REVIEW & COMMENTARY
2ND QUARTER 2011

Fiddling while fiscal conservatives burn

Over the past 30 years a good friend frequently ends our investment conversations with …" these are interesting and trying times." In other words, there is still a lot to worry about and there always will be. As we start the third quarter of 2011, we have something new to worry about and something old to worry about. The latter is the ongoing issues surrounding the debts of many of the smaller Euro nations ("PIIGS"- Portugal, Ireland, Italy, Greece and Spain) and the former is the United States of America whose lawmakers continue to disagree about whether to increase the government's debt ceiling. While the level of indebtedness in the US is not as great as that of the PIIGS on a percentage of GDP basis, the potential impasse among law makers in Washington poses a serious threat to both the world economies and capital markets. So does the unravelling of the Eurozone. No wonder the markets are jittery. We think neither will happen but let's have a look at both.

August 2nd, 2011 is the deadline in Washington to increase the debt ceiling. Raising the US debt ceiling isn't new. In fact, the ceiling has been raised 74 times since 1962, 10 times since 2001 and 7 times during one Presidency! Thus, this is a relatively frequent occurrence. So what is the big deal? Congressmen and women can't agree on how to pay for the increased debt. As the potential default on paying US debts is looming, lawmakers look more like the depiction of Nero playing the violin as Rome burned (historically inaccurate because the violin was created about 1500 years later- like the Romans, why let the facts get in the way of a good story). Ironically, prime time posturing and political self- promotion has overwhelmed their collective thinking to the point where they have lost sight that the failure to come to some kind of an agreement would have significantly more dire economic consequences than adopting either side's plan to pay for it. American politics is becoming more like a staged reality show where the ratings mean more than the content. Regardless, we do feel the US debt issue will be resolved which should reassure the markets for several reasons.

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One of these reasons is that among the many negotiating points in the debt discussions is whether to include a bill to repatriate US company's holdings of foreign earnings. This happened back in 2004 and met with limited (thus the ongoing debates) success. But J.P. Morgan estimates that there are approximately $1.4 Trillion in undistributed foreign earnings outside of the US and roughly one third to two thirds of that may make its way back home. Whether it will translate into new jobs (another bone of contention south of the border) it certainly will make those conglomerates considerably more attractive. If this plan is adopted, more than half the funds may well go towards increased dividends and stock buybacks which will, in our opinion, reinforce the notion that the economy may remain weak but will definitely make the publically traded companies considerably more attractive.

On to the PIIGS! This is an ongoing saga that has serious undertones if not dealt with decisively. This situation was a hot topic a year ago and has resurfaced since it wasn't resolved then. This cycle will continue until the EU makes the necessary and difficult decisions required. There has been a reprieve in the Greek situation but it would appear that they just don't have the economic firepower to regain solvency so the only long term solution, unless they undertake a complete sale of state treasures, is default. As it did a year ago, concerns are moving from Greece to other countries. Italy's finances have caused recent market gyrations. However, Mr. Smaghi, a European Central Bank policy maker states the Italian economy is much stronger and dynamic and will "never default". It would also be a mistake to look at Portugal in the same light as Greece. The Portuguese have been much better at taking their austerity medicine and haven't put up anywhere close to protests of their counterparts in Greece ringing true the commonly bandied phrase … ' when the Greeks go to the streets, the Portuguese go to the beach.' But as all this unfolds don't forget the one saviour that could provide the necessary financial relief to appease investors- the Chinese. They have a vested interest in maintaining the Eurozone not only as a trading partner but also as an alternative currency investment to the US dollar. There is no reason to play their hand until the music has stopped. With their support the figurative 'can' will be kicked well out of sight and equity markets will improve.

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