

From the Editor....



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Market Update

There has been a substantial increase in the role of government in business since the start of the global financial crisis (GFC). This has become even more evident in Australia over the past few weeks as the influence of government is getting large in business.

Governments around the world believe via their actions they saved us all from a significantly worse economic fate. No doubt, the swift action of many governments in terms of stimulus did save us from a much deeper global recession. That includes Australia, where the Rudd Government has done an admirable job in terms of its initial reaction to the GFC. They acted decisively, swiftly and in scale.

However, it's the next leg of the post GFC reaction that leaders of the business world are now afraid of. The next leg is basically "the system failed us, capitalists can't be trusted, and we need to run this show". The next leg will involve over-regulation and over-legislation. It will be classic shutting the door after the horse has bolted and will place too much power in the hands of the governments. But its populist to tax the rich and its happening right here, right now.

Already in Australia we have had decisions taken in Canberra that have seriously affected the price of a given equity. It's not just a gun to the head of Telstra. The Federal Government introduced an alcopops tax with no

consultation with the industry, hurting Fosters. The government issued what is effectively a "use it or lose it" ultimatum to Woodside Petroleum over their massive Browne basin reserves, giving them just 120 days to come up with an answer. The stock has fallen quite substantially since then. Then just recently we saw the PM basically tell Westpac customers to find another bank, while we have seen reviews into the wealth management industries and the entire taxation system under the Henry Review. Of course, the Emission Trading Scheme (ETS) is another huge piece of regulatory risk across a variety of sectors that has and will affect equity prices.

The risk of being sideswiped as an investor by the stroke of a pen in Canberra has never been higher. Business and bureaucrats don't mix and regulated returns are lower returns.

This doesn't mean we can't make money, but we need to be aware that this is a different playing field with a government that follows through on its rhetoric.

This is obviously not just the issue in Australia. This is a global event and one that the mighty Goldman Sachs recently caved into by agreeing to pay their staff bonuses in shares. You can see that the White House played a role in that decision, and when the greatest capitalists in the world bow to political pressure you know you are operating in a different environment.

In the UK, new government legislation has slapped a 50% tax on any bankers-

bonuses over 25,000 pounds.

Sovereign Debt Defaults

Governments the world over have spent the past year bailing out, backstopping, insuring, and stimulating their financial sectors and economies. Trillions of dollars, euros, yen, and pounds have been thrown around. Officials have assured us there's little risk to that strategy.

But we have warned that the opposite is true. At the end of the day the basic fundamentals are: If you borrow and spend too much, all you're going to do is transform a Wall Street debt crisis into a Washington debt crisis.

The bill for all this global fiscal and monetary stimulus is beginning to come due. Debt and deficit problems are going from bad to worse in many nations. That's raising the very real risk of the unthinkable: Widespread SOVEREIGN debt defaults.

The first sign of this came when Dubai dropped a bombshell on the markets. A government-backed holding company, Dubai World, warned that it needed to restructure its debts. The firm has massive debts of US\$26 billion in obligations tied to its property development arm Nakheel and other subsidiaries.

The United Arab Emirates tried to alleviate market concerns by pledging some aid to regional financial institutions. Many investors were also initially reluctant to sell their regional holdings because they believed Dubai's oil-rich neighbor Abu Dhabi would step in and bail Dubai out. But that optimism is rapidly fading. The prices of bonds issued by Nakheel, as well as other Dubai-backed companies like DIFC Investments and Dubai Holdings Commercial, are dropping fast. Moody's added to the concerns by downgrading the debt of several Dubai firms.

Even more troubling: The cost of credit default swaps — a form of bond insurance — on Dubai's own official government debt is exploding. It now costs \$545,000 a year to insure \$10 million of Dubai debt against default, more than twice as much as a few months ago.

The most troubling aspect of this is that Dubai is NOT alone.

Greece is part of the European Union, and it's rapidly sliding down the slope toward default. Its budget deficit has exploded to 12.7 percent of GDP, the worst in the 27 EU countries, while its outstanding public debt load is on track to hit 125 percent of GDP next year.

In order to avoid stiff EU sanctions and penalties, Greece is slashing its operations budget by 10 percent. The government is also planning a 2010 hiring lockdown and a partial public salary freeze. Greece's Finance Minister George Papaconstantinou says there is "absolutely" no default risk.

But those measures don't appear to be comforting investors. The Athens Stock Exchange General Index has plunged more than 28 percent from its mid-October high. Meanwhile, Greece's two-year government debt just dropped in price by the most in 11 years.

Fitch has already cut Greece's sovereign debt rating to "BBB+." That's the third-lowest investment grade rating. Standard & Poor's rates Greece "A-," but that rating may be lowered soon.

Bottom line: We're facing the very real possibility of a significant sovereign debt default or bailout in Europe.

What about Spain? The U.K.? The U.S.? At times like these, investors naturally ask themselves where the next domino might fall. How about Spain? S&P just lowered its credit outlook for that country to negative from stable. The ratings agency cited "pronounced deterioration" in the country's public finances.

Spain is in trouble because it experienced its own gigantic housing bubble, one that has long-since popped. Unemployment is on track to top 20 percent in 2010, while the nation's deficit is swelling toward 11 percent of GDP. The economy has shrunk for six straight quarters, prompting the government to spend billions of dollars to stimulate growth.

Then there's the U.K. Its budget deficit is running at 12 percent of GDP, the highest in the Group of 20 community of nations. As previously mentioned, that's forced the government to impose a 50 percent tax on banker bonuses, and to boost income taxes. Despite those moves, the U.K. Treasury is still going to have to borrow billions more pounds than it originally planned to fund its deficit.

And what about the US? The fiscal 2009 budget deficit here soared to \$1.4 trillion, the worst ever. That was equal to 9.9 percent of the overall economy — almost triple the level of a few years ago and the highest in the nation's history, excluding years where deficits were bloated by massive war spending (i.e. World War II). Over the next decade, the Congressional Budget Office projects an *additional* \$7.2 trillion-plus of deficits.

The US are now borrowing record amounts of money. In the week of the US Thanksgiving holiday alone, the U.S. was forced to sell a whopping \$118 billion in debt. That included \$44 billion in two-year Treasury notes, \$42 billion in five-year notes, and \$32 billion in seven-year notes — all record amounts for any single auction.

The US debt load is rising so fast, Congress will soon need to raise the so-called debt "ceiling." The current \$12.1 trillion limit could reportedly jump by as much as \$1.8 trillion.

Everyone knows the cap is a joke. Every time they come close to tagging it, lawmakers just raise it again. But the frequency and size of those increases is getting totally out of control.

Indeed, we may be seeing the first signs of a bond investor rebellion. The recent auction of \$13 billion in 30-year bonds bombed big time. The Treasury could only sell the debt by offering much higher-than-expected yields, and even at those elevated yields, key measures of demand were weak.

Result: A key interest rate spread — the difference between yields on 2-year notes and 30-year bonds — blew out to 372 basis points. That's the highest in 29 years of record keeping.

The loud and clear message from the bond market? We will buy very short-term Treasuries, but if you want to borrow long-term money at the same time you're printing dollars like crazy and selling the most bonds in the history of the world, you're going to have to pay up!

Nobody expects the U.K. or U.S. to lose their AAA debt ratings anytime soon. But Moody's just warned in a report that both countries' ratings are at more risk than those in other triple-A rated countries like Germany and France. And we don't see any credible plan coming out of Washington to get their disastrous budget situation under control anytime soon.

 Information in this Newsletter is drawn from various sources, including extensive and comprehensive research by FN Arena, Bloomberg and the local press.

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