Market Update – Part 1: 06/04/2015
Written By: Doug Ciocca

The summer is filled with difficult decisions: go swimming or jogging? Cook-out or have a picnic? Enjoy an ice cream bar or a snow cone? And if you live in the Midwest, what the heck do we do to entertain ourselves on another rainy day?!?!

The financial markets, representing the collective and emotional embodiment of its participants (a.k.a. all of us investors), are also confronted periodically with difficult decisions and two have taken center-stage: Will Greece remain a member of the European Union (EU) or secede? And, will the Federal Reserve Bank raise interest rates soon or will it be much later this year?

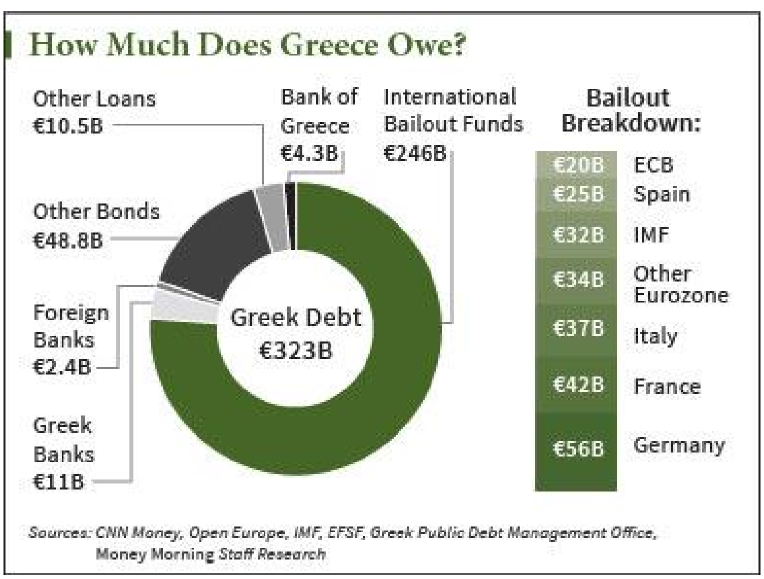
We are going explore each and also investigate why they have catalyzed the recent volatility in stock and bond markets and exacerbated the intra-day price swings of both.

We'll break this into 2 separate installments…..tonight Greece and next week, the Fed…..each weighs heavily enough on the mind of the market to merit independent examination.

Greece.

Will Greece get the boot from the EU? Like any self-disrespecting macroeconomist, I would handicap the odds of Greek maintaining membership in the EU at around 50%....essentially a coin toss. While my perspective may be a bit skewed from Leawood, Kansas where one cannot readily glimpse the Aegean or Mediterranean Seas, the issue does not seem nearly as complicated as the market is to be making it out to be. There are 3 problems as I see it:

Problem #1: Greece owes a several organizations a ton of money, and it owes that money soon[1]. Those organizations, represented in the pie chart below are the International Monetary Fund (IMF), the European Central Bank(ECB) and the EU. Simultaneously, they have obligations to pay salary and pension benefits to their government employees…..also very large sums.



http://moneymorning.com/2015/03/25/how-much-does-greece-owe-4-charts-that-put-greek-debt-in-perspective/

Problem #2: Greece is notoriously and historically horrible at collecting taxes from their citizens. As reported in the Wall Street Journal in February[2]:

> ***"At the end of 2014, Greeks owed their government about €76 billion ($86 billion) in unpaid taxes accrued over decades, though mostly since 2009. The government says most of that has been lost to insolvency and only €9 billion can be recovered.***
>
> ***Billions more in taxes are owed on never-reported revenue from Greece's vast underground economy, which was estimated before the crisis to equal more than a quarter of the country's gross domestic product.***
>
> ***The International Monetary Fund and Greece's other creditors have argued for years that the country's debt crisis could be largely resolved if the government just cracked down on tax evasion. Tax debts in Greece equal about 90% of annual tax revenue, the highest shortfall among industrialized nations, according to the Organization for Economic Cooperation and Development."***

Think how incredible that is! To repeat, tax debts in Greece equal 90% of annual tax revenue…..who are the 10% that are actually paying their taxes?! It would lead one to wonder why would such a vast majority of Greeks fail to fulfill their civic, and yes legal, duty to comply with their tax code? Well, the article goes on to suggest:

> ***"….Greeks have a widespread aversion to paying what they owe the state, an attitude often blamed on cultural and historical forces.***
>
> ***During the country's centurieslong occupation by the Ottomans, avoiding taxes was a sign of patriotism. Today, that distrust is focused on the government, which many Greeks see as corrupt, inefficient and unreliable."***

Wow. So, it would logically follow that the Greeks voted in January to elect new leadership to right the ship, correct? You know, get back in the good graces of those entities that provided a financial lifeline in their time of dire need! No, incorrect. They did elect new leadership, but that led to problem #3……

Problem #3: The Greeks elected a gentleman named, Alexis Tsipras, a member of the Syriza Party, whose platform is "anti-austerity," which loosely means: creative welching. [That is my personal interpretation, not featured in any campaign circulars that I have seen.] The goal of the new electorate is to renegotiate Greece's debt, essentially rejecting a chartered course to repay the aforementioned, though not as snappily titled above, "Trokia" (IMF, ECB & EU) who extended them funds designed as a rescue package or bailout during their financial crisis which took place from 2010-2012.[3]

Therefore, the state of affairs in Greece has sown concern in financial markets of the repercussions of any defaults in the European banking system. Such defaults could threaten the availability of credit crucial to promoting a Eurozone economic recovery. And keep in mind, in this globally-intertwined financial landscape, any European sneeze can lead to a global cold. Hence the choppy trading in both foreign and domestic stock markets, but also, in their respective bond markets.

Even more than stocks, bonds tend to trade on integrity and confidence. Bonds are loans and any whiff of concern as to the repayment of those loans, however slight, can push interest rates up on those loans. When interest rise, bond prices fall. When interest rates rise, capital costs elevate. When capital costs, elevate, less free cash flow is available to investors. This viscous cycle ebbs and flows until resolution is achieved.

And just today, after the close of the European markets, Greece elected to "defer" a €300 million payment to the IMF, "invoking an obscure mechanism in abeyance since the 1970s to bundle all debts due in June and pay them at the end of the month."[4]

To say that this situation is as fluid as a shot of ouzo, would be an insult to ouzo, but it is a thick as a drum of olive oil. That is why I think it is even odds as to whether Greece stays or goes from the EU.

Expecting more volatility until some semblance of order is reinstated would be prudent. But please understand, from volatility emerges opportunity and we are assessing the situation with an optimistic posture and with patience – looking for investments that cheapen as a result of this volatility.

We'll keep in close touch on the developments in Greece as well as dissect the dissension among the Fed Heads in next week's installment.

Have a great evening and if you are in Kansas City – GO OUTSIDE, IT HAS STOPPED RAINING FOR A FEW MINUTES!! dc

[1]http://www.theguardian.com/business/2015/apr/24/greek-debts-what-does-it-owe-when-will-the-money-run-out

[2]http://www.wsj.com/articles/greece-struggles-to-get-citizens-to-pay-their-taxes-1424867495

[3]http://www.bbc.com/news/world-europe-30975437

[4]http://www.telegraph.co.uk/finance/economics/11652893/Greece-misses-IMF-payment-in-warning-shot-as-showdown-with-Europe-escalates.html