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Euro-Zone Debt Crisis

Over the last several weeks, the financial markets in Europe and some parts of the world have been in turmoil because of the quickly developing realization that many of the countries in Europe had accumulated levels of debt that simply cannot be supported by the levels of income collected in taxes and fees by these sovereign states. The crisis started in Greece where the government acknowledged that previous statements regarding the central government's annual budget deficit and accumulated total debt underestimated both. As this news was slowly released, the financial markets were spooked and started selling Greek sovereign debt, which resulted in lower prices and higher interest rates. As fear spread, the markets sold the debt of other euro-zone countries with high deficits and high levels of accumulated debt. These countries – Portugal, Ireland, Italy and Spain are known, along with Greece by the acronym PIIGS. As the crisis deepened, the euro fell in value (now at a four year low), stock markets were weak and shares of European financial institutions known to hold large amounts of euro-zone sovereign debt came under pressure. The strongest countries – Germany and France, along with the "independent" European Central Bank (ECB), came together to develop a rescue package for Greece and the other weak countries. After a slow start, the euro-zone and the International Monetary Fund (IMF) put together a massive one trillion dollar rescue package to stabilize the financial markets and provide liquidity to these countries. This rescue package of direct loans, guaranteed loans, and open market purchases of troubled sovereign debt is designed to give these countries two to three years of breathing room in order to get their finances back to sustainable levels. This will result in major spending cuts in government services, salaries, subsidies, etc., along with significant tax increases. If these fiscal measures are successfully put in place, the result will be a significant slow down in economic growth and a sharp rise in unemployment. For example, the IMF estimates that Greece has debt levels four times that of the standard set when the euro was created, and that when these austerity measures are in place, the Greek economy will decline 4% this year and 15% next year.

Other implications of this crisis will be slower growth in profits of European companies and rising risk of failure of some of the euro-zone financial institutions. The decline in the euro has resulted in the rise in the U.S. dollar. A flight to safety has resulted in a significant decline in U.S. interest rates, especially those of U.S. Treasury securities, and an increase in the price of gold.

The fall in the euro will eventually stimulate euro-zone exports and tourism, while the rise in the dollar will hurt U.S. exports. Success of these austerity measures are far from assured as they have already resulted in some social unrest, which could escalate. It may also result in changes in some of the governments because of this unrest or election results.

Furthermore, a slowing or decline in the growth in these countries raises the risk the economic recovery in the U.S. will be muted but will also keep U.S. interest rates lower longer.

Longer term, there is a distinct risk of rising euro-zone inflation as the ECB, which has been a large buyer of sovereign distressed debt, decides to monetize this debt resulting in a large increase in the money supply. This inevitably results in significant increases in inflation. In addition, it is still possible that some of these nations actually default which could result in losses of 30-50% in the value of the defaulting nation's debt. This in turn would put some of the large holders of this debt at risk. It could result in the financial crisis spreading beyond the euro-zone. Since many areas of the world's economy are still over leveraged – including the U.S. federal government and many of our states – the spread of any financial contagion could have serious consequences for many of the world's markets and economies.

Finally, there is a risk that the euro itself, as a currency, does not survive and that the euro-zone ceases to exist with major but unknowable consequences.

Given the above, we have examined our security holdings to see if any are especially vulnerable to this crisis. In addition, we continue to limit our exposure to securities of financial institutions which might be exposed to problems.

The euro-zone debt crisis is one of several factors increasing volatility in our financial markets. It is a leading cause of the correction to the stock market in May after the 15 month rally. Given the unresolved situation in Europe and the ongoing uncertainty and fallout to the markets, we think it is best to maintain our cautious approach in the management of assets.

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