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Is Greece *Really* a Done Deal?

This issue is going to be a double header with the first half devoted to two historic developments that have occurred in the last two weeks. Those developments are:

1) The ECB swapped roughly 50€ billion worth of Greek bonds that it owned for new bonds of the same value
2) The announcement of the Second Greek Bailout

The significance of #1 cannot be overstated. Indeed, this development underlies the primary problem facing the financial system today, namely that Governments/ Central Banks are managing the private markets and economies (and failing).

This subject alone is worthy of an entire book. But the simplest breakdown of the tensions inherent in this set-up concerns the way that these two different groups of people (Central Bankers vs. private sector businesspeople) view money.

For your average Central Banker, the professional relationship between money and risk is a distant one. This has much to do with the fact that your average Central Banker is an academic, someone whose income has been fixed based on his or her status at a particular academic institution (tenure vs. non-tenured).

Consequently, there is virtually no direct correlation between a salary increase and risk-taking or innovation. In academia, politics and the number of one's publications (which is also a highly political process) are what determine one's income, status, and power.

Compare this to an entrepreneur or small business owner (who comprise 70% of jobs in the economy and whose efforts ultimately lead to the creation of medium and even large businesses). For this group of people, money and risk are very

<u>Short-Term Trends</u>
-The ECB changes the rules for the capital markets.
-A Greek deal?
-Germany wants control of Greece

<u>Intermediate Trends</u>
-Greece still to default within two months.
-Italy and Spain are next to take center stage.
-The EU to break-up within six months.
-The US to enter a new recession within the next three months.
-Increased civil unrest and potential riots.

<u>Long-Term Trends</u>
-Global debt implosion.
-New alignment of politico-economic powers.
-Trade wars and very likely REAL warfare.

closely related: every decision they make concerning spending capital comes with the risk of the loss of said capital and subsequent damage to their business.

In this environment, one thinks about money very, very differently from those in academia. Income and salary are far from guaranteed. For many entrepreneurs and small business owners (particularly in this economy) the security of a bi-weekly paycheck is non-existent. Moreover, business capital, once lost, is very difficult to rebuild.

Mind you, I am primarily focusing on entrepreneurs and those who create and grow businesses here. Most managers at pre-established, medium to large enterprises tend to avoid taking risks as their focus is on climbing the corporate ladder step by step. Thus they tend to avoid taking large risks or engaging in much innovation as the career risk of failure far outweighs the benefits of success. Yet even for this group, the chance of losing money for their employer makes the relationship between money and risk palpable (unlike academics).

To return to our Central Bankers, once one leaves academia to join a Central Bank, the salaries remain fixed (though they can be quite high: the Swiss National Bank's head earns almost $1 million per year vs. Bernanke's $175K per year). Thus, one's personal relationship towards money does not change dramatically in the sense that one's salary is still fixed. The only difference is that one's power and influence are now so great that many life expenses (travel, luncheons and dinners, etc.) are covered by various institutions and no longer come out of one's own pocket.

However, on a *professional* level, your average Central Banker's relationship to money has changed *completely*. Money is no longer simply a data input for a formula to be tested on economic models. It is now literally something that can be created out of thin air by the pushing of a button. And that money can be sent into the economy or banking system permitting a real-time real-world execution of one's academic theories/ economic models.

One can only imagine the sense of entitlement and power this situation would create, particularly for those who have never worked in the private sector or started a business and thus haven't participated in actual wealth generation.

I raise all of these issues because they go a long way towards explaining the unbridled arrogance of the ECB's recent Greek bond swap. The details of the swap are as follows: the ECB simply exchanged 50€ billion worth of old Greek sovereign bonds (which were soon to be worth much less if not be outright worthless) for 50€ billion worth of *new* Greek sovereign bonds which would not be exposed to default risk or any kind of debt restructuring (unlike those bonds held by private Greek bond holders).

I want to mention here that the ECB only owned about 50€ billion worth of Greek sovereign bonds to begin with. So they exchanged roughly ALL of their exposure to Greece to new bonds that will not lose money during a restructuring or default.

The message here is clear: all private investor sovereign bond holdings are now subordinate to those of the Central Banks/ the IMF.

The ECB had been toying with this idea of subordinating private debt holders for over a year now: all negotiations concerning a Greek debt restructuring featured private debt holdings taking a "haircut" while the ECB, IMF, and Eurozone countries kept their holdings at 100 cents on the Dollar.

However, this latest move by the ECB has made this arrangement completely formal. Essentially, the ECB just told the private bond market "what we own and what you own are two different things, and ours are the only holdings that are risk free because *we* make the rules."

Thus, the academics, who have been governing the private economy and private capital markets for the last four years, have finally made their control of these entities explicit. It's simply astounding. And the repercussions will be severe.

However, for now, the mainstream media believes this move to be insignificant:

> **Feared Bond Swap Met With Shrug (from the *Wall Street Journal)***
>
> A bond swap completed last week aimed at protecting the European Central Bank from a restructuring of Greek government debt was widely seen as unsettling euro-zone sovereign-bond markets. So far, though, it hasn't.
>
> Last week, the ECB swapped the estimated €45 billion to €50 billion ($59.2 billion to $65.7 billion) face value of bonds—bought in the open market in 2010 and 2011 in a vain effort to quell bond-market turmoil—for bonds of the same face value. The new bonds—unlike the old—won't be subject to any forced restructuring like those held by private bondholders.

The above story only confirms that that mainstream media, like the Central Banks themselves, have no concept of the unintended consequences such policies can create: if you'll recall most coverage of the Fed's QE 2 announcement only briefly mentioned that some "critics" thought the move might result in runaway inflation. *What actually happened were numerous revolutions, riots, and a massive increase in the cost of living as inflation took food prices to record highs.*

With that in mind, it is not surprising that the media has not caught on to the true consequences of the ECB's move. However, the ripple effect this will have on the private bond market is going to be seismic in nature.

The global sovereign bond market is roughly $40 trillion in size. And the ECB just sent a message to all bond fund managers and private financial institutions that their Euro-zone sovereign bond holdings are not only the only holdings that are "at risk" for debt restructuring, but that ECB can change the rules at any point it likes.

This instantly and immediately makes Euro-zone bonds far less attractive to private investors. It was bad enough that the idea of a 50+% haircut on a sovereign bond was on the table. The only reason private Greek bondholders were willing to stomach this was in order to avoid a default/ catastrophe and the total loss of capital.

However, now *all* private bond investors know that not only will they be shouldering *all* of the losses during any upcoming sovereign defaults/ debt restructurings but that the ECB can change the rules any time it likes.

Indeed, the only reason the ECB was able to get away with this without causing private bondholders to flee European sovereign debt en masse was because it didn't take a profit on the debt swap.

In terms of Europe's ongoing debt Crisis, this move is *extremely* damaging to any hopes of clean debt restructuring for Greece or the other PIIGS countries (Portugal, Ireland, Italy, and Spain). Remember, this entire round of the Euro Crisis was caused by concerns over 14€ billion in Greek debt payments that were due *March 20th*.

So what happens once we get into the hundreds of billions of Euros' worth of sovereign debt that needs to be rolled over in the coming months. The ECB, IMF, and EU have already spent 176€ billion trying to prop up the PIIGS bond markets. What happens now that private bondholders know that any potential restructuring of sovereign bonds for these countries means them taking a large hit while the ECB doesn't suffer a cent in losses?

Again, we really need to step back and think about what just happened: the entire Eurozone and financial system were on the verge of collapse because of a mere 14€ billion in debt payments from minor country. This should give us pause when we consider the fragility of the financial system.

Regarding the actual Greek deal itself, it:

1) Fails to address Greece's debt issues (the new forecast is that Greece will cut its Debt to GDP ratio to 120% by *2020*)
2) Slams Greece with additional 3.3€ billion in austerity measures (spending cuts and tax increases) thereby guaranteeing a weaker Greek economy (Greece is already in its fifth year of economic contraction)
3) Is anything but guaranteed (Germany and the Netherlands have raised issues that could stop the deal dead in its tracks)

Regarding #1, there really isn't too much to say here. The facts are that EU leaders are willing to spend another 130€ billion on a country whose GDP is only 227€ billion. Not only that but these folks only expect Greece to gets its Debt to GDP ratio down to an amount that is *twice* what the original Maastricht Treaty called for within the next eight years.

In plain terms, anyone who thinks this represents a solution for Greece or the Eurozone has lost his or her mind.

Indeed, even the EU, IMF, and ECB don't believe this plan will work: a report prepared by these groups and leaked to the press admits that Greece will need *additional* debt relief in order to even meet the Debt to GDP ratio forecast of 120% by 2020.

As for the private Greek bondholders, they're now taking a 53% haircut and swapping 100€ billion of their current bonds for longer-dated securities that pay a lower coupon (essentially agreeing to let Greece keep their money for much longer while paying them much less in terms of yield). This ultimately means these investors losing about 70% of their money on the deal (through the haircut and lower yield).

And yet, even with this 100€ billion in debt relief, and private bondholders taking a 53% haircut, the ECB, IMF, and EU leaders admit that Greece is going to need *more* help in the future.

As I've said before, anyone who thinks this bailout represents a solution for Greece or the Eurozone has lost his or her mind.

Regarding #2, Greece has already committed to a number of austerity measures, which resulted in open riots in the streets. The Greek economy is in an outright depression. Greece's GDP fell 6.8% in 2011. And the new bailout assumes Greece will somehow return to economic growth by *2014.*

This assumption is outright insane. Greece's problems stem from far more than its excessive debt. For one thing, demographics wise, Greece is a disaster.

Real Clear Markets shares the following facts.

- Greece's fertility rate is 1.3 children per women. This is nearly a full child below the "replacement rate": the number of children needed to maintain the current population.

- Greece's population of 65 and over has soared from 11% in 1970 to 24% in 2010. It will hit 33% by 2050. Meanwhile, Greece's working population will decline to 20% over the same time period.

- Because of this, Greece spends 12% of its GDP on pensions.

As if this weren't bad enough, the unemployment rate for Greeks aged 15-24 is 40%. For Greeks aged 24-34 it's 22%. Imagine being a young person, not being able to find a job, and then knowing that huge percentage of your efforts (42%) are going to be taxed to fund all the crazy social welfare programs for Greece's aging population. Small wonder that **seven out of ten young Greeks want to work abroad and four of out ten are actively seeking work outside of Greece**.

Also, it's no surprise that those Greeks who *do* have jobs, don't want to pay this massive tax load. Consider that the Greek working population is roughly seven million people. **95 percent of them declare annual income of less than 30,000 euros.**

So that's the situation in Greece. Terrible age demographics, an economy that's in the toilet, and a culture that believes paying taxes is for suckers. The idea that this country will somehow return to economic growth within two years, based on an additional 130€ billion in bailouts is, again, outright insane (Greece already received 110€ billion in bailout funds in 2010… and still posted GDP growth of -4.5% in 2010 and -6.8% in 2011).

And somehow another 130€ billion is going to get this country back to economic growth in two years' time? Greece hasn't experienced *any* growth in *five years.*

Now for the third and final point: that this second bailout is anything but guaranteed. As I've noted on these pages before, Germany wants Greece to hand over its fiscal sovereignty in order to receive the second bailout. Now the Netherlands is joining in, demanding a full-time observation post in Athens to monitor how the Greek government addresses its financial issues.

However, this is nothing compared to what Germany has now proposed: German Finance Minister Wolfgang Schäuble has proposed that Greece should postpone its April elections as part of the bailout package. In simple terms, Schäuble is concerned that the unpopularity of the austerity measures being imposed on Greece as part of the second bailout package will lead to a "wrong" democratic choice.

This is a step up from Germany's previous demands that Greece submit its fiscal authority to an EU council; now Germany is outright pushing to interfere with Greece's elections.

Schäuble is no idiot. He knows that there is no way Greece would go for this. So his comment can only be seen as an attempt to incite a Greek backlash while also winning political points in Germany where those who show themselves willing to play hardball with Greece have seen a huge boost in the polls (Merkel recently saw her approval ratings hit their highest levels since her re-election by doing this).

We should also take Schäuble's statements in the context of Angela Merkel's recent backing of Nicolas Sarkozy's re-election campaign in France against adamant socialist François Hollande, who wants to engage in a rampant socialist mission to lower France's retirement age, cut tax breaks to the wealthy, and break the recent new EU fiscal requirements Germany convinced 17 members of the EU to agree to.

Current polls show Hollande taking 60% of the French vote. The fact that Sarkozy's re-election campaign just kicked off with an MP from his party announcing that the Nazis never deported homosexuals from France to Germany during the Holocaust (hardly a statement that boosts Sarkozy's chances of re-election) isn't helping.

Put another way, German leaders, particularly Merkel and Schäuble see the writing on the political wall: that both Greece and France are likely going to find themselves with new leadership that is pro-socialism, anti-austerity measures, and most certainly anti-taking orders from Germany.

Thus, Germany must be aware (as the EU, IMF, and ECB are to some degree) that it is ultimately fighting a losing battle by participating in the bailouts. Indeed, Schäuble even went so far as to recently call Greece a "bottomless pit" where money is wasted (having just participated in Greek bailouts that exceed the entirety of Greece's GDP, I have to admit he *does* have a point here).

Schäuble's statements have not passed unnoticed. Greek politicians have regularly brought up Germany's lack of war reparations to Greece while the Greek media has begun regularly portraying Schäuble and Angela Merkel as Nazis.

So while a "deal" may have officially been struck for Greece, there are deep underlying tensions that could bring proceedings to a crashing halt at any point.

Big picture, we must remember that Greece is just the opening act for what's to come in Europe: Italy and Spain are waiting in the wings to take center stage as soon as the Greece bailout deal is finalized (*if* this happens… which remains to be seen).

Germany is aware of this, as well as the fact that there is no way German voters will go for bailouts of either of those larger countries (even if Germany, the IMF, and ECB *had* the funds to bail out Spain or Greece… which they don't). This is why Germany has decided to play hardball with Greece. It's also why Germany has put into place a contingency plan that would permit it to leave the Euro if it had to.

As a brief recap, this contingency plan consists of:

1) Legislation that would permit Germany to leave the Euro but remain a part of the EU
2) The revival of its Special Financial Market Stabilization Funds, or SoFFin for short, to which Germany has allocated 480€ billion Euros to in the case of a

banking crisis (the fund will also permit German banks to dump their euro-zone government bonds if needed).

So Germany is ready to bail if it needs to. Meanwhile, on the other side of EU equation, Spain and Italy must be watching what's happening in Greece and asking themselves whether they want to go through this whole process of negotiating for bailouts via austerity measures.

Both countries have already had a small sampling of the austerity measure medicine. Spain recently implemented a meager 19€ billion in austerity measures while Italy passed 30€ billion in austerity measures in 2011… hardly a drop out of their respective 1.06€ trillion and 1.5€ trillion economies.

Yet, even these tiny moves resulted in protests and riots. One can only imagine what Spanish and Italian politicians are thinking as they witness the widespread civil unrest, country-wide strikes, and economic depression that have occurred in Greece as a result of that country's full commitment to the EU's austerity measure demands.

Spain's official Debt to GDP is only 64%, but its private sector debt is at an astounding 227% of GDP. And the Spanish banking system is leveraged at 19 to 1 (worse than Greece).

Moreover, the country is already experiencing an economic Crisis with an unemployment rate of 20+% and an economy that has been contracting since mid-2011 (in fact Spain's GDP just actually went negative in the first quarter of 2012).

In contrast, Italy sports an official Debt to GDP of 120% and a real Debt to GDP north of 360% when you account for unfunded liabilities. Its economy has been contracting since mid-2010 and has been in negative territory since the middle of last year. Italian unemployment is 8.9% (not nearly as bad as Spain's). However, the Italian bond market is the third largest in the world and Italian banks are leveraged at 20 to 1.

In plain terms, both countries are at most a few months away from a banking and/or economic crisis which would result in them seeking bailouts. Of the two, Italy is most likely to take center stage first: the ECB was already intervening in the Italian bond market throughout the second half of 2011.

With that in mind, we need to consider that Italy has already gone through the removal of a democratically elected Prime Minister who was subsequently replaced by an academic economist. This makes it more than likely that we'll see a good degree of can kicking and/or austerity games from the top of the Italian Government.

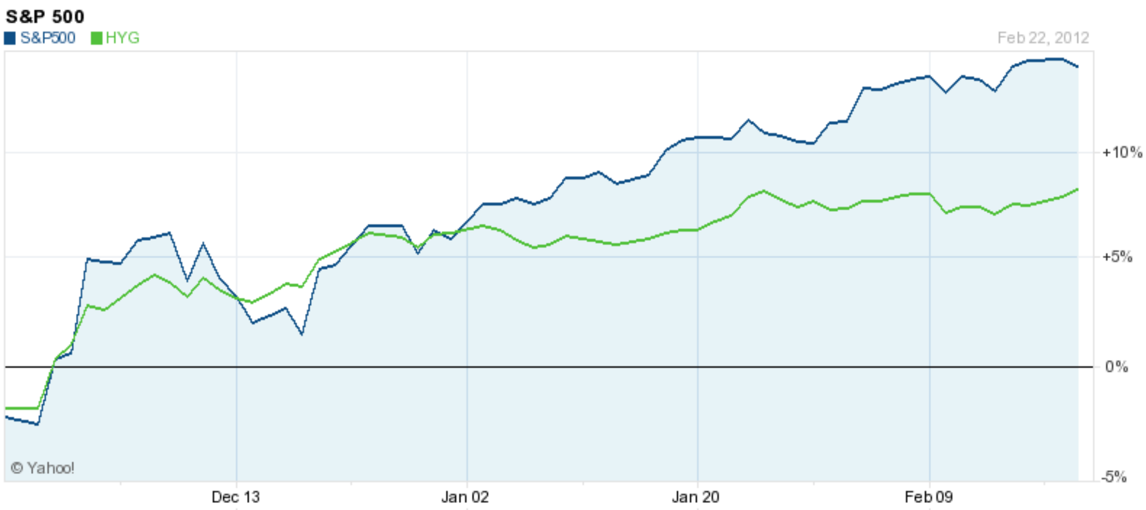
However, the Italian parliament may not be so inclined to go along with additional austerity measures, particularly now that it's clear that a country can default, collapse, and get its financial house in order relatively quickly (Iceland). The fact that Greece has played ball with the ECB and EU for two years now and remains in a Depression isn't going to do much to convince Italian politicians to opt for the austerity/ bailout route either.

So… we must consider that it is highly likely the option of simply defaulting is being discussed at the highest levels of the Spanish and Italian government. Should either country decide that austerity measures don't work and it's simply easier to opt for a default, then we are heading into a Crisis that will make 2008 look like a joke.

Mind you, all of the above analysis is only relevant if the second Greek bailout gets passed without a hitch. If this deal goes awry in any way, all bets are off as Greece will default which will greatly increase the likelihood that Italy and Spain will follow suit.

I believe the markets are already beginning to discount this. For one thing, the S&P 500 has formed a very clear rising bearish wedge pattern. This is a classic termination pattern and the fact it's occurring on dwindling volume sets the stage for a very strong correction likely to 1,250 if not lower.

We get confirmation that stocks are heading for a fall from the massive divergence between high yield bonds (blue line) and the S&P 500 (black line), two assets that typically have been very closely related with high yield bonds typically leading stocks both to the upside and the downside:



We also see a massive divergence between the Dow Jones Industrial Average and the Dow Jones Transportation Index: another red flag that stocks are on thin ice.

The picture is no prettier for the Emerging Markets which have not only trailed the US indexes during this latest rally, but are coming up against major resistance:

As far as currencies go, it's worth noting that despite all the hype and hope, the Euro has failed to take out major resistance both in the short-term:

And in the long-term:

Meanwhile, the US Dollar, has managed to hang onto support despite this recent Euro strength. If the greenback can break above the 50-DMA, we're going to 84 in short order and the Euro will plunge.

All of this points to another round of deflation being just around the corner. Stocks are tremendously overbought. The primary excuse for the Euro to rally (hype and hope for a Greek bailout) is gone. Gas and oil are soaring which will slow economic activity worldwide. The US Dollar looks primed for its next leg up. Even US Treasuries are maintaining support at extremely elevated levels (signifying that investors area extremely nervous about the state of affairs in the financial system):

In plain terms, everywhere we look there are red flags that all is not well in the financial system and that another round of deflation is just around the corner. The markets are telling us point blank that the Second Greek Bailout doesn't solve anything and that we are on very very thin ice.

With that in mind, it's highly likely we'll be opening our Crisis Trades in the coming days. So be on the lookout for an alert from me between now and the next issue of ***Private Wealth Advisory*** due out on March 7th.

This concludes this portion of this week's issue of ***Private Wealth Advisory,*** I will send out a full portfolio review tomorrow regarding our current positions. I'll also have a number of new trades for you at that time. Until then…

Best Regards,
Graham Summers