

5th May 2010

Slipping on Greece

Australian investors woke this morning to news that overseas share markets had fallen by 2-4%. These falls stem again from concerns over Sovereign debt issues in Europe, particularly in Greece.

Most people would be aware that Greece's economic woes are by no means "new news". This issue came to prominence in the last quarter of 2009, yet six months later the market continues to react to this news.

Not surprisingly, our market opened down this morning, following the lead of the US and other major markets. Although Australia has very little in the way of economic links with Greece, the positive correlation of our share market with larger world share markets was explained in some detail in our last BLa BLa BLa

<http://www.blapl.com.au/newsletter/documents/April2010.pdf>

The purpose of this email is twofold:

- Provide a brief analysis of how the Greece situation is causing this share market instability; and
- Confirm our position in relation to what clients should be doing in the current environment.

Why do the Greek issues cause our share market to react so violently?

Many would regard the creation of the Eurozone as being the greatest economic concept to come out of the late 20th century. Aligning European countries under a single currency, with the effective removal of borders for trade and migration, offered enormous efficiency in the creation of an economic super power. However, one has to be careful in choosing their bedfellows, as they may not like the view when they wake up the next morning.

In 1999, Greece was left out of the Eurozone for failing to meet the EU's economic criteria. It was admitted as the 12th country of the Eurozone in January of 2001. To qualify for euro membership, the Greek Government had to adopt a tough austerity program, making deep cuts in public spending. At the time of Greece's admission the

president of the European Central Bank, Wim Duisenberg, warned that Greece still had a lot of work to do to improve its economy and bring inflation under control.

The difficulty of the European union has always been the fact that it is a “two tiered” system. European superpowers such as Germany, France and Italy sit alongside the minnows of Greece and Portugal. These are countries that have very different economic strengths and weaknesses, yet operate effectively under a common central bank and currency. To a degree we face this problem in Australia, where at present you have the very strong economic states (such as Western Australia), sitting alongside the economic train wreck that is New South Wales. When the Reserve Bank sits to decide on interest rates, it cannot set one rate for WA and a separate one for NSW, it must try and get the balance right between the two tiers.

On 27 April 2010, the Greek Government suffered a downgrade of its credit status to almost “junk bond” level. What this means for Greece is that any borrowing that it undertakes is going to be (a) harder to get, and (b) more expensive, as lenders want a premium on the additional risk that they carry. This makes it all but impossible for Greece to undertake the borrowing that it needs, essentially reliant on handouts from the rest of the Eurozone.

Although agreements had been reached over the weekend for a \$160 billion international bailout for Greece, the major contributors of this bailout (such as Germany), obviously have concerns. At a political level the German government faces public opinion with some 87% opposed to German funds being used to bail out Greece. There are of course no guarantees that these funds will do the job. Economic conditions are a fickle thing, and with general dissent in Greece itself over the austerity measures that the Greek Government is forced to take, the political climate could change very quickly.

The concern is now becoming one of contagion, in that if this matter is not resolved quickly, it will spread. Portugal has long been considered to be the “next cab off the rank”, while overnight the Spanish Prime Minister had to publicly deny rumours that Spain is preparing to ask for an economic bailout as well.

The longer it is before things are definitively resolved, the more nervous investors will get as they seriously consider the possibility of Western Governments being unable to meet their obligations. Given that it was the relatively “left field” issue of sub prime mortgages which started the GFC in 2008, it is understandable that an effective “liquidation” of European countries may well be the trigger for GFC mark II.

Here in Australia, the Reserve Bank Board raised interest rates yesterday, for the sixth time in eight months. Although mentioning the European situation, their comments were almost sanguine in stating:

Global financial markets are functioning much better than they were a year ago, but sovereign risk concerns have escalated significantly in Europe over recent weeks. This has prompted additional efforts by policymakers to put fiscal policies onto a sounder

footing and to provide support for Greece in the near term. To date, there has been very little contagion outside Europe.

It would appear, as recently as yesterday, that the Reserve Bank had little concerns that the European situation would escalate to the point that it would destabilize the Australian economy.

Contagion, however, is a funny thing. The major losers overnight were the European banks, particularly those with any exposure to the problem countries of Europe. The British Santander Bank, which is highly regarded as a very well run and sound financial institution, had its share price fall some 6.5% overnight, as it holds a relatively large exposure to Spanish bonds. As Banks in Europe become more concerned, they tighten lending policies, contracting the economy, causing further economic slowdown. It is not surprising that our financial sector is experiencing larger falls (compared with the other sectors within the ASX) as banks worldwide reassess their market exposure to what may now be suspect economies.

What should you do?

With the GFC firmly in our memory, we see it as natural that many investors would take the “once bitten twice shy” route at this point in time. As mentioned above, given the relatively “off radar” issue of sub prime mortgages caused the initial GFC, should not the prudent investor cut their Greece losses and get out now before it gets any worse?

It is timely that we addressed this type of issue in our last BLa BLa BLa (<http://www.blapl.com.au/newsletter/documents/April2010.pdf>), in our article, “a year on, what have we learnt”. Some of the pertinent points to arise from that article were:

- Markets react to bad news more than they do to good news;
- Third bucket strategies survived and worked;
- Capitalism survived; and
- Market timing is great if you can do it, but is fraught with danger.

The last point is perhaps the most relevant. We would strongly suggest that BL&A clients re-read this newsletter article, particularly in relation to the market timing point, to understand our response to this situation.

In short, what we have always maintained is that what happens tomorrow, next week, next year is an *unknown unknown*. This can be a good *unknown unknown*, or a bad one. Making investment decisions based on what might happen in the future is fraught with danger. We recall many conversations with clients in February/March of 2009 who could only see more bad news coming from the GFC and were determined to cut their losses, move to cash and stop the rot within their portfolios. Hindsight now shows us what a disastrous move that would have been.

As you appreciate, investing is counter intuitive. When things are recovering and going well, everyone wants to invest. When the market is having an ugly patch, everyone wants to go to cash. The Greek position could continue to linger, creating more short term instability, or it could be resolved tomorrow, resulting in markets reversing and moving upwards. To make long term investment decisions about short term issues is, we maintain, very dangerous.

In closing, we would recommend clients of BL&A learn from the lessons of the GFC and maintain their faith in the three bucket approach. If the three buckets are working properly, it will only be buckets two and three which have been affected by this recent instability, with bucket one (cash) unaffected. As you know buckets two and three are reserved for consumption in 4-7 and 8+ years, so this instability, although hard to ignore, should be.

If you have any questions, please do not hesitate to contact us.

The BL&A Team