

Note

RE: Greek Default and the US Budget Impasse

The media is doing two things well with respect to these major issues. They're keeping everyone's undivided attention on problems that must in the not too distant future be addressed, and they're doing a wonderful job of detailing how they might each play out in worst-case scenarios. Unfortunately, they're also leading some investors to believe that the worst-case and most-likely resolutions are one and the same, which is not the case.

A sovereign default is mostly determined by the will of its people. There's a severe price to pay when a country's finances reach the point of Greece's, and it's abundantly clear that the Greek people don't have the stomach for the austerity required to right their ship without a default. So rather than paying the full price for their financial plight, they will pass some of that along to the bond holders who for years turned a blind eye to the risks involved. So "if" is not really the pertinent question but rather "when" will Greece default, and the answer is not now, as European banks are too exposed to Greek debt and their books are still too vulnerable this soon after the 2008 Financial Crisis. Every policy maker involved knows these simple facts, which mean another round of funding must be made to push this problem at least into next year if not the year after. Somewhere in that timeframe Greece can be allowed to default and what happens next to a country that can't devalue their currency to partially offset the really nasty economic consequences to follow is an open question. But it's highly unlikely this eventuality will take place before European banks are strong enough to weather the storm, which means it will not spawn another Financial Crisis.

The US Budget Impasse is another situation that won't be resolved soon, but that doesn't mean a default is imminent. A minority political party posturing that they might seriously entertain such a calamitous end shouldn't surprise, as it's the only meaningful leverage they possess. Twice before in recent years this sort of high stakes poker has played out, and of course both times political compromise was reached and debt ceilings were raised. To imagine any other resolution means having not just a couple with this extreme view in Congress, but a majority, and that's simply not the case. The core underlying issue of balancing the US budget will almost certainly be pushed until after the next presidential election. While an electable candidate must win their nomination, Republicans have great confidence given the economic situation that they will take back the White House in 2012, which means they have no reason to compromise now. Regardless of who wins that election, investors in US debt will demand a credible plan to balance our long term budget early in that term. This means tackling a number of very hard problems, and hopefully we will have no choice but to do so.

Once band aids are applied to these two issues, investor focus will turn back to economic and corporate performance, and that picture has the potential to brighten markedly following the slowdown that just occurred. That doesn't mean robust growth, which isn't feasible with housing destined to be such a drag over the next few years, but moderate growth remains the consensus expectation. This will keep GDP well below Potential GDP for much longer than is normal in a recovery, but perhaps that produces a longer, more durable recovery in the end. While long term equity prospects are always solid, perversely, nearer term prospects could be better than many realize as well.

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