

## Thought for the Week: Monday, October 3<sup>rd</sup>, 2011

### European Update

Despite the lack of any new facts, the Greek Debt Crisis continues to drag down Global Stock and Credit Markets. Considering Apple has reportedly enough money on its balance sheet to write a check tomorrow and clear the European bank exposure to Greece, the profound, far reaching effects of Greece's financial problems is astounding.

There are two major reasons for European worry:

- Contagion
- Banking Exposure

...both of which threaten the Global credit stability, given that no one really knows what liabilities the major investment banks contain deep within their balance sheets.

The negative effect a troubled European economy would have on world growth is giving the rest of the World reason to worry.

#### Contagion

Greece has a serious, debilitating disease that can be cured but they are currently on the waiting list for the remedy (medical waiting lists are common in Europe where treatment is predominantly free). The disease can be cured; it's just so expensive that no one wants to pull the trigger just yet.

As a consequence, the patient is slowly deteriorating in front of everyone's eyes and the longer they stay infected the greater the chance of those in close proximity catching the infection.

So, for those of you who have seen the recent Matt Damon movie, **how might the contagious Greek virus spread?**

Greece really should default on the repayment of its loans; however, if the political leaders allow this to happen, it will signal a lack of desire to support the economic union. Therefore, the credit rating of Portugal and Ireland, amongst others, may take a hit as a direct result of Greek default.

This lack of confidence will increase the cost of borrowing in the debt (bonds) of those countries. The financial position of those countries facing increased cost of borrowing (yield on bonds) will therefore deteriorate as they have to pay more to service their debts.

Although Portugal and Ireland's debts are fairly small relative to the European economy, the market will see that Greece was allowed to default, so why not Portugal and Ireland? The European leaders will be faced with the same issue: Kill or Cure? Rescue or Default?



#### ***Ironically:***

*"Inspiration for the € (Euro Currency) symbol itself came from the Greek epsilon (€) – a reference to the cradle of European civilization (Greece) – and the first letter of the word Europe, crossed by two parallel lines to 'certify' the stability of the euro."*

...The European Commission.



If the crisis gets to this point, confidence in the next tier of the PIIGS, Spain and Italy, will fall quickly causing their debt payments to increase dramatically.

Spanish and Italian debt levels are too high for a bail out, these are major economies. Therefore, the Greek debt virus will have spread to all the other countries with a low tolerance to weakening financial conditions.

### **The Car Repayment Story**

Imagine a 24 year old worker on a \$50,000 salary that takes a car loan of \$3,500 a year because they can just about afford it. Imagine if the bank then dramatically increases the interest rate on the loan. This is what is happening to Greece. And no one would tell you Greece could afford the loan in the first place!

If the worker defaults, what will the bank do to every other 24 year old when they walk in and ask for a loan? Jack up the interest rate to cover the increased risk of default.

This is the Greek situation exacerbated by the fact that Greece's "salary" is actually falling as their GDP contracts on an annual basis.

### **Bank Exposure**

As in the Car Story above, the banking system holds the majority of the debt of Greece and the other PIIGS.

If Greece defaults and the contagion spreads, the value of the debt held by banks will fall dramatically. Therefore, the financial ratios controlling the banking system will change dramatically – overnight banks will become undercapitalized. Financials will not have the collateral they once had, they may have to move or sell assets which will create further deterioration.

One worry is that Greece is driving Europe to a "Lehman Event" where no one knew how much of Lehman debt they owned and panic ensued as asset values dropped.

We don't see this being the case but action needs to be taken soon. The banking system operates on confidence. We monitor the level to which banks in Europe are lending between themselves - things seem to be working fine at the moment.

Also, whereas it's hard for a politician to sell a "spend to save Greece" policy in France or Germany, it's a much easier proposition to garner support for a "spend to save our domestic banking system" policy. The political will and urgency to save your own national banks will be greater than that to save Greece.

### **Economic Growth: Final Words**

- Following strong economic and financial market performance in 2010 and first quarter of 2011, some weakness was to be expected.
- The traditional driver of the U.S. economy, the consumer, continues its housing and employment struggle.
- Lack of coherent, decisive U.S. and European policy creates prolonged market weakness. The longer this continues, the weaker the confidence in economic recovery.
- Europe must address its debt and structural issues if it is to contribute to Global growth.
- We still see a slow recovery and not a double-dip recession.

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