WASHINGTON CROSSING ADVISORS

WWW.WASHINGTONCROSSINGADVISORS.COM

May 23, 2012

Greece's Choice

Stay or Leave the Euro?

Until very recently, the thought of a Greek departure from the European Monetary Union (EMU) was seen as remote. Further progress along the lines of austerity and fiscal integration were seen as the only path. Since elections in Greece on May 6, markets have been confronting the reality that "austerity" does not sit well with an electorate under an "austerity" regime who are looking for more rapid and painless solutions to their problems. The upcoming Greek elections on June 17 will be another test of whether the current path toward austerity and fiscal reform is sustainable. Should the people of Greece reject that path, an alternative path potentially leads out of the European Union entirely. Such an outcome could be disruptive, at least in the near term.

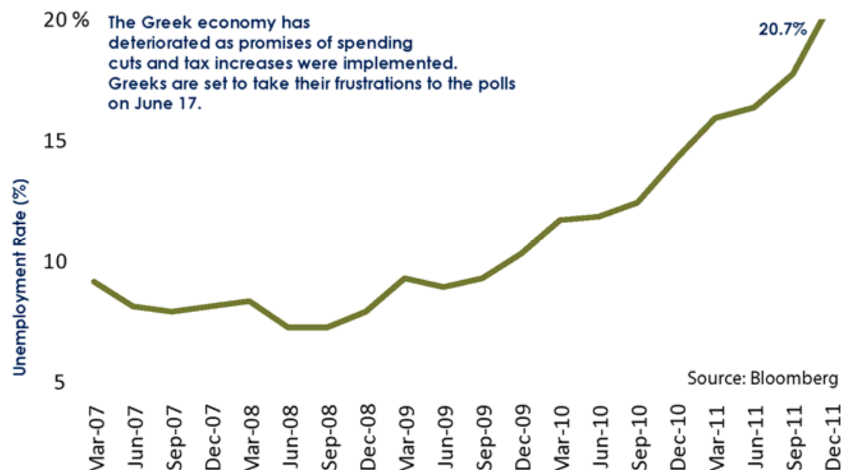
A Greek exit from the EMU would place the heaviest burdens first on the people of Greece themselves. The country would have to reconstruct a functioning monetary and banking system in short order to replace the Euro and the Eurosystem banks. Until such a time a reconstituted currency and banking system could be fully implemented, life inside Greece would be difficult. Banks would be severely impaired, and lending would decline sharply. Hand to hand transactions would be difficult in the absence of available domestic currency. Contracts denominated in Euros would require reinterpretation. A decline in trade could result in shortages, rationing, and significant price increases should trading partners be reluctant to accept promises of a new and untested currency. The value of savings would likely be impaired in real terms. All of this would put further strain on a society already confronted with a 20% unemployment rate (see below), rapidly contracting production, and massive deficits.

Kevin Caron
Portfolio Manager
(973) 549-4051

Chad Morganlander
Portfolio Manager
(973) 549-4052

Matthew Battipaglia
Analyst
(973) 549-4047

Greek Unemployment



STIFEL NICOLAUS

Although a Greek exit from the European Monetary Union is far from certain, such an outcome would require a robust and swift policy response.

Potential Impact of a Greek Exit

The direct effect on the global economy from a Greek exit is small in terms of trade. Greece is a $300 billion economy and accounts for less than 0.5% of world GDP, so the direct impact from lost trade is likely to be small.

The more immediate and significant concern is with European banking. It is impossible to predict the ultimate impact across the network of individual banks, but we can estimate that the direct losses to the Eurosystem from a Greek departure would be in the 100-150 billion Euro area. This represents the amount of Greek obligations currently owed to other banks and the European Central Banks via uncollateralized obligations (so called Target 2 obligations to other banks and obligations to the European Central Bank). The size of those losses represents approximately 20-30% of the capital cushion at the European Central Bank and 10% of "firewall" funds. These exposures appear manageable on the surface, but further contagion would need to be contained.

In a leveraged financial system, losses tend to crimp lending and restrict credit creation. Banks will initially seek to husband capital in the event of a loss tied to Greek debts, which could further curtail lending in a region struggling to jumpstart growth. Moreover, those same banks' lending activities outside Europe to some emerging market economies could also be threatened and potentially could cool growth in other emerging economies around the world too.

By contrast, the United States dollar would likely benefit from the flow of capital seeking safe haven – at least for a time. Commodity prices could decline further on dollar strength and as forecasts for European growth are reduced.

What Can Be Done?

Although a Greek exit from the European Monetary Union is far from certain, such an outcome would require a robust and swift policy response. The response would likely include some combination of the following:

1. Stepped up purchases of assets by the European Central Banks to provide needed liquidity to the Eurosystem banks.
2. "Firewall" funds of the European Financial Stability Fund and the European Stability Mechanism would be drawn upon to insulate other economies such as Spain and Italy.
3. Deposit guarantees for Europe as a whole would become necessary.

The effectiveness of these steps will depend critically (if needed at all) on the speed with which the European Central Bank acts. Ultimately, the primary purpose of the central bank is to act as lender of last resort precisely during such events, hence nothing short of the credibility of the bank would be at stake in such an eventuality as a Greek departure from the Euro. We have no reason to doubt the ECB's commitment to its role under the current circumstances.

Our view is that Europe will move down its stated path.

What Next for the Euro?

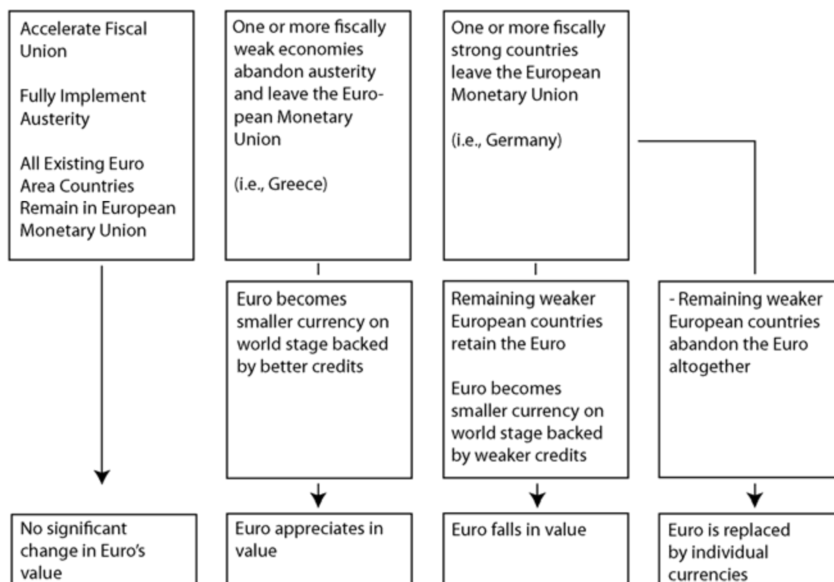
Ultimately, the decision by Greece to stay in the European Monetary Union or leave will have important implications for that country and the evolution of the 12-year-old Euro experiment. There are a number of ways that experiment can play out from here. Europe may continue to move down the path toward true fiscal integration all together. Alternatively, one country or group of countries may eventually decide to go another direction. Only time will tell. Each path is not without precedent, and each path has different implications for the Euro.

Our view is that Europe will move down its stated path – to maintain the European Monetary Union fully though the implementation of responsible budgets and new initiatives for growth. Member states will have to cede some sovereignty and pool together their creditworthiness to achieve lasting stability. The central bank will also likely be called upon to provide additional leadership and take on additional responsibilities in coordinating monetary policy, banking, interest rates, credit, and currency matters.

Another possibility is that one or more countries may, over time, choose to go their own way (as Greece is now contemplating). Here, the outcome for the Euro may be a function of who stays and who remains. Should weaker countries such as Greece leave, the eventual outcome for the Euro may be a stronger currency tied to more creditworthy sovereigns. Should stronger countries such as Germany leave, the eventual outcome for the Euro may be a much weaker currency tied to weaker and more profligate sovereigns. It could also be the case that the Euro is abandoned entirely, but this is not at all likely.

Should Greece depart from the European Monetary Union, all eyes will be watching how that country fares on its own.

Possible Euro Roadmap



We have no reason to believe that American banks are suffering any material adverse consequences as a result of Europe and Greece.

Back in the United States

In the meantime, we continue to monitor fundamental trends here and abroad. Those trends are generally supportive of modest growth. New orders are rising faster than inventories (inventory-to-sales ratio is 1.2 for durables); personal consumption is up 1.8% over a year earlier (had been 1.5% as of December 31); automobile sales are rising at a 14.4 million annual rate (was 13.5 as of December). On a less rosy note, jobless claims have again edged modestly higher and the 4-week average number of claims for unemployment insurance is back above 384,000 (was 377,000 at the start of the year).

Importantly, the recent concern over Greece and Europe has not had a measurable impact on the condition of U.S. banks as evidenced by the St. Louis Federal Reserve Financial Stress Index (see chart below). Additionally, the April Senior Loan Officer Opinion Survey on Bank Lending Practices revealed that there was a modest easing of lending standards and stronger demand for loans during the most recent period. Thus, we have no reason to believe that American banks are suffering any material adverse consequences as a result of Europe and Greece.

St. Louis Federal Reserve Bank Financial Stress Index

Our assessment remains fundamentally positive, therefore. The actual trends in data reflecting the underlying performance of the economy and other fundamental conditions remains supportive of continued modest growth and low inflation. Accordingly, our asset allocation recommendations remain unchanged.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.