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## **Special Report—Europe and the Financial Markets**

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We sent you a special update about the Greece situation on May 6, but given all the new developments since then, we thought this would be a good time to share our perspectives on things and to go beyond just Greece. Our goal is to give you the big picture so that you can put the news into perspective.

Our clients seem to be either very calm about what is going on, or distracted by other things. So, as they say at the beginning of the TV series *Glee*, “Here’s what you missed.” The financial markets have been extremely volatile following a May 9 European Union rescue package of \$1 trillion, for Greece and other troubled European Union countries. What brought this package about? And why have the markets reacted the way they have?

### **Background**

Leading up to the rescue package was the liquidity crisis of the Greek government. It was unable to get additional financing and restructure its loans of \$135 billion. But it wasn’t just Greece. By early May, Portugal owed \$286 billion; Italy \$1.4 trillion; Ireland \$867 billion; and Spain \$1.1 trillion. These problem nations—the so-called PIIGS—collectively owe over \$3 trillion in a very complicated and interconnected web with other European nations.

To put one country’s debt into perspective, according to the *New York Times*, just the amount that Italy owes France is 20% of the GDP of France! But it is also a matter of interconnected economic relationships. For example, a large amount of Germany’s exports go to Greece and the other PIIGS. A default could throw them into a severe recession, and hurt Germany’s exports to them. So, letting Greece—or any of the other PIIGS—start a chain-reaction default was not an option.

***That’s why Germany, France, the International Monetary Fund, the European Central Bank, our Fed, and other organizations reluctantly put up a whopping \$1 trillion of additional funds for the troubled nations over the next three years. A default would be simply too painful for their economies.*** Unfortunately, the delay and politics of making the decision made the situation more expensive to fix than if it had been addressed months earlier.

With this rescue package came some stringent austerity measures for Greece, which included a combination of budget cuts, tax increases, and reductions in entitlement programs equal to 15% of it’s GDP over the next four years. Similar strings apply to other borrowers. The government has accepted them, but as you may have noted from images of the riots, this wasn’t sitting well with the Greeks, especially the many public employees who make up more than 40% of the Greek workforce.

The financial markets roared their approval the next day (May 10) with one of the largest one-day gains in history. Since then, the markets have pulled back in spite of improving economic reports. With the S&P 500 index down about 12% from its April 23 high, many wonder where we go from here.

Greece is caught in a trap. Its economy was sluggish to begin with, and now the austerity measures, tax increases, and debt payments will further suppress economic growth. And the necessary political, cultural, and economic reforms will take time to kick in. And a decentralized Europe has to deal with its eclectic collection of thrifty and spendthrift nations with different political systems. But the crisis has at least been defused, and the so-called “contagion” to the other PIIGS and ultimately to the rest of the European Union has been postponed and hopefully averted.

### **So, what’s that got to do with us?**

It does and it does not affect us. The Greek economy is small, about the same GDP as North Carolina’s. Fortunately, according to *The Economist*, US banks hold only 7% of outstanding Greek debt. But, according to economist Robert Samuelson, U.S. bank lending to Europe was \$1.5 trillion. So a default now or later could affect our major banks.

The interest rate on 10-year US Treasuries has dropped—not because the US suddenly got its own house in order—but because the US dollar is viewed as a ‘safe haven’. So, U.S. bonds are in high demand. This can help with our deficit because the US will pay less in interest on its long-term borrowings. Lower interest rates make business borrowings and mortgages cheaper, but they also hurt savers.

The higher US dollar is good for travelers and lower oil prices. Unfortunately, a higher dollar is bad for our growing exports, one of the major bright spots in our economic recovery. This can affect everything from Boeing airliners, to wheat, to US tourist sites. And it can affect US-based companies with extensive operations and sales abroad. ***We think this fear is what may have been driving some of the market correction.*** Exports make up only 11% of U.S. gross domestic product (GDP), and only about 20-25% of U.S. Exports go to Europe.<sup>1</sup> ***That means that less than 3% of our \$14 trillion economy has any direct exposure to the European export market.*** Furthermore, according to Dr. Jerry Webman, Chief Economist at Oppenheimer Funds, only 20% of the S&P 500 Index companies derive their earnings from Europe, on average, and only 20% of their revenues come from Europe. The weaker Euro may make European multinational companies more competitive to those in the U.S., thus helping their sluggish economies.

### **Are We Greece or Europe?**

Some commentators are drawing parallels between Greece and the United States. But fortunately, we’re not Greece and we’re not Europe. While our deficit as a percentage of GDP is similar to that of Greece, most of ours, according to Nobel Prize winning economist Paul Krugman, is relatively new in response to the economic crisis over the past two years. For better or worse, much of it is being used for infrastructure and economic stimulus. The Greeks are probably trying to remember what they unnecessarily purchased seven years ago during good times and are paying for with loan repayments today. And their long-term bond interest rates are 10%, rather than our 4%. Depending

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<sup>1</sup> Ned Davis Research, 12/31/2009.

upon how you aggregate the Department of Labor's statistics, about 21% of our workforce is employed in the public sector, vs. about 40% in Greece. That country is legendary for its underground economy and corruption; we're much better, but not perfect.

But the biggest difference between us and Greece and Europe is that our economy is recovering and Americans are highly productive and innovative workers. That's why our major stock indexes are still about where they were six months ago, and way above where they were a year ago. We have better opportunities to work our way out of our situation and we have the ability to act quickly and independently with our own Federal Reserve.

## **Our Outlook**

***Basically the fundamentals haven't changed much in the past month when the Dow and S&P Index hit a new high for the year. If anything, they have improved.*** What have changed are people's perceptions and their fear of slipping back to where we were 18 months ago. But the facts of today's economy and financial markets simply don't justify those perceptions and emotions. Yes, some indicators are still not good, such as the unemployment rate and housing, but the majority is up and continues to improve.

We see stock prices very undervalued according to the several variables we use in our model. We expect modest gains in GDP in Europe and Japan while the U.S. and most of the developing world will see good growth. This will help with the deficits, but they will take time, patience and fortitude—elements that the typical investor is largely lacking. But it will happen simply because these nations have no choice. Meanwhile, we expect continued high volatility in the financial markets.

***It seems so strange to us that the rescue package and acknowledging that we even have a problem have triggered such a reaction. It should have been just the opposite.*** But then, whoever said the financial markets were completely rational? To have ignored the problem—as the United States did with sub prime mortgages, Bear Stearns and Lehman Brothers—would have had major economic consequences for Europe, and ultimately the United States and other nations. In this global economy, no nation is an island anymore.

As always, we will continue to closely follow global economic developments and their effects upon our widely-diversified holdings and make adjustments within the boundaries you have established in your investment policy statement. Not all asset classes go up or down in the same direction indefinitely. At some point people will come to their senses and realize that U.S. Treasuries and gold are highly overvalued. And like at the bottom of the market in March of 2009, our clients will be in an excellent position to take advantage of this with their well-diversified portfolios.

## **What Should You Do?**

This is a good time to reassess your comfort level with risk, your need to take risk, and your capacity to handle volatile periods like the one in which we find ourselves. We would be happy to assist you in this process. ***You can't control the Greeks, Europe or the U.S. economy. But you can control your reaction to events, how much you spend and save, when you retire, and how you allocate your investments.*** We can help you with those choices. As always, we welcome your comments and we appreciate your loyalty.