

May 2010: A Greek Drama

As we watch footage of Greek rioting being played over and over on CNBC and the word "contagion" is on everyone's lips, it's an opportune time to update our clients on our view of what it all means.

The unwinding of Greece's terribly mismanaged fiscal house was preordained. The country's financial crisis stems from a culture of entitlement and corruption...nothing more, and it's being forced to its inevitable conclusion. To highlight, Greece's population is 11 million people, out of which only 15,000 people declare income of over €100,000 – a statistical improbability to say the least. When its economy softens, this situation of excess and abundant government programs supported by no payments is exposed and its debt/GDP ratio explodes to the upside.

Global bond investors have tired of funding the situation in Greece and are balking at the country's attempts to rollover its debt on the same terms as it had in the past. This presents a problem for the Eurozone because if Greece can't raise the funds in global capital markets, a combination of the Eurozone, the IMF and the ECB will likely have to step in to provide the much needed funds. This rescue, however, will require that draconian terms be imposed on the Greek government and its people. The situation is also bringing intense heat on other southern European countries that have been profligate for years, that are terrible at collecting taxes, and whose economies are imbalanced after decades of excess and entitlement. Hence, the contagion risk is heightened.

The only real cure to a debt balloon is a good old currency devaluation—and that's exactly what we're seeing. Because Greece doesn't have the drachma anymore and is instead shackled to the euro, the natural tendency is for the euro to drop in order to alleviate deflationary pressures and stimulate Greece and other parts of the Eurozone economy. Secretly, Germany is rejoicing at a weakened euro as it helps its numerous export businesses (and its tax revenue). Whether the euro survives is an open question, but it looks doubtful at this point.

The current view is that troubles for Greece equate to troubles for the broad Eurozone. A contrarian view, however, is that once the dust settles, the Greek fiasco could be bullish for stock prices in healthier parts of the world because the threat of debt deflation in other over-indebted countries (including the U.S.) will force their central banks to keep monetary policy accommodative to stimulate export businesses and prop up asset prices longer than economic activity would warrant. The latter is highly probable.

In addition to Greece's woes, several other headlines in April collectively shook investor confidence. First, a volcano erupted in Iceland, spewing an ash cloud so large it shut down air travel between the U.S. and Europe for 6 days. Then Goldman Sachs was charged with fraud by the SEC, sending its stock plummeting and raising questions about the viability of Wall Street's business model. Then, a deepwater drill contracted by British Petroleum exploded, spewing

thousands of barrels per day into the Gulf of Mexico, threatening the fragile coastline ecology as well as many livelihoods across these badly battered gulf coast states. As such, investors are spooked, and a lot of money has flowed back into bonds.

When global liquidity contracts – as it has in recent weeks – it manifests itself as a dollar rally, continued risk aversion and declining asset prices. The European sovereign credit crisis and the risk of contagion fed into this, but a secondary contributor was the Fed’s slowing of its quantitative easing program and its commitment to stop buying residential mortgage securities. The conundrum for U.S. policymakers (and they would never say this) is that they *do not want a strong dollar* because it threatens the lynchpin of the Administration's economic recovery strategy: U.S. exporters. What we’re likely to get is more fiscal profligacy, with zero interest rates in the U.S. and low rates around the world until the cost of living and the level of taxation rise to painful levels; in other words, for as long as humanly possible.

With continued low rates comes punishment for the savers, frugal and risk-adverse as they likely won't be able to keep pace. They essentially are footing the bill for excessive entitlements, Wall Street misdeeds, and super-easy monetary policy targeted toward stimulating consumption. Zero rates would be fine if the cost of living was decreasing, but it’s not.

How does one protect wealth in this environment of continued simulative monetary policy? We believe it is important to own assets that hold their long-term value in the face of weak paper currencies and inflation. Examples include gold, energy assets and shares of businesses that provide things that people need for their basic standard of living, that can pass on increasing costs to their customers and where customer demand is not highly sensitive to changes in price. It is also important to maintain exposure to economies where incomes are rising rapidly and productivity is increasing, such as Asia.

We don't believe Greece's woes will push the global economy into a tailspin. Recent developments, however, illustrate the potential fate of over-leveraged economies. As countries continue to delever, there will be periods of anxiety and risk aversion. Hiding in cash, however, likely won't protect an investor over the long-term, particularly if paper currencies are under pressure. Instead, we need to try to protect against the risks, and recognize that these periods of risk aversion often lead to buying opportunities and that enduring market volatility is part of the cost of protecting oneself.

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