

# insights

October 2011

## A Quarter to Remember

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The third quarter of 2011 will certainly be remembered for the extreme market volatility and significant world economic events. The S&P 500 (Standard and Poor's) turned in the worst performing quarter since the financial crisis of 2008, down -13.87% for the quarter and -8.68% for the year.

The S&P 500 peaked on April 29th up 8.43% and bottomed on August 10th at -10.88%. By contrast, the bond market, as measured by the BarCap Aggregate Bond Index, is up 6.65% for the year providing some offset or balance to the negative performance in the equity markets.

We believe there are three themes which are the cause of the significant correction and dramatic moves in the equity markets over the last quarter.

### European Debt Crisis

For the past 18 months, the markets have wrangled with the question of solvency surrounding the PIIGS nations, the acronym which represents Portugal, Italy, Ireland, Greece, and Spain.

Over the past three months, the concern regarding Greece in particular has escalated. The European authorities of the



European Central Bank (ECB), European Union, and the newly formed European Financial Stability Facility (EFSF) are now

grappling with the stark reality that Greece is insolvent and other nations such as Italy and Spain, which are much larger issuers of debt, may face a liquidity crisis.

Greece, who was introduced to the Euro in 2002, has a population of nearly 11 million. The economic woes of Greece are correlated to the financial crisis of 2008 and the country has witnessed a -7.8% contraction of GDP over the last 12 months. Greece's annual GDP is \$310 billion while its public outstanding debt is \$470 billion. With a debt to GDP ratio of 152%, unemployment at 16.6%, a severely contracting economy, and significant government austerity measures, there is little hope Greece can grow their way out of this problem.

Greece is a relatively small country and debt issuer, but the concern resides with the holders of Greek debt. The largest holders of Greek debt are banks, specifically the largest banks in France and Germany. There is also an estimated 1,000 small banks throughout the Euro zone which hold their

debt. The European banks have not been as aggressive as their U.S. counterparts to recapitalize and write down bad assets after the financial crisis of 2008; therefore their capital structure cannot withstand a large write down or the stress from losses associated with a Greek default.

If Greece defaults on their debt in an unstructured manner, there are predictions that a shockwave would spread through the banking and financial system. The best analogy to describe how this works is to think of the mechanical workings of a watch. A watch has several wheels which spin in unison with one another but each has a specific purpose. If a wheel malfunctions, the watch seizes. The same can be said of our global financial system. If international banks cease to conduct overnight lending and operations with one another because of credit concerns, the free flow of capital and credit seizes the system. The 2008 bankruptcy of Lehman Brothers impacted the markets in a similar capacity. The one positive difference is that we know who holds Greek debt and this debt has not been leveraged upon. With each passing day, the machinations in Europe regarding Greece and the debt crisis impact our markets driving confidence up or down based on the specific headline.

### U.S. Economy (Housing & Jobs)

As the economic events in Europe unfold, we must be cognizant of the fact that our financial worlds are intertwined. Events unfolding in Europe impact the U.S. economy, just as the earthquake and tsunami in Japan impacted manufacturing supply chains throughout the world. While outside macro-economic events can provide drag or sail to the U.S. economy, recent indicators clearly show the U.S. economy has slowed in addition to the European situation.

Unemployment remains in the 9% range and the most recent reading of revised 2nd quarter GDP showed the U.S. grew at an annual rate of 1.3%, which was actually better

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than forecasted. However, growth rates of 1 to 2% are not enough to reduce the overall unemployment rate, particularly in light of population growth. Housing will remain constrained until high unemployment abates and businesses will not hire until they are confident future demand will increase. In essence, we have a recession in confidence and until that cycle is broken, the U.S. economy will sputter along, growing annually between 0 and 2%.

This is not to say that companies are not profitable; the recession of 2008 forced businesses to run lean and efficient operations. In fact, business capital spending has been strong, which correlates with the thesis that companies are trying to do more with less by investing in technology and equipment, rather than people.

## Politics of the United States

Rarely do we use the space of our newsletter to delve into politics, but we, like so many, were disheartened and frustrated with the behavior of our political leaders during the debate leading up to the August 2nd debt ceiling deadline. As the 11th hour deal was crafted, it became clear that the legislation was ill-conceived and did not address the long term issues of deficit reduction and tax reform. The bill tabled the tough choices to a bipartisan committee of 12 House and Senate leaders to deliver a package of deficit reduction reforms at a future date. The markets voiced their displeasure loud and clear as the S&P 500 shed 138 points, or 11%, in the 7 trading days following the debt ceiling deadline. It has become clear that fiscal policy from Washington is a critical component to foster our recovery and get people working again. The Federal Reserve Bank cannot be the sole stimulator of our economy and a common sense bipartisan economic policy is critical to restoring confidence to business owners and those who deploy capital in this country.

## Is it all Doom and Gloom?... What Happens Next?

In Europe, the sense of urgency to take action to contain the crisis has escalated. *The Economist* reported two weeks ago that four things need to take place to restore financial order in Europe. First, restructure debt for those deemed insolvent and provide liquidity to solvent nations to prevent further erosion. Second, provide a liquidity backstop to impacted banks that have to write down Greek debt. Third, shift policy from focused cost-cutting to one of growth; and fourth, put measures in place to prevent future problems.

U.S. economic health and our political system have become intertwined. Prudent fiscal policy, which acts to cut the deficit in the long term while providing stimulus to grow the economy in the short term, is the solution. More importantly, rebuilding confidence and providing guidance into the future will go a long way in restoring economic growth in the U.S.

Predicting the unpredictable is a tough business, however, the incentives are in place in both the U.S. and Europe to take bold action. Coupled with low stock valuations, bold action could move equities sharply higher if the right measures are put in place. We do recognize this is no small feat when relying on politicians!



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