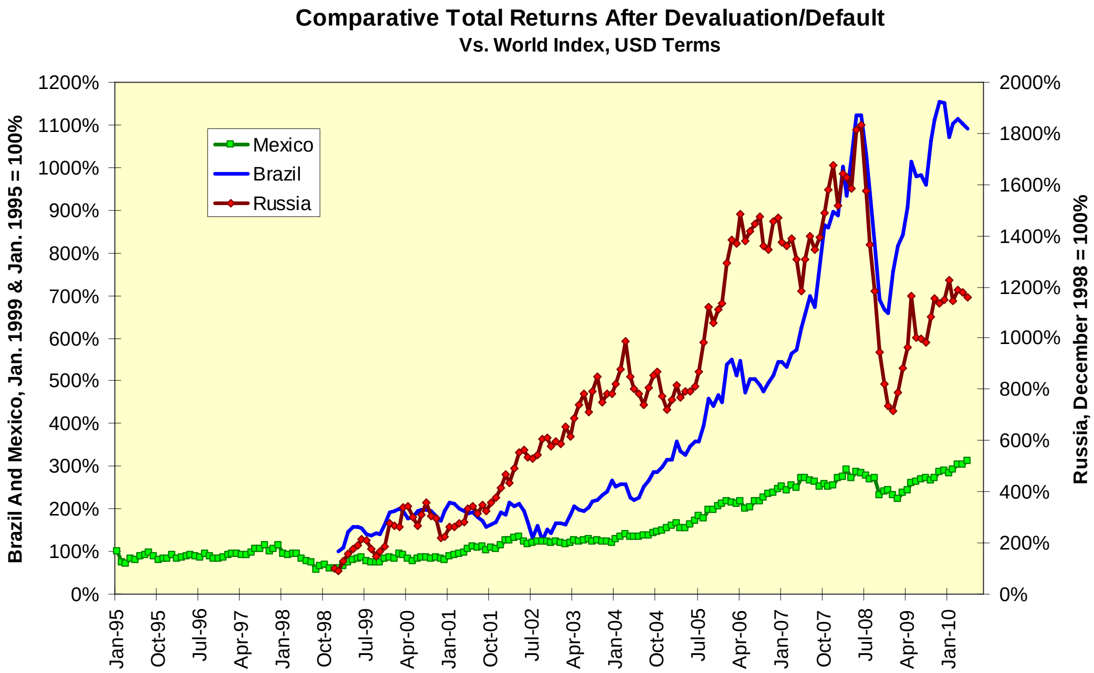
Mexican Interest Rate Response To Peso



We could trace a similar response for various East and South Asian countries during the 1997 Asian You-Know-What. Each time, the response was the same, rates shoot higher, investors allow themselves to be bribed and eventually order is restored.

Equity Response

Now let's take a look at the relative performance of three countries who went through the wringer in the 1990s, the aforementioned Mexico and both Russia and Brazil. Russia defaulted in August 1998 and the Brazilian real took a dive in January 1999. The latter two are now members of the BRIC quartet; without them, it would just be IC.



In all three cases, the performance of the national equity market relative to the MSCI World index in USD terms took off after the devaluation or default event. The chart above displays relative performance re-indexed to the event's month.

The lesson should be clear here: If you let someone or something fail, it will recover eventually. If you try to prevent anyone, anytime from feeling any pain, as the U.S. and Japan have done, you prolong the agony and forestall the recovery. Then you wind up with a crisis of legendary proportions on your hands.