



CUMBERLAND

## GREEK TRAGEDY OR FARCE?

So let's get on with it already. Greece is broke and playing charades with their debt and pretending that they will pay it off. It isn't fooling anyone. The only advantage is to defer the reckoning and possibly dampen the impact until the European banks are in better financial shape. Otherwise, this appears to be throwing more good money after bad. Imagine what could be accomplished if the Europeans faced up to the realities of their overleveraged governments and directed additional funds towards productive purposes.

In the meantime, while we're all looking across the Atlantic, maybe we should pay attention to what's happening on the other side of the Pacific. If there is one thing that everyone is in agreement, it is that China is the growth engine for the world. We occasionally debate the rate of growth, but very few doubt the ability of the Chinese government to sustain its economic progress.

It wasn't that long ago that Japan was also put on that pedestal.

And what about the U.S. budget debate and debt ceiling? Is the U.S. debt rating in jeopardy? According to Moody's it is, yet 10 year bond yields are at historic lows.

If that isn't enough to worry about, consider that economies around the world seem to be rolling over. Is the current "soft patch" about to become a "bad patch"?

Now, is there any question as to why the markets have given up their year-to-date gains and continue to look lower?

Well, let us weigh in on some of these "macro" issues but first let me state that I'm still bullish on this market. There is still a lot of liquidity around, interest rates are causing investors to look for better returns than government bonds and there are no usual symptoms of a market top; such as overvaluation and unbridled investor enthusiasm. In fact, there is a great deal of uncertainty which has, at least partially, discounted a bad outcome on some of these issues. So my sense is that there is a lot of bad news already baked into the market prices and any positive resolution will result in a market rally.

Obviously, if we're wrong on any of our assumptions, we'll have to re-assess, but what's more important is that we don't believe the consequences of a wrong opinion would be serious. As a well known investor once said, "if it's in the paper it's in the price."

### The Euro Mess

So, let's start with the Euro mess.

It's hard to believe that a European country with just 11.0 million people can hold the world's financial system to ransom, and maybe we shouldn't. In my opinion, it's the superficial solutions that the European Finance Ministers are proposing that is preventing any resolution. Greece is broke. Its debt is

trading in the open market at 50 cents on the dollar, and pretending that it's worth face value to maintain bank capital ratios is nonsense.

What is provoking the problem is Germany's proposal to have banks voluntarily roll over some of their debt and the rating agencies unwillingness to go along. In their opinion, this arrangement would constitute a default, and the reaction to this wisdom demonstrates how far governments are willing to go to cover up reality.

German Chancellor Angela Merkel said that the rating agencies shouldn't be allowed to exert excessive influence on policymakers.

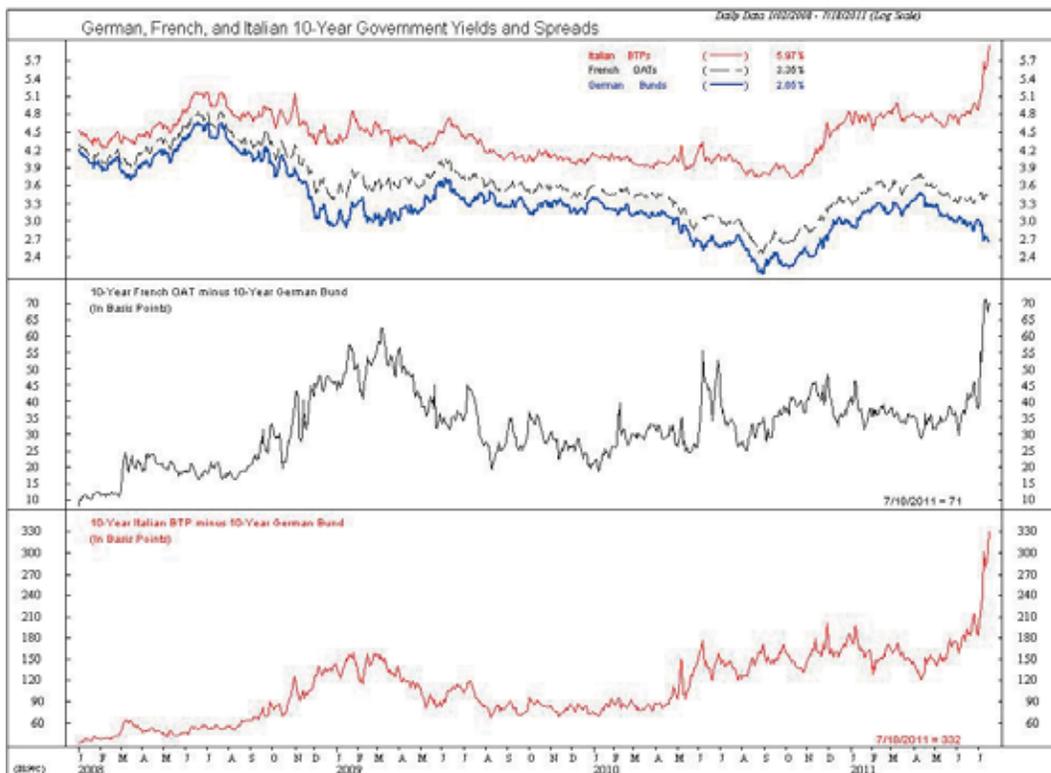
Austria's Chancellor, Werner Faymann said he would move to create a European rating company. The sovereign debt crisis has shown that the rating companies lack "local knowledge" and "empathy" for the European condition.

Russia, also frustrated by rating agencies, proposes setting up a new agency and says the proposed organization will seek to work with Europe and the BRIC countries.

China set up Dagong Global Credit Rating Co. a year ago. Russia is rated "A" by Dagong, one level below the U.S., while Moody's ranks Russia 7 steps lower and S&P and Fitch rate Russia 8 levels below the U.S.

Ironically, two years ago the rating agencies were being accused by some of these same governments as not having done their job properly by not being tough enough in their ratings during the mortgage crisis.

So this little technicality has stymied any progress specific to the Greek cover up. Then along came the bond vigilantes and their assault on Italian debt.



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As you can see in the top clip of this chart, bond yields on Italian debt suddenly spiked higher as their financial stability was questioned.

This was a sobering wake-up call as two things became apparent. First, if the EU Finance Ministers were unable to deal with Greece, they would likely be helpless at resolving anything of greater consequence. And second, “kicking the can down the road” wasn’t a solution, suggesting that the problem would persist, leaving other countries open to financial abuse.

To date, the reaction by the finance ministers has been to step back and reassess the possibility of allowing Greece to default.

This unexpected reversal was taken quite negatively by the markets, as the uncertainty leaves open the possibility of far worse consequences than the proposed short term deception.

Until there is some real resolution to this issue, it will continue to hang over the market. But from our perspective, the decision to reassess a Greek default was a positive. Deferring the problem was not a solution as it would have left the door open to attacks on other financially weak countries and throwing good money after bad would have made the problem much bigger. Greece’s problem is too much debt. Lending them more won’t help.

So, what are the consequences of a default? Without getting into the numbers, which are big, and are all over the map, the first impact would be on the banks that hold Greek government bonds. Those bonds are currently carried at face value, and because they are sovereign, they don’t require the banks to pledge any capital. A default would require a write-down against the banks’ assets and, depending on the bank, could require them to raise more funds to meet regulatory capital requirements. There are also all the corporate and personal loans that would be affected, not only in Greece but in other countries as bank capital constraints cause them to curtail lending.

There is also the contagion into U.S. money market funds where it is estimated that almost half of the holdings by prime corporate funds are invested in European bank paper, about \$800 million. There are also all of the derivatives that guarantee the purchasers of Greek bonds against default and no one knows who the counter parties are against these instruments.

So, contagion concerns are real and the full consequences are unknown. However, in our opinion this is not another “Lehman” moment. When Lehman Brothers went down in 2008, there were many unintended and unexpected consequences which we’ve learned from.

This time, there will be fallout but it’s unlikely to cause the same uncertainty. Secondly, these transmission channels of contagion are well understood and would be mitigated by any decision to let Greece go.

Is there a resolution to the problem? Again we think so. First you have to believe that letting Greece default is the right decision. In our opinion Greece is burdened by too much debt. That may appear to be an obvious statement. But if so, then the answer is to eliminate some of the debt while controlling the fallout, not by lending the country more when it can’t afford what it already owes.

The reality of reorganizing Greece's debt is that it is already being done in the open market where a 10 year Greek treasury trades at 52 cents on the dollar. So for private investors, the market has already imposed a reorganization or default discount, which shows you how absurd the Finance Ministers' proposals were to allow the banks to pretend that they are still worth par.

So, maybe a better solution would be to allow Greece to purchase its own debt in the market at a discount and retire it, thus lowering its total obligations and reducing its interest costs. If additional funds are going to be lent, maybe it should be directly to the banks that would require additional capital.

For Germany, lending money to their own banks is probably more politically palatable than the perception of giving anything more to the Greeks.

There is also the possibility of selling Euro Bonds to funnel money to the individual countries that are shut out of the public bond markets.

And finally, they should consider the possibility of a Euro type "TARP" program similar to what the Federal Reserve did to absorb bad loans from the U.S. banking system.

Right now, the ability to come to grips with additional support for Greece is a political paradox with German Chancellor Merkel being caught between making the right economic decisions and appealing to voters who are opposed to bailing out a bunch of "Speedo wearing Greek deadbeats".

A default however would no doubt break the log jam. The consequences of not controlling the contagion will otherwise have far reaching economic consequences worldwide and especially for Europe.

So, do they get their act together to prevent contagion and worsening financial consequences? We have a hard time believing that when push comes to shove, that the politicians won't put aside their national animosities and do what's in fact in their own best interests, and that's to contain the fallout and get at really fixing the problem.

Something similar will also probably have to happen with the other PIIGS. Spain and Italy are already sliding back into recession and trying to reduce their debt to GDP will be impossible with a falling denominator. A more realistic solution is to reduce debt and require fiscal responsibility rather than austerity. The temptation to punish profligate countries has appeal but at the end of the day, governments will probably bite the bullet and do what is economically in their own best interest.

## China

While all the attention has been focused on Europe, there was a release from China's National Audit Office that caught our attention.

There have been China doubters around for sometime predicting that the country's growth is about to collapse and that its housing bubble is about to burst.

But a release came from a government agency, China's National Audit Office, which reported that loans to local governments were about 10.7 trillion Yuan (\$1.654 trillion) at the end of last year. That's about 27% of GDP.

One has to question whether these reports are politicized given that the People's Bank of China had earlier estimated local government borrowing at 14.4 trillion Yuan, and Moody's suggested that the loans were about 1/3 higher, or 3.5 trillion Yuan more than the official report.

Moody's also suggested that total nonperforming loans at their banks could reach as much as 12% versus the official rate of 1.14%

This is an interesting insight because local governments are not allowed to borrow from banks or to issue bonds. So, apparently 6,576 financial vehicles were used to get around these regulations.

S&P said in April that they thought that as much as 30% of these local government loans could go bad. Moody's also did a study on a number of Chinese companies and raised "red flags" on 61 of them sighting accounting, governance and quality of financial statements.

If the rot in the Chinese banks is real, then there are going to be consequences for the Chinese economy because the banks, especially the five largest government controlled banks, are the agents of government policy.

Beijing's 2009 stimulus program was administered through the banks as the government channeled \$586 billion into those financial institutions causing lending to increase by \$1.4 trillion. These loans were used to finance public and industrial infrastructure, real estate and state-owned corporations. That lending was almost double the previous years. It wouldn't be a surprise if a lot of this type of lending was un-economic.

Outside of government directed lending, there has also been a lot of loans made for fixed investment such as plant and equipment which is leading to overcapacity and more nonperforming loans; capacity utilization is already dropping.

There are also a lot of off-balance sheet loans and unconventional practices. I'll describe only one as an example because it plays into our concerns over commodity pricing. As I said, state-owned companies have had no difficulty in getting a loan. However, this is not true for many smaller businesses and real estate developers where their borrowing costs in the "grey" market are in the mid-teens.

To facilitate these borrowers, commodities are purchased through the use of a letter of credit. The physical commodity is then used as collateral for a loan from the bank, which is then lent to less credit-worthy borrowers at a significant spread.

This has created stock piles of commodities from copper to soybeans that are not intended for production. Any problems with one of these loans could trigger the dumping of a number of these over-inventoried commodities on the market. Set-backs in one area could result in sales in other areas that are fundamentally unrelated. Once prices break, hoarded goods could become available from highly leveraged owners.

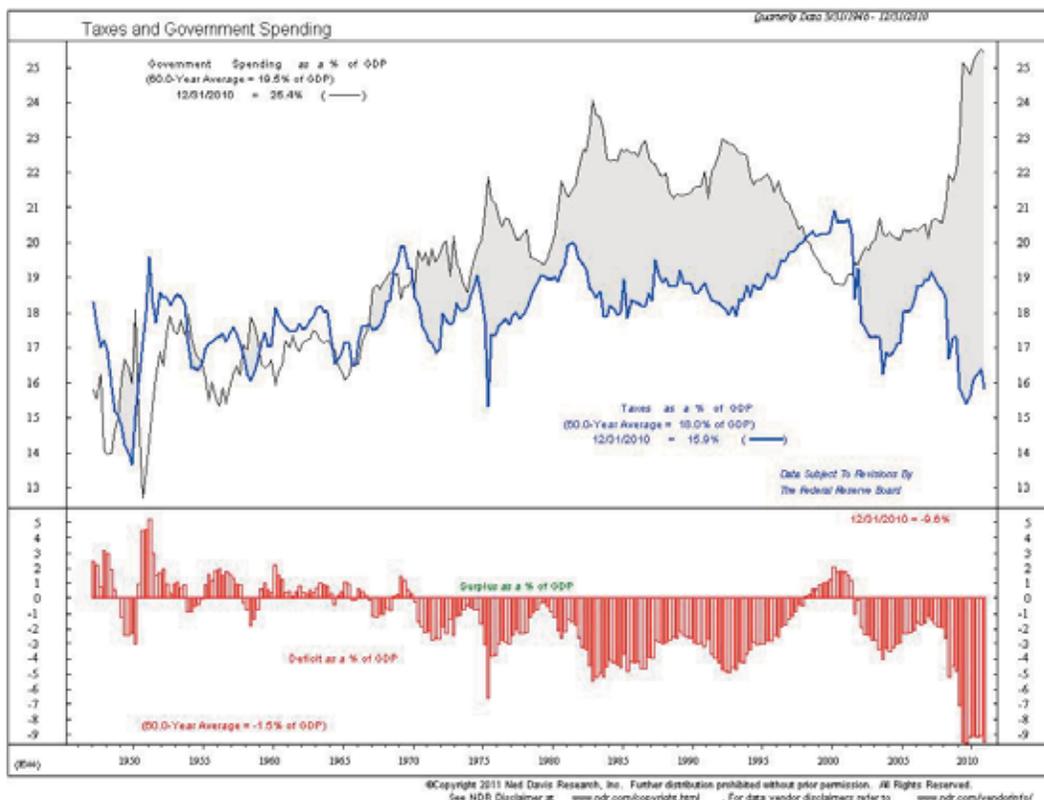
In the end, the central government is unlikely to let any of its banks default. But the system is accident prone when government policies to control inflation and exchange rates are causing distortions.

I don't think China is about to roll over; but when you see problems being identified by official agencies, one should pay attention. Certainly the Shanghai stock market is. The Industrial and Commercial Bank of China, the world's largest bank, is down 19% year-to-date and so are most of the other major banks. Bank of China is off 26% and Bank of Beijing is down 47.9%.

So, although China is not likely to become a sovereign debt issue, it has created financially overextended banks and local governments. Should delinquencies continue to increase, it will cause investors to question China's ability to sustain its high economic growth rate along with its negative impact on world growth and commodity prices.

### U.S. Debt Ceiling and Budget Deficit

To round out the sovereign debt issues, the United States is facing its own challenges to raise its debt ceiling by August or face a technical default and loss of its "triple A" financial rating. Key to this is a budget debate which is attempting to get the deficit under control. This could be very good news if the politics are put aside and real cuts are made to spending. But the Republicans are insisting on only cutting spending while the Democrats want tax increases to be part of the solution.



When you look at the above chart, you can see that taxes as a percentage of GDP are currently 15.9% compared to an average 18%. Similarly, spending is currently over 25% of GDP compared to its long-term average of 19.5%.

So, in our opinion, two things are required for a real resolution. Taxes will have to go up and legitimate spending cuts will have to be made to the entitlement programs such as Social Security, Medicare and Medicaid. Failing these actions, I doubt that the market or the credit rating agencies will take any agreement to raise the debt ceiling seriously.

Optimistically, there is a chance here for the politicians to do something right. There are plenty of incentives for the Democrats to get through real changes to get this issue off the table before the 2012 election. Conversely, the Republicans may not want to complete a significant budget deficit reduction agreement that would lose this cause before the elections.

Meanwhile, 10 year treasury yields are at their lows suggesting that investors are more concerned about Europe than the debt ceiling tiff that the politicians are having in Washington.

### Economy

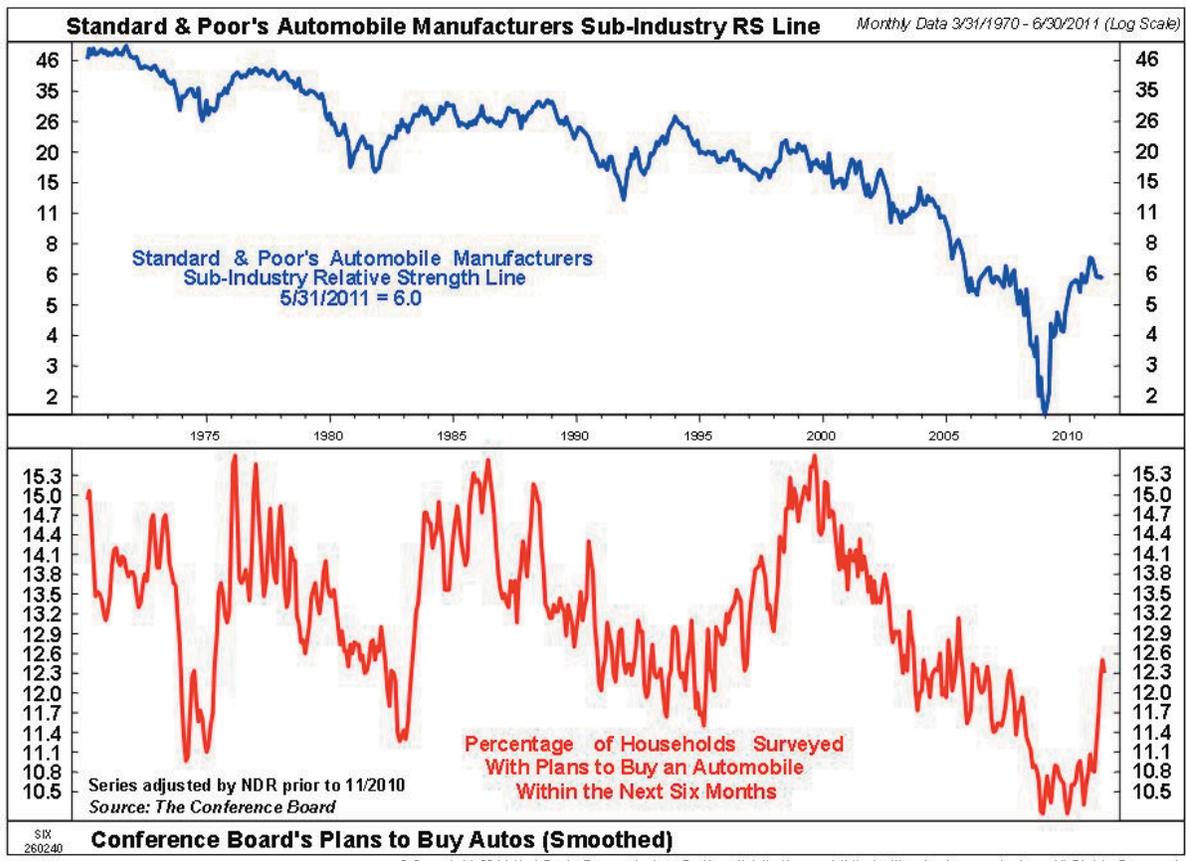
If sovereign debt issues weren't enough, there is also some question as to the sustainability of the economic recovery. Should the economy fall back into recession, governments have few options left to re-stimulate. The consequences would be serious.

However, we think economic growth will re-accelerate by this fall, for a number of reasons.

First, we believe that the earthquake in Japan had a supply chain impact on a number of industries worldwide. But there are signs of recovery with industrial production in Japan jumping by 5.7% in May after falling by 15.5% in March.

One industry that was hit the hardest was the auto industry. A parts shortage hit in April resulting in a production decrease of 12.5% to 7.9 million units, which was below U.S. domestic sales of 10.2 million. Total June auto sales declined to an annualized 11.4 million units compared to 13.1 million in April as a result of depleted inventories.

The slowdown is being further aggravated by the auto manufacturers moving planned summer shutdown for re-tooling into June in order to give supply chains time to repair. Production should ramp up significantly by early fall to meet pent up demand and inventory rebuilding.



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As shown in the bottom clip of this chart, there has been a significant increase in plans to purchase an automobile.

Capital spending should also continue strong as we are only six quarters into a cycle that historically lasts 4-7 years. With \$2.58 trillion on their balance sheets, the S&P 500 companies will likely try to get their spending in before the 100% write-off incentive expires at year-end.

Oil also set the economy back in the spring as gasoline prices shot up by about a \$1.00/gallon to almost \$4.00. The U.S. used 7.1 million/day of oil over this past year. There are 42 gallons in a barrel which equates to 383.2 million gallons per day or 143.3 billion gallons last year. A \$1.00 increase took roughly \$150 billion out of consumers' purchasing power. However, oil has declined about 17.5% since the end of April and gasoline is back down around \$3.50 per gallon. So there should be some rebound in consumer sales and an improvement in attitude.

Employment has been a chronic problem and June's employment increase of only 18,000 jobs was a major disappointment. But again, we think there's reason to be positive.

First, we don't buy the June report. Unemployment reports are probably the most inaccurate of all the government releases and historically get revised several times.

This latest report didn't reconcile with the ADP report which shows employment up by 152,000 nor did it square with other surveys that show hiring plans improving. And how can retail chain store sales be up 6.9% in June if hiring is so sluggish?

Well, if you look at the raw, unadjusted numbers in the government release, they show a 101,000 increase in jobs for the Household Series and a 376,000 pickup in the Establishment Series. What I like about the later report is that includes small business and 80% of people work for companies with 500 or fewer employees.

The difference between the official release and the unadjusted numbers is probably due to the season adjustment factor. Regardless, there are a lot more people working than what this report would lead you to believe.

We're also now past the start of a new fiscal year for state and local governments which by law have to balance their budgets. So there have been a lot of payroll cuts leading up to the new fiscal year, so these cuts should now be behind us.

On balance, we're giving the benefit of doubt to the economy and expect the pace of growth to pick up this fall.

### Conclusion

On balance, we don't think Europe will self-destruct, China is a worry but there's nothing imminent, the U.S. has an opportunity to do something right on its deficit and the pace of economic growth should improve. Maybe that's why the market has fallen only about 6.4% from its peak this year compared to last year's spring sell-off on sovereign debt concerns of 16%.

Our strategy this spring to raise cash, reduce our exposure to resource stocks and to generally favour more defensive, large cap, dividend-paying stocks has been spot on.

In May, the S&P cyclicals fell 2.6% while the defensive names rose 2.1% as the market transitioned to a more cautious stance. This was supported by valuations at the end of April that saw large cap, and some of the world's best companies, trading at 13.1 times forward earnings while mid cap commanded 16.6 X and small caps an even more expensive 17.8 X.

Resource stocks have declined along with their commodity prices, which will help take the pressure off of inflation and perhaps eliminate the need for further interest rate hikes that are threatening world economic growth in the emerging markets.

The macro concerns that we have just discussed are certainly threatening. But they are well known and at least partially priced into this market. What isn't, is any positive resolution to these issues.

Anyway you cut it, there is little likelihood that the monetary picture is going to tighten while these issues remain unresolved and there's a lot of money around that's looking for a better rate of return.

There is also almost \$3.0 trillion sitting on corporate balance sheets. As mentioned earlier, some of it could be used to benefit the economy and hiring. It could also be put to use for the benefit of the stock market through increased dividends considering that the payout ratio of earnings is currently at a record low 28%. Mergers and acquisitions could also increase or companies could elect to buyback more of their shares. All of these would help valuations.

The concerns over the big macro issues are legitimate and we're constantly reassessing them. But the stock market will be a much more dangerous place once these issues are resolved, and everyone feels they've been given the green light to rush in.

GRC/amh  
July 4, 2011

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