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Europe and the Summer of Uncertainty

It's no secret that what's happening in Europe is driving financial markets worldwide. Even if you have a sound asset allocation strategy and a well-diversified portfolio, it's hard to ignore the fact that this summer seems to have the potential for turbulence. Markets dislike uncertainty, and at this point uncertainty is high, particularly in advance of the June 17 elections scheduled in Greece.

Here's a brief review of what has led to the current situation, and how various types of investments have been affected.

High noon on the continent

To qualify for a second bailout from the European Union and the International Monetary Fund, the Greek government agreed in February to adopt strict austerity measures intended to cut its budget deficit and debt burden, and to specify additional cuts by June.

However, in the wake of May's Greek parliamentary elections, it's unclear whether that agreement will hold up. The political parties that signed off on the bailout agreement were eclipsed in the elections by political parties who campaigned against the austerity programs. However, those parties have been unable to form a coalition government, so new elections have been scheduled.

One of the major areas of uncertainty is whether a new Greek government would try to renegotiate the rescue package. That would mean a showdown with Germany and other countries who have stood firm against renegotiating an agreement that was difficult to get adopted in the first place. In addition to questioning why it should support countries who are unable or unwilling to balance their budgets, Germany is reluctant to jeopardize its stellar credit rating. Also, it benefits from being able to borrow at the super-low interest rates made possible in part by high demand from investors, who are taking money out of Greek banks and putting it into investments seen as safer, such as the German bund (the equivalent of our Treasury bonds).

European countries that have adopted strict budget cuts designed to reduce deficits have found themselves facing slower economic growth, angry voters, and even greater difficulty balancing their budgets. Since the recent election of Socialist François Hollande as president of France, there has been increased talk about the need to balance austerity with pro-growth measures. But from Germany's perspective, if Greece is allowed to renegotiate its bailout to try to stimulate growth, what is to stop other countries who are struggling to meet their own austerity guidelines from making the same demands?

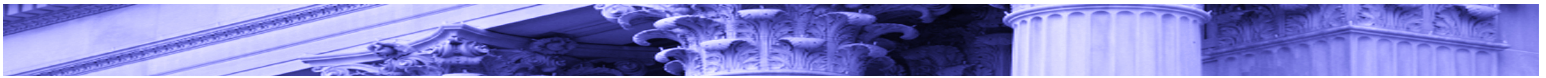
Why don't other countries simply kick Greece out of the eurozone?

Many Germans are asking themselves the same question. However, there are several reasons why leaders are struggling to avoid a Greek exit (dubbed a "Grexit").

Leaving the eurozone would mean abandoning its shared currency. Greece would need to pay its bills and debts in some alternate currency, such as a "new drachma." Any such currency would almost certainly be worth less than the euro, and reduce the value of any assets or accounts held in Greece. The danger of the Greek government defaulting on debt owed in euros could shake Europe's banking system--already fragile because of the real estate collapse in many eurozone countries.

Fearing that possibility, investors have already begun pulling money out of Greek financial institutions. That has raised concerns about the potential impact of a run on the country's banks. (If you've ever seen the movie *It's A Wonderful Life,* you've seen what can happen when everyone tries to take their money out of a bank at the same time.)

Also, a Greek exit from the eurozone or default on sovereign debt would likely increase concern that other debt-ridden countries--especially larger economies such as Spain--might do the same. And it wouldn't take an actual exit by other eurozone



members to create problems. In addition to potentially destabilizing the continent's banking system, investor fears would affect the interest rates paid by those governments. The rate on a 10-year Spanish bond has already gone well over 6% recently (Germany and the United States pay less than 2% on an equivalent bond). A Spanish government already struggling with debt, bailout requests from banks and regional governments, and austerity measures similar to Greece's can't really afford to pay even more interest on borrowed money.

Furthermore, rising interest rates on sovereign debt don't just hurt governments; they hurt the banks and other investors that hold those bonds. Bond values fall when interest rates go up. If banks worldwide suffer losses because the value of their bond holdings drops, they could have even more trouble meeting capital requirements and staying afloat, or lending money to businesses and individuals who need it.

What does it all mean for my portfolio?

Investors have already begun to price in the potential disruption of a hasty Greek exit--either voluntary or involuntary--from the euro. That, coupled with signs of a slowing U.S. economy, cost equities dearly in April and May. It's unclear how much potential pain has already been recognized by global markets, especially if the U.S. economy worsens or election results suggest future eurozone infighting. However, remember that even in a bad market, individual stocks may buck the trend. Also, at least two European scenarios might help equities rally: 1) if the results of the June 17 Greek election renew optimism about the strength of the bailout/austerity bargain, or 2) if other eurozone members or the European Central Bank agree to fresh supportive measures, such as a jointly backed "eurobond." And of course, signs of new strength in the U.S. economy would be helpful.

And it's an ill wind that blows nobody good. As the flight to quality has become a stampede in recent weeks, the prices of U.S. Treasury bonds have seen a strong rally. Investors have become willing to accept record low interest rates as a tradeoff for the relative security offered by Uncle Sam. Sooner or later that trend is almost certain to reverse, but so far the uncertainty abroad has been good news for Treasuries. Unfortunately, investors who have relied on Treasuries for income and now want to roll over the proceeds of maturing bonds might be disappointed with today's low interest rates. If that's the case for you, you may need to explore supplemental sources of investment income to replace any reduction in interest from Treasury bonds.

If you're using a money market fund as a safe haven or a place to park money in anticipation of potential buying opportunities, don't forget that some funds may still have some exposure to foreign debt (though they may also have taken steps to hedge that exposure). An investment in a money market fund isn't insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and though money market funds attempt to keep their share value at $1, it is still possible to lose money in one. If you absolutely can't afford even the remotest possibility of a loss, an FDIC-insured account might be your best bet.

Global troubles can make it more difficult to try to protect your portfolio through diversification; the 2008 financial crisis hurt a variety of asset classes that normally might not be highly correlated. Diversification alone can't guarantee a profit or protect against potential loss. However, it might be worth exploring whether there are ways to hedge your portfolio's exposure to possible market volatility as Europe wrestles with its ongoing dilemma and the U.S. economy struggles to recover.

Uncertainty in the financial markets could persist for months, but it's important to keep it in perspective. While you should monitor the situation, don't let every twist and turn derail a carefully constructed investment game plan.

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