

BULL AND BEAR BULLETIN

Flu Season: Is Insolvency Contagious?

By: *The Investment Committee*

We touched on America's potential debt issue in last quarter's Advisory Notes Article: *Problem Solved or Merely Delayed?* In the article, we referenced the parallel between the potential issues our government and society may face with the current difficulties in Greece. Subsequent to the publication, the situation in Greece has deteriorated even further. The declining solvency of the Greek government has led to a spike in volatility for nearly every global market, as investors attempt to quantify the impact of Greece's debt crisis and the potential spread of government insolvency.

To understand the entirety of the Greek dilemma, several variables must be discussed. We will attempt to outline the situation, its complexity and its impact on investors both in the short-term and the long-term.

By itself, a bankruptcy of Greece has little financial impact on the global economy. The Greek economy has an annual value of roughly \$300 billion (USD) or the equivalent of 2% of the US annual GDP. However, Greece's membership in the European Union (EU) and, in turn the Euro currency, magnifies the potential fallout from a Greek default.

According to the EU's official website, it is "a unique economic and political partnership" with an intended focus on "peace, prosperity and freedom for its 490 million citizens." In addition, the EU offers a law-making authority for member nations to direct certain economic and political policies. The end result produces a more fluid medium of exchange for goods, services and capital across multiple borders. Similar to the union of our own 50 states and the US dollar, the EU can only exist if its members are willing to follow union laws and if there is a belief that the system exists to validate the Euro currency and the union's existence.

In its attempt to gain membership in the EU, Greece manipulated its statements of financial health to meet the EU entrance requirements. With the recent global recession and the dismal tax collection demographics of the country, Greece recently found itself on the brink of insolvency as the government's annual deficit approached 10% of the nation's annual GDP. After Greece revealed its "true" financial state, investors started to withdraw capital from the country. Unable to attract capital to finance new debt and to refinance existing debt, the Greek government has been forced to seek a bailout from the International Monetary Fund (IMF) and the other EU member nations.

The EU nations have little choice in the financial bailout of Greece. If they were to remove Greece from the Union rather than finding an alternative solution, a portion of the belief system that allows the EU to exist would be destroyed, as many investors would question how the EU would handle a crisis of one of its larger economic members. If the belief system is significantly impaired, there would be an end to the free movement of goods, services and capital upon which the EU was founded.

While the recently purposed \$1 trillion bailout is more than sufficient to aid the Greek government, the greater fear is the contagious aspect of insolvency. Global investors remain focused on the same issues for the other PIIGS (Portugal, Italy, Ireland and Spain) EU nations. The collective economies of the PIIGS account for a much larger percentage of the EU and any negative effect on their respective debt servicing would almost certainly destroy the EU. The \$1 trillion bailout is aimed at removing uncertainty surrounding the entire EU. As we outlined in last month's Advisory Article, the currently purposed bailout only buys time. The EU members in question will still have to reduce their budget deficits going forward, as adding debt to a debt crisis only compounds the issue.

Volume 1, Issue 5



Asset management
as individual as you

With Offices at:

400 East Water Street
Elmira, NY 14901
(607) 734-2665
(866) 734-2665

24 West Market Street
Corning, NY 14830
(607) 936-1203

350 West Church Street
Elmira, NY 14901
(607) 733-9022

www.valicenti.com

BULL AND BEAR BULLETIN

While the headline news would lead a casual reader to believe the issue is isolated to Europe, in today's global dependent world, capital has no boundaries. Europe is China's largest trading partner. A potential double-dip recession in Europe would clearly impact the Chinese economy. Over the past few years, China has utilized its significant capital surpluses to act as a global buyer of last resort. If China's capital surplus were to become impaired, it is probable that it could slow its spending.

While many individuals may feel that China would be rightly served given its handling of human rights and controversial economic practices, it is important to understand how China's new found wealth has benefited America. China has deployed its capital surplus over the past few years to expand its own infrastructure, purchasing electrical equipment, elevators, air conditioning systems and other capital goods, benefiting companies like General Electric, United Technologies and Emerson Electric. The Chinese government has also used the capital surplus to stimulate Chinese consumer demand for everyday items such as household furnishings and computers, helping companies like Corning, Clorox and Intel. Most importantly, the Chinese capital surplus has been a major contributor to the US government's ability to issue billions of new Treasury obligations every month. Without the Chinese government's redeployment of capital into the global economy, the safety net would be removed for many nations' economies.

From an investor's perspective, it is important to dissect both the short-term implications of the Greek situation and the potential long-term fallout. In the near-term, the uncertainty has reallocated capital from the EU into those economies perceived to be more stable. Specifically, we have witnessed massive selling of global equities and European debt and an equivalent level of purchases in US Treasury obligations over the past two weeks.

While the US has its own debt issue, with an annual budget deficit over 10% of annual GDP, it may be best categorized as the "best of the worst". As long as the US currency is viewed as the reserve currency for the world, investors will flock to US government assets in time of uncertainty.

As previously discussed, the recently purposed EU bailout may help reduce some of the fear surrounding multiple EU nations defaulting on their debt and may support the sustainability of the EU. As uncertainty diminishes in the short-term, it should result in a return of capital to global equity markets and spur a continuation of the 15-month rally.

From a long-term perspective, there will be a saturation point where investors will no longer be willing to purchase government debt from any questionable economy. At this point, there may not be enough global capital to bailout those nations facing insolvency. The level of uncertainty and the fear surrounding this saturation point will likely have significant effects on global currencies, as investors will flee for stable currencies. Corporate earnings will almost certainly decline as we experience a global recession. Interest rates will increase significantly to adjust for higher risk premiums. Overall, we will witness a global reallocation of capital to those economies that have instituted and maintained fiscal restraint away from those economies that attempted to solve every economic slowdown with fiscal deficits, inflation and currency manipulation. The difficulty is accessing the timing of this pending outcome.

It is our belief that the markets are in the initial stages of recognizing a saturation point. Investors still seem to be willing to participate in bailout attempts and to accept artificially reduced risk premiums assigned to those nations with high levels of indebtedness. It is likely that as the near-term uncertainty surrounding the EU declines and US corporate earnings and economic data continue to improve, the broad equity markets should continue their recent upward trajectory. While we remain focused on the US recovery, we will continue to monitor the mounting global debt crisis and we will be vigilant for any necessary change in our strategy.