The CJ Investment Newsletter

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Why Greece Matters

Purpose

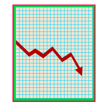
This is a reissue of previously disseminated information.

The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

Quick Look

Market	**Next Expected Move**
?	

- We discuss some of the major implications worldwide and in the US of Greece's potential bankruptcy and/or bailout.

Greece is the Word

You may have heard about "PIIGS" lately. PIIGS is an acronym for the most troubled of the European Union's economies – Portugal, Ireland, Italy, Greece and Spain. Of these, the currently weakest is Greece, a country whose government profligacy has even exceeded ours on a per capita basis. Greece is in imminent danger of defaulting on its sovereign bonds. There is a ton of statistics involved in this problem, but we'll try to keep from losing the conceptual message by using a flood of statistics.

Greece and the other PIIGS got into this problem by overspending, primarily on social programs. After all, by our standards, most of Europe is partially to mostly socialist in their approach to government and economics. Greece is the first of what may be many economies (not just in Europe) to have

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*"When the people find they can **vote themselves money**, that will herald the end of the republic."*

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reached the "point of no return." They cannot service their current debt and pay for their government programs. Additionally, their situation is so bad, that they are unable to continue to borrow to push the debt service into the future.

By now you might be asking, "So what?" There are two basic reasons why what's happening to Greece matters to us.

Foreshadowing A country with a sovereign currency would normally deal with this situation by inflating away the debt through the devaluation of their currency. Does this sound familiar? It should. It's Washington, DC's current course of action. It's also the way they've dealt with deficit spending since at least WWII, if not since Teddy Roosevelt's appearance as the first progressive President. And since we created the Fed in order to enable this behavior.

Unfortunately for Greece, this temporary cure that can buy time for a more permanent solution is not available to them because they are part of the European Union (EU) and they cannot devalue.

Therefore, Greece's condition looks a lot like California's, except that California is a lot larger than Greece in both population and in economic output. California, though, I believe is over 20% of the US total population and constitutes a similar percentage of US GDP. 60 million people and the 8th largest economy in the world, if measured separately from the US. Greece, however, represents only about 3% of the EU's population and GDP. Watching how the EU deals with the Grecian debt situation may tell us how we should deal with California's extreme debt situation – or, maybe, how not to.

There is serious discussion of a bailout by the rest of the EU, which means the "load" would fall primarily on the most financially successful countries, and would especially affect the largest creditors of Greece – namely, France, Switzerland and Germany.

The Greeks ultimately make the decision as to what happens. After all, they are a sovereign country, albeit constrained by being a member of the EU. They have 3 choices that would "solve" their problems:

- Take the bailout, if offered, and make the drastic budget cuts and tax increases that will keep them in the EU and work themselves out from under their debt. This would mean a protracted recession/depression for at least several years.

Further Reading

Much of this information comes from John Mauldin's excellent recent e-newsletter "Between Dire and Disastrous:" http://www.2000wave.com/printarticle.asp?id=mwo022610

- Default on the debt and enter a recession/depression for an even longer time. They would also not be able to count on any new debt financing from any other country, which they could in limited amounts using option 1.
- Leave the EU and create, then deflate, their own sovereign currency. This would amount to practical default on their debt. Again, their ability to borrow, even for catastrophes, would be virtually nonexistent for some time.

Global Impact The moral hazard issue may preclude the EU, and especially Germany (as it's strongest economy) from bailing out Greece. Moral hazard occurs when a party insulated from risk may behave differently than it would behave if it were fully exposed to the risk. (From *Wikipedia*) After all, the remainders of the PIIGS are fragile also. As John Mauldin (see reference above) puts it: "If Germany bails out Greece, Ireland, which is actually making such cuts to its budget, can legitimately ask, "Why not us?" And will Portugal be next? And Spain is too big for even Germany to bail out."

There is also the problem of contagion. It's an interconnected world and you can bet there are a lot of derivatives in play related to all EU debt, and especially the PIIGS. There would be severe financial stress outside of Greece as well as inside. No one is sure how much stress or where else in the EU or the world it will manifest itself.

Finally, if the Greeks are allowed to default and with the bulk of their debt in 3 countries, the consequences could be disastrous to the EU's banking system. From Mauldin:

"Make no mistake, a Greek default is another potential credit crisis in the making. As noted above, it is not just the writedown of Greek debt; it is the mark-to-market of other sovereign debt… That would bankrupt the bulk of the European banking system, which is why it is unlikely to be allowed to happen."

This last point also has a sub-point (if you will) that bears consideration: Prior to this, sovereign debt was

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: **BEAR**
Appropriate Current Allocation: **DEFENSIVE**

Asset Class	**Conser-vative**	**Aggres-sive**
Money Market Funds	70-10%	55- 5%
Long Positions:		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
Aggressive Positions:		
Shorts and/or Options	0%	0- 5%

Notes:
Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. Such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains as the dollar declines against foreign currencies due to Fed monetary policies.

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considered "safe" from credit risk if from developed countries. There would be currency risk from changes in the relative values of the currencies as they floated in the world's forex exchanges, but credit risk was not often factored into 1st world sovereign bonds. We now know that sovereign debt from EU countries is no longer "safe," nor is the US$. Another "gift" from fiscally irresponsible governments buying votes with deficit spending on socialistic benefits. Thanks, guys!