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May 2010 Economic Update & Commentary: Financial Crisis in Europe

Summary

The European Union and the International Monetary Fund (IMF) have agreed on a rescue package worth 110 billion euro (US\$145 billion) to help the pressured Greek economy. In return for this unprecedented rescue package, the Greek government has announced a set of domestic austerity measures. The austerity measures have created visible social unrest.

On May 9th the European Union Commission announced the creation of a \$1 trillion three-year

aid plan with contributions from the 16-nation euro zone and the IMF. These funds will certainly ease liquidity pressures in the short run, but will not solve Greece's real problems which are structural and long-term. Debt restructuring is inevitable because Greece's problem is a solvency issue, not merely a liquidity issue. The well-publicized debt problems of Greece and some other euro zone countries will have important negative regional growth implications in the years ahead.

What's Going on in Europe?

A number of European countries are struggling to meet their debt obligations. This sovereign debt crisis has serious economic, political and social implications. The headlines have made it appear that it is all about Greece. It is more complicated than that. Here is where we stand today and here is our opinion on the situation.

After months of costly delay, the euro zone and the IMF have come up with a \$145 billion three-year bail-out deal to rescue Greece's embattled economy. The package is equivalent to slightly more than a third of Greece's outstanding debt. The European Central Bank (ECB) also announced that its' minimum credit rating threshold will not be applied to Greek assets until further notice allowing for Greek bonds to be used as collateral in ECB funding operations. What persuaded the euro zone countries and the IMF to lend Greece such a large sum was the fear that if Greece defaulted other countries like Portugal or even Spain could follow. While the "patient may be out of the emergency room" plenty of doubts remain, however.

In return for the financial support, the Greek government has unveiled sweeping reforms that will slash public-sector wages, cut pensions, freeze public and private-sector pay, liberalize Greece's labor laws and raise some taxes. This will, in theory, help it reach a deficit-GDP ratio of 3% by 2014 down from 13.6% in 2009. This plan buys time and shelters Greece from the fierce winds of the markets.

State of the Greek Economy

Following a 2.0% decline in Greek GDP in 2009, the economy will contract sharply in 2010 and growth will remain extremely weak over the medium term. Higher unemployment, significantly tighter fiscal policy, reduced availability of credit, and larger spare capacity levels mean that domestic demand—which had been the engine of growth during the past decade—will struggle for a considerable time. Moreover, a low savings rate, the relative lack of openness of the economy, and its' very weak external competitiveness mean that the adjustment will be lengthy. The only way to improve that competitiveness in the short run is by reducing costs—for example wages—as Greece does not have control over its exchange rate.

The Greek government seems to be willing to tackle politically sensitive topics, such as public sector wages and pensions. Our main concern remains that these tough measures will likely trigger social tension and jeopardize



the stability of the government. Widespread strikes and demonstrations are expected over the coming weeks in response to the government's austerity measures. Nevertheless, the public still seems to support the government on the whole, but polls suggest that this support has been decreasing in recent weeks. We are concerned that this will continue to be the case should the economic situation further deteriorate. If that happens, the main worry is that the important reforms so badly needed to ensure sustainable growth and the health of the public finances, such as pension reforms, may be watered down.

Euro Zone-IMF Response is Too Little Too Late

Lessons from previous sovereign debt crises suggest that they tend to intensify until the financial markets are confronted with evidence that leads to a sharp shift in investor expectations. For a bailout to restore confidence it needs to meet several conditions. First, it should be assembled rapidly. Procrastination can be self-defeating. In late 2008, arrangements for Hungary, Iceland, Latvia, Pakistan and Ukraine were approved within four to six weeks. By contrast, it has been six months since Greece shocked the financial markets by announcing a drastic revision to its 2009 budget forecast. Germany has been reluctant to rescue Greece knowing that most voters view a bailout as a reward for Greece's wasteful spending. The delay has caused the Greek debt crisis to turn into a wider European conflagration that threatens Portugal, Spain and potentially other indebted countries.

Second, a bailout needs to be big enough to deliver a big jolt to the financial markets. The longer the governments delay, the larger the jolt has to be – thus the current \$145b package may not be enough. Moreover, the commitment to multi-year support has to be credible. With questions and doubts swirling over Germany's commitment to financing – even for 2010 – any evasion or hedging on financing for 2011-12 will sink the whole package.

Third, conditions for economic adjustments are essential, but will lack credibility if they are too tough – and they must cover the relevant issues. In Greece, that means dealing with fiscal as well as financial policy, because of the strains the banks are under. However, the bailout package has completely ignored the financial sector.

Fourth, the package must not just provide financing to allow bondholders to rush for the exits. Greece's creditors will continue to flee until they are convinced that the Greek government has put its debt burden on a sustainable downward track.

Finally, the burden of adjustment in the negotiated Greek bailout plan falls on the European (\$105b) and international taxpayers (\$40b). There will be no contribution from European banks that hold large amount of Greek debt. That taxpayers should contribute so that financial institutions can get away with reckless lending seems perverse and leads to the moral hazard issue in the future.

Given these problems, it is hard to conceive how the bailout package in its current form will succeed in stabilizing the Greek economy. *In our opinion, Greece's fiscal predicament requires not just adjustment and new financing but ultimately debt restructuring.*

The Inevitability of Debt Restructuring and Devaluation

Consider the prerequisites for a successful bail-out program. First, Greeks must comply with a sharp decline in their living standards over the next three years. Will the Greek public be willing to bear that burden? Second, after three years of the bail-out program, Greek debt will be much higher than today's 115% of GDP. At that point markets will have to think it plausible that Greece is on a path toward reasonable debt levels because it is able to grow fast enough and maintain the fiscal belt-tightening for some considerable time. Doubts on the



part of markets on any of these issues will lead to higher costs of borrowing for Greece and put it back into the viciously self-sustaining fiscal debt dynamic in which it has found itself recently, except that the starting point in terms of debt level will only be worse.

Given the huge fiscal retrenchment now planned and the absence of exchange rate or monetary policy offsets, Greece is likely to find itself in a prolonged slump. Will structural reform do the trick? No, not unless it delivers a huge fall in labor costs, since Greece will need a prolonged surge in net exports to offset the fiscal tightening. The alternative would have to be a huge expansion in the financial deficit of the Greek private sector. That seems inconceivable given the current state of affairs. *Thus Greece's fiscal predicament requires not just social adjustments and financing but devaluation and debt restructuring.* With devaluation to be achieved through painful deflation, the case for restructuring looks only stronger. *Substantial loan write-offs will therefore be inevitably necessary in our opinion.*

The Latest European Union Package

The recent EU \$1 trillion package with additional ECB support, announced on 9th May, is a comprehensive attempt to quell the panic in markets by introducing a lender of last resort. This measure will greatly reduce the near-term probability of a sovereign liquidity crisis in Europe. *The most important signal in the package is that this time the policy makers will do whatever it takes to preempt markets' reactions rather than respond to them.*

Most of the details of the package still need to be announced and it is possible that the market may still question whether all the measures announced can pass through national parliaments. However, the major concern is that the solvency situation of a number of countries still looks precarious. The funding rates of the new package will not be much lower than in the Greece bailout. As such, debt-ridden countries that seek funding through the market will still face a high interest burden. Assuming similar conditionality is attached, *the fiscal tightening required is likely to have a significant negative impact on growth in any participating country. As such, troubled sovereigns will still find it difficult to reduce their debt burdens. And it remains to be seen just how much austerity electorates will tolerate.*

Other Countries in the Euro Zone

The sustainability of a government's debt-to-GDP ratio depends on its current value, the size of the primary fiscal deficit, the interest rates the government needs to pay on its debt and the economy's nominal GDP growth rate. Although the Greek government may have the most difficult task ahead, government debt in some other Euro-zone economies, such as, Portugal, Spain, and Ireland are also of immense concern. *The risk of contagion from the Greek crisis spreading across the euro zone is growing by the day.* The next couple of months will be vital and much will depend not only on how the Greek situation unfolds, but also on how the highly indebted economies inside the euro zone perform.

Portugal

Although the deficit and debt levels are lower in Portugal than in Greece and the Portuguese government has much more fiscal credibility than its Greek counterpart, the underlying problems are very similar; these are two very uncompetitive economies within a common currency area.

With a fiscal deficit standing at 9.4% of GDP in 2009, further fiscal consolidation is all the more difficult. Domestic demand will be under intense pressure from significantly tighter fiscal policy, while the weak external competitiveness of the economy means that it will be very difficult for Portugal to "export" its way out of the recession. It is clear that the markets do not believe that the fiscal measures implemented by the government to deal with the deteriorating public finances are enough, *and we expect further austerity measures over the coming months. One major concern is that there are doubts about how the euro zone will respond if Portugal*



becomes the next victim of bond short-sellers. The German government has made it clear that the safety net in place for Greece is a one-off and there are questions about its political willingness to continue helping economies in distress.

We are concerned that the absence of a euro zone safety net for Portugal could make it extremely vulnerable in bond markets, driving up yields and eroding the government's ability to bring down the fiscal deficit. The sluggishness of the euro zone in coming up with a detailed bailout plan - and the apparent differences between Germany and most of the other Euro zone members - has increased fears about the availability of help should Portugal require support in the future.

Spain

It could be argued that Spain presents the most serious long-term risk to the euro zone, given that it accounts for some 11.5% of the region's real total GDP, as opposed to Greece's share of 2.6% and Portugal's 1.8%. Reeling from a burst housing bubble built on cheap and easy debt, Spain is also suffering from a 20% unemployment rate. Its credit rating has recently been downgraded. Although Spain's immediate public finance problems are not as bad as Greece's, there are serious concerns over its longer-term economic outlook.

What's Ahead in Europe?

History shows that governments can achieve significant fiscal corrections, but these adjustments have generally been spread out over years. Belt tightening requires sacrifice, which increases as the speed of the underlying adjustment quickens. *A government's ability to deliver fiscal adjustment ultimately depends on the willingness of the public to accept painful spending cuts and tax increases.* The questions that investors need to ask themselves regarding each of these economies is whether the citizens will have the will to bear the necessary pain. Answers to these questions likely will not be forthcoming overnight. *Therefore, long-term government bond yields in economies that require significant fiscal adjustments could remain elevated for quite some time and the euro is likely to be under pressure for some time.*

Taking a broad view of the current crisis, there are at least three areas where the 16 euro zone nations need to coordinate economic policy in order to avoid a repeat of the current crisis: fiscal discipline, macroeconomic imbalances and crisis management.

Fiscal policy is governed by the EU's stability and growth pact, which sets an upper limit for national budget deficits of 3% of GDP in normal times, but allows temporarily higher deficits if economic conditions turn sour. Countries that ignore recommendations from the European Commission and fellow governments to restore fiscal order can be punished with fines. In fact, that has never happened in the euro zone's 11 year history. In 2003 Germany and France worked to loosen the stability pact's rules. Euro zone countries need to strengthen its surveillance of national budgetary policies, and take more effective action against governments repeatedly flouting the stability pact.

Euro zone should also address the gap in competitiveness between over-achievers such as Germany and Austria and chronic under-achievers such as Greece and Portugal. This gap expresses itself in enormous current account surpluses in the first group and enormous deficits in the second. One solution would be to raise domestic demand in the first group and to improve competitiveness of the second by means of productivity-enhancing structural reforms.

The Euro zone should set up a permanent crisis resolution mechanism for Greek-style crises. The mechanism of a 'lender of last resort' should contain disincentives so unattractive that no government would voluntarily want to borrow funds under it.



Eurozone Implications for the U.S. Economy

The impact of this financial crisis will mostly hit in Europe, where the banks and insurance companies that hold most Greek debt are based. But given the nature of the global economy, in which everything is connected, there is every reason for U.S. businesses and investors to care about the turmoil overseas. *The debt crisis in Europe is going to push more capital into the U.S.* The timing actually could be fairly good for the U.S., since the U.S. federal government is itself cutting back on the emergency aid programs that were instituted at the height of the credit crisis. We expect this crisis will likely result in:

- *A Stronger Dollar:* The euro had been sliding in value against the U.S. dollar. The EU \$1 trillion package to support the euro may help to keep the exchange rate from dropping below 1.25 dollar against the euro.
- *Lower Interest Rates in the U.S.:* Money is moving into dollar-denominated assets, pushing up the price of stocks and the price of U.S. Treasury debt, which remains the safe haven currency, despite considerable financial problems in the U.S. As demand for US assets rise (e.g. stocks), their prices will rise and so we expect this crisis will help rates stay lower than they might otherwise have been in the U.S.
- *Impact on Trade Deficits:* A stronger dollar should keep the U.S. trade deficit high for the foreseeable future.
- *Cheaper Oil:* The price of oil will decline in anticipation of slower growth in Europe. U.S. businesses and consumers will benefit from lower gas prices and fuel costs. For oil intensive businesses, this should be helpful to profitability.
- *Demand for Corporate Debt:* As Treasury rates in the U.S. fall, the yields on U.S. corporate debt will look relatively attractive, helping U.S. businesses raise capital. That will be a shot in the arm for economic activity across the country. Investment grade corporate bonds still appear to be attractive on this basis.

Overall, the debt crisis in Europe should be mildly positive for the U.S. economy - as long as it doesn't spin out of control. In the event of a real panic, investors tend to sell everything except the very safest assets, such as Treasury debt.



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2010 Forecast

The economic recovery continues to accelerate. The private sector finally stopped cutting jobs and started adding to payrolls. We are in the very early stages of an economic upswing. 2010 should see above average economic growth and above average performance for stocks.

Performance

For the three months ending April 30th, the growth accounts under the management of Barden Capital were up about nine percent lagging slightly behind the performance of the S&P 500, which was up about eleven percent. During periods of fast-rising markets we will tend to lag somewhat due to the multi-asset class composition of the portfolios. In quickly appreciating markets, less risky assets like treasury bills and corporate bonds act as a drag on performance.

For 2010, the U.S. stock market is the best performing market out of the 15 developed country markets. International markets have lagged substantially as European markets are pre-occupied with the fate of the Greek debt crisis. Investments in emerging markets have also created a drag on performance in 2010.

For the last twelve months, the growth accounts are up more than 40%. Since Barden Capital's inception in November, 2006, the growth accounts have outperformed the S&P 500 by 3% a year on average with lower volatility.

Corporate Profits

The market looks as far out as it can see. It's not the change in expectation on near term earnings that

drives stock prices, but it's the change in expectations on earnings 12 and 24 months out that has the most impact on stock prices. Over the last 22 years, investors have valued the market at 17.6 times forward earnings, on average. Valuation has ranged as high as 28 times forward earnings during the dot-com boom, and as low as 10.8 times during the credit crisis of 2008-9.

Today, investors value the market at 15.2 times earnings, a little low by historic standards, but these are obviously not ordinary times. Multiple expansions tend to coincide with increased investor confidence. As the market recovery matures, it's likely that the multiple will increase to at least 17 times earnings, likely peaking somewhere around 20 times earnings.

Regardless of how confidence plays out, the earnings component of the valuation equation continues to improve. At the end of 2009, analysts anticipated \$84 in 2011 earnings for the S&P 500. Now, just three months later, analysts are projecting S&P 500 earnings of \$91, an all time high. At the conservative 15.2 times earnings, the current estimate implies a year-end price target for the S&P 500 of 1383, or an additional 17% appreciation from today's levels.

The high water mark for S&P 500 earnings was \$88 in 2006. If the S&P 500 sets a new high for earnings, stocks will likely set a new high as well. My guess is that the S&P 500 will exceed 1500 sometime within the next 18 months.

Market Strategy

Large, high-quality growth stocks continue to lag small low-quality stocks. This is typical coming out of a bear market, but what is unusual is the size of the performance disparity. Eventually, this disparity will reverse, and high quality stocks will outperform, but the timing of this shift is unknowable. It appeared that the Greek debt crisis might start a run to quality, but after a couple of false starts for blue-chips it's too soon to tell if the recent outperformance of high quality stocks will last.

I'm reluctant to chase low quality stocks that are outperforming. We have a portfolio of undervalued



companies with strong quality characteristics like low debt and strong cash flows. This prevents us from matching the gains of the most aggressive strategies. But, we are pursuing a course that will yield stout gains through strong earnings growth while limiting our risk by owning high quality companies.

Economic Outlook

The stock market is a leading indicator of the overall economy. Now that the first year of the new bull market is behind us, we can get a sense of the potential of the impending economic recovery. From the low on March 9th, the S&P 500 was up 68% over the next year. That makes this the best first year of a bull market performance since the 1930s. Given the severity of the economic downturn, it's quite likely that we are setting up for the strongest economic expansion since the end of the Depression.

Inflation

Core inflation continues to gradually decline in spite of higher energy costs. High unemployment precludes any significant wage increases, which is a requirement for runaway inflation. A strengthening dollar also mitigates the risk of inflation. Even though many observers stress the risk of deficit spending, the nearly unprecedented increase in private savings has so far more than offset the increase in government spending.

Unemployment

The private sector finally stopped cutting jobs and started adding to payrolls. The most optimistic economists are forecasting as many as 300,000 new jobs a month for the rest of the year. But, the economy needs to add approximately 3,000,000 jobs just to reduce the rate of unemployment by 1%. To reach what economists consider full employment (5% unemployment) the economy needs to create about 15 million jobs. Assuming the optimists are right, it will still take the economy more than four years to get back to full employment levels. This is a simple estimate for the expected duration of the current economic recovery.

2010 has started off relatively well, but problems tend to surface when investors least expect them. Currently, the U.S. is benefitting from Europe's problems as most investors believed Europe was in a stronger position coming out of the credit crisis of 2008. Portfolio managers who limited their investments in the U.S. are now racing to catch up. This is clearly a very fluid environment and we won't hesitate to change course as events dictate.

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