June 4, 2012

Note

RE: Euro Zone Concerns

Much of the stock market's gains this year were erased over the past month due to mounting evidence of slowing worldwide economic growth and Euro-zone debt concerns, particularly in Greece and Spain. Both are problematic, but Greece, Spain and the strength of European banks are first and foremost on investors' minds.

Political will, or more correctly the lack thereof, is a chief issue, and this has repeatedly prompted Mario Draghi, President of the European Central Bank (ECB), to exert pressure on the political process. Draghi's comment last week that the Euro currency union as currently structured is "unsustainable" was his latest prod of the political process, and while unsettling to investors, he did nothing more than call the kettle black. Tighter fiscal coordination and oversight is essential, as is addressing the fundamental issue of uncompetitive labor markets in struggling Euro countries.

This latter issue has gained little press attention, but it's one of the most important ones to address. The traditional solution to an overpriced labor market is currency devaluation to bring wages to more competitive levels. Countries like Greece and Spain desperately need this to occur, but for stronger countries like Germany who share the same currency, devaluation will create inflationary pressures. This creates a lesser of two evils paradox and in this instance Greece/Spain must prevail, with something approaching Euro/Dollar parity in the end. Very encouraging and not something investors should miss is the fact this process is already well underway.

Another major concern is Greek willingness to fulfill their austerity pledges. In the end, this is a matter the Greek people will decide via who they elect to political office. As this has played out in other countries, thus far each has agreed to abide by their agreed upon plans, but Greece may very well take another path. A Greek withdrawal from the Euro-zone will unsettle markets in the short run, as contagion will spread across the European banking system. This will force Draghi to step in to back bank deposits, particularly in Spain, as the US Fed backed US banks in 2008. Draghi will find that course distasteful, as it will relieve some of his pressure on speeding a political resolution, but he'll have no choice. The markets should calm once this action is taken.

This leads to the most important point. Market selloffs occur with regularity, and some will lead to panics. To be successful, equity investors MUST recognize this upfront and not follow the herd when they stampede off the cliff. Big problems lead to protracted, messy resolutions, but in the end there is resolution. That may mean Greece is no longer a part of the Euro-zone, and if the case, we need to take that event and the inevitable overreaction of others in stride.

Keep the faith!

Lowell