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# Memo

**Date:** May 20, 2010

**To:** Investment Clients

**From:** Mark Pellegrino, Chief Investment Officer

**Subject:** The Pause That Refreshes?

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### The Pause That Refreshes?

Would it have seemed possible that an oil spill larger than that of the Exxon Valdez tragedy would have been overshadowed by economic issues overseas? That's exactly what's happened, as the Greek sovereign debt crisis clearly has investors' attention.

The focus of concern is simple. Is it possible, or even probable, that this debt contagion will spread throughout the rest of Europe, cross the Atlantic and undermine the US economic recovery, in the same way that the US housing crisis in 2008 battered Europe? The facts are these:

The impact of negative economic growth in Europe is an obvious deterrent to global economic recovery. Beyond that, as the dollar continues to strengthen against the euro, US exports to Europe become more expensive, and US businesses face a competitive disadvantage against European firms in Asia and elsewhere. By itself, Greece is far too small to have much direct effect on the US. Its economy is about 2% of the size of the US's and it takes in less than 0.1% of US exports. Adding in other troubled Eurozone economies – Portugal, Spain and Italy – takes the number to a manageable 2.3% of US exports. However, if you bring the larger, healthier countries – Germany, The Netherlands, France and Belgium -- into the mix, that moves the number to as much as 14% of US exports.

European sales currently account for about 10% of S&P 500 company revenues. Therefore, a 5% cut in export demand from Europe could translate into a 0.5% loss on corporate revenues.

The banking sector is certainly not immune to these debt issues. Losses on loans to Greece and the other weak European nations could produce big losses for European banks, which borrow from US banks, causing a general panic and freezing lending, all of which exacerbates the other economic issues. US banks hold more than \$1 trillion of European debt.

Aside from the true economic issues, finance officials in the European Union (EU) haven't helped the cause any either. Germany's standoff on the bailout package for Greece has been an obvious deterrent to relief, fostered by the highly unpopular idea of handing Greece a bunch of money in the midst of a German election period. Commentary by European Central Bank (ECB) President Jean-Claude Trichet that the ECB "hadn't even thought about quantitative easing programs", like our Fed used to stanch the credit crisis here, has left investors with waning confidence in the ECB's ability to control the financial issues of the day. Additionally, commentary by French President Nicolas Sarkozy hinting at the possibility of France abandoning the EU if Germany doesn't ratify the Greek bailout package only throws fuel on the fire, while raising questions about the future of this coordinated economic zone and the viability of its currency -- the euro -- as a dominant currency on the global stage. Today, German Chancellor Angela Merkel announced curbs on government bond trading. At best, this feels like an over-reaction. At worst, it seems like a cop-out to the ECB finding real solutions to the debt contagion.

Those are the facts. Do they offer an economic **possibility** that Europe's problems will bleed throughout Europe and across the Atlantic to the US? Sure. Do they offer a reasonable **probability** of such an event? That's unclear...but the heightened volatility in the markets seems to be telling us that there is enough of a probability. Recall that the markets were telling us something important in the early stages of the subprime debacle. The unknown at this juncture is whether today's predication ends in economic reality, as it did during the subprime crisis, or merely in perception. One thing (of many) that the markets have taught us over the years is that, for short periods of time, perception can trump economic reality.

Another thing that the markets have taught us is that when volatility gets elevated, it's often best to take a step back -- a pause, if you will -- to let the markets find their direction. That's exactly what we intend to do for now. We'll let the markets settle a bit, in hopes of seeing an easing in the tension and maybe even some more positive responses from European financial officials. If today's heightened volatility dissipates, we'll continue our staged re-entry to the equity markets. If the central issues persist or deteriorate further, we'll reassess. For now, we feel comfortable holding our current positions in a "watch and wait" mode.

Until next time...