QUICK MARKET UPDATE

Greece: Mythology Meets Reality

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In Greek mythology, Sisyphus was a powerful and feared king promoting navigation and commerce.[1] In short, he was in charge of the GDP growth of his kingdom. He was, however, very deceitful, and eventually his deceit angered Zeus. As punishment, Zeus designed a task to frustrate Sisyphus for eternity. He would have to roll a boulder up a hill, only to have the boulder roll away from him as he neared the summit, at which point he would have to start the task again. He would have to repeat this never ending task for eternity.

There are strong parallels between the myth of Sisyphus and the reality of the eurozone's task to stabilize the euro currency by providing a solution to the Greek debt crisis. Various attempts have been made to stabilize the situation, but as with Sisyphus, it seems every time a final solution is in sight, the boulder rolls down the hill and the eurozone members have to regroup and start pushing back uphill.

More specifically, it seems that German Chancellor Angela Merkel, French President Nicolas Sarkozy, former European Central Bank (ECB) President Jean-Claude Trichet and the International Monetary Fund (IMF) are taking turns pushing the boulder. The most recent proposal to combat the sovereign debt problems in the eurozone came at the Euro Summit in Brussels on October 26.[2] Before discussing the various decisions which came out of the summit, a brief review of the problem is necessary.

The eurozone represents a collection of 17 countries in the European Union which have agreed to a common currency, the euro. However, the countries in the eurozone do not share political or fiscal policies, and several countries have been running fiscal deficits that are not sustainable. The focus of the recent concern is a group of countries referred to as the European PIIGS - Portugal, Ireland, Italy, Greece, and Spain. The national debt of these countries has been financed by issuing sovereign bonds which are owned by investors and, to a large extent, by various European banks. Each year, the current year fiscal deficit gets added to the debt, and investors have started to take notice.

The concern is that the debt has become unsustainable relative to the GDP of each country, raising the risk that one of the nations will default on its debt. Of the PIIGS, the country with the most near-term trouble appears to be Greece. The fear is that a default by Greece will result in a domino effect which will ultimately result in another credit crisis. This crisis would be similar

[1] Wikipedia
[2] Euro Summit Statement, October 26, 2011

to the global credit crisis which followed downgrades of subprime mortgage obligations here in the United States in 2008 and 2009.

In my opinion, the domino effect might proceed as follows: Greece defaults and is the first domino. Banks which own Greek debt have to recognize the loss of value due to default on their balance sheets by expensing the losses through impairment charges, thereby also weakening their own credit quality, a second domino. The default of Greek bonds has implications for the debt of other countries (the PIIGS less the G) and likely means the value of the debt of those countries also has to be impaired, a third domino which further weakens banks. Those banks have to raise capital to make up for the balance sheet impairment, and if they are unable to obtain that capital, they risk a default or bankruptcy of their own, a possible fourth domino. In the meantime, other banks and investors own the bonds of the weakened European banks and have to take their own impairment charges to reflect the deterioration in quality of those obligations, a potential fifth domino which may fall across the Atlantic.

To address the problem, leaders of the eurozone convened in Brussels last week and agreed on several items, the three most important of which are:[2]

1. The Eurogroup authorized the disbursement of the sixth tranche of EU-IMF support for Greece. The EU-IMF package provides funding to Greece (and other troubled nations) to refinance debt which is coming due. The authorization of funds is predicated on Greece's ability to implement austerity measures to reduce the annual fiscal deficit. The authorization of this tranche basically removes the immediate threat of default – at least until the next round of funding is needed.

2. The first serious attempt at an orderly restructuring of existing Greek debt was announced in the form of a working agreement with banks to take an impairment of 50% of the principal value of Greek debt. Prior to this agreement, there was acknowledgment that impairment is necessary, but uncertainty regarding the amount of impairment charges to be taken by banks. The guidance removes uncertainty and specifies the amount. In addition, the group announced agreement that banks will have to recapitalize to capital ratios of 9% by June 2012. Again, this removes the uncertainty of knowing what banks will have to do. Management (and equity analysts) can plan for the impairment and the capital raises and move on with some level of certainty of what will be required.

3. The funding of the European Financial Stability Fund (EFSF) was increased to 1 trillion euro by ratification of the member states.[3] The EFSF functions by providing credit enhancement to debt issued by Member States. This is similar to debt being issued with an insurance policy against default and lowers the interest rate investors require based on the credit quality of the issuer alone. In addition, the EFSF was authorized to set up special purpose vehicles to provide for external investment in the bailout funds – notably targeting China's participation.

[3]"Australian, New Zealand Dollars Strengthen on Europe Accord," Bloomberg, October 27, 2011

These three points of agreement are notable attempts to push the boulder up the hill. Equity markets globally rallied on the news of the agreement.[5] That was, until Greek Prime Minister George Papandreou called for a Greek referendum on the European bailout which basically kicked the boulder back down the slope.[4] The referendum on the package, which includes additional, very unpopular austerity measures, re-introduces uncertainty that the agreed upon package may not succeed in bringing an orderly restructuring of Greek debt and, ultimately, may not avoid an escalating credit crisis.

In the meantime, in a pattern that has existed since Standard and Poors downgraded the U.S. long term debt rating in early August, markets are trading day-to-day based on headline news instead of the fundamentals of each individual investment.[3] Here in the United States, the companies in the S&P 500 are quietly adding another quarter of strong earnings growth, with 74% of companies reporting exceeding analyst expectations.[6] Notwithstanding the strong level of earnings and fundamentals such as limited debt and high cash levels, companies are trading at valuations that are consistent with deep recessionary expectations.

What are investors to do? The day-to-day ups and downs of equity markets are likely to continue as the sovereign debt boulder is pushed back up the hill again and again. Fortunately, there is separation between the worlds of mythology and reality in that every crisis in the history of the market has eventually come to an end. This crisis will pass and investors will deal with the aftermath, finding a new way forward.

From a portfolio perspective, we believe investors may be able to address the uncertainty by planning for necessary short term liquidity and by investing for the longer term through a diversified mix of assets which is rebalanced as needed to maintain an appropriate level of risk for each investor.

If you have any questions or concerns, we recommend you contact your H.D. Vest Advisor for guidance.

[4] "Stocks, Euro Decline as German Bunds Rally on Greek Referendum," Bloomberg, November 1, 2011
[5] Based on review of the S&P 500 and MSCI indices, Bloomberg, October 27- 28, 2011
[6] S&P 500 Earnings Season to Date, Bloomberg, November 1, 2011

Disclosures and Important Definitions

The eurozone officially called the euro area is an economic and monetary union (EMU) of 17 European Union (EU) member states that have adopted the euro (€) as their common currency and sole legal tender. The eurozone currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. Most other EU states are obliged to join once they meet the criteria to do so. No state has left and there are no provisions to do so or to be expelled. Monetary policy of the zone is the responsibility of the European Central Bank (ECB) which is governed by a president and a board of the heads of national central banks. The principal task of the ECB is to keep inflation under control. Though there is no common representation, governance or fiscal policy for the currency union, some co-operation does take place through the Euro Group, which makes political decisions regarding the eurozone and the euro. The Euro Group is composed of the finance ministers of eurozone states, however in emergencies, national leaders also form the Euro Group.

The European Financial Stability Facility (EFSF) is a special purpose vehicle financed by members of the eurozone to combat the European sovereign debt crisis. It was agreed by the 27 member states of the European Union on 9 May 2010, aiming at preserving financial stability in Europe by providing financial assistance to eurozone states in economic difficulty

Investments are subject to market risks including the potential loss of principal invested.

The S&P 500 is an index of 500 major, large-cap U.S. corporations. You cannot invest directly in an index.

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Investments in individual sectors may be more volatile than investments that diversify across many industry sectors and companies. Certain sectors of the market may expose an investor to more risk than others.

International investing involves special risks due to specific factors such as increased volatility, currency fluctuations and differences in auditing and other financial standards.

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