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Yesterday, And Tomorrow

What happens when debt is too much

Bill Henderly, CFA | Nvest Wealth Strategies, Inc.

Greek contagion fears spread yesterday as financial market vigilantes concluded it time to address the issue. When governments and authorities fail to address critical issues either timely or correctly, the financial market vigilantes take matters into their own hands. The result, for a day (or yesterday and probably lasting for several more weeks), is nerve-racking volatility and drawdown of asset values. These are akin to "hiccups" that often pause a new bull market after monetary authorities raise interest rates. Hiccups typically cause the market to correct by 6% to 10% over six or eight weeks.

Market vigilantes passed judgment on the ECB yesterday, which failed to adequately address Greek debt and its austerity plans. And, the message is heightened by concerns for the lack of financial discipline (to manage increasing budget deficits/debt from years of overspending), spreading to other countries (Portugal, Spain, Italy, or maybe other European countries). The day of reckoning is at hand. You can only "kick the can down the street so long"; the "bill is coming due."

As a result, other market participants pursued a flight-to-safety trade, selling risky assets and buying US government and German bonds and gold. Greek 2-year bond yields are approaching 20% (sounds like 1981 US short interest rates). At one point yesterday, a trading system glitch exasperated participants' fears that "Chicken Little" had arrived, and the "sky was falling".

What we learned yesterday is that market vigilantes will dictate negative consequences when action is slow or inadequate. Second, diversification within investment portfolios is critical, but not fail-safe (this has been proven many times in the past as well). Portfolios experienced drawdown, but not market level declines. A quality focus also helps, a lot. Third, Greece and et. al, with the ECB must implement difficult actions to improve financial strength to debt laden member countries. Fiscal austerity is imperative. As a result, the near-term will experience additional volatility and "hiccup". But, the economic recovery (much stronger than when Lehman Brothers failed) underway can be expected to endure and the financial markets will resume their upward track. We do however, expect the financial markets will be influenced for years to come with sovereign governments dealing with extended debt situations.

Fourth (and a most important lesson), any individual or country including the US, who believes they can live in excess of their means or live on borrowed money in excessive ways, will see the "bill come due". It often costs high rates of interest (as in Greece) before the issue receives appropriate action. The US will need to address huge deficits. Spending must be reduced so cash flow from reasonable taxes may be used to repay debt. At the same time, taxes and interest rates cannot be so heavy that they choke economic growth. And, the answer is not found via turning up the government printing presses; that boosts inflation to levels that create many other challenges. Time and discipline are keys to the solution, as excessive debt problems are not eliminated overnight. Pay the bills; they are coming due.

In the meantime, we continue to invest carefully, with discipline using diversification, and focusing on managers of no-load funds that seek higher quality ideas. We feel confident...

- The Fed will keep fed funds rates lower longer
- Lower interest rates and energy prices should help support the US consumer and economy
- Interest in gold will mount as a substitute for fiat currencies (from countries with heavy debt)
- Current events present another buying opportunity for quality

Our process has worked well over many years, even during challenging times like 1981, 1987, 2000 – 2003, and 2008. Tomorrow will share many challenges, and we will monitor developments closely.

Call us with questions and/or concerns.

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CONTACT US:

2310 Home Road
Delaware, Ohio 43015
740.917.9234

WWW.NVESTWEALTH.COM
Email: info@nvestwealth.com