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Dear Valued Investor,

For the second year in a row, we have experienced an early summer economic soft spot with Europe at the epicenter. Last year, the S&P 500 market posted gains through late spring when concerns about Europe's debt and an environmental catastrophe (oil leak in the Gulf) started a summer of volatility and uneven economic data. Sound familiar? This year, the S&P 500 market had an 8% gain through May before falling prey to concerns about Europe and global growth impacts resulting from an environmental catastrophe — the earthquake in Japan.

The result is yet another summer soft spot for the global economy, which like a bruise on an apple is unsightly but does not render the rest of the fruit rotten. For the global economic "apple," there remain many signals that the recovery from the worst recession since the Great Depression continues. Business and consumer spending remain solid, jobs are being created (albeit at a slow pace), and some companies are in line for record profits by the end of the year.

That said, the global economic "apple" still faces a significant bruise, which happens to be the same pesky soft spot that the markets had to deal with last year — namely Southern Europe, and more specifically, Greece. Saddled with debts that it cannot repay and austerity measures that are not fully embraced, Greece appears headed for a showdown with creditors and a potential default on its loans. The real question is why does the market care so much about Greece? Can Greece really cause enough disruption to halt the global recovery in its tracks? The truth of the matter is that the market does not really care about Greece; it cares about the potential contagion of Greece's troubles to the rest of the world.

Here is a possible scenario: should Greece not make good on its debt burdens, significant impacts could ripple through the markets. Investors in Greek bonds, which are largely other banks and financial institutions, would lose significant money on their investments. More importantly, the default could cause banks to not trust other borrowers. These banks could be "once bitten, twice shy", which would create a reduction in global lending and worst case, a freeze-up of capital markets.

While these outcomes are certainly possible, it is a huge stretch for the market to be making comparisons of Greece to Lehman Brothers, which was the "poster child" for the financial crisis that resulted in the Great Recession of 2008 – 2009. Greece is not new news and investors, particularly the banks that own Greek debt, have taken great steps over the last year to mitigate the potential negative effects of that ownership. More importantly, Greece and Lehman Brothers are as different as is cause and effect. Lehman and its huge bets on sub-prime housing debt was a cause of the financial crisis. Greece's poor fiscal management, on the other hand, is merely an effect. Stated more appropriately, Greece's situation is a consequence of what happens when a country has too much debt and not enough growth — one causes a financial crisis (Lehman Brothers), the other is just a by-product of a financial crisis (Greece).

With respect to Greece, the market is being realistic and does not require a solution, but simply a resolution. Greece is not "too big to fail," but the financial institutions that own the Greek debt are. Once the Greece situation is under control, or at least the market gains comfort that the impact will not result in a contagion that could weaken the global recovery, it is likely that the economic data and corresponding market performance will improve. The collective global efforts to coax a resolution are underway and I anticipate a resolution, maybe not a solution, to be forthcoming in the next few weeks.

In the meantime, current conditions support a cautious stance through this economic soft spot. However, we expect this soft spot to be transitory. As the summer unfolds, we anticipate that investors will realize that the economic growth "apple" is just bruised, not rotten, which will transform volatility and fear into investment opportunities. As always, if you have questions, I encourage you to contact David Waters.

Sincerely,

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