Trouble in Greece

becomes trouble for all, but a major intervention appears to have averted the crisis, for the moment…

Last week was a flashback experience of the September-October 2008 market swoon. What is going on?

The domestic economy has been slowly healing from the 2008 financial crisis, and the US banking system has been able to work its way out of a deep hole following the purchases of mortgage backed securities by the Federal Reserve, the Treasury's TARP program, bank stress tests and then massive injections of private capital.

But things have played out differently in Europe. By its nature of being a collection of sovereign nations, Europe as a whole is really challenged to act as expeditiously and boldly as the United States can. The European Central Bank was reluctant to initiate the creative programs to help European banks that the Federal Reserve created in the aftermath of the failure of Lehman Brothers. The bottom line is that European banks have not been able to cleanse themselves of bad assets to the extent that US banks have.

The nature of what have become bad assets is somewhat different in Europe. While plenty of European banks got into trouble in 2008 by owning US mortgage backed securities, they mainly own European bonds issued by member states from the bigger and stronger nations like Germany and France, but also from the smaller ones that are making headlines like Portugal, Italy, Ireland, Greece and Spain – the so-called "PIIGS."

While the US housing market blew up rather spectacularly in 2007-08, the problems brewing primarily in Southern Europe have been on a slower track but have also now blown up to the point that the European financial system is at risk. Greece is by far the worst member state in terms of its debt-to-Gross Domestic Product (GDP) ratio, and so it is no surprise that its debt problems were the first to reach crisis levels.

Greece has a long and troubled financial history. It is hard to believe, but over the last 180 years Greece has been in default half the time. It is a failed state in which government spending makes up over 50% of the GDP. The government has overpromised very generous retirement and health care benefits. Corruption is rampant and productivity is well below the European average. The adoption of the Euro also has had unintended consequences. Greece has easily borrowed in Euros, and the nation's debt has exploded from 6% of GDP in 2001 to today's 108%.

Meanwhile, the European Union has been soft on members that have not complied with fiscal and economic requirements, and having the Euro as the common currency removed the perceived "currency risk," therefore masking the overall risk of buying Greek bonds, at least at first. And while concerns about Greek debt have been around for many months, the policy makers in Europe have been slow to deal with it, which in turn has spread the concern to the debt of the other "PIIGS." Fear of contagion has become rampant.

Recently, the policy makers in Europe began to address the gravity of the problem, pushing through a $140 billion rescue package that will demand of Greece substantial cuts in government programs. Many Greek citizens are deeply upset and rioting in the streets, but there is no realistic alternative and the plan is going forward.

But the markets in Europe and the United States and the rest of the world fell anyway. Why? The sense in the markets was that the European banks needed to find more universal relief for their holdings of sovereign debt issued by the "PIIGS." The situation had become very serious. Last week, European banks started to curtail short-term lending to each other, reminiscent of the days after Lehman's collapse. If lending flows were not quickly restored to normal levels, another global crisis could result.

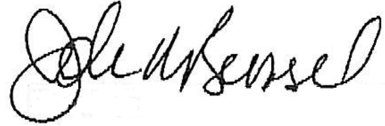
So the European Union and its Central Bank met this past weekend to avert another crisis, and in one massive effort the European Union and the International Monetary Fund committed to create a package of almost $1 trillion to support Euro-zone economies in need, and the European Central Bank announced a purchase program of both sovereign and corporate debt. This morning, markets across the globe are reacting very favorably to the plan.

It is our view that predicting how markets will react to the European debt woes is an almost impossible task. Economic activity in Northern Europe has actually been good – manufacturing activity is up 4-5% in Germany and France, and even Spain and Portugal are improving from a low base of economic activity. There are reasons for hope.

Our non-US exposures both in equities and bonds are well-diversified across the globe, and we have great confidence in our managers' ability to work through this latest crisis. Riding through these market corrections is not fun, but the world has made extraordinary progress since March of 2009. While the Europe debt crisis is a serious bump in the road

to recovery, and there will likely be more along the way, we remain cautiously optimistic about the global economy in the long run. Stay tuned.

Sincerely,



John Bussel, on behalf of the Investment Committee
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