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How a trip to Greece may cost a lot less down the road

While markets have pretty well determined that Greece will eventually default on its massive debt load, we watch seventeen European nations debate how to deal with this issue. Memories of the financial ramifications of Lehman Brothers' collapse are still fresh on investors' minds so everyone hopes a default on economically insignificant Greece does not spread into other Southern European countries. Here is our best guess as to how this may play out. While in the short term, European leaders debate on whether or not to continue Greece's lifeline, the European Union has two main longer term options. One is to force the weaker southern countries out of the Euro zone and back to their own currencies. Bring back the Drachmas, Pesetas, Escudos, and perhaps even the Lira, and each of those countries can devalue their currency and instantly become more competitive export wise and cost wise and we can help by visiting their countries at a 30 or 40% discount to current cost in dollar terms. This option is messy in the short term but it could work in the longer term.

The second option is to proceed to further Euro integration through issuance of a ton of Eurobonds to backstop the weaker countries. This option may not be a viable long term solution though as Southern Europe will remain uncompetitive with their overvalued Euro. Export driven Germany benefits from maintaining the status quo currency-wise but how will the German electorate feel about risking their country's net worth backstopping debt ridden southern neighbors? This option is the least messy in the short term but probably does not work in the long term.

Predicting what will occur here is tricky but one thing is clear. It is in everyone's best interest to avoid the Greek situation from spreading. If push comes to shove, all measures will be taken by central banks and governments to prevent that from happening. It will take steel will politically to deal with this issue and we hope it does not take a crisis before viable long term corrective action is taken. Longer term, the default of a smaller or medium sized nation is manageable (recall Argentina and Russia defaulting in recent years) but any perception of default risk on Japan, US or UK debt will be disastrous for financial markets. Fortunately the bond market continues to price in almost no probability of default in those nations, so they have time to get their houses in order.

So what does this mean for us and most importantly for your portfolios? This debt situation is a tough one to call. In past history, stock market downturns have typically been caused by recessions or some type of event such as a war, a terrorist attack, a pandemic health issue such as SARS, Y2K, or as was the case three years ago, too much private sector leverage. Outcomes from those situations were easier to predict. Market history has taught us that recessions or event risk eventually ends and markets inevitably rebound. Too much government debt on the other hand is, at minimum, a problem that markets will have to face for at least a decade. Hopefully we will see major countries do what the Canadian federal government did when it previously owed about as much as many profligate nations owe today, Canada slowly but surely got debt to GDP ratios down to much more reasonable levels.

This debt situation provides an unpredictable risk to financial markets both in the short term and the long term, so here is our strategy to manage accounts with this risk in mind:

1. Don't sell now. We say that with no certainty that this European debt problem won't spread but simply put, stocks are off close to 20% and are undervalued price wise. Stocks are even cheaper when compared to incredibly low interest rate alternatives. Corporate balance sheets are in good shape and earnings growth rates, while slowing, are still ok. In our careers, we have seen corrections of this magnitude many times and with the exception of the events of three years ago, all ended close to these levels. In the past fifty four years, there have been fourteen stock market declines of at least 20% and all eventually proved to be good buying opportunities for long term investors.
2. With maturing bonds we will keep rolling proceeds into safe investment grade bonds and a pool of high equity Canadian mortgages.
3. We are increasing our 'bar of quality' further in terms of fixed income issuers we use for new buys.
4. Stock wise, it always pays to be well diversified by country, currency, industry and to ensure not too many eggs are placed in any single equity.
5. Forget about avoiding the US. If the US goes down, our resource based economy goes down also, and our currency typically weakens, meaning we at least cushion the blow by owning U.S. currency based investments. That is happening once again presently.
6. We continue to hold gold indirectly through our ETFs and broad based mutual funds. An average client has about 5% of total stock exposure in gold equities through these diversified pools of investments. Gold has finally declined of late and if it gets low enough, we may add a direct Gold ETF to our model portfolio.
7. Our stock approach is to focus on domestic companies such as pipelines, utilities, telecommunications and rail companies that can perform well in a slow growth environment. Dealing with sovereign debt in the developed world will likely slow the developed world's growth rate to about 2% per year over the next decade and this defensive domestic stock strategy should perform well in this environment. Global growth on the other hand should be close to a normal 4% level as the developing world achieves strong growth rates over the next decade due to an increasing middle class and more competitive wage rate. Global multinational companies are inexpensive right now and will do well in a 4% growth rate environment, so that is our focus for non Canadian stock exposure.

The silver lining in this debt situation is that interest rates should stay low. Low interest rates are good tor the economy and means almost nothing can be made in risk free investments over the years ahead (so this improves the likelihood of money gravitating towards stocks and corporate fixed income.) A combination of high quality corporate fixed income investments, Canadian real estate trusts (REITs), defensive domestic stocks and global multinationals should perform well over the years ahead with the usual caveat of price fluctuation along the way.

Most client portfolios have fallen approximately 6% in the past four months. With markets down about 20% from recent highs and the corporate fixed income market having weakened, accounts have held overall. Expect upward and downward volatility to be on the high side until we get better clarity on Europe.

Times like these can cause concerns so please call us anytime to discuss your portfolio.

Kindest regards,

Sincerely,
CIBC Wood Gundy

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Yields/rates are as of October 7, 2011 and are subject to availability and change without notification. Minimum investment amounts may apply.