Lassus Wherley ...a view from the top

Building Better Futures

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Who Hit Rewind?

It Feels Like a Replay…..

This May didn't feel a lot different from the last May or even the one before. Is it that we all want to wrap things up for vacations or that we just don't expect back-to-back good quarters or …………..? The reality is the uncertainty in Europe, and the uncertainty around elections both in the US and around the world is leaving the financial markets with a definite queasy feeling these days. We will cover many of the challenges in this issue, including the ones in the euro-zone.

As Steven Russolillo stated in "The Morning MarketBeat" from the WSJ one day last week, "The euro-zone crisis has resembled a never-ending, three-way game of chicken between the ECB and the bloc's stronger north and struggling south." Steven's suggestion to solve the problem is "do nothing." The idea is that if they wait, it will force the politicians to actually make decisions that will solve the underlying problems. That would be a really good thing even if it seems to be a bit of a stretch today.

This level of uncertainty is always uncomfortable for markets and for those of us who like being in control. We have been searching for that crystal ball so we can better predict what the leaders are going to ultimately decide to do in Europe and in the US, but so far it has eluded us. The good news is that some recent positive market action has given everyone a chance to catch their breath after a really tough May.

So Much for the First Quarter…..

Global stock markets have been weakening ever since we entered the second quarter on fears of a possible breakup of the euro-zone and a global economic slowdown. The month of May was particularly harsh with international, emerging markets, commodities and small caps being particularly hard hit. At the same time, the best performing asset classes have been bonds, particularly US Treasury bonds. This was one more case of the most defensive asset classes doing the best as concerns about global economic growth and the possible aftereffects of Greece or Spain leaving the euro-zone grew.

With investors already on edge, markets were dealt a real sucker punch on Friday, June 1, when the May jobs report was released. Only 69,000 jobs were added in May, in contrast to the consensus expectation going into the report of 150,000 jobs. The numbers for March and April were also revised downward by 11,000 and 38,000, respectively. Investors sold stocks after this report, assuming that such weakness indicated that the US economy was slowing.

The bottom line is that the US economy has been growing by about 2% (real GDP); and given the numbers of jobs lost in the Great Recession, this is not enough real economic growth to create meaningful numbers of jobs. Nearly 8.8 million jobs were lost from 2008 to 2010, and while 3.7 million jobs have been added since the job market bottomed in February, 2010, the pace at which jobs are being added is not enough to allow us to quickly climb out of the hole in numbers of workers employed. Investors are beginning to realize that there are no quick and easy solutions and that it will take time to get back to levels of full employment.

Another issue which has been contributing to the climate of nervousness this year is the issue of what is being called the "fiscal cliff." We have written previously about the issue of the fiscal cliff or the very dramatic reduction in the federal budget deficit which is due to come about at year-end. This drop will be as a result of tax increases and reductions in spending which will take effect under current law. Policymakers are obviously facing difficult trade-offs in formulating the nation's fiscal policies. Our stance has been that neither party will benefit from moving too rapidly to bring down the budget deficit and that this issue will be addressed, but most likely not until after the November election.

We expect that a combination of policies will be enacted, including both a) changes in taxes and spending that would allow the deficit to widen in 2013 and b) a reduction in deficits later in the decade. As hard as it will be, we expect that some compromise around these issues will be reached before year-end 2012.

As expected, we heard over the weekend that Spain had agreed to a €100 ($125 billion) bailout from the European Financial Stability Facility and its successor, the European Stability Mechanism, with the money to be directed to its ailing banks. This is not the end of the story in Europe, however, and Spanish bonds and European stocks both sold off after early euphoria.

Investors are putting more and more pressure on the shares of banks throughout Europe, and this is having a negative impact on the financial markets. The main issue at the bottom of the European sovereign debt crisis has been the fact that the banks own too much of their home country's sovereign debt, and the home governments are also closely tied to the banks.

Earlier this year, the low-cost loans called LTROs (long-term refinancing operations) made by the European Central Bank (ECB) to European banks served to bring down yields on debt for weaker members of the euro-zone. Now investors are concerned that the banks will no longer support their own country's debt in this manner.

After not acting quickly or forcefully enough, it is clear that European leaders must begin to find a way to do the following:

recapitalize their banks

formulate policies that will have a mix of both austerity and policy reform

create better international circuit breakers system-wide

provide outright loans to the weaker nations and be prepared for some of the weaker members to leave the euro-zone

We continue to expect that the European leaders will eventually, albeit belatedly, face up to the issues and take the steps required. We will see continued volatility in the markets around these issues over the next few months. We are still somewhat optimistic that the eventual rebound in stock prices will leave us with positive returns for the year.

Prior to the June 10th announcement of the bailout of Spanish banks, the issue which was most concerning investors was the risk posed to the world economy by a possible exit by Greece from the euro-zone rather than by the financial contagion which could result from a Greek exit. While the US is not as vulnerable to either possibility as we were prior to the Lehman bankruptcy in 2008, these issues create concern and discomfort.

There are two very different outcomes that could result in Europe either prior to or after the second-round Greek election scheduled for June 17th. Things could either turn out very badly or very well, and no one can know for sure which result we will see.

Greece still represents a large risk, and there is significant potential for a breakup in the euro-zone if the election on June 17th does not go well. Latest polls in Greece suggest a very close race among the three main parties: New Democracy, Pasok, and Syriza. The Greek people have been drawn to Syriza, the radical left-wing party, since its leader, Alexis Tsipras, has said he would cancel the terms of €130 bailout of Greece which was agreed to back in February. Telling the Greek people that they don't have to live under austerity anymore is obviously very appealing, but unfortunately, there will be no further funds coming to Greece unless they hold up their side of the deal.

The Greek people like Syriza but they also say that they want to stay in the euro-zone and they won't be able to have it both ways. We can hope that most of the Greek people understand that they have to vote for parties that support austerity, in spite of the pain, since Greece cannot pay its bills without European Union (EU) or International Monetary Fund (IMF) support. We also hope that the wealthy euro-zone countries can begin to show some leniency towards Greece. Please be aware that a lot of what is being said in the press by European leaders such as Angela Merkel, on the one hand, and Alexis Tsipras, on the other hand, is political jawboning meant for the consumption of the domestic electorate and not necessarily what is being said behind closed doors.

If Syriza implements its plan, a showdown with its creditors and a Greek exit from the euro-zone would become very likely. The choices for the Greek people are stark. Either they must cut back on budgets and increase taxes or be prepared to leave the euro-zone. Printing drachmas and trying to pay people in this currency is unlikely to work on either a political or economic level. A vote for the Syriza party will be devastating for the Greek economy.

The primary risk in Greece right now is that a bank run will precipitate an exit from the euro-zone. Money continues to leak out of the country just as borrowings from the European Central Bank (ECB) come in to top off the leaky bucket. If the ECB stops pouring money in because Greece stops holding up its end of the bargain, the rate at which capital is leaving the country would pick up.

Spain is most at risk of contagion from the financial crisis in Greece. The issue in Spain is that its banks are undercapitalized and still in poor shape from mortgages made during the housing boom of the last decade. About 20% of loans are considered "doubtful" and the number is still rising. Spanish debt represents 70% of GDP, which is not a huge amount compared to other European countries on the periphery. (Greece's debt to GDP ratio was at about 155% as of March 31st.) The bailout this weekend could bring the level to 80%, which would still be below average. The problems in Spain, however, could lead to a significant recession.

There is obviously a lot of uncertainty surrounding the situation in Greece, and this will not be diminished until after the election. It is important to recognize, however, that this problem has different implications for the Greek people, for Europe and for the US.

If Greece leaves the euro-zone, it will be a catastrophe for Greece and very expensive for Europe. For Europe, the main risks would be the financial losses and the hits to business and consumer confidence. A total default by

Greece would amount to about €250 billion or 2.5% of European GDP. If there were to be contagion to Spain, then we would expect that the European Central Bank (ECB), supported by the Federal Reserve and the IMF, would jump in to provide liquidity.

The impact of a Greek default should be much more limited for the US. Although exports to the Euro Area would be hit, US exports to Europe only represent 2.1% of US GDP. The US financial system has quite limited direct exposure to the banks on the European periphery. The US banking system has been largely recapitalized since 2008 and is much healthier now than it was then. We would expect that the Federal Reserve would stand ready to act as a lender of last resort if there were to be any impact on US banks.

Finally, while there could be a hit to US consumer confidence in the event of a Greek exit from the euro-zone, we don't expect the US economy to buckle from a Greek exit. However, an exit by Spain could have a more serious impact. One main offset to any hit in confidence would come from the lower gas prices which we are starting to see as a result of falling oil prices in the wake of lower expectations for global growth.

While markets are likely to react negatively to any news that Greece is leaving the euro-zone, we believe that announcements of coordinated financial system support on the part of the global central banks will come quickly after any such announcement. We would expect that the ECB would make more low-cost loans to euro-zone banks (LTRO), that deposit guarantees would be made available to banks across the European Monetary Union, that austerity requirements and interest rates would be lowered and that the ECB would once again be buying the sovereign debt of the weaker euro-zone countries.

Putting such measures in place to prevent contagion of the crisis to the rest of Europe and ensuring that the global financial system can handle the strains are a tall order indeed and time is of the essence. These measures will hopefully buy time and help to reduce the amount of capital that is leaving the other weaker euro-zone countries.

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We are continuing to allow allocations to US stocks to become overweighted vs. target in light of the stronger US growth profile and the reduced exposure which the US should have to any negative impacts from the Greek crisis. The Greek election provides us with two possible outcomes. If Syriza wins, the outcome could be quite negative. If a coalition of the New Democracy and Pasok parties wins, the outcome would be better. So what are we doing in portfolios under these two very different but possible outcomes?

A broad-based asset allocation is more important now than ever as macro risks once again rise. All of our portfolios have exposure to ten different asset classes, and the benefits derived from this broad-based diversification are most important during the market's darkest days. This is not a time to be either all in cash and bonds or all in equities since we just don't know what will happen in financial markets over the next few weeks. We do know that the US is less exposed than Europe to the events which could occur there and that the balanced approach in our portfolios should serve as some protection as we go through this period.

We continue to review cash levels in portfolios to make sure that cash is sufficient for client needs. If you know that you will have an extraordinary need for cash coming up, please let us know as soon as you become aware of it so that we can raise the cash prior to the moment of need.

A big thank you to our clients who continue to challenge us with great questions. Please let us know if you have any questions you would like to share with others.

Question: *Is it time to throw in the towel on stocks?*
Answer: We know that you may well be getting weary of all the volatility that we have been experiencing in the stock markets over the past few years. We understand that some investors are even deciding that they really don't want to hold stocks anymore. This is definitely the wrong tack to take. It is important to have stocks as well as bonds and some cash for liquidity purposes. If your time horizon is at least three to five years, stocks represent a much better relative value than either cash or bonds at this time.

The dividend yield on the S&P 500 is now 2.2% compared to the 1.6% yield on the 10-year US Treasury. This is a very rare occurrence and is indicative of just how much more comfortable investors have become with holding US Treasury bonds rather than US stocks.

While we understand that US bonds may look very attractive, given the risks apparent for stock markets in the short term, it is necessary to hold stocks as well as bonds for their superior long-term growth and inflation protection. We liked the recent comment made by Leon Cooperman of Omega Advisors that "buying 10-year US Treasuries at these levels was like picking up dimes in front of a steamroller." Also, we would point out that we were surprised to find that famed market bear, Marc Faber, agreed with long-time bull, Jeremy Siegel, about the relative attractiveness of stocks vs. bonds.

As always, the world of finance and investment is never dull and boring. Sometimes boring would be a really good thing but until that day comes, we will continue to focus on ways to balance the risk and return.

Stay cool and enjoy your Summer!

Diahann

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