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Debt Crisis: Greek Tragedy or Greek Myth?

How exactly does all this affect you anyway?

As of late, the economic news and earnings announcements have been breathtakingly positive, driving the stock market sharply higher. The Greek debt crisis is ruining the party. The issue is far from over.

Here is what you need to know in terms of what just happened and how it affects the global economy...and potentially you.

1. Greece wanted to enter the European Monetary Union. It's previous government mislead the European Union about the true amount of debt the country owed.
2. **When the global economy hit the skids over two years ago, the amount of Greek sovereign debt ballooned in proportion to its GDP.** The country was in violation of EU (European Union) restrictive debt covenants.
3. As Greece's debt load ballooned, private investors (banks, mutual funds, pension funds, hedge funds, basically institutional investors) shunned buying any more debt. Greece was shut out of borrowing from the private investment community. With its bonds coming to maturity, the country needed to borrow from new investors to pay back old investors.
4. This became a "contagion" because large European banks are big holders of sovereign Greek debt. These debt holdings, the growing concern was, were going to be written down in value, **thereby forcing these banks to take giant hits to their capital.** If these banks have to reserve more money for the hits, that is less money available for loans to consumers and businesses. This creates a "tightening credit market". What happens to economies when credit becomes tight (harder to get, in other words)? The economies slow down and may even tip into recession. The Greek debt crisis tipped into the rest of Europe. The other more indebted EU nations with a high ratio of sovereign debt to GDP, were infected the most; Spain, Portugal, Ireland, and Italy.

5. Just to give you an idea of investor angst, the stocks of the major European banks are all trading well below the mid-point between their trailing 12 month highs and lows; UBS, HSBC, and Barclays to name a few.
6. Credit markets in Europe are virtually shut down. **"Investment grade corporate debt sales in the region plummeted 88% last week to $1.2 Billion from the previous period, according to data compiled by Bloomberg."** (Bloomberg.com) Simply put, banks in Europe don't trust each other and traditional fear gauges such as LIBOR and TED Spread are rising. These rates simply mean that banks are charging each other unusually high interest rates for overnight loans…a sign of worry among bankers.
7. Investors are worried that a major European bank could be brought down…a systemically important one at that.
8. **The near Trillion Dollar rescue package cobbled together by the International Monetary Fund and the European Central Bank, it is widely believed, was created to shield big Euro banks from taking giant hits to their capital…which would further restrict the flow of credit on the continent. It is from this giant money pot that Greece and other debt-constrained EU nations may go to for money because they're unable to sell more sovereign debt into the private sector. Meaning, without this available money, Greece wouldn't have been able to pay back principal on its debt that matures in the very near term…it would have defaulted. This event would then bring down debt of the other debt-constrained EU nations and ultimately, German and French banks would be left with massive exposure to non-performing assets. Since our U.S. banks are so intertwined with the big EU banks, our banking system would be next to become infected. This is what is meant by contagion and this is the sum of all fears of central bankers world wide. To be sure, this is a worst case scenario, but at least you now understand why financial markets have been so jittery as of late.**
9. The conundrum is that the single currency was the easy part. The EU doesn't have a common tax code nor does the ECB have power over sovereign nations.

What about us?

1. It is widely believed that the major U.S. banks have limited exposure to Greece, Portugal, and Spain. But Italy, France, Germany, and England are most likely a different story (England is not part of the EU, by the way).
2. If the U.S. financial services industry has too much exposure via counter party risk (global banks often lend to one another and are involved in credit lines and trade loans as well) to European banks, then the 2 Trillion Dollars on their balance sheets (of U.S. banks) will continue to be hoarded in order to weather another financial tsunami. Credit Default Swaps are indicating that the cost of insuring European bank debt and sovereign debt is rising, so whoever is the originator/issuer of the CDS's, they could create another "Lehman" event if it didn't adequately reserve for the potential payouts. This is exactly what happened to AIG; it didn't have enough capital to make good on its CDS obligations.

3. *Ultimately, our problem would be if our own domestic credit markets were to tighten up.*
4. U.S. officials from Treasury and the Federal Reserve have said they are monitoring the situation closely. The Fed has made available credit loans and facilities to European banks and the ECB.

Who else is being affected?

1. In a word, China. Europe is obviously a big trading partner of China. As the Dollar has rallied because global investors are dumping Euros in favor of Dollars, China's exports are already taking a hit. The Chinese Yuan is pegged to the U.S. Dollar. Simply put, China is disadvantaged when the Dollar is strong. Their imports cost more in Europe and the U.S. for businesses and consumers alike.
2. Chinese exporters are heavily reliant on short term letters of credit from major global banks for trade. Meaning, a tightening of credit through no fault of its own, China faces a major drag to its economy.

Tie it all together:

1. The ultimate disaster from the Greek debt crisis is a vicious cycle in which credit tightens in all three regions; Europe tightens first, then the U.S. and then China. China's growth slows, the U.S. exporters see less Asian demand for its products, our economy slows, and then our credit tightens.

The 3 factors that have driven our stock market rally have been low inflation, low interest rates, and strong corporate earnings. When you have these factors in existence simultaneously, it is great for stocks. Of the three, the one that is now called into question is corporate earnings. *From an investor's perspective, the 1200 level on the S&P 500 looks like it is becoming the resistance level for now. Meaning, we're looking a little "toppy" right now even with great economic and fundamental news. The interpretation may become that the recent good news in terms of strong corporate earnings and economic stats are factored into stock prices. The question is how long this thought will occupy the psyche of investors. The longer this psyche lasts, the more it will become the conventional wisdom of the day…which may potentially keep a lid on stocks.*

Despair not! There is a silver lining in all this:

1. It is pretty much a slam dunk for interest rates and inflation to remain tame for quite some time; thereby, the Fed could be expected to retain the "extended period of time" regarding its low interest rate policy.
2. Oil is finally coming down in price; just in time for the summer driving season.
3. Domestic publicly traded companies have strong balance sheets, the strongest since the post WWII era.

4. King Dollar has forcefully reclaimed the throne as the world's stable currency. It wasn't that long ago that China said it wanted to diversify its foreign reserves out of U.S Treasuries into Euros and Russia said it wants to price its oil in Euros. I think it is a fair bet that those plans are off the table.
5. Housing, while still problematic, is recovering.
6. Employment, while still problematic, is also recovering.
7. The Chinese consumers' spending and quality of life trajectory is still pointing higher.
8. There is, what I believe, a resurgence in technology spending that could be even bigger than what we witnessed in the '90's.
9. M&A activity is on the rise.
10. The policy actions of the late '07 to early '09 era (low interest rates and stimulus spending) are actually just starting to take hold.

Can the U.S. economy withstand an embattled Europe and a decelerating Chinese economy? For now, I'll answer with a "yes". Can things get uglier between now and the next 6 months? Again, yes. Do I expect the Eurozone to deteriorate more? Emphatic yes! Do I expect all of this to cause a double dip recession? For the above reasons, no. Therefore, patient investors will undoubtedly survive the storm and opportunistic investors will catch a few bargains. I hope this brief explanation helps to explain how a small country, Greece, which has virtually no impact on U.S. GDP, can have such a powerful affect on the global economy.

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Thanks for reading this. Please forward this to anyone you know who may find it interesting. Please reply me if you'd like to comment.

Interested in becoming a client? Call me. Let's talk about it.

(Disclosure: This is solely MY opinion. Of course, you are welcome to share your opinions with me too. If you act on any of this without speaking to me first and you lose money, don't blame me. I may be wrong. I reserve the right to change my mind about any of this whenever I want and without warning. Have a great day! ☺)

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