

Thought for the Week: Monday, November 14th, 2011

Deal or No Deal

The dramatic decline experienced during the Third Quarter of 2011 was followed by a record-breaking start to the Fourth Quarter. October was the best month for equities in over thirty years.

The period saw the political leaders in the U.S. and Europe reach broad agreement on the solutions to their respective financial problems. We also started to see broadly favorable economic data: earnings continued rising, employment started to creep upward again and China is heading for a soft landing, according to both China's President Hu Jintao and the International Monetary Fund (IMF).

Does this mean global economies and markets can now continue their slow recovery? The important people are all on the same page and now they'll simply fix the problems.

Not so fast. Even though all the people controlling the money have agreed to certain fiscal remedies, there's very little probability that the remedies will be seamlessly implemented in detail, to an agreed timescale and without arguments along the way.

Europe

The Greek debt crisis solution reassured markets that Portugal and Ireland would be looked after if they needed further financial help. Unfortunately, it also imposed a 50% 'haircut' (reduction in value to investors) on those holding Greek debt. Obviously this is a default of sorts, but the main issue was: "if Greek debt was cut by 50%, what's Italian debt now worth?"

This is the contagion scenario in full effect; how much is should be lopped off the value of other European debt?

The focus of the Bond Vigilantes (those Hedge Fund-types who profit from drops in bond values) quickly shifted from the smaller members of Club Mediterranean (Greece, Portugal and Ireland) to the larger members, especially Italy. Even France got a special membership as they do have some coastline in the Med.

In an attempt to appease markets, Italy, true to the old Maxim "if you don't like the government, wait a year and a new one will come along," replaced their Prime Minister with a new guy who had an economics background.

So, we now have clear high-level political agreement that Europe's financial woes will be fixed. And, in our opinion, they do have the ability to fix the problem if they implement a U.S. style bank recapitalization and a bond purchasing program. Remember, contagion is the falling values of a country's bond prices causing the cost of their borrowing to rise. When this happens, as it is now doing, their debt and deficit issues get worse. In the U.S., we anticipated this by printing money which unfortunately increased our sovereign debt. However, the money was used to buy our bonds causing the price of Treasuries to rise and therefore lowering the cost of servicing the debt, FOR NOW.

Europe in a Nutshell

The following news caught our attention:

"German construction group Hochtief revealed it may have to write down the value of its road contracts in Greece due to mass toll dodging."

Bottom Line:

The EU loaned money to Greece in the form of bond purchases. Greece spent the money on various infrastructure projects including the 2004 Olympics. German contractors won many of these lucrative contracts.

However, does anyone trust the European political system to quickly implement all these changes without argument or frequent disagreement?

As Shakespeare once said: “There’s many a slip twixt the cup and lip” which means that when an outcome appears to be a done deal, there are many things that may still go wrong.

U.S. Super-committee

The Debt Ceiling Crisis a few months ago ended with broad agreement on deficit-reducing budget cuts, the details of which would be defined and agreed upon by a congressional Super-committee.

Ever since this accord was announced, the media pressure moved to Europe; the U.S. financial situation moved off the front page. However, with a November 23rd deadline looming, what are the odds of both parties producing impressive deficit-busting measures without any bickering? It’s hard to see our President putting pen to paper on a painless agreement.

Although there’s plenty of lip on Capitol Hill, we are not convinced they’ll drink from the cup without any slips.

Investment Outlook

Although we have increased our conviction to a slow but sustained recovery in light of recent positive economic data, we remain worried by the potential for near-term, politically-inspired volatility as described above.

For this reason we have been taking risk out of many portfolios. For example, Conservative Income has been raising cash at every opportunity for a few weeks now.

Cash will probably be King for a little while unless you want to ride the politically rollercoaster.

In our view, buying opportunities may present themselves in coming weeks or months. We are prepared to take a back seat to the coming political announcements and be ready with dry powder when the dust settles.

Is Default the End of the World?

It appears to many observers that Greece wants to be out of the Euro as much as Europe wants it to stay in. One reason might be the historical performance of countries that have defaulted on their debt.

Remember Argentina in 2002? They defaulted after a period of sustained crisis. The chart to the right shows what happened next.

No one is saying default is good; but admitting your problems does seem to be the start of the solution.

And don’t forget Russia’s default in 1998.

