

MARKET COMMENTARY

Investors warned to prepare for Sovereign default and another double dip in 2010

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There is a very real possibility that we will see Sovereign nations defaulting on their debt as well as a double dip in the global economy as the next step in the ongoing global financial crisis, says Michael Lang, Chief Investment Officer and Principal of NZ Funds.

On 26 November, Dubai World announced it was seeking to delay repayment of its US\$60 billion dollar debt. Ordinarily a private company's financial difficulties have little or no international ramifications, but according to Lang this is no ordinary company.

Because Governments of the world are as heavily indebted as their populace there is zero room for error, Lang says. Any "error" may result in another double dip to the global economy next year.

In a recently released research paper, Lang said Japan has the highest total central government debt as a % of GDP of in excess of 162%, but then just as vulnerable were smaller countries like Greece and Belgium. Even the United Kingdom's debt load is becoming unsustainable as it is currently around 60% but forecast to increase to over 90% by 2014.

Today's paradox could be a deflationary shock that generates the inflation much feared by bond gurus. If inflation comes in the form of a currency and debt dislocation, then it will come at a terrible cost. "Severe deflation is indistinguishable from hyperinflation," Lang warns.

Whether the catalyst is Dubai World, a second downturn in the global economy, or more likely some totally unforeseen event, Lang cautions participants in the global financial markets to consider strategies for preserving their capital.

"At some point we will find a tipping point and that will unseat the pyramid of sovereign debt that has been accumulated. When that happens, those investors who have been taking excessive risks will once more be exposed".

Lang says Dubai World is a high profile sovereign wealth fund. The United Arab Emirates-backed company is behind some of the most ambitious projects undertaken in modern

times including the Palm Jumeirah, the world's largest artificial island and the Nakhell Tower, the world's tallest building. It is also the third largest port operator in the world following its acquisition of Peninsular and Oriental Steam Navigation Company (P&O) of the United Kingdom.

The markets short term reaction to this news has been underwhelming, despite recent share market volatility. "If one of the seven countries which comprise the United Emirates, one of the world's wealthiest regions, are drowning in debt what are the implications for the rest of the world? It is my pick that in 2010 extraordinary events will unfold and when they do the ingrained positive prejudice that sovereign defaults are things of the past will be overcome.

"Let's face it, despite its large global portfolio, Dubai World is globally insignificant. But how many fund managers hoovering up shares in emerging markets have considered the ramifications of larger sovereign nations defaulting?" asks Lang.

"The possibility of a 1930's style debt deflation is as repulsive now to Government's around the world as it was in 1930's," Lang claims. During the great depression, US Secretary of Treasury Andrew Mellon was vilified for his advice during the great depression to "Liquidate labour, liquidate stocks, liquidate the farmers" to "purge the rottenness out of the system."

"Faced with a similar crisis today almost every Government in the OECD has not allowed a nationwide liquidation. Instead they have borrowed and spent. Unfortunately they may have borrowed too much, leaving them as vulnerable to default as their indebted citizens.

"Eighteen months ago the US consumer had private debt of 100% versus GDP, today that number has scarcely changed, but US public debt has now ballooned to nearly 90% of GDP."

Lang points out that Governments' can not go on borrowing and spending indefinitely. "The longer it takes to revive the global economy the higher the risk that we will see a major sovereign nation default.

“Investors forget that within the last 50 years we have seen many Latin American and Asian countries default, as well as Russia. Even the United Kingdom had to go to the IMF cap in hand in 1976.”

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