MV Capital Management Thought Content Series:
Markets in Transition

Volatility, the Sequel

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If you're kayaking through rough waters and suddenly you find yourself out of the rapids, gently gliding along a calm sun-speckled surface, you may have one of two reactions: (a) take a deep breath, lay your paddle down and close your eyes to savor the warmth and peace of the moment; or (b) tense up and wonder what lies around that next bend. Last Thursday our paddles were at the ready, but like pretty much everyone else watching the markets between 2.00 and 2.30 that day we experienced the stomach-churning vertigo as some bizarre hurlyburly of frazzled nerves, computer glitches, hedge fund wolfpack-think and heaven only knows what else caused the Dow to collapse over 900 points in the space of what seemed either like a few short seconds or an eternity of agony. The Yogi Berra in all of us spoke up: *déjà vu* all over again. Had we stumbled upon a wormhole and found ourselves transported back to the fall of 2008? We half-expected to see CNBC footage of Hank Paulson rushing over to Capitol Hill to write a flurry of checks compensating Goldman Sachs and JP Morgan 100 cents on the dollar for their AIG counterparty exposures.

Such, happily, was not the case. The markets recovered from the worst of that freefall, though still in deep red territory by the end of the day, and the idea of anybody on Capitol Hill giving Goldman Sachs anything other than a Bronx cheer was put to rest by the gratingly comical performance of 85 Broad Street's own Fabulous Fab Tourre and the Merry Men of Mortgage Malfeasance earlier in the week. Still, there was no doubt that market volatility was back with a vengeance. Equities markets have been shrugging off the simmering debt crisis in Greece for months now – this particular X factor showed up on the radar screen back in February but since then has largely taken a back seat to the much cheerier story of the stronger-than-expected economic recovery in the US.

Last week the simmering pot finally boiled over. The pleasingly astonishing thing is how fast the chefs ran back into the kitchen to take control. "EU Leadership" is a phrase viewed by many as an oxymoron, an inherent contradiction along the lines of "Long Island Expressway" or "Bipartisan Congress". But there they were over the weekend, hammering out a rescue package adding up to more than $1 trillion. There was European Central Bank Chairman Jean-Claude Trichet doing an eerily accurate impression of Ben Bernanke, working out the details of the bailout to ensure the wealthy nations' financial institutions would get 100 cents on the dollar for their risky sovereign counterparty risk – sound familiar? Small wonder the stocks of European financial services firms rocketed up more than 20% on Monday, leading the broader market's rebound from last week's plunge. Now of course the big question is: what's next?

For those who don't want to read on here is our summary take: we expect to see more volatility in the markets over the coming months, but we also expect that the US is likely to do relatively better than other parts of the world. To the extent that the EU rescue efforts keep a lid on immediate crises, which is a reasonable assumption given the size of the package, we believe the markets' focus will return to the generally upbeat story in the US, and that could bode well for domestic equities. We would caution against exuberance, though, because there are plenty of reasons to be concerned about prospects beyond the immediate cycle, and we discuss some of these concerns here below.

Greece is not a major economic force in the world. Its GDP is considerably less than that of a number of US states and dwarfed by the likes of California or Texas. But Greece is also a member of the EU, and the EU is the world's second largest economy, with a collective GDP of just under $11 trillion compared to our own $14 trillion-plus. Greece is also a member of the Eurozone, and so what happens in Greece

affects institutions, merchants and households throughout the lands where Euros change hands in daily commerce. In fact, Greece's choosing to trade their old national currency, the drachma, for the spiffy Euro in 2001 is why this crisis threatened to mutate into a global pandemic rather than just being a momentary blip on the world radar, nearly inconsequential for anyone outside of Greece itself.

Here's why that is so. Greece has run trade and fiscal deficits for many years. It borrows heavily to import things from other countries that improve the living standards of its citizens – like high-quality durable goods and capital equipment from Germany – and at the same time maintains the deep social safety nets, services, pension plans and similar perquisites of a European social democracy. Now – if a country gets in over its head in debt it makes a big difference whether that country has its own currency or not. Before 2001 the Greek government could simply print more of its own currency to pay its bills. Flooding the market with more drachmae would sharply devalue the currency and keep more Greeks at home for the summer holidays rather than vacationing in Bavaria or Bourgogne – but the problems wouldn't resonate beyond those beautiful Aegean islands.

That's not possible with the Euro, though, because the Euro is the EU's currency. Greek policymakers can't simply will more Euros into being any more than Maryland state regulators in Annapolis could turn on the printing machines at the US Mint every time they needed to fill a budget gap for police officers or road construction. In this scenario investors looked at Greece's worsening position and saw a high likelihood of default on sovereign obligations, perhaps as early as the middle of this month. And of course by the time last week's market meltdown happened the talk was less of Greece itself – a foregone conclusion – and more about much larger EU economies like Italy and Spain. It was in this fearful climate that the mandarins of EU financial policymaking came together and surprised the world with their audacious bailout plan. At stake was nothing less than the survival of the Euro itself.

Will the plan work? The markets are already second-guessing – stocks in Europe and Asia today were broadly lower though not in meltdown territory, while US markets have been mostly quiet. Like any bailout plan, it is not a free lunch. In particular, the provision of guarantees to bankers protecting them from their sovereign exposures addresses a liquidity problem, but not a solvency problem. *Liquidity* is when you don't have the cash on hand to pay for something. Let's say you are at a Home Depot and really want that sexy top-of-the-line John Deere tractor-mower. It costs over $2,500 and your credit cards are tapped out. Suddenly an angel swoops down in the form of a Home Depot customer service rep and offers you a store credit line up to $2,700. Problem solved! For now, anyway – you can buy the tractor but you are no more *solvent* than you were when you entered the store. In fact you are even more in debt.

And at a larger level that's still the problem with those second-tier European economies. Living standards, social programs and infrastructure are not going to improve for Athenians or Andalusians unless their economies can grow again through some combination of demand-side stimulus and/or good old-fashioned organic growth. Neither of these are in any way implicitly or explicitly assured by the bailout program. In addition, though, the EU in its entirety now has to cope with the burden of a larger debt overhang, just as the 2008 bailout here at home remains a sword of Damocles hanging over our long-term economic prospects. The best way to get yourself out of a debt trap, whether you are a country or a Home Depot shopper, is organic, real growth (our fearless tractor shopper's troubles presumably go down as his biweekly paycheck goes up). But that kind of growth is in short supply these days. The other way to achieve growth is through government-led demand side stimulus – spending to create jobs and encourage businesses to invest with the hope that real growth will follow. But stimulus risks inflation. In the EU the most powerful economy by far is Germany, whose policymakers view inflation with more antipathy and bile than US Republicans view tax increases – something that can happen when pigs fly.

To be sure, these are questions for tomorrow more than they are questions for today. The big migraines plaguing the market last week – will Greece miss a May debt repayment? Will Portuguese or Italian debt auctions fail? – these questions have largely been put to rest by the EU rescue package. That is likely to

relieve some of the markets' volatility in the near term. As we noted above, we think this containment strategy will be most beneficial to the US, where economic data points thus far this year have built a sufficiently robust case for near-term growth. However, we believe that higher volatility is here to stay, even if at times it will be more latent than actualized. The meltdown in US markets last Thursday was an overreaction and based at least partly on data glitches – but it also shows how quickly things can go sour. Looking over the global landscape it is not too hard to find cause for fear. Greece's gross-debt-to-GDP ratio is currently 133%. What should be much more alarming is the corresponding debt/GDP ratio for Japan – *197%.* That's right – the $5 trillion economy with a dysfunctional government, chronic long-term deflation and a stock market worth less than 25% of its value 21 years ago – that is the country at the top of the world's Club of the Indebted. We have to at least contemplate the possibility – not the probability, but the possibility – that the turmoil of the past week is little more than a dress rehearsal.

For now we can express relief that when push came to shove the EU demonstrated pleasingly effective, if unexpected, leadership. We can continue to take heart in an all-American growth story here at home – and take measures to ensure that our portfolios are positioned for growth. But here in the kayaks we don't expect to be setting down the paddles and kicking back for the gentle glide any time soon.

With warm regards,

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