The Greek Debt Crisis & Equity Market Decline

Clients of Blackhaw Wealth Management

Given the volatility and associated declines that have unfolded in global financial markets in the past 4 weeks, I thought this might be an appropriate time to send a special communication to the clients and friends of Blackhaw Wealth Management. There are two primary topics that I would like to address: (1) What actually happened in the past 4 weeks to precipitate declines of 10-20% in major global equity markets, and (2) What affect, if any, do these recent developments have on the management of client portfolios at Blackhaw Wealth Management?

What actually happened in the past 4 weeks to precipitate the 10-20% declines in major global equity markets?

The single greatest factor that has contributed to financial market volatility and asset price declines is recognition that the government of Greece is insolvent; the result of running exceedingly high fiscal deficits and reaching a level of indebtedness that almost eliminates any reasonable possibility of Greece being able to satisfy the required principle and interest payments owed to its bondholders. Put simply, Greece is bankrupt. Under *normal* circumstances, an external debt default by a country with a total economic output that is equivalent to that of Connecticut would not be detrimental enough to jeopardize the global financial system and cause $4 trillion in worldwide equity market capitalization to be wiped-out in a matter of weeks. But, as it turns out, these are not normal circumstances. Despite being a fairly small and economically insignificant country (my apologies to any Greek's that my be reading this letter) Greece happens to be a member state that shares the Euro currency, and thus the situation in Greece has threatened the entire European Monetary Union, and the stability of the European banks that hold vast sums of Greek bonds. At the time of this writing, the situation remains unresolved, at least in terms of a coordinated effort among the other member countries. This lack of coordinated action and resolve has compelled investors to shun European sovereign debt markets, sell existing investments in stocks and bonds, and reduce their euro currency holdings.

Along the way, this situation has been exacerbated by a litany of unrelated events that have collectively led to a wholesale reduction in the risk appetite of market participants. Among them was the extraordinary, albeit brief, sell-off in domestic stock markets on May 6th, during which time the Dow Jones Industrial Average fell 1,000 points with most of the loss occurring in a 20 minute period of time, only to reverse itself by rising 600 points in the subsequent 15 minutes. The phenomenon has been dubbed the "flash crash" and it is somewhat disturbing to know that, almost 3 weeks later, our securities regulators are not entirely sure of what caused the crash in the first place. Such an occurrence, and the subsequent inability of the so-called authorities to understand its origin, certainly doesn't inspire confidence among market participants or investors.

Those looking for something else to worry about haven't needed to look very hard. The sinking of an oil rig and subsequent (and ongoing) environmental disaster in the Gulf of Mexico has plagued the energy sector. Aside from the liabilities to BP, which are incalculable, drillers and oil producers are expected to face significantly higher taxes, regulatory oversight, and consequently higher operating costs going forward, as well as reduced access to offshore drilling leases. The result will be a host of negative long-term consequence for the drillers, major integrated E&P companies, and related oil services companies. Furthermore, any politicians who were previously supportive of offshore drilling will swiftly change their positions – this is an election year after all. The prospect of achieving a sensible and comprehensive national energy policy, as slim as it may have been before, is now totally gone, and the long-term impact on energy prices, although impossible to quantify, is at least directionally obvious – oil prices will be higher.

As if this wasn't enough, it recently became apparent that a North Korean submarine was unquestionably responsible for sinking a South Korean naval vessel, leading to the deaths of dozens of sailors and heightened tension on the Korean peninsula. North Korea has committed an act of war and it is likely that a South Korean response will be necessitated. This situation is so serious that, if it weren't for the Greek debt crises, the Gulf of Mexico oil spill, and the season finale of Lost, I suspect the Korean situation would be a leading news story, but many here in the U.S. are not even aware. However, the situation has not been lost by equity and currency markets, as Korean stock indices have swiftly declined in the past week.

All of these events – and others that I have purposely omitted for the sake of brevity – contributed to the sell-off in risky assets that ultimately evolved into a full scale correction as investors have been compelled, and in some cases forced, to reduce risk and market exposure. Technically speaking, the stock market has also crossed below its 200-day moving average, which is very important indicator to some market participants, and this event itself actually initiates automatic sell-orders at many institutions and hedge funds, which only adds fuel to the fire. In other areas of the capital markets, such as gold and foreign currencies, leveraged investors have simply been forced to reduce positions that have moved against them, and what were are now experiencing is a worldwide, liquidity-driven sell-off of risky assets; a negative feedback loop in which selling begets selling, and prices march steadily lower as holders of risky assets reduce their asking price over and over again, only to find a dearth of willing and able buyers. This is the situation, as it stands today.

What affect, if any, do these recent developments have on the management of client portfolios at Blackhaw Wealth Management?

Please be certain about this point: no accounts under the discretionary control of Blackhaw Wealth Management have exposure to any Greek bonds, directly or indirectly. Clients of the firm currently have positions in as many as four different mutual funds that may hold investments in the sovereign debt of developed and emerging market economies. None of these four funds have any exposure to Greek bonds – not one of them holds even a single bond issued by Greece or any Greek entity. In fact, the portfolio managers of two of these mutual funds made an explicit decision to avoid Greece altogether, and in 2009 sold-out of all related holdings, as they correctly perceived the attendant risks and acted decisively to protect the investor capital. Our lack of exposure to this disaster was not coincidental; it was intentional. As our clients know, the firm has systematically avoided making direct investments in developed European markets, and our carefully selected managers have explicitly avoided Greece itself.

Clients of Blackhaw Wealth Management know that our investment philosophy is predicated on maintaining long-term discipline, identification of superior investment managers and opportunities, avoidance of loss through risk management, prudent diversification, and minimization of costs, fees, and taxes. The firm places considerable emphasis on risk management *before* such protection becomes obvious and necessary. Much like a homeowner in Florida who pays for hurricane insurance, we prepare for the eventuality of a financial hurricane before the storm becomes visible. The time to prepare for storms, both meteorological and financial, is long before they become apparent to everyone. This does not mean that we, as investors in financial markets, can avoid losses entirely. Instead, we merely seek to minimize losses in the near-term, while having offsetting investments in place that will provide safety and preserve capital, in order that we may take advantage of the opportunities that invariably present themselves during such periods of market dislocation - this is the recipe for long-term investment success.

It is also important for our clients to distinguish between two types of situations: (1) adverse, but temporary, price movements in security prices and (2) permanent losses of capital. As investors in global financial markets we do face adverse, temporary, price movements in some of our foreign bond holdings. This is unavoidable. The owners of Greek bonds, on the other hand, face a decidedly worse outcome - a permanent loss of capital.

There is one other core investment principle that I would like to mention: opportunistic investing. We firmly believe, as history would support, that truly great investments are often made during periods of uncertainty and turmoil within markets. As all "risky" assets are seemingly being devalued by the day, a situation occurs in which many sound securities begin trading at substantial discounts to fair market value. In other words, there are many proverbial "babies" being thrown out with the bathwater at this point. This happens because various market participants become unwilling or unable to hold certain positions and eventually begin to sell indiscriminately, regardless of the relationship between price and value. Such opportunities are currently presenting themselves in certain equities, currencies, commodities, and of course in foreign bonds. One specific example would be the Australian dollar, which has lost 10% of its value in the past month. The Australian economy is strong and diverse, its monetary policies are sound, and its fiscal policies are so conservative that it is the only developed economy in the world today that may actually have budget *surpluses* within two years' time. The majority of the recent decline in the Australian currency is attributable to the aforementioned leveraged institutional investors who are facing near-term losses and are forced to change their positions, regardless of the long-term fundamentals of the Australian economy and its role as a producer of many crucial economic inputs to the burgeoning Asian economies. I see this as an opportunity and may look to increase our investments in Australian bonds and equities very soon.

Concluding Thoughts

The world is an increasingly interconnected place in which economic shocks in one region quickly translate to other regions. The Greek problem, which initially appeared to be regional in nature, rapidly morphed in a worldwide de-risking that has reduced global equity markets by trillions of dollars in a matter weeks. Coupled with financial market shocks, such as the flash crash, and geopolitical uncertainty, we continue to believe that the global financial system is somewhat more fragile than most would have believed just one month ago, and that the range of possible outcomes for economic growth, inflation, and financial asset prices is uncomfortably wide. It is likely that the volatility will continue for many months to come, albeit with less directionality than we've seen recently. I want our investors to know that their financial assets are being diligently managed and that I continuously seek to balance the trade-off between short term capital preservation and the need to take advantage of the attractive investment opportunities that always present themselves during periods of stress in financial markets.

Aside from these investment opportunities there are some additional, perhaps more practical conclusions that our clients and friends may find worthwhile. For example, anyone that has contemplated a European vacation in recent years should seriously consider making such a trip this year. The euro has lost almost 20% of its value relative to the U.S. dollar in the past 6 months. The true contrarians among us may go so far as to plan a vacation to Greece itself – you are guaranteed to find hotels that resemble ghost towns, with commensurately low rates, and you probably won't have to wait in line to see the Acropolis. The oenophiles among us (I count myself in this group) will be happy to know that French wines should become decidedly cheaper in the following months. Providence itself may be on our side, as it just so happens that the 2008 vintage from Bordeaux is showing promise. Many of these noteworthy wines are just now reaching their retail locations…providing savvy connoisseurs with an attractive opportunity of their own.

If you have any questions about this letter or anything else related to your investments at Blackhaw Wealth Management, please do not hesitate to contact me.

Ian McAbeer, CFA
President
Blackhaw Wealth Management, LLC
512-425-0535
ian@blackhawwealth.com

Blackhaw Wealth Management is an independent financial advisor in Austin, Texas. As an independent financial advisor, our firm works with private clients and foundations to develop, implement, and manage investment portfolios.