



WEALTH MANAGEMENT, LLC

The Greek Debt Crisis

Crisis Overview

Greece joined the Eurozone in 2001. The Stability and Growth Pact (to which all Eurozone members must agree) states that each country's annual budget deficit may be no higher than 3 percent of GDP, and its national debt must be lower than 60 percent of GDP. Greece's deficit as a percentage of GDP is at 13.6 percent, and its national debt as a percentage of GDP is at a massive 115 percent.

These two statistics show just how bad the fiscal problems are in Greece. These problems did not happen overnight, but were the result of spending too much and collecting too little in tax revenue. The present crisis is a concern that Greece is on a path toward default on its debts.

The recent news has been Greek officials agreeing with the European Union on a bailout plan. To receive a bailout, Greece agreed to cut expenditures, raise taxes and reduce corruption. However, this plan has not gone over well in Greece. There was a massive strike among public workers because their pay would be cut due to lower government spending. The strike and protest turned violent after a fire bomb hit a bank in central Athens. Three bank employees died due to the fire bomb.

Market Reaction

The current yield on a two-year Greek note is at 14.84 percent. The cost of a five-year credit-default swap (CDS) for sovereign Greek debt is currently 830 basis points. These statistics show that the market is not convinced that Greece will avoid defaulting on its debt. Further, most governments cannot afford to raise money by issuing bonds that yield around 15 percent.

Greece is in a spiral where its fiscal problems caused its cost of capital to rise. Now that Greece is serious about fixing its problems, the rate on its debt is too high to solve the problems.

There are several scenarios for how this could end for Greece. One possibility is default, which certainly is a risk as evidenced by the yield on Greek debt. Another possibility is a combination of the European Union and the International Monetary Fund lending to Greece at below-market rates for the next few years as Greece gets its house in order.

Contagion Risk

There are other countries in Europe with fiscal problems, such as Spain and Portugal. However, it should be noted that the market does not view these countries anywhere near as likely to default on their debt as Greece. (Portugal's five-year sovereign CDS is 430 basis points, while Spain's five-year CDS is 245 basis points.) That doesn't mean the risk of default isn't there, and these countries will need to choose between decreasing their spending and paying high interest rates to raise capital.

How Does Recent United States Spending Compare to Greece?

The situation in the United States is much less severe than Greece's situation. In 2009, the United States debt-to-GDP ratio was 83 percent, which is high. (As recently as 2002, this number was below 60 percent.) However, a high debt-to-GDP ratio does not necessarily mean impending doom. From 1945–1947, the United States had debt-to-GDP ratios above 100 percent in each year.

The recent spending is a cause for concern, but the United States has many advantages that Greece does not. The U.S. dollar is the world's reserve currency, although there has been talk of change. The United States remains one of two most productive countries in the world and is the world's most diversified economy.

Effect of Crisis on DFA Global Bond Funds

Given the headlines, one might ask about the effect of the crisis on DFA's global bond funds. Investors should know no DFA funds have exposure to Greek or Portuguese bonds. Further, DFA diversifies the portfolio across countries and continuously monitors the credit quality of the bonds it purchases.

Implications for Investors

There is no doubt that things are bad for some of the weaker members of the European Union, and it is certainly possible that things will get worse for these countries. However, knowing this information is not enough for investors to make a profit (or avoid a loss). For investors to capitalize on the current crisis, they would need to know whether things will be worse or better than the market already anticipates. The best indication of how bad things will get is the reaction of the financial markets. This is manifested in the yield of Greek bonds and the price of CDSs on Greek sovereign debt.

Clearly, the market is aware of the situation in Greece and has factored the expected outcome into prices. If things turn out worse than expected, prices will fall. However, if things turn out better than expected, prices will rise. Smart investors know that the world is a risky place and factor this into their investment plan. This plan accounts for all kinds of risk, not just the most recent debt crisis in Greece. Choosing the asset allocation that fits the investor's ability, willingness and need to take risk is the best way to be prepared for the risks of the market.

One of the biggest problems investors have to deal with is hindsight bias. There is an old saying that we all make great quarterbacks on Monday morning. With the benefit of hindsight, the right play to call and the winning strategy are always obvious. Unfortunately, it seems to be a human failing that we are either unable or unwilling to recall what our beliefs were before the events actually occurred. We have a tendency to exaggerate our pre-event estimate of the probability of an event occurring. This hindsight bias may lead us to believe that even events the "experts" failed to foresee were not only painfully obvious, but also possibly even inevitable. Every day, we hear after-the-fact analysis explaining market moves in a way that sounds as if an event were predictable.

None of us has a clear crystal ball as to how events will play out. It certainly is possible that we could see a repeat of the "Asian Contagion" that caused a sharp market correction in the summer of 1998. On the other hand, the problem could be solved quickly and markets return to normal. Unfortunately, if we do experience a severe market, many investors will believe that it was obvious that it would occur and they should have acted. And obviously there will be some market gurus making such a forecast — just as there were gurus who last March, with the S&P at 600, were predicting it would drop all the way to 400 (such as Nouriel Roubini). However, there is an overwhelming body of evidence that efforts to time the market based on forecasts of events is the loser's game.

Copyright © 2010, JDH Wealth Management, LLC. This material and any opinions contained are derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and is not intended to serve as specific financial, accounting or tax advice. To be distributed only by a Registered Investment Advisor firm. Information regarding references to third-party sites: Referenced third-party sites are not under our control, and we are not responsible for the contents of any linked site or any link contained in a linked site, or any changes or updates to such sites. Any link provided to you is only as a convenience, and the inclusion of any link does not imply our endorsement of the site.