

A Momentary Lapse of Reason

What if this time is different?

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Wouter ten Brinke



Theta Capital Management B.V.
Johannes Vermeerstraat 9
1071 DK Amsterdam
The Netherlands

Telephone: +31 (0) 20 5722733
Fax: +31 (0) 20 5722744
E-mail: ir@thetacapital.com
Website: www.thetacapital.com

What if this time is different?

The guiding principle for every investment decision should be Karl Popper's concept of falsification: "What would prove my thesis wrong?"¹ This question may not be sufficient, but it is certainly a necessary condition for investment success. For, those who are blind to unlikely events, will also fail to benefit from the associated opportunities. This note is about investment themes that may be unlikely and contrarian today, but could have a tremendous impact on investment returns tomorrow (or the day after, for that matter).

While it may be tempting to join the media and not-too-well-informed politicians in calling out Armageddon-scenarios for the world economy, we would like to share with you our slightly different take on things.

The European debt crisis is serious but will be contained to Europe and is not a prelude to a wave of global deflationary forces. Nevertheless, it very well illustrates the type of developments that create investment opportunities on both the short (pre-crisis) and long (post-crisis) side of sovereign debt, interest rate and currency markets.

We see several sovereign and political forces influencing financial markets today and in the coming years:

- **Sovereign credit and interest rate risk** in developed markets will continue to take centre stage as governments inflate their way out of unsustainable debt positions;
- **Bull market in politics:** typically following a boom-bust cycle, we can expect governments to become an increasingly dominant (regulatory) force in Western financial markets;
- **De-globalisation:** coordinated policy responses to the financial crisis give way to the pursuit of local (political) interests across Western economies. Protectionist tendencies could ultimately lead to a wave of de-globalisation; which would be a structural impediment to global economic growth.

However, the shorter-term impact of these forces on global financial markets is not clear. There is no one-size-fits-all scenario in which the sovereign risk crisis would be deflationary on a global scale. In contrast, we believe financial markets will continue to separate the good from the bad in terms of economic growth potential, profitability, fiscal discipline and credit risk. The difference between now and two years ago is that the focus of credit risk has shifted from corporate to sovereign entities.

In this strategy note, we describe a few interesting, and mostly contrarian, investment themes that we classify as "sovereign opportunities". One of them has already been in our portfolios for more than two years (the European Divergence trade, see below); others are more recent additions or are still being researched. In a way, these positions can be seen as long option

¹ Popper's main question to the answer *falsification* was: "What makes a theory true?". However, the search for the truth in financial markets is a futile exercise, as we have learned again in recent years.

Sovereign risk: global opportunities, regional challenges

positions: spend a small premium to gain leveraged exposure to the underlying investment theme. Obviously, the more contrarian the trade, the cheaper the “option” will be. Indeed, some of funds will implement their trades using options and long CDS positions. But first, let us describe the overall investment environment as we see it today.

It is important to note that these investment themes were not selected by Theta, but were presented to us by hedge fund managers that we respect and with whom we have good and long-standing experience in terms of value investing or contrarian investment themes.

Investment outlook

Government misery, corporate prosperity and abundant liquidity

This decade begins with an unprecedented combination of record pressure on government balance sheets and high structural profitability of Europe’s corporate sector. In sharp contrast to European governments, corporations will soon regain full profitability (partly on the back of export exposure to EM growth and a weaker euro currency). Corporates’ financial health ultimately supports new capital expenditure or M&A activity (or both) and this can hardly be a negative for equity markets. Also, both the ECB and the Fed are likely to keep interest rates at record-low levels for longer, which should prompt many emerging market central banks to slow down their own tightening campaigns.

The flipside of this bullish story is the emergence of sovereign risk and social unrest, as currently witnessed in the European debt crisis. It seems that the only way out of this crisis is for the ECB to follow the Fed and monetise large amounts of European government bonds, which will boost money supply, reduce the cost of capital and debt burdens, and create demand. In this scenario, global excess liquidity should grow by even more, lifting the prices of commodities and other risky assets, widening the gap between emerging markets and developed markets growth and ultimately adding to global inflationary pressures.

The endgame: as the private sector has passed on its debt burden to the public sector and sovereign credit risk intensifies, the temptation to inflate away a mounting public sector debt becomes irresistible and global inflationary risks are on the rise.

Theme # 1 - European Divergence

It’s a solvency crisis, not a liquidity crisis

Notwithstanding this generally favourable investment environment, we see several pockets of weakness (and ultimately, investment opportunities), most notably in the sovereign sector. The European fiscal emergency plan addresses near-term *liquidity* problems but it does little to solve the true problem of government *solvency* in Europe. Indeed, by further increasing the weak fiscal countries’ debt load, it may even make things worse in the medium term.

While the consensus seems to be that the Greek crisis and the resulting contagion to other non-core euro area bond markets served as a wake-up call for governments and will be followed by substantial fiscal-tightening measures

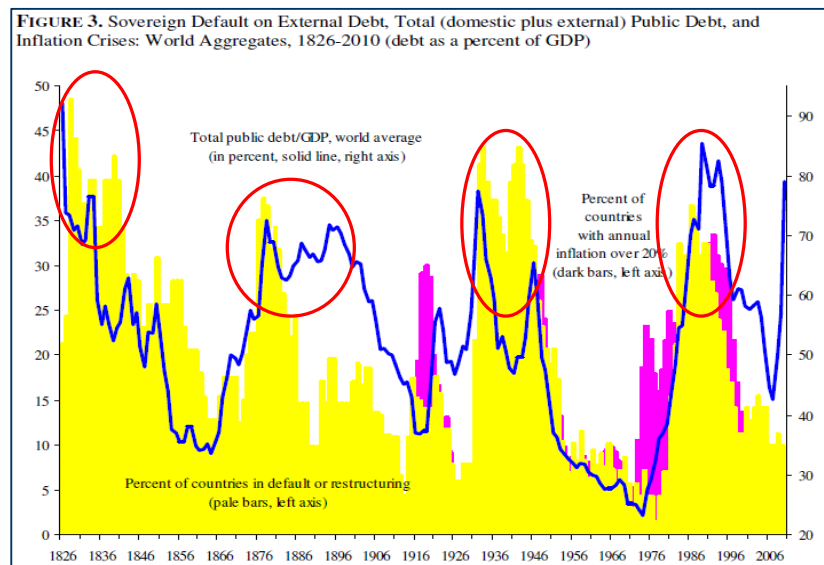
across the euro area, there are as yet few **credible** signs that fiscal policy has entered a new regime in the core euro countries. Concerns about fiscal austerity and sovereign credit risk will migrate to countries in North-Western Europe².

Interestingly, having generated substantial profits from short positions in the government debt of Greece, Portugal, Spain and Italy since November 2007, and having paid back more than 100% of our initial investment (made in February 2008), the investment manager of the European Divergence theme has moved on with the view that France and Belgium are next in line. Indeed, risk premiums on the government debt of Belgium and France have **almost doubled** in recent days.

Sovereign defaults do occur and cluster around financial crises

But will we actually see sovereign defaults on a global scale? To be frank, we have no idea, but Chart 1 below (taken from the brilliant book “This Time is Different - Eight Centuries of Financial Folly” by Carmen Reinhart and Kenneth Rogoff) gives some perspective. It shows the percentage of countries in default in any given year from 1826 to 2010 (77 countries analysed, representing 90% of world GDP). The conclusion is rather sobering: sovereign defaults are not that rare: on several occasions, almost half the countries analysed experienced default or restructuring simultaneously. Indeed, these clusters of sovereign default tend to occur around significant events such as wars or financial crises and coincide with high debt-to-GDP ratios.³

Chart 1 Percentage of countries in default or restructuring



² Please see a [recent Theta presentation](#), for some interesting data supporting this view.

³ Note that the OECD estimate for the average developed economies' 2011 debt-to-GDP ratio is 110% (well off the chart above - follow the light blue line); for emerging economies the forecast is 40%.

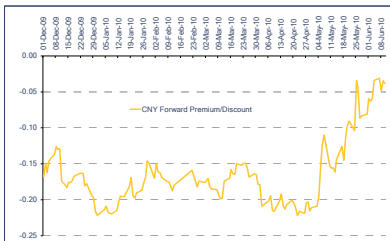
Theme #2 - China Opportunity

China is experiencing an unsustainable boom in its real estate and infrastructure sectors fuelled by excessive credit growth. The resulting misallocation of capital leaves China vulnerable to a violent adjustment process. China's exchange rate system promotes extraordinary money creation and speculative foreign capital inflows. Indeed, one of our managers estimates that of the USD 2.4bn official FX reserves in China, about 1/3 reflects *speculative* capital inflows which have helped fuel bubbles in Chinese stock markets and real estate. The resulting imbalances leave China vulnerable to external demand shocks and a flight of speculative capital from the country, which in turn would put the Chinese currency (CNY) under serious pressure.

Next major move in Chinese currency may be down

While the market consensus is that the CNY is *undervalued*, this manager believes that the relative sizes of the Chinese and US money growth imply a massive *overvaluation* of the CNY. Therefore, while an appreciation is likely in the short term, the next major move in the CNY would most likely be lower. Potential catalysts for this move would be:

- A stronger USD, which makes Chinese exports less competitive versus its Asian trading partners (due to USD peg) and may create an incentive for Chinese policy makers to devalue
- Bursting of the Chinese asset bubbles which would trigger a flight of speculative capital out of China
- Protectionist policies by the US which could be met with a Chinese currency devaluation
- Removal of the USD peg



Chinese credit bubble bursting would trigger rapid contraction in risk appetite across the globe

Reviewing the state of the US mortgage sector in 2007-2008 in this framework, it is clear that the subprime mortgage crisis had the potential to trigger a global financial crisis. But China?

While the probability of a Chinese default or restructuring is arguably very low, any indication of trouble in Chinese asset markets and the economy has the potential to trigger a rapid contagion to risky assets across the globe. Expanding on the Kaminsky/Reinhart/Vegh “Trinity” described above, it is clear that there has been a tremendous *surge in capital flows* into China in the recent decade. Indeed, some estimate that more than 35% of the \$2.4 trillion in Chinese foreign exchange reserves reflect speculative flows, which can be subject to a rapid reversal once the *surprise element of the announcement* is met. Although the Chinese credit bubble gets more attention recently, we would argue that very few investors have adjusted their portfolios to account for this risk. The whole investment community is basically long China, which means a sufficiently large negative surprise could trigger a rapid contraction in risk appetite across the globe. Finally, the *leveraged common creditor* should be easy to identify. Extremely accommodative monetary policy stances (both by means of low interest rates and a myriad of liquidity arrangements) from central banks across the globe are keeping the speculative capital flows into China intact, which means “the rest of the world as a whole” would qualify for this role.

Theme #3 - Iceland Opportunity

Iceland entered a severe financial crisis following the collapse of three major banks. Credit ratings on sovereign debt have been downgraded (with negative outlook), the currency (ISK) has depreciated more than 35% against the euro, and the stock market fell 50%. The central bank of Iceland has introduced currency controls, which led to a significant divergence between the onshore and the offshore ISK rates.

The crisis has created many distressed opportunities in Iceland and a small special purpose fund set up by one of our managers will actively trade long-biased investments in Icelandic assets (more specifically the offshore currency and Icelandic government debt) with the objective to profit from the recovery in the macroeconomic, political and fiscal situation of Iceland. The fund aims to benefit from 1) convergence from the offshore ISK rate to the onshore ISK rate once FX controls are lifted, and 2) appreciation of the ISK/EUR to from 175 to 145 within a time frame of 1-2 years.

Iceland is leading Europe in financial restructuring

According to our investment manager, Iceland is arguably the strongest sovereign credit in Europe, with a current account surplus, a strong real economy based on fishing and potential revenues from thermal energy, a fully funded pension system, and a banking system that has been recapitalized after foreign holders of Icelandic bank debt took a USD 80 bln loss⁴.

⁴ Indeed, the true start of a solution for the European banking problems would be to accept write-downs on mortgage, corporate and sovereign debt of questionable credit quality. Iceland seems to be well ahead of the rest of Europe in this respect.

Icelandic Krona may become safe haven currency in Europe

Furthermore, Iceland has struck a deal with the IMF and the IceSave situation is expected to be resolved soon (now that elections have been held in the UK and the Netherlands), essentially eliminating the default risk of Icelandic government debt. According to the manager, the ultimate endgame may well be that the ISK would actually be viewed as a safe haven currency in Europe. Indeed, recent market developments point in this direction: the onshore ISK/EUR has strengthened from 180 to 156 this year. At the same time, CDS spreads on Icelandic government debt narrowed from 675 to 350bps (see Chart 2 below, with CDS spreads of Iceland in pink and Greece in yellow).

Chart 2 CDS spreads on government debt of Iceland and Greece



As the main risks on this investment theme, we have identified:

- Default on Icelandic government debt
- Limited liquidity of assets (offshore ISK and Icelandic government bonds)
- Convertibility of the offshore/onshore currency into EUR
- Timing and implementation of the investment theme

On balance, we believe the risk-reward profile of the investment theme is very interesting and we have made a small allocation to this fund.

Theme #4 - Rising Inflation

The ultimate endgame will be higher inflation

Sovereign risks have recently further depressed inflation expectations, as measured by both surveys and the inflation-linked bond markets. However, if policy rates are low for longer due to the sovereign crisis, central banks may have more work to do later. We believe the ultimate endgame of (developed markets) governments inflating away their debt burden will be higher inflation. The current contrarian nature of this theme makes valuations compelling (US

and European expected inflation rates for the next 5 years are trading around 2% - close to their multi-year lows).

Historically, gold has shown a strong correlation to the money supply and precious metals offer the best returns in inflationary periods. We are currently researching various ways of getting exposure to a rising inflation environment. This could be in the form of a fund focused on the equity of gold mining companies and gold derivatives (increasing demand meets constrained supply) or a fund trading only options on interest rates, metals and other commodities, with the idea that the *perception* of future inflation should impact the implied volatility of the options, in addition to the price of the underlying commodity. The first fund would give a more linear exposure to inflation and the second fund would provide protection against extreme inflation (expectations), similar to the payoff of an out-of-the-money option position. Clearly, a combination of both may also be a sensible investment strategy.

Conclusion

In the past months, we have made (or increased) allocations to the investment themes described above, for portfolios where the liquidity profile allows for medium-to-long-term investment themes. Although allocations are relatively small, they do introduce compelling asymmetric risk-reward dynamics to the portfolio, and may act as a hedge to more long-biased exposure to risky assets.

Indeed, the European Divergence theme described above (in our Theta Deep Value portfolio since February 2008), has contributed +1.4% to the strong year-to-date performance of +7.2% of Theta Deep Value Fund.

As a reminder, we have recently introduced a new share class in the Theta Deep Value Fund with quarterly liquidity and we will take in new capital per 1 July 2010. Should you be interested in participating, please do not hesitate to contact us.

Reference

Kaminsky, Reinhart and Vegh (November 2003), *The Unholy Trinity of Financial Contagion*, NBER Working Paper No. W10061.