



The View

Investing and Wealth Management Insights

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Special Update:

European Crisis Quickly Worsening; We Review Likely Outcomes and Implications for Investment Strategy

On the eve of this Thanksgiving, financial markets have not offered much to be thankful for. Indeed, each day seems to bring with it more trouble, largely from Europe. Unfortunately, the situation in Europe is deteriorating at an accelerating pace. Because financial markets depend almost entirely on confidence, the erosion of confidence that Europe will identify a solution feeds on itself, thereby accelerating the downward spiral. Below we outline the implications of the European financial crisis, the likely outcomes, and how we are positioning portfolios accordingly.

Bottom line: European politicians will need to be pushed to the edge by markets before they act definitively, so it is likely that volatility will increase, and equity markets will suffer further before we get clarity on a potential solution. However, it is more likely than not that a solution will be found, averting a potentially catastrophic collapse of the European Union. Finally, any solution will almost certainly include at least an element of debt monetization (i.e. printing money and using it to retire debt), which will have profound effects on currencies, economic growth, and potentially inflation.

Strategy: For the vast majority of investors it is folly to try and trade around this volatility. Using previous financial crises as models, once markets get clarity and a resolution appears in sight, they will react incredibly quickly. Quantitative easing/debt monetization/money printing will soon be taking place in countries that amount to over two-thirds of the world's economy. If one considers that China and other emerging markets are also loosening monetary policy (even lowering interest rates in the case of Brazil) there will be an unprecedented amount of liquidity flooding global markets. Massive liquidity should ultimately reignite growth and likely spawn inflation. This could take time, perhaps more than a year or two, but it is prudent to scope out the potential outcomes and probabilities, and prepare for them as much as possible in advance.

Europe is smoldering

It is increasingly apparent that European politicians are content to let markets run their course...at least for now. Bond yields (i.e. the return investors demand for lending their money) continue to explode to new records, making it more and more expensive for countries like Italy and Spain to borrow money. On Tuesday, yields on Spanish bonds DOUBLED from just a *month* earlier. The cost to insure against default by European nations, including France, is at record highs, well above the levels during the 2008 financial crisis. These countries have so much debt, they must constantly issue new bonds to pay off old bonds. If yields rise too high (like they did in Greece), these markets will be effectively shut off, rendering governments impotent and unable to roll their debt, eventually resulting in default. Given the current lack of conviction for a definitive solution, bond yields are likely to rise further. Inevitably, governments will be compelled to act or risk watching the European Union go down in flames.

Many economists believe the only solution for salvaging the European Union will be to monetize the debt, a.k.a. print money, and use the funds to pay off the debt. Sound familiar? Yes, we in the United States have done our fair share (over \$1 trillion worth and counting) as has Japan. There are multiple arguments about whether this is currently legally possible under the EU's governing laws, but it is clear that if the European Union is to be saved, there will need to be a bigger solution than austerity and marginal structural reform. Time is running out as the contagion is spreading at an accelerating rate. Indeed, even France has been put on watch by rating agencies for a credit downgrade.

No one knows exactly how this will play out and markets are pricing in greater levels of uncertainty. Still, we can use history to help reveal likely outcomes that can help us manage through this. Here are four things to focus on:

1. A total European meltdown still seems unlikely. Just like 2008 in the U.S., all countries have a vested interest in not letting the situation deteriorate to the point that it destroys the European economy. While some restructuring of the EU is assured, the de facto leader of Europe, Germany, would be in trouble if it were to separate from the EU, as its currency would appreciate dramatically, devastating its export-driven economy. Arriving at a solution will be a messy and painful process, but ultimately the most likely outcome is that this will get resolved, and a systemic failure will be averted.
2. The crisis is still presently confined to Europe, but risk of contagion is increasing. As bond yields rise and investors get more and more nervous, markets are locking up in Europe and credit pressures are intensifying – this increases the chance that this crisis will leap from financial markets to a real “main street” economic crisis. The longer this goes on, the more infected the real economy will become and the greater the probability of it spreading to the rest of the world. We must watch this closely. It still seems unlikely that this problem will spread to the U.S. and the rest of the world, and most credit market indicators that would react to such a phenomenon remain at or below levels seen during last summer's correction and well below the levels of 2008.

3. European QE (money printing) is on the way: Many economists believe that the European Central Bank, in order to keep the European Union together, will be forced to print Euros and use the funds to purchase the debt of European countries to alleviate their funding crises and lift them into solvency. Getting 17 countries to agree to this will be a challenge to say the least, but if the alternative is the breakup of the European Union, it seems likely that the solution will involve more government monetary stimulus.
4. Volatility will get worse before it gets better. As this unfolds, markets will continue to be buffeted by rumors of failures and solutions. If we assume that European politicians will need to be pushed to the edge by markets before they act definitively, it is likely that volatility will increase, and equity markets will suffer before we get clarity on a potential solution. Recall that the S&P 500 recovered around 16% in late 2008 as markets breathed a sigh of relief that it appeared the crisis had been contained after Lehman Brothers failed in September, only to nosedive 27% in early 2009 before bottoming at in March.

Navigating these choppy waters:

Recognizing every portfolio is different and each investor has different levels of risk tolerance, income needs, time horizon, etc, here are four key things we are focusing on in this environment:

1. Cash/flexibility: maintaining higher than average levels of cash for most, and substantial levels for some, will help portfolios weather the market volatility and also provide the flexibility to buy securities at attractive prices. History shows us that markets will overshoot to the downside as investors process news flow from a financial crisis.
2. Dividends: Low interest rates and slow growth are likely to persist for the foreseeable future. Therefore, dividends will likely constitute an increasing percentage of total returns. There are a number of stocks and ETFs now that focus on dividends that have robust yields. Absent a catastrophic European Union dissolution or global recession, it makes sense to pick up quality, dividend-focused securities at good prices into market weakness.
3. Secular themes:
 - Money printing and the debasement of fiat currencies will have substantial consequences for developed and emerging economies for years to come. Central banks are focused on diversifying their reserves away from traditional paper currencies, so it might make sense to explore adding gold to your portfolio. Gold can be volatile and pays no dividend, so it is hard to value and may not be appropriate for everyone, but there are several reasons, including the potential for inflation down the road, that support a gold investment thesis for the long term.

- The inexorable urbanization of emerging markets, which constitute more than half the world's population, will continue to drive long term demand for goods and services. Emerging markets account for around 30% of the world's GDP (and growing rapidly) but only around 15% of the world's equity market capitalization.
4. Options: As we wrote recently in *The View*, increased volatility can be used to one's advantage when it comes to option investing. Selling covered calls against equity positions that can help generate proceeds for protection and/or income. Moreover, there are additional option strategies one can use to help provide protection during market downdrafts. Options are not appropriate for everyone, and it is important to understand all the aspects to a particularly strategy before moving forward.

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What's Your View?

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