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A Greek Tragedy: Act III

Summary

- The European financial/economic crisis has entered a new phase and, over the near-term, the risks associated with a possible Greek exit from the euro-zone have increased substantially.
- We expect the euro-zone to evolve into a smaller entity underpinned by much stronger regional coordination and financing mechanisms. The result should be a euro-zone that is stronger and more durable.
- The US economy looks strong relative to Europe, but is threatened by the possibility of substantial tax increases and spending cuts in early 2013.
- We remain optimistic about the long-term prospects for robust growth in the global economy over the next decade but are sobered by the volatility one is exposed to in the meantime.
- Institutional investors (pension funds, endowments) have tools for managing volatility not currently available to individual investors. Aspiriant is working on a solution to make institutional risk reduction strategies available to individual clients.

From what I remember (helped by Wikipedia) about the Greek tragedies, they remind us of the fragility of the human condition. According to Aristotle,

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> *the structure of the best tragedy should be not simple but complex and one that represents incidents arousing fear and pity—for that is peculiar to this form of art…The change to bad fortune which he undergoes is not due to any moral defect or flaw, but a mistake of some kind.*[1]

In this light, as we watch the unfolding of the Greek crisis, its impact on Europe, and the human toll, it seems appropriate to describe the entire situation as a "tragedy."

The European financial/economic crisis has entered a new phase driven by the lack of economic growth in the European Union outside of Germany, acute financial crisis in Greece and Spain, and "austerity exhaustion" by voters in the periphery and France. Near-depression conditions in some areas have created a fresh round of skepticism about the currency union.

Despite implementing austerity reforms, a number of countries are finding themselves in the same, or worse, fiscal position which is creating popular resistance to some of the accepted policy prescriptions of the IMF and EU. Not surprisingly, several European heads of government have lost office (Greece, Spain, Portugal, Netherlands, Italy and France) over the last few months, bringing to 8 (out of 17) the number of euro-zone governments which have been voted out of office in the last couple of years.

New political leadership is attempting to re-frame the ongoing debate about the proper role and sequence of austerity policies in helping to stabilize economies that desperately require growth, but the way forward is anything but obvious.

Greek voters want a change

Over the near-term, the risks associated with a possible Greek exit from the euro-zone have increased substantially. On May 6th, Greek voters—who have undergone nearly 2½ years of income cuts, tax hikes and high unemployment—gave a majority of votes to several parties that are opposed to the spending cuts demanded by European finance ministers in return for more help paying off Greek debts.

The second round of elections is scheduled for June 17th and is widely viewed as a referendum on whether the country will stay in the euro-zone. At this point, the outcome remains highly uncertain as recent polls indicate a seeming incompatibility of voter preferences: the majority of Greeks support anti-austerity parties yet also overwhelmingly support remaining in the euro currency union. The Greeks likely cannot have it both ways. So unless the Greeks vote for a government willing and able to abide by its commitments, the euro zone may cease to provide bailout funds, setting in motion a course of events that will likely lead to a Greek exit from the currency union.

Greece may be a small economy, but a Greek departure from the euro would not be a small event. An exit and subsequent default would cost European banks, firms and taxpayers a lot of money. Nobody truly knows what the economic consequences would be but estimates have ranged around $1 trillion collectively. So the cost is very high in terms of lost output, with lots of uncertainty around those estimates (and that is without counting the danger of a general contagion in other weak euro-zone economies).

The bigger risk is a spread to larger Euro countries…

The virus of contagion may be taking hold even before the Greeks make up their mind in a second general election. Global equities have declined precipitously over the last several weeks, yields on Spanish and Italian sovereign debt have increased above levels considered sustainable, European bank stocks have notably underperformed and, perhaps most troubling, bank deposits are being withdrawn at an accelerated pace in Greece.

A "run on the bank" scenario is the most pressing concern at the moment because it could happen at any time. The standard central bank response to this problem is to provide enough liquidity to solvent banks to ensure that deposit holders are always able to withdraw their money, in which case the panic should eventually subside. In this instance however, depositors are less concerned about liquidity and more concerned about potential exchange-rate risk.

If Greece repudiates its reform commitments and subsequently exits the euro, depositors fear the devaluation of their deposits, now in drachmas, relative to the euro. This may well lead to similar fears in Portugal and Spain.

… but there are no obvious, easy policy responses.

Although no formal policies have been announced, there are some superficial signs of progress. Coming out of the recent G8 summit, leaders strongly reaffirmed their commitment to keeping Greece in the currency union and developing a combination of policies that balance fiscal responsibility

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1 Aristotle. Poetics, Trans. W.H. Fyfe. Cambridge: Harvard UP, 1932. Section 1452b

and the need to stimulate growth and job creation. Polling in Greece has fairly consistently indicated a strong voter preference for wanting to remain in the euro and the pro-austerity parties are now polling much better than a month ago.

The status quo is no longer an option for Europe over the three to five year horizon. We have not found a realistic scenario which avoids the euro-zone evolving into a smaller entity—probably, a closer political union of countries with more similar conditions (likely including France, Germany, Italy and Spain) which, together with other remaining members, would be underpinned by much stronger regional coordination and financing mechanisms. Such an evolution is not the easy way out – it would require a lot of proper coordination, a more balanced policy mix, stronger financial circuit breakers (well beyond the ECB's lender of last resort facilities), less vulnerable banks, and some luck (no tsunamis!). The result, though, should be a euro-zone that is stronger and more durable.

The US is heading for a "cliff."

Despite last week's disappointing employment figures, the US looks radiant relative to much of Europe. Threatening that, however, is the fact that many of the political compromises over the last two years are scheduled to expire in January, two months after the election. A stimulus package consisting of a payroll-tax cut, investment tax credit and enhanced unemployment insurance expires then, as do George W. Bush's tax cuts (which have already been extended by two years from their original end-date of 2010). The new Medicare tax on investment income also kicks in in 2013. At the same time an automatic, across-the-board cut in domestic and defense spending takes effect, cutting about $100 billion from government spending next year. The combination of spending cuts and tax increases has been called a "fiscal cliff."

The non-partisan Congressional Budget Office (CBO) estimates that the combined effects of the sequester and the expiring tax cuts would add up to 3.6% of GDP in fiscal 2013, causing the economy to contract at a 1.3% annual rate (a "mild recession") in the first six months of 2013. The CBO would expect the economy to stabilize in the second half of 2013 and grow by 0.5% over the year. According to Morgan Stanley, the closest precedent was in 1968, when individual, corporate, excise and payroll taxes collectively rose by the equivalent of 3.1% of GDP, mostly to pay for the Vietnam war and to damp down inflation. The next year, the economy fell into recession.

As we saw in late 2010, Congress can move quickly when necessary, especially during less politically risky lame duck sessions. We expect that Congress will consider measures to avoid the fiscal cliff again late this year, but the last minute nature of the debate creates uncertainty that could unnerve equity markets.

Investment implications

To predict near-term investment dynamics in these circumstances requires analyzing a global economy buffeted by complex realignments yet lacking historical precedents. Meanwhile, monetary policy and banking regulators are innovating by trial-and-error, while political anti-incumbency is growing and extreme polarization is amplifying social tensions. As if that weren't enough, partisan disagreements further undermine reaching an agreement on what ails individual countries, let alone the vision and sense of shared responsibility to solve it.

This combination results in a self-reinforcing cycle of largely reactive partial policy responses, subsequent complacency, and recurrent localized crises. The longer this persists, the greater the probability of a series of market inflection points in the next three to five years.

Why bear the risk of today's markets? For one, because bull markets often start during economic contraction. Consider the last five bull markets:

US GDP Growth During The First Quarter of a Bull Market (S&P 500)

Quarter	GDP Growth	Bull Market
Q3 1982	-1.5%	69%, 14 MONTHS
Q3 1984	3.9%	128%, 37 MONTHS
Q4 1990	-3.5%	233%, 84 MONTHS
Q4 2002	0.1%	101%, 60 MONTHS
Q1 2009	-5.0%	80%, 14 MONTHS

Source: Standard & Poors, Crandall Pierce.

This dynamic exists because valuations often become attractive during economic contractions and because markets constantly look forward to beyond the crisis dujuor.

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Consider, for example, how the S&P 500 appreciated by 40% off the March, 2009 low in just two months, while the economy was still severely contracting and well before it was clear that the financial crisis in the US had passed.

Moreover, European companies (like US companies) are increasingly global, innovative and lean. We want to participate in their growth, particularly because they trade at a discount to US companies.

As long-term investors we are excited by the prospects for long-term economic growth, which should translate into healthy investment returns. As we've written recently, the developed world's struggle with debt (particularly government debt and social program obligations) will take a toll on economic growth, but it isn't the whole story—or even the primary story. The world's developing economies stand in sharp contrast to the West—their budget and trade surpluses, lack of social liabilities, modern infrastructure, and young and educated populations have been the engines of economic growth over the last 5 years and are positioned to continue that leadership for the foreseeable future. (See our extensive comments on this topic in our 2011 article "Emerging Markets… Emerging."

Despite our long-term optimism, we're sobered by the volatility one is exposed to in the meantime, particularly in times of relatively high uncertainty such as now. The challenge for us is how to respond to the current environment, if at all. Most investors have only one tool for controlling short-term portfolio volatility—managing the amount of investment in "risk" assets (e.g., equities, commodities, real estate) versus defensive assets (e.g., bonds and cash). While effective at reducing volatility, the approach of timing markets is perilous… as the chart above shows, the periods of best investment returns often occur when one is least comfortable with risk assets.

Institutional investors such as pension funds and endowments have long had another tool for managing volatility, using stock options to hedge extreme risk events (called "tail risk" hedging). The challenge for even wealthy individual investors is that implementing a tail risk hedging strategy just isn't cost effective for individual portfolios. We're working on a solution to bring the strategy into client portfolios in a cost effective manner, and will have much more to say about this in the coming weeks.

In the meantime, we're eager to put the equity market volatility in personal context for you and assist you with thinking through the implications for your own investment portfolio and financial planning decisions.

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