Ten Little Indians
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By John Mauldin

One little, two little, three little Indians
Four little, five little, six little Indians
Seven little, eight little, nine little Indians
Ten little Indian boys

- Children's rhyme

Why is it that the Irish must take upon themselves the debts of their banks, which in reality are debts owed to German and French banks? Why should the Germans bail out the Greeks and the Spanish? Is the spread of "contagion" starting to taint the debt of Italy and even Belgium, the home of the EU? This week we look over the pond (of the Atlantic) and wonder how all these things will end. As I noted last week, we are getting a string of not so bad news out of the US, so now there are really just two things in the short term to worry about (at least in terms of a positive US GDP): will Congress extend the Bush tax cuts and will Europe sort itself out?

While I am on a cruise ship off the coast of Mexico (with a sporadic and very slow internet connection), the news we do get seems to suggest that the former will get done, but the latter looks rather dodgy. This week we look at a few statistics and then I try and give my US readers some perspective on Europe, by comparing Texas to Ireland (or Portugal or…). There is a connection, or at least I will try and make one. It should be fun, if a little controversial.

But first, and quickly, my friends from GaveKal will be in Dallas this week, on Wednesday December 8, for a full-day conference. If you are an accredited investor or a fund manager join me, Charles and Louis Gave (and some of their team), and George Friedman of Stratfor for a full day of presentations and analysis of the current world. Just drop me a reply and someone from either my staff or theirs will be in touch with you.

Ten Little Indians

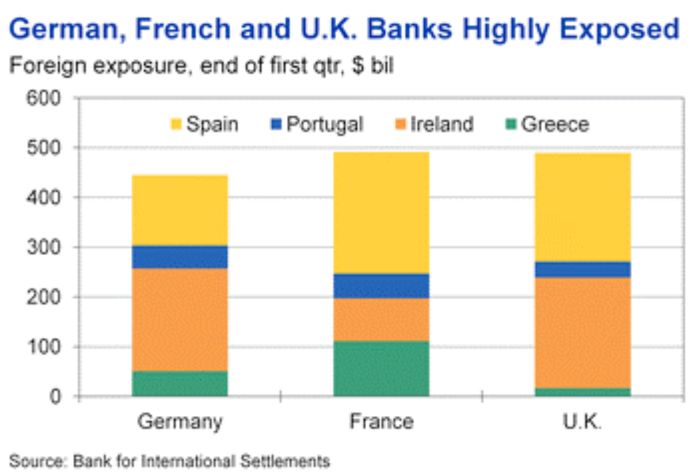
There is the childhood story and song about the ten little Indians. And of course the Agatha Christie tale of the same name, with 10 people invited to an isolated place, only to find that an unseen person is killing them one by one. And that seems to be what the markets want to do with European sovereign debt. First it was Greece, then it was Ireland. Very soon it will be

Portugal, then Spain, and even Italy? Belgium perhaps? How many more Indians till it hits the core of Europe?

My friend Dennis Gartman wrote a very humorous note yesterday about the following conversation between two Irishmen, Liam and Paddy, sitting in their local pub. The current Irish government has agreed to borrow something like $88 billion euros to shore up their banking crisis. That is about $27,000 for every man, woman, and baby in Ireland, a rather small country with a little over 4 million people.

"Aye, Paddy, now that it's all done, lad, we Irishmen owe the IMF; we owe the countries of the European Union; we owe those damned Englishmen; we owe the Danes; we owe the Swedes for God's sake! Oh, and we owe the banks, and we owe ourselves. Aye, lad; we owe the whole bloody world it seems."

That they do. And a lot of that Irish debt is owed to German, French, and UK banks. A lot more debt owed to banks than the Greeks owe, which had everyone worried not so long ago. See the graph below. (For those who are seeing this in black and white, the top section is Spain, then Portugal, Ireland, and Greece. Irish and Spanish debt dwarfs Greek debt.



And that chart is what is really going on in Europe. It is not about Germany and France wanting to help out Ireland and Greece (and eventually Portugal and Spain). They are not that benevolent. It is that they are worried about their banks going belly up.

Look at how upset the UK got when Iceland decided not to back their banks. Never mind that the bank debt was 12 times Iceland's national GDP. Never mind that there was no way in hell that the 300,000 people of Iceland could ever pay that much money back in multiples lifetimes. The Icelanders did the sensible thing: they just said no.

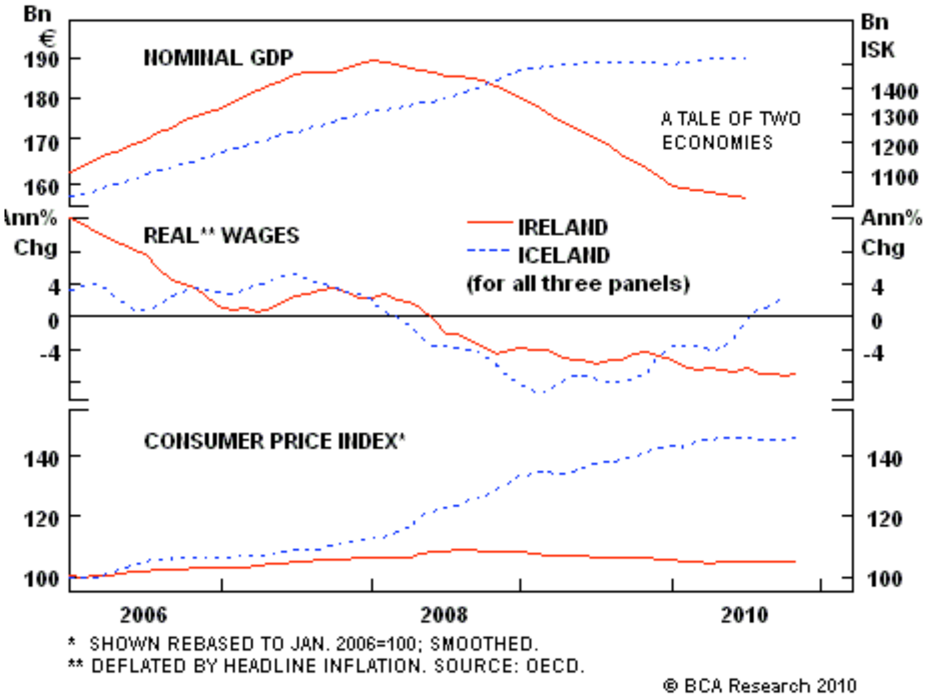
Yet Ireland has decided to try and save its banks by taking on massive public debt. The current government is willing to go down to a very resounding defeat in the near future because it thinks this is so important. And it is not clear that, with a slim majority of one vote, it will be able to hold its coalition together to do so. This is what the *Bank Credit Analyst* sent out this morning:

"The different adjustment paths of Ireland and Iceland are classic examples of devaluation versus deflation.

"Iceland and Ireland experienced similar economic illnesses prior to their respective crises: Both economies had too much private-sector debt and the banking system was massively overleveraged. Iceland's total external debt reached close to 1000% of its GDP in 2008. By the end of the year, Iceland's entire banking system was crushed and the stock market dropped by more than 95% from its 2007 highs. Since then, Iceland has followed the classic adjustment path of a debt crisis-stricken economy: The krona was devalued by more than 60% against the euro and the government was forced to implement draconian austerity programs.

"In Ireland, the boom in real estate prices triggered a massive borrowing binge, driving total private non-financial sector debt to almost 200% of GDP, among the highest in the euro area economy. In stark contrast to the Icelandic situation, however, the Irish economy has become stuck in a debt-deflation spiral. The government has lost all other options but to accept the €85 billion bailout package from the EU and the IMF. The big problem for Ireland is that fiscal austerity without a large currency devaluation is like committing economic suicide – without a cheapened currency to re-create nominal growth, fiscal austerity can only serve to crush aggregate demand and precipitate an economic downward spiral. The sad reality is that unlike Iceland, Ireland does not have the option of devaluing its own currency, implying that further harsh economic adjustment is likely."

This is what it looks like in the charts. Notice that Iceland is seeing its nominal GDP rise while Ireland is still in freefall, even after doing the "right thing" by taking on their bank debt.



Whither Portugal?

Portugal is one of those countries that is on my short-list of places I want to get to. Maybe I have romanticized it in my mind, but I have a wonderful picture of vineyards and mountains and ocean and sleepy little villages. But the country also has a rather staggering amount of debt.

As my friend and co-author of my new book, Jonathan Tepper, wrote last week in *Variant Perception,* Portugal is seeing all sorts of its economic dynamics go into reverse, except:

"The only thing that is not likely to move in reverse is debt levels. There are two main reasons for this. First, the measures the government are adopting to reduce the fiscal deficit will likely result in a deflationary dynamic, boosting the debt-to-GDP ratio.

"Second is Portugal's strong reliance on international investors to fund its debt. **80% of Portugal's *public* debt is held by foreigners (Portugal is very similar to Ireland in this respect), and its total *external* debt position amounts to 90% of its GDP. The deflationary correction elicited by the austerity measures will in itself be a reason for outside investors to stay away from Portuguese debt.**

"This will continue to be a source of vulnerability because it leaves the country exposed to the continuing risk of having financial markets shutter to its debt. Portugal's government debt, at 82% of GDP, currently sits at less than that of Greece (126%) and Ireland (almost 100%). Yet adding in corporate and private debt, Portugal's debt-to-GDP ratio rises to over 250%. Foreign investors are unlikely to tolerate such situations for much longer. It thus likely Portugal will have to apply for an EU/IMF bailout in a matter of weeks rather than months."

Portugal needs to raise €51 billion to cover its fiscal deficits (€24 billion) and roll over its debt that is coming due (€27 billion). It is highly unlikely that foreign markets will be so kind as to lend the money, and the Portuguese economy is too small to finance that internally. It is a matter of sooner rather than later before Portugal is forced to accept the kindness of strangers.

But then that brings up the problem of Spain. Earlier this year I documented the difficult and mounting problems that are Spain. 20% unemployment. Large fiscal deficits. An external debt situation that is worse than Portugal's.

Yet Spain must figure out how to get €635 billion over the next few years to finance its deficits and bond repayments, which it hopes to roll over into brand new bonds. David Rosenberg wrote a few days ago:

"What is remarkable is that since the Greek bailout was unveiled back in May, instead of alleviating fiscal concerns in the Eurozone periphery, contagion risks have actually intensified. Even with German 10-year bond yields declining 25bps, they have risen nearly 70bps in Italy, 150bps in Spain, 225bps in Portugal, 420bps in Greece and 460bps in Ireland. Once the stabilization fund ends in 2013, there is no way these countries can fund themselves at current debt-service cost levels.

“Ireland may have secured funding, but at a 5.8% interest with nominal GDP declining, the situation is untenable in terms of sustaining any balance sheet improvement. Debt restructuring is inevitable. Looking at current CDS spreads, we are up to around 80% on default risks in Greece, 60% in Ireland, over 50% in Portugal, nearly 40% in Spain (this is big), nearly 30% in Italy and 20% in Belgium. No wonder the VIX is breaking out.

“The risk is one of financial contagion to be sure, but there is the added macro risk as U.S. exports to the EU account for over 20% of the total volume of shipments sent abroad — about double the relative importance of the B.R.I.C.s in relation to U.S. producers. Plus, there is the added deflationary thrust from the strengthening U.S. dollar, which will come home to roost in that large share of corporate earnings derived from foreign sources.”

The US stock market gave a resounding sigh of relief this week when the Irish bailout was announced. This surely solved the problem, right? Right: Let’s solve the debt problem by making them take on more debt. Oh, that the world could be that easy.

"How did you go bankrupt?
Two ways. Gradually, then suddenly."

- Ernest Hemingway, *The Sun Also Rises*

Why Ireland is Like Texas

Let me quickly claim a point of personal privilege here and go into a little personal history that will hopefully offer some insight into the problems facing Europe.

My grandfather was born in West Texas in 1859 (not a typo). His uncle (a Kelly and Irish) was a charter member of the Texas Rangers, which was formed around 1836. When the mayor of Waco telegraphed the Rangers in the 1870s that there was a riot in town and to please send the Rangers, he got a telegram back saying they would be there on the noon train. The mayor met the train and was dismayed to see that only one Ranger got off. When asked why he didn't have more men with him, the Ranger supposedly replied, "There's only one riot, isn't there?" That became the motto of the Rangers: "One riot, one Ranger." These were the toughest SOBs in a tough state. And the uncle was Irish to boot.

Texas started out as a republic and was independent for nine years. The treaty that made us a state allows us to either split into five states (wouldn't that change the balance in the Senate?) or to leave the union, at our choice.

I was once in a hotel bar (a shock, I know) somewhere in Africa and was asked where I was from. "Texas," I replied. "Interesting," came back the response; "Whenever I meet someone from America they always say they are from the US or America. Except when they are from Texas. Then they are always from Texas." Yep. Texas is a state of mind, and those who come here eventually adopt the state as their own. Just seems to happen.

Now, a thought game. What would happen if California and Illinois and New York came to Texas and said, "We think your taxes should double so that we can finance our debt, and please buy even more of our debt next year to pay for our unfunded pensions. Oh, and while you are doing that the Fed is going to print massive amounts of dollars (far, far more than they are now) and destroy the value of the dollar, so your Texas pensions will be worthless.

My guess is that my fellow Texans would look around and decide which Ranger to set on these guys, and make it clear that this was not the ride we had signed on for, and dust off that old treaty and work out an exit strategy.

Understand, in the runup to the recent election our sitting governor talked about secession. I was been in meetings with Very Serious Texas Politicians where secession was earnestly discussed 15 years ago – maybe over some whiskey, but with the conclusion that Texas might be better off without the crushing debt that was coming down the pike.

Do I think that could happen? No. The Fed will never choose hyperinflation, and I do not think you can find 60 Senators to decide that bailing out the states that let their own spending and taxes get out of control would be acceptable with their voters. Further, even though I am a very proud Texan, after 9/11 it was not the Texas flag that brought a tear to my eye, it was the Stars and Stripes. It would have to take a series of massively stupid decisions to bring Texas to the place where it would even remotely consider leaving the union.

Now consider, if I have some pride in being Texan, with less than 200 years of history, proud as it is, what is it like to be Greek or Irish or French or German or any of the European mix? What deep cultural roots must they have? Nearly every country at one point was on top of the heap, and all have rich heritages. There is history around every corner in Europe. Except a history of unity.

If you ask a European in that African bar where he is from, does he say Europe? No, he is from a country. (Unless he is Basque. Or Catalonian. Or Welsh.) One is not from Great Britain but from one of the divers components of the UK. And a large number of Scots want out. Could Belgium split apart? Possibly.

But essentially, what the eurozone is asking Germany (and the Dutch and the rest of "core" Europe) to do is bail out Greece and perhaps much of the rest of the periphery, and to assume massive deficits and rising taxes. Because for there to be enough money for the deficit nations to borrow cheaply, there must be an AAA rating and a 30% cash-to-loan deposit, as I understand it. Spain or Ireland may try and borrow their share of the bailout fund (such irony), but they do not get that AAA rating. For all intents and purposes, it is on the back of Germany and, to some extent, France.

Will German taxpayers go along with that? Will France?
Will the Germans still finance the Greeks in 2013 when they have not whittled down their deficit and the Greeks still want to retire at 50 on full pensions? Will the Irish decide that it is in their best interests to take on massive debt so that French and German and UK banks are paid back? Can the solution to a debt problem be more debt?

Will Texas singlehandedly bail out California so their prison guards can continue to make $100,000 a year? Tough questions.

Next Monday's Outside the Box will be from Dylan Grice, who choreographs a three-part dance in which those in authority first deny there is a problem, then say it is a minor problem and then, when it becomes a large problem, deny it was ever their fault. He lays bare a rich vein of recent history. Those who are denying that the euro is at risk are still in the first steps of that dance.

I have long been a euro skeptic. But that does not mean I am not in favor of the euro. The world is better off with the euro, I think. But for it to survive there must be a huge (as in trillions) stability fund created, and/or the ECB will have to print euros on a level that would make the Fed blush, simply to get the various national debt levels down to where the peripheral countries can actually pay them down.

Can that happen? Maybe. The euro never was an economic currency. It is a political currency, and for it to remain a currency or at some point in the future become an economic currency, it will take massive political resolve on the part of the members of the EU.

I wrote last year that there are only a few paths in front of us. The peripheral European countries can simply default – Greece did so just 20 years ago. Rates got up to 20% for them. Banks would take losses, but the ECB can be the backstop. And after a while people would forget and lend the Greeks money again.

Or some of the peripheral countries can leave and go back to their own currencies, taking the path to devaluation, like Iceland did. Or Germany can decide to go its own way after what will be a very volatile and controversial election in the future.

Or the ECB can print euros and buy out the debt on European banks' balance sheets. Or create a massively large stability fund and combine that with some haircuts for euro bond holders.

There are no good solutions, just very difficult ones. And not one that I see that is euro-bullish in the medium term.

Ten Little Indians. How many will remain in a few years? I wish them well. I really do.

Cabo and New York

I got an email from someone a week or so ago who is in Cabo San Lucas but have misplaced it. If you get this, please write back.

I get back home on Sunday night to a very packed schedule for the next few weeks. Absurdly so, even when I am in town. I will go to New York for a day next Sunday and then back to Texas.

The Forbes cruise has been fun. Renewing acquaintances with the Aden sisters and Rich Karlgaard and being on a panel with Steve Forbes was good times. It was good to get back to Puerto Vallarta and visit Chico's Paradise. It is a treasure of a restaurant about an hour south of PV and is one of my "must do" things when I get to the area. You should check it out if you are ever in PV.

I enjoyed getting to meet Ken Fisher. His speech was very persuasive. He almost made me go out and buy an index fund. Did you know that it has been 70 years since the markets went down the year after a midterm election?

Finally, I was sitting with Tiffani and Ryan in a wonderful little place somewhere on the beach in Cabo, eating guacamole and ceviche. At the end of the meal I reached into my billfold to get the credit card to pay the tab. Tiffani noted that I brought out a business card and rolled her eyes. Even though I do think the entire trip is a business expense, Tiffani said, "Dad, you so cannot make this a business expense," with that little sigh that means Dad is pushing it. It is tough when your travel companion and business partner is also your conscience. But that is why I let her run the show. Keeps Dad out of trouble.

Time to hit the send button. I have to run off to another speaking session, but this one is mostly Q and A with a lot of interaction, so it will be fun. Have a great week, and if you come to the GaveKal conference be sure and say hello.

Your really enjoying Mexico analyst,

John Mauldin