

President's Letter & Market Commentary – Q3 2015

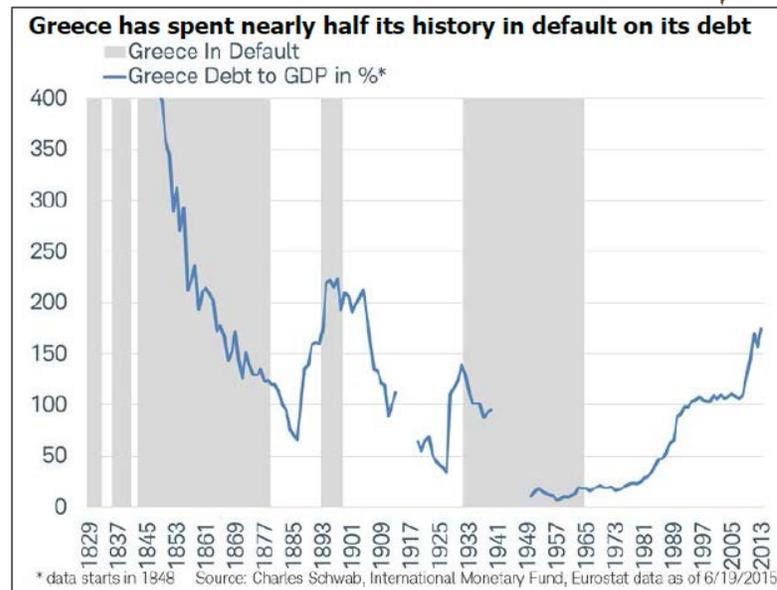
“Rather go to bed without dinner than to rise in debt.”

- Benjamin Franklin

As the saga in Greece continues to unfold, and debate about the ultimate fate of the EU intensifies it is important to not lose sight of the root cause of this crisis. Simply put, Greece has borrowed more money than it can possibly pay back. Hampered by low growth, 25% unemployment, and years of poor fiscal management, Greece's debt to GDP currently stands at about 177% (to provide perspective the US is just over 100% and Germany stands at about 70%). Countries that find themselves in these situations typically print lots of money, devalue their currency, and therefore make their exports cheaper and at the same time force their debt levels to shrink. Unfortunately for Greece, as a member of the EU they do not have this option available since their currency is now the euro. Therefore Greece has turned to the stronger countries in the EU, as well as other international monetary bodies like the IMF for help. In return for loaning Greece billions of euros, the lenders have looked to impose severe measures on the Greek people (needless to say this call for austerity has not been well received).

What does this problem or a potential Greek default mean for the markets? Here are a few points for consideration:

- In terms of size, Greece's GDP is around \$238 billion. If Greece were a US state, that would rank 25th, just behind Louisiana (Alabama's GDP is around \$200 billion).
- The risk of financial contagion has diminished greatly since the Greek issue first appeared in 2011. Over that time frame more than 75% of Greece's debt has been moved onto the books of government institutions and is no longer held by highly leveraged banks that could cause a financial crisis or a hedge fund that could cause a market failure.
- The risk of spreading panic in Europe is likely contained since the European Central Bank (ECB) stands ready to buy the debt and recycle the bank deposits of member nations.
- A default does not necessarily mean a Greek exit from the euro. Opinion polls have shown that a majority of Greeks want to stay in the Eurozone and since the treaties do not provide for an exit from the EU, steps can still be taken to create liquidity if Greece were to enter into a technical default.
- Most importantly, the global economy is on much stronger ground now than it was in 2008 and 2011 when the extent of Greece's problems became known. Halfway into 2015 it appears that all of the world's major economies are growing and are in a much better position to weather shocks resulting from a Greek default.



If a possible Greek exit looks to be primarily an issue for the European countries and the Greek people, how is our economy shaping up at the halfway point in 2015? At the highest level US economic data continues to improve, admittedly at a subdued rate. This moderate growth is allowing the Fed to ‘normalize’ monetary policy at a measured pace without having to take drastic action to counter inflationary pressures. Retail sales have rebounded after a string of weak readings in the first half of the year, which could be an indication that consumers are starting to open their wallets again. Further acceleration in consumer spending could result from lower energy prices, dropping unemployment, low interest rates and rising wages. Additional benefits can occur from increased home sales and rising home ownership levels.

While the fundamentals appear strong, all eyes remain on the Federal Reserve as we try to determine when they will begin to raise rates. Expectations earlier in the year that the Fed would act in the spring proved incorrect as inflationary pressures eased due to lower energy prices and a stronger dollar. The Fed has gone to great lengths to prepare investors for the inevitable hikes in interest rates that are likely to come this fall. With such a high level of transparency, the Fed is hopeful (as are we) that the disruption in the financial markets will be minimal. September seems a very likely point to begin the tightening process, absent sudden acceleration in inflation in the near term. While this doesn’t mean that there won’t be some hiccups along the way, and almost certainly we will see increased volatility, no one should be caught off guard if and when the rate hikes begin.

We will continue to focus on the fundamentals, looking for strong companies with the financial strength to weather these storms and the business strength to thrive in the next phase of our economic cycle.

Sincerely,

Eric O. Kallen, President & Chief Investment Officer
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