Email Letter #11

Below I have written another email letter to you regarding the ongoing concern about sovereign debt. Although it is not so much in the news these days because we have entered the "silly" season of electoral politicking, it is still of real concern to economists and policy makers worldwide. And it should be of concern to you. If you have any comments or just want to talk about this issue with me, please call at your convenience.

Developed and Overextended

Conventional wisdom says that buying Treasury bonds is the safest place to put your money, and very nearly as safe is putting your money into the sovereign (government-issued) debt of other developed nations like Japan, England, Germany, Spain and Greece.
But I'm sure the first thing that came to your mind when you saw that short list of developed nations was: wait a minute! Didn't Greek government bonds nearly default last Summer? Wasn't Spain on some kind of watch list? Isn't the U.S. deeply in hock to China? And, of course, you're right; there is growing evidence that, after bailing out their economies after living beyond their means for decades, developed nations around the world have overextended their balance sheets.

This has produced one of those strange anomalies that you see in the investment markets from time to time: what may be the safest government bond investments around the world also happen to be some of the highest-yielding.

Much of this is laid out in a fascinating new white paper authored by Rob Arnott and Research Affiliates, Inc. in Newport Beach, CA. Entitled "Debt Be Not Proud," the paper compares the total percentage of government debt outstanding for developed and emerging nations with other measures that hint at these countries' ability to pay back what has been borrowed. The report tallied up the total debt that developed nations--Europe, Japan, the U.S., Canada, Australia etc. currently have on their books--$16.7 trillion in all--and calculated that this makes up 89.5% of the world's total. Yet these developed economies make up only 62.4% of the global economic output (what economists call GDP), and have just 19.1% of the world's population.

That's right; countries with just 19.1% of the world's population have borrowed almost 90% of the world's total sovereign debt.

The figures for the United States alone are not totally comforting, but by at least one measure, we are not out of line. The U.S. population represents 5.9% of the world's people, but our economy makes up 23.6% of the world's GDP. Our share of the total debt: 23.2%, slightly less than our share if measured in terms of economic output.

The situation is completely reversed for the smaller, less-developed countries, and yet they're paying MORE in interest to borrowers than the larger, less-solvent nations. In aggregate, the government debt of emerging markets is paying more than twice what U.S. Treasuries are offering. The International Business Times recently estimated that 10-year bonds issued by countries like Malaysia, India, Peru and Hungary are yielding an average of 6% a year, compared with 2.5% for U.S. Treasury bonds of comparable maturity. The article notes that many of these less developed countries are in better fiscal condition than the nations whose banks teetered on the edge of collapse during the credit crisis and recession.

This assessment is confirmed by the Research Affiliates white paper, which points out that total government debt issued by emerging market nations--just over $1.95 trillion--equals 10.5% of the world's total. Yet these economies include 80.9% of the world's population and their economies generate 37.6% of the world's economic output. The paper argues that their balance sheets are, by these measures at least, much stronger than the countries you normally associate with economic strength. Indeed, the report notes that China and Russia have foreign reserves larger than their respective bond debt, while Saudi Arabia, Kuwait, Qatar, the Cayman Islands, Monaco and Lichtenstein all have zero net debt. Of the 45 emerging markets that are included in various indexes, only Taiwan and Singapore have as much debt as ANY of the G-5 countries, measured relative to GDP--and by most measures, those two countries really belong on the developed side of the equation.

What does this mean for investors? Emerging market debt is probably yielding a bit more than the fundamentals would justify. But the real story may be just how overextended the developed world's balance sheets have become following the recent economic trauma. Greece and Spain may be the headlines today, but the industrial nations that don't successfully reign in their borrowing in the next ten years could become the subject of scary headlines somewhere down the road.

It may be worth noting that Year-to-Date as of July 31 Emerging Market debt mutual funds and ETFs have returned about 19.1% besting Emerging Market Equity Fund, Domestic Large and Small Cap Fund and Developed Market International Fund Indices according to JP Morgan.

Research Affiliates white paper can be downloaded here: http://www.researchaffiliates.com/index.htm

Emerging markets debt vs. Treasuries: http://www.ibtimes.com/articles/62196/20100914/emerging-markets-bonds-yields.htm