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300 Greeks



2010 is the year of exits. The current concerns over Greek sovereign finance are natural as investors continue to worry about the country's large-scale debt, compounded by several years of less than

prudent or transparent fiscal management. The solution is a significant 'deleveraging' (repayment of debt) episode that has negative implications for economies and risk assets and which should prolong the period of low interest rates.

Just like the Greeks at Thermopylae (August or September 480 BC), the emphasis needs to be on covering one's exit.

Aware that his force was being outflanked, Leonidas dismissed the bulk of the Greek army, and remained to guard the rear with 300 Spartans, 700 Thespians, 400 Thebans and perhaps a few hundred others....

So far, 2010 has looked very different from 2009. Last year the markets moved from a fear of economic depression to a concern about the strength of recovery. The authorities' enormous fiscal and monetary policy efforts appear to have been sufficient to turn the world economy around, but the bill for previous excesses still needs to be paid. The tricky balancing act for authorities in 2010 will be to pay for these excesses while avoiding a capital shortage similar to that which occurred in 1994. We have argued repeatedly that, saddled with debt, the Western governments can not contemplate anything but a fiscal 'exit'.

Possible policy mix

Year	Monetary policy	Fiscal policy
2009	Extremely loose	Extremely loose
2010	Loose	Neutral
2011 / 12	Loose	Very tight
2013 / 15	Neutral	Tight

Source: Newton

Removal of certain liquidity measures that have kept markets open is a given, but a rapid reversal of quantitative easing measures or increases in short-term rates appear very unlikely given the focus of markets upon debt/GDP levels. Raising rates while increasing one's borrowing levels at 12% of GDP per year without a credible plan to reduce them is tantamount to the Spartans sending the Greeks home but handing their weapons over to the Persians as well.

There are two difficulties with a fiscal exit strategy: first, when to apply the pain and, secondly, ensuring that the markets trust its architect to follow it through. The current Greek government seems ready to start to apply the medicine this year in the hope that the economy will be strong enough to bear the pain. A fresh liquidity injection from the European Union (EU) will no doubt ease the burden, but the Greek electorate is not as compliant as its Irish counterpart. The Greek government enjoys good support at the moment, but this honeymoon may not last once the full effects of spending cuts and tax collections take hold. We see the Greek bond market as attractive at current high-yield levels, especially when compared to Central European peers; but there is likely to be significant volatility in Greek bonds over the coming months.

The EU has endorsed Greece's current budget plan and will put in place new economic statistics monitors. Once Greek data is endorsed by the EU, the risk of default should be diminished substantially. Following the EU's prompt decisions, there could be a period of relative calm but Greece has significant refinancing to carry out before May and the potential public backlash will keep the market on its toes. The other weak link in the euro 'shield' is Portugal. Once the 'shorts' on Greek debt are closed, attention will shift to Portugal as its recent budget did not contain sufficient cuts. Further contagion to Spain and Italy looks unlikely as both countries' public-sector debt positions are much less precarious.

The other notable feature of 2010 is that 'risk on, risk off' is back. 'Risk on' won the battle decisively last year as growth expectations changed significantly. This year the battle will continue, but the 'easy' wins have been achieved. Economic growth momentum

seems strong (as evidenced by the recently released U.S. Institute for Supply Management survey), but there will be substantially less support from the authorities in the period ahead and some issues have not been resolved. Most obviously, the battered housing market in the U.S. is still a drag on wealth and a debilitated Western banking system is hampering recovery.

Eventually these negative factors will be overcome and, in the meantime, high levels of cash on companies' balance sheets, together with low official rates, should keep the world's major economies from a 'double-dip' scenario while fiscal tightening begins. Tight fiscal policies with loose monetary policies can be good for the long end of bond markets (as long as output gaps stay wide). We believe that Europe, through the straitjacket of the euro (Maastricht rules), will be forced to follow this tighter path sooner than the U.S. or the UK. This is good news for the German bond market in the near term and also for the peripheral European markets if and when their exit plans prove credible.

This fiscal and monetary policy mix is not good for the currency and could result in a gradual devaluation of the euro. The most interesting market response so far in 2010 has been the strength of the U.S. dollar during both the 'risk on' and 'risk off' phases. The dollar looks oversold, and markets may be turning their attention to the balance of policy response. If the U.S. is slower to tighten fiscally but keeps its monetary policy loose meanwhile, the dollar could continue to benefit against the euro.

Summary

A pro-dollar currency stance, coupled to a pro-European bond market stance, seems the best way to play the early part of the 2010 'exit year'. Like the Greeks at Thermopylae, when you are about to be overcome by Persians (bond vigilantes) it is important to know you have a plan.

All data is sourced from Bloomberg unless otherwise stated.

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