The Global Economic Doctor

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Life During Wartime

This ain't no party, this ain't no disco,
This ain't no fooling around
No time for dancing, or lovey dovey,
I ain't got time for that now
— Talking Heads, Life During Wartime.

Summary: The narrative for the global economy is going to be dominated by political risk factors through the rest of 2016 and well into 2017. Brexit was certainly a factor in the US Federal Reserve's decision not to raise rates in June and July; the massive injection of uncertainty into markets in the aftermath of the British vote will pressure the US central bank not to raise rates again in 2016. There will be further pressure not to raise rates from the uncertainty surrounding the US presidential election in November. Other headwinds to global growth include what could be a worsening bank crisis in Italy, a recession in the UK and possibly other countries in Europe. Asia, the Middle East and Latin America have their own set of political risk factors, which add stress to markets. Moreover, Q2 2016 US corporate earnings, which start this week with **Alcoa**, are not likely to lift markets on a sustained or meaningful basis. The consensus view is that the S&P 500 Index companies are expected to see another drop; this time a 5.1% decline year-on-year. This is better than Q1's 6.8% decline in profitability. The thing to watch with earnings is the outlook for the rest of the year. Markets will be keying in on what CEOs have to say about the business environment for the second half of 2016. Our view is that they will be saying what they have been stating over the last several quarters – it is difficult to forecast due to weak global growth, slowness in wage expansion in the US, and political uncertainty. The exclamation point on all of this was the tragic, racially-charged violence that very recently marked the US in Minnesota, Louisiana and Texas. It is, therefore, easy to look at the world through the lens of the Talking Heads song, some of which is quoted above. The path forward is through a fog of uncertainty and risk. If political and economic conditions deteriorate further, the issue facing investors is increasingly going to be not one of a getting a higher rate of return, but preservation of capital. Cash remains attractive and gold, gold stocks, utilities and US Treasuries are likely to have a good run as we sift through the variables in challenging markets and investors are driven to safe harbors.

Table of Contents

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Another Crack in the EU Wall — Italian Banks

Scott B. MacDonald, Ph.D.

Since 2008, Europe has stumbled from one crisis to another. First, there was the impact of the Great Recession. Next, sovereign debt problems in Greece, Ireland, Portugal and Cyprus. The socio-political turmoil related to waves of migrants from the Middle East and Africa culminated with Brexit in June 2016, which witnessed one of Europe's major economies deciding through the ballot box to leave the European Union (EU).

Now we have a simmering crisis with Italian banks, which could make Italy the next major EU crisis.

Italian banks were problematic before the June 23rd UK referendum, but are even more problematic after the vote, as the banks are one of the weakest links in the European banking chain. Weighed down with troubled loans, the Italian banks are caught up in the cross-currents of trans-European angst over the EU's and Italy's own particular brand of politics.

Considering that the Italian economy is the third largest in the Eurozone at $1.86 trillion and has extensive trade and investment linkages with Germany, France and the UK, the systemic shakiness of Italian banks represents a major contagion risk to the rest of Europe.

Italy's banks have a history of opaqueness, carrying sizeable amounts of bad loans and keeping a number of weak Italian companies on life support. Over the last several years there have been improvements in making the banking system more transparent, dealing with some of the capitalization issues and bringing Italian banks closer to other major EU banking standards. However, the Italian economy has been weak and the business environment in Europe since 2009 has been difficult.

Europe's banking regulators have been putting pressure on the Italian authorities to further clean up their banks and force them to either sell or write off bad loans. Italian banks have been slow in this regard and are estimated to sit on problem loans worth €360 billion (US$396 billion). The Italian government wants to recapitalize its banks, probably to the tune of US$45 billion, but European regulators are opposed to any bailout. New EU rules (pertaining to bank resolution) seek to protect taxpayers from assuming the cost of keeping banks afloat and instead transfer that cost to investors (referred to as a bail-in). These investors would lend money to the banks by converting their bank bonds into equity, which, in turn, would probably be worth less.

Italy's Real GDP (%)

2012	2013	2014	2015	2016	2017
-2.4	-1.9	-0.4	0.8	1.0	1.0

Source: International Monetary Fund.

European banks have generally been under considerable stress since the Brexit vote, but Italian banks have been hurt the most by nervous investors. In particular, **Banca Monte dei Paschi di Siena** (MPS), the world's oldest bank and Italy's third largest, is under acute pressure as regulators have upped the amount of bad loans they want the institution to remove from its books. MPS's stock price has fallen 80% over the last 12 months, which obviously raises questions over capitalization.

This is where the new EU bank rules are creating a crisis. While the Italian government is inclined to make capital available for MPS and other banks, new EU laws make this illegal. The situation is further complicated by who holds Italian bank debt. According to the economic research organization, Bruegel, Italian families own about a third of Italian bank debt. As *The New York Times* Peter Eavis noted (July 7, 2016): "Not only would bail-ins focus the pain on Italian households, the fear of losses might also prompt investors to stop lending to banks and lead depositors to withdraw their money. This would make a bad, but manageable, situation much worse."

Matteo Renzi
Prime Minister

Political factors add another layer of complexity. The center-left Renzi government has called an October referendum to push through changes to the country's constitution, which will help the government to implement badly needed economic reforms. Since Italy adopted the euro in 1999, the economy has barely expanded. Real GDP growth in 2015 was an anemic 0.8%. The IMF is calling for 1.0% GDP growth in 2016 (but we expect it to be lowered due to the impact of Brexit on trade and tourism). Unemployment remains stubbornly high, over 11%, and there are serious issues related to pensions due to the country's poor demographics. All of this feeds back into the political picture.

The October referendum looms large over the Italian landscape. Prime Minister Matteo Renzi's center-left Democratic Party did poorly in recent municipal elections, with the populist Five Star Movement's candidates winning control of the mayor's office in Rome and a few other key cities. The next election contest is the October referendum. A major bank crisis in the lead-up to the October vote could set the stage for Renzi to lose. As *The Economist* (July 9th 2016) noted: "The feeling will grow that Italy is getting scant benefit from the supposed pooling of risks across the euro zone, but is damaged by the many constraints it is under – by its inability to devalue its way towards stronger growth, by a fiscal compact that shackles its budget, and now by bail-in rules that came in after other counties had bailed out their banks."

If Renzi loses the referendum his government is likely to fall and

Italy Political Map *Source: Nations Online Project* new elections would have to be held. Opinion polls indicate that if an election were held today the Five Star Movement would defeat the Democratic Party. This clearly has implications in terms of risk as the Five Star Movement's platform includes a referendum on Eurozone membership (holding out a possible return to the lira), tax cuts and spending increases. Considering this mix of policy options, it is likely that Italy would face much higher sovereign bond yields, further economic weakness and greater pressure on its sovereign ratings (Baa2/BBB-/BBB+).

To this we would add that the Italian general government debt/GDP ratio is the third highest among advanced economies after Japan and Greece at 132.7% (according to Eurostat). A major crisis in the banking sector could rapidly complicate the sovereign's access to international capital markets. Italy's debt is in excess of $2 trillion — quite possibly too big to bail out.

What to do? Despite resistance from Germany and other northern European countries, the EU should allow the Italians to recapitalize their banks by a rapid injection of government cash. In return, the Italian authorities will have to commit to a more rapid cleaning up of bank portfolios, either selling off troubled assets or writing them off entirely. Short of this, the EU runs the risk of alienating voters in another key European economy. The Renzi government is trying to do the right things; a Five Star Movement government could well trigger the departure of Italy from the euro zone. Along these lines we concur with *The Economist* view, "If Italians were ever to lose faith in the euro, the single currency would not survive." We believe that Italians are already very close to that loss of faith.

What to do? Despite resistance from Germany and other northern European countries, the EU should allow the Italians to recapitalize their banks by a rapid injection of government cash. In return, the Italian authorities will have to commit to a more rapid cleaning up bank portfolios, either selling off troubled assets or writing them off entirely.

Although Brexit is dominating the headlines, the Italian banks represent a major risk to European and global economic growth, especially if there is some contagion to other European banking systems. The US is to some degree buffered from the Italian problem, though any cooling in markets and growth complicates the policy environment and the job of the US central bank.

Looking ahead, Italian banks are likely to loom larger on the risk agenda, making it incumbent on the EU and Italian authorities to find a solution. Timing is everything; a systemic banking crisis in Italy, which hurts households, could have political consequences akin to Brexit.

Italexit anyone?

U.S. Virgin Islands – Another Puerto Rico in the Making?

The US Virgin Islands (USVI) is located in the Caribbean, has a population of 106,400, with an economy based largely on tourism. It is a territory of the United States. As another US territory, neighboring Puerto Rico has fallen into a major debt crisis, it is possible that the same is occurring in the USVI. According to Bloomberg, the USVI has US$2.4 billion of debt spread across a number of issuers, which amounts to US$23,000 in debt for each resident. This is more than Puerto Rico, where debt per resident equals US$20,000. And for those watching, Puerto Rico has just defaulted on its US$72 billion of debt.

Although the USVI's debt levels are nowhere as consequential as Puerto Rico's, the USVI is in trouble. In June and July, rating agencies were active in downgrading the territory's bonds, with Moody's taking the USVI's Matching Fund Revenue Bonds to B1 and B2 from Baa2 and Baa3. According to the agency, the ratings downgrades "primarily reflect a closer alignment of these special tax ratings with the Virgin Islands government's general credit position, which has continued to erode and reached a severely weak condition. The government's challenged financial position increases the possibility that it will use the matching fund revenue credit for new deficit financings, as it has in the past. Additionally, while the legal structure of the matching fund bonds is stronger than the government's unsecured general credit quality…it has not been tested in a stress scenario, and warrants a closer alignment of the matching fund bonds with the government's credit as its finances weaken."

Also according to Moody's, the USVI's government credit profile is defined by "persistent general fund deficits addressed primarily with repeated deficit financings; very high and rising debt levels; declining gross domestic product and population; high unemployment; and a large unfunded pension liability." Moreover, "A further challenge is the government's need to access the capital markets to balance its budget and to bolster its liquidity, and the severe stress that could result without this access."

Fitch has also put the USVI's ratings (between BBB to BBB-) on watch for a possible downgrade for many of the same reasons as Moody's. In acting, Fitch took into consideration new US legislation, S.2328, an act known as "Puerto Rico Oversight, Management, and Economic Stability Act" or PROMESA. Prior to PROMESA "the perception was that territories were assumed to be like states which would not themselves be subject to insolvency proceedings. PROMESA creates a framework to allow an oversight board to initiate proceedings aimed at restructuring territorial tax-backed debts as if the territory itself was a municipality." This is a major change in how rating agencies are likely to see debt issued by US territories.

Governor Kenneth Mapp
US Virgin Islands

Fitch further noted that while PROMESA does not create an oversight board for territories other than Puerto Rico, the treatment of debt in other US territories (namely Guam and the USVI) could see the same treatment, especially from the standpoint that "the rating of the tax-backed debt of other territories would be consistent with the approach taken when rating municipal debt in states where local governments are not currently authorized by state government to file proceedings under Chapter 9."

The government of the USVI strongly denies that its territory is heading in the same direction as Puerto Rico. According to Governor Kenneth Mapp, "The bonds of the Virgin Islands are not in jeopardy, nor are we 'shadowing' Puerto Rico in its default of its bonds. We've structured our debt completely differently than how Puerto Rico structured theirs." That may be the case, but the Virgin Islands still remain dependent on markets to refinance its debt and that means it has to find buyers. Considering the tough conditions facing the Virgin Islands' economy in recent years, the rating agency pressure on its ratings, and the long shadow being cast by Puerto Rico's debt crisis, the US could have another debt crisis, albeit much smaller in nature, in the Caribbean.

Risk, Markets, and the 1930s – Redux?

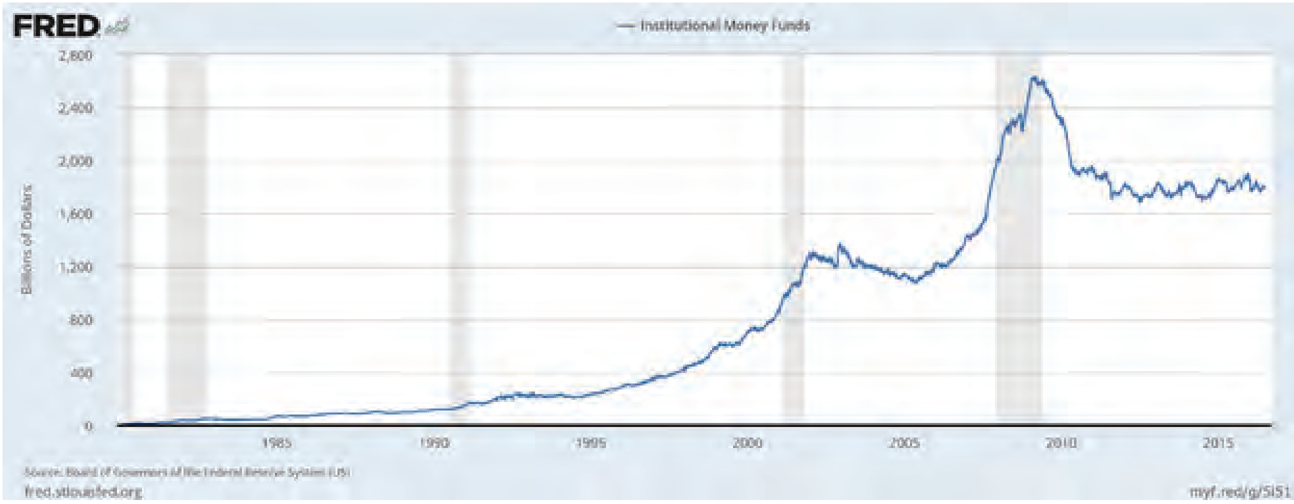
It was a time of economic dislocation, profound public discontent with political and business elites, rising populist leaders advocating simple solutions to complex problems, and a sharpening of ideological lines both within countries and between them. It was a time of civil war (Spain), military interventions, an aggressive questioning of longstanding borders and the willingness of certain parties to use terrorism. We are, of course, talking about the 1930s, a period of extended economic disequilibrium and political upheaval that eventually slid into worldwide conflict.

Like the 1930s, we have slipped into uncharted territory characterized by political grievances trumping economic considerations, a spreading willingness to use violence to resolve differences, and a sharpening of battle lines between "us" and "them" in many countries. Europe is increasingly divided between populist nationalists who are disillusioned with the rule of an unelected bureaucratic elite in Brussels and center-left political groups who strongly identify with the grand European experiment of market unity, political stability and an extensive social system. Brexit fits into this context, as the perception exists that the European experiment was hijacking British national interests and that the dominant force in the EU was Berlin. Brexit is a disruptive event — even if it ultimately does not result in an actual UK exit.

At the same time, the more autocratic states of China and Russia face substantial economic problems and no longer carry strong ideological axes to grind; rather they have taken advantage of old-fashioned nationalism to bolster leadership figures and asserted old territorial claims to bolster their positions with potentially restless populations. For China, the place to assert nationalism is the South China Sea, Taiwan and East China Sea. For Russia, the place to show the flag is the region between Moscow and Berlin, a traditional arena that encompasses Ukraine, Belarus, Moldova, and the Baltic states.

Japan is preoccupied with a shrinking population, a near-stagnant economy and how to contend with a rising China. The ruling Liberal Democratic-led coalition's victory in the July 10th election could also add to the gloom as it has given the Abe government enough seats in the Diet to make changes in the constitution, including having the ability to hold a referendum on rewriting Article 9 that prohibits Japan's military from embarking upon overseas missions. For parts of Asia, this brings back memories of Japanese military adventurism in the 1930s that led to World War II.

At the same time, emerging market powers are struggling from the collapse of commodity prices and China's cooling economy. In Brazil, the situation is compounded by massive corruption scandals that knocked an incumbent president out of office and ensnared a large group of other political and business leaders. In South Africa, corruption is also affecting the Zuma government and a severe drought is savaging the economy; while in Nigeria, the radical Islamic group, Boko Haram, challenges the government in the north and another insurgent group, the Niger River Avengers, is active in the oil-producing region, disrupting exports. Saudi Arabia and Iran continue their Cold War, while each government grapples with substantial economic challenges. In Turkey, the increasingly autocratic government of President Erdogan faces a restive Kurdish population, radical Islamic terrorism with links to the Islamic State, and tensions with Syria and Russia. It appears that the high-flying emerging markets of only a



few years ago have given way to countries bogged down by internal political and economic fissures.

As for the United States, racial problems continue to percolate, with lethal shootings of two African-American men in Louisiana and Minnesota and five police officers in Dallas, Texas. Moreover, the presidential election, which is just starting, portends to be nasty and highly polarizing. Whoever wins in November will face an enormous task of unifying the country, addressing public frustration with widening income inequalities, how to generate jobs and determining the right foreign policy approach to an increasingly more volatile world.

The combination of all-of-the-above means debt, equity, commodity and currency markets are going be volatile. Investors will remain skittish and the search for safe harbor investments will maintain pressure on sovereign bond yields, possibly pushing US 10-year yields closer to the negative zone before all is said and done. If nothing else, the low interest rate environment is going to be with us much longer than anyone initially expected.

This low rate mix is also pushing investors into more risky assets, such as high yield and emerging market bonds. While investors may not want to be in those markets, they have to consider them as the demographics of advanced economy country populations demand rates of return that the growing number of retirees can live off. In turn, lower rates and the need for financial products with some rate of return is encouraging high grade corporates to issue more debt, which is readily absorbed. The other option for many investors is to buy gold, or gold company securities, or remain in cash. According to the Federal Reserve Bank of St. Louis, institutional funds hold roughly US$1.8 trillion in cash.

2016 is a year of uncharted terrain for investors, with everything from negative interest rates to an abnormally abnormal US presidential election. Polarization marks most political systems in advanced economies and there is discontent with political elites in many emerging market countries, including Brazil, Venezuela and Turkey. We have reached a stage where we drift between being in a light version of the 1930s or heading into the Great Depression with wrong policy ideas and a penchant for conflict.

Perhaps the words of author Bernard Beckett are worth noting, "Human spirit is the ability to face the uncertainty of the future with curiosity and optimism. It is the belief that problems can be resolved. It is a type of confidence. And it is fragile. It can be blackened by fear and superstition." Currently there is too much fear and there is a pressing need for greater confidence. Policymakers from Washington and London to Beijing and Brasilia need to understand this and take action. Failure to do so leads into the 1940s and we all know what happened in the first part of that decade.

The Global Risk Monitor

Rank	Risk
1. Federal Reserve Stumble (last week #1)	The Federal Reserve remains at the core of decision-making for the US economy and, by extension, the global economy. The direction of US interest rates is clearly central to the conduct of daily business, the running of markets, and economic decision-making around the world. In 2016, the problem is that confidence in the Fed has slipped. Forward guidance has become a flop and there are many who question the fortitude of Fed Chairperson Janet Yellen in the face of any new systemic financial crisis. While some of the blame for this sits with an unpredictable global political environment, the confidence in the Fed has eroded, partially as it appears that the US central bank no longer has a clear direction on the policy front. This could be very dangerous in looking ahead, as interest rates could head lower and prospects for a recession could grow. We do not expect any raising of rates in 2016.
2. European Disequilibrium (last week #2)	The June Brexit vote created a new crisis for Europe; in July, Italian banks appear to be the next crisis to emerge. Italian banks have considerable problems with around US$400 billion in troubled loans and are in need of recapitalization, probably to the amount of US$40-45 billion. The Italian government would like to step in and inject capital. The European Union, operating under new rules to protect taxpayers, says not so fast, as bailouts are now illegal. Instead, the Italian government is expected to preside over a bail-in which would see bondholders have their debt converted into equity (at a loss). The problem is that a third of bank bonds are held by Italian families. Although the EU law would protect taxpayers, some of the same taxpayers are holders of Italian bank bonds and would be hurt. On top of this, Italy has a referendum on constitutional reform set for October, which could be turned into a vote of no confidence in the center-left reformist Renzi government, leaving the door open for the opposition Five Star Movement to come to power and have their own referendum on returning to the lira. Elsewhere in Europe, the natives are restless with more referendum talk in the Netherlands and France. Europe and Italy need to quickly resolve the capitalization issue; otherwise this crisis is likely to grow.
3. China's Challenges (last week #4/ raised one notch)	China has multiple problems, which keeps Asia's largest economy on our watch list. These problems range from a population that is aging faster than it is growing rich, major pollution issues, painful questions over future water scarcity and food security, and a painful (but necessary) economic restructuring. One challenge that cuts across all of these problems is how to deal with China's massive surge in debt over recent years. Since 2008, China has opened the credit gates and only recently sought to come to terms with the problem. In early May, a front page article in the *People's Daily*, the voice of the Communist Party, warned that high leverage could spark a financial crisis. Although public sector debt is low — a little under 50% of GDP — corporate debt has expanded rapidly in recent years, taking China's overall debt (according to the Bank for International Settlements) to well over 200% of GDP — above the US and Germany and a little below the UK, Italy and France. (Japan, of course is in a league of its own.) China must do much more to reduce debt; if it fails to do so and there is a wave of corporate defaults (openly admitted or nor not), the costs will be felt in fiscal pressure, capital flight and a further reduction in foreign exchange reserves, all of which will push China's economy toward a hard landing. While Chinese authorities can use their usual lack of transparency to hide some of the carnage, this is a major problem and involves not just Chinese banks, but foreign creditors and investors as well.

Rank	Risk
4. US Presidential Elections	The US presidential election season is about to shift into higher gear, with the July conventions set to show off the respective candidates, their vice presidential selections and platforms. Democratic candidate Hillary Clinton was able to dodge a major bullet in avoiding being indicted over her email scandal at the State Department. If nothing else, Clinton's avoiding the indictment and ability to ride through the outrage of her husband meeting with the US attorney general prior to the FBI decision on whether to proceed with criminal charges, demonstrated that the Clintons are above the law. *The New York Times*' Maureen Dowd (July 9, 2016) caught the dilemma of many US voters, stating of the Clintons: "They're always offering a Faustian bargain. This year's bargain: Put up with our inequities or get Trump's short fingers on the nuclear button." As for Trump, his anti-free trade rhetoric and comments about negotiating prices for Treasury bonds has hurt him with business and Wall Street, though endeared him to those left behind economically in the country's rust belt. Like them or hate them, Clinton and Trump are not stupid and are set to wage war against each other. This will continue to be an abnormally abnormal election year.
5. Asian Political Tensions (This was raised from 10 to 5)	Asian tensions are likely to rise due to the Philippines' victory in its case against China (started in 2013) at the UN's International Court of Arbitration (in The Hague). The judges rejected China's claims to the region, stating: "There was no legal basis for China to claim historic rights to resources within the sea areas falling within the' nine-dash' line." Although China has boycotted the legal process and called the results "null and void", the ruling complicates Beijing's quest to make the South China Sea into a Chinese lake. What next? China will probably continue to build new islands, fortify its holdings and generally seek to exclude other Asian countries from its waters. It may also take some actions against the Philippines. In turn, this will give greater impetus to the Philippines, Vietnam and Indonesia to strengthen their naval capacity as well as look to greater support from the US, Japan and India. Clausewitz's words have an echo here: "Politics is the womb in which war develops." While we do not see war around the next corner, China's total rebuff of international law in this case, reduces non-military options over the future of a region that is rich in oil and fish. There is more to come on this front. The outlook for China's economy should be given greater clarity when Q2 2016 GDP results are posted; we expect to see a minor quarter-on-quarter decline.
6. Eastern Complications (this was dropped from #3)	Although we have dropped Eastern Complications down three notches, the region between Berlin and Moscow remains tense. The July NATO summit in Warsaw saw the following policy lines advanced — a new program of support for Ukraine as it reforms its military and government; a boosting of NATO's security commitment to the east by the deployment of four battalions to Poland and the Baltic states; and more aid will be given to countries in North Africa and the Middle East fighting against the Islamic State. The battalion sent to Poland will be commanded by the US and it will be composed entirely of US troops. While these actions are meant to demonstrate Western resolve vis-à-vis Russia and strengthen NATO's eastern frontier, they also play into Moscow's fears of western efforts to contain their influence in what it perceives as a traditional sphere of influence. Consequently, we see political tensions in this region remaining high, with the potential for a small incident unintentionally turning into a major crisis.

Rank	Risk
7. Middle Eastern Tensions (this was dropped one notch)	The Islamic State has lost ground over the past several months, but this does not mean that it is a spent force, especially as appears to have upped its terrorist attacks. The spate of terrorist attacks in Bangladesh, Iraq, Saudi Arabia and Turkey indicates that radical Islam still is willing to challenge both regional governments and the West. Indeed, the use of terrorism on a global basis can have a negative economic impact seen in the form of less international travel, delays for travelers and higher security costs, not to mention the challenge such acts mean in democratic societies. At the same time, conflicts continue in Yemen, Syria and Libya, the last of which raises the risk of a possible new Islamic State being created due south of Europe.
8. Emerging Market Dislocations	Most emerging market countries face substantial headwinds which complicate their ability to recover from the collapse of commodity prices and slower Chinese economic growth. These headwinds include uncertainty over global interest rates, the impact of a stronger US $, and internal political problems that cover everything from terrorism to disruptive corruption scandals. For the global economy to regain stronger momentum we need emerging markets to regain forward motion. This is becoming a critical factor in the slump in global trade.
9. US Recession	The US economy is likely to remain out of a recession in 2016, posting roughly 2.0% growth. However, wage growth has lagged, underemployment remains substantial and the stronger dollar has hurt the profits of US exporters. Much will hinge on who wins the election in November and whether the Congress wants to return to work on fiscal policy and other critical issues, such as infrastructure, which could help keep the economy out of a recession.
10. Japanese Economic Problems	Japan's economy continues to struggle on the growth front, while the nation's leadership appears more focused on changing the constitution to rewrite Article 9, which would allow the Asia Pacific country to normalize its military situation. Debt and demographics remain the dominant themes that dog the Japanese economy and leave it vulnerable to external shocks.

Key Country Data

Country	Real GDP (%) 2016	Industrial Production (%)	Consumer Prices (%)	Unemployment (%)	Budget balance/GDP (%) 2016
US	2.0	-1.1 Apr	1.1 Apr	5.0 Apr	-2.5
China	6.5	6.8 Mar	2.3 Apr	4.0 Q1	-3.0
Japan	0.5	0.1 Mar	0.0 Mar	3.2 Mar	-6.2
Germany	1.5	1.2 Feb	-0.1 Apr	6.2 Apr	0.4
France	1.3	0.6 Feb	-0.2 Mar	10.0 Mar	-3.5
UK	1.9	-0.5 Feb	0.3 Apr	5.1 Jan	-3.6
Canada	1.6	0.8 Feb	1.3 Mar	7.1 Mar	-1.4
Brazil	-3.6	-11.3 Mar	9.4 Mar	10.9 Mar	-5.4
India	7.5	2.0 Feb	4.8 Mar	NA	-3.7
Russia	-1.3	-0.4 Mar	7.3 Mar	6.0 Mar	-2.2
Australia	2.6	4.8 Q1	1.6	5.7	-2.0

Sources: Smith's Research & Gradings, International Monetary Fund, and Organization for Economic Cooperation & Development

Australia's Inconclusive Election: It has been a year for unexpected results at the ballot box. This was the case for Spain, which has gone through two elections (December and June) which gave no single party an outright majority; it is now the same for Australia. The center-right Liberal-National coalition headed by Prime Minister Malcom Turnbull took a gamble to hold an early election on July 2nd. The main reason for an earlier-than-expected contest was Turnbull's hope that he could clear the Senate of troublesome minor parties and independents, who were obstructing his government's jobs and growth programs. Although the opposition Labor Party failed to make much headway, a number of independents won seats leaving them in an advantageous position. Turnbull's new government, which is a minority of 73 seats (76 are needed to have a majority), has gained the support of 3 to 4 independents and it is possible that a few more may support it. The bottom line is that Australia went from having a government with a secure number of seats to a minority administration, dependent on independents. Reflecting the greater uncertainty over the government in Australia to deal with such issues as stimulating stronger growth and dealing with slippage on the fiscal front (a deficit of 2% of GDP) and a current account deficit of 4% of GDP, Standard & Poor's changed the outlook on the country's AAA sovereign rating from stable to negative.

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City ____________ **State** ______ **Zip** ________

Phone ________________

Fax ________________

E-Mail ________________

Rates:	Individual
Standard	❑ $650
Issuer	❑ $125
Single Copy	❑ $30

Payment Information

❑ Bill Me ❑ Payment Enclosed

❑ Credit Card - MasterCard, Visa, Discover or Amex

Card Number

Exp. Date / Verification Number*

Name on Card:

Signature

*Please enter the Credit Card Verification Number on your credit card.

Puerto Rico: Default Is Inevitable

Terence M. Smith

Puerto Rico entered the rogues gallery of municipal bond issuers who have defaulted on their solemn pledge to make timely principal and interest payments.

On July 1, Puerto Rico failed to make $2 billion in debt service payments or be in default.

To make the matter perfectly clear, the Governor of Puerto Rico and the Government Development Bank (GDB) have received very poor financial and legal advice that suggests defaulting on debts is a sovereign right. *Smith's Research & Gradings* has met with the Governor, the non-voting member of the US House of Representatives, the leaders of the Puerto Rico legislature, and Union officials — all of whom confirm the advice is to default in order to get more favorable terms and eliminate large parts of the payment obligations.

Puerto Rico's Constitution makes payment of the General Obligations Bonds a priority over all other debts. In the past, the Government of Puerto Rico has actually shutdown and furloughed employees in order to honor this Constitutional obligation.

The security for Puerto Rico's senior sales-tax backed bonds, known by its Spanish language acronym of COFINA, has a pledge to pay bonds from the first monies collected as well as a lock box mechanism outside the general fund. The risk of a clawback, in the event of a GO default is further mitigated by the Senate of Puerto Rico's written intention that COFINA's senior bonds are separately secured.

However, Governor Alejandro Garcia Padilla claimed Puerto Rico can't cover what it owes without shutting off essential public services critical to the safety and security of the island's 3.5 million residents. The Governor also claimed Puerto Rico's economic slump has deepened because the population has sought employment on the US mainland.

Smith's Disease Event Risk Alert was first to warn investors that the arrival of the Zika virus would severely hurt the tourism trade that the Governor included as part of his economic program.

Recovery Act

The Government of Puerto Rico passed a law that allowed it to restructure the payments for bonds issued by Puerto Rico Electric Authority (PREPA) if the bondholders would accept restructuring terms. Dubbed "the Recovery Act", bondholders led by Blue Mountain Capital and The Rochester Funds, filed a lawsuit with The Supreme Court of The United States (SCOTUS). The highest court in the land ruled Puerto Rico could not restructure its debt over the objections of bondholders.

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Siding with bondholders, SCOTUS ruled 5-2 on June 13 that Puerto Rico's measure was barred under federal bankruptcy law. Eventually, PREPA reached an agreement with the bondholders.

PROMESA

The US House of Representatives passed legislation to bail out Puerto Rico before going on recess at the end of last week. Majority Leader Paul Ryan deserves all of the credit for pushing the problem onto the Senate floor.

At the center of the Puerto Rico bailout, issuers would be allowed to enter into a bankruptcy, if creditors do not agree to restructuring terms. In exchange, Puerto Rico must give up self-rule and be governed by a Control Board, which would have ultimate financial oversight and complete control on spending.

The US House was in recess until after the Fourth of July holiday. But the US Senate voted to send debt relief for Puerto Rico to President Obama's desk before they leftfor the holiday.

But, there could be roadblocks, especially after the BREXIT vote demonstrated just how sick and tired people are of the liberal agenda. Many Democratic senators have yet to endorse to the Puerto Rico bailout legislation and some want even greater changes. Senator Bob Menendez (D-NJ), a leader of the Hispanic vote, tried to fillabuster to block the bill (i.e. make speeches and demand changes).

With Puerto Rico facing a massive debt bill on July 1, lawmakers had little time to spare.

The next twist to the plot is a movement on the island of Puerto Rico to reject the Federal Oversight Board (but take the bankruptcy allowance.)