ECONOMIC UPDATE JUNE 2012

JUST WHEN YOU THOUGHT IT WAS SAFE TO GO BACK IN THE WATER . . . .

Like the tagline from the movie Jaws 2, investors are dealing with a global stock market that has managed to show its teeth for a third consecutive spring. Once again for the third time, the culprit is the birthplace of democracy – Greece. With all the chatter in the media about the troubles in Europe that are causing global economic concerns, we felt that a short list of answers to frequently asked questions would be of use. With that, the following is an attempt to briefly address the current environment from Alpha to Omega.

WHAT IS GOING ON IN GREECE?

Greece is up to its eyeballs in debt, and its economy is too weak to generate the profits needed to pay the interest and principal back. Most of Europe is in various stages of this problem, but Greece is arguably the weakest link. The country has essentially defaulted on its debt. Its lenders agreed to restructure the loans by reducing the face amounts and extending the maturities. That occurred earlier this year, and the markets rallied after the problem was addressed. Now the country has stalled on further restructuring, which has re-introduced more uncertainty about its ability to survive. The concern is that Greece will stop using the euro as its currency and go back to its old pre-euro currency.

WHY IS IT SUCH A BIG DEAL?

If Greece returns to its old currency, the other European countries that have loaned it money will face even more losses because the value of the Greek currency won't be nearly as much as the euro. All of these losses would continue to weaken these countries' banks. This would lead to panic, runs on the banks, the inability for businesses and consumers to get loans, etc. (Think 2008.) Also, if Greece ditches the euro, it is presumed that more weak EU countries will follow, which would make the problem even worse. All of this is bad for the global economy, since a further slowdown in business in Europe would reduce economic activity in all corners of the world.

WHY HAS THIS CAUSED A SCARE FOR THREE YEARS IN A ROW?

"The chief business of the American people is business." – Calvin Coolidge

For all the criticisms against the U.S., we have created a much better set of rules with which to conduct business. Our system lets survival of the fittest run its course, which results in ripping the Band-Aid off failures and cleaning up the mess (bankruptcies, foreclosures, lost investment dollars) relatively quickly. This of course is not comfortable for those to which it is occurring, but it cleanses the system so that the rot doesn't sink the boat for everyone else. The system in Greece and the rest of Europe allows problems to continue longer. This can make things better immediately but ultimately creates more long-term pain. A modern-day example of this is Japan.

That country's real estate bubble burst over 20 years ago, and its stock market is still below where it was in 1989. Europe has been dealing with its debt problems for over three years but still hasn't taken the medicine needed to get better.

HOW ARE MY INVESTMENTS BEING POSITIONED TO HANDLE THIS?

Several portfolio management steps have been taken to address the risk that exists in Europe. For some time, certain components of portfolios have been underweighted in exposure to the region. Also, other international exposure has been periodically reduced as risk levels have increased. That being said, at some point, some of these problematic countries will likely be positioned for solid performance. Because of this, they are continuously being monitored for the time when it's appropriate to go from playing defense to offense.

THE STOCK MARKET HAS GONE UP A LOT SINCE 2008, BUT IT HASN'T FELT GOOD. ARE THINGS EVER GOING TO FEEL BETTER?

After the explosive rally that the market had in 2009, it has made little progress with lots of volatility. To a large extent, this is understandable. A diet is a good analogy. In the early weeks of a diet, the pounds tend to be shed quickly. Then the progress slows and it's a battle to keep going. Currently, the economy is in the slow stage of shedding debt, and the market is having emotional responses to reading the scale. As such, the volatility has been extremely high, which has overshadowed the progress that has been made.

Are things going to get better? Yes, we believe the world's best days are still ahead. However, that doesn't mean that there won't continue to be ongoing volatility and/or another recession right around the corner. Using history as a guide when analyzing the current environment, it seems that one of two scenarios could likely unfold. One scenario is a continual improvement in the U.S. picking up economic steam. (Manufacturing is coming back from China because increased labor costs are reducing the cost advantage there.) There could be much more trouble out of Europe that results in six month stretches of panic, but this might not derail U.S. growth from pulling the rest of the world into a period of strong economic expansion. With the stock market being relatively cheap after a 13 year digestion of the tech bubble, it could produce good returns in this environment. A second scenario is less optimistic but could present plenty of opportunity to piece together respectable investment returns. During times in history that have been similar to the one we are currently in (deleveraging economy, shrinking middle class, political unrest) the expansions and contractions of the economy have been shortened. While this can cause declining periods to occur more frequently, it can present rallies off of very low valuations and other classic investment opportunities that became unavailable after the start of the roaring bull market of the 1980's and 1990's. This is a reason why Warren Buffett said that one of his favorite periods as an investor was during the 1970s -- a back and forth period rarely categorized as a good investment environment. Remembering the saying that it's darkest before dawn, at Ryan Poage & Co. we are constantly evaluating potential opportunities in the midst of attempting to manage risk.

Ryan Poage & Co. | Kansas City, MO | www.ryanpoage.com | ryan@ryanpoage.com | (816) 531 - 4555