Greece Trap Service Required!!

No, the title of this quarter's Commentary does not contain incorrectly spelled words; rather, the spelling is intended to be a play on words. A grease trap is a mechanical device inserted into wastewater systems and is designed to be an interceptor of most solids and grease before they pass throughout the system. The purpose of the grease trap is to avoid globs of grease from clogging or obstructing the flow of the entire system. Well, that is indeed what the European financial markets immediately need: a way to keep "Greece" and its inherent financial toxicities from clogging the European credit and financial markets and, therefore, potentially clogging up the banking and financial system for the entire world.

The delay of the Greek and European authorities in properly addressing Greece's financial instability has only made matters worse. Greece's significant budget deficits and resultant national debt burden is the issue. Importantly, the solutions to these problems are painful to most everyone involved (both the Greek people and those invested in Greek investments, etc.). Therefore, it should be easy to understand why political leaders are so reluctant to take the necessary action. European and worldwide leadership may not lack the knowledge or understanding of how to improve Greece's economic situation, but that same leadership evidently lacks the political will to deal with the problems. If that assessment of political inhibition is correct, it is no wonder that the European Union is taking so long to render its prescription for healing the Greek spending and debt disease. After all, as the agony of indecision and uncertainty increases the fears within the marketplace, the pain associated with the necessary corrective action becomes more and more acceptable.

While it is possible that Greece will not 'default' on its debt obligations, it is still highly unlikely that the country can avoid a "financial bailout" likely lead by the EU with support from China, the U.S., and possibly other countries. Therefore, back to our analogy, the Greece trap has been overloaded and is now in need of a complete cleaning or pumping out of the accumulated clogs; can we say "bailout"? Whether or not such a bailout will occur is still yet to be seen, but we will not see a stabilization of this tense situation until dramatic action is taken by the policy makers involved.

No Man is an Island

So, why all the fuss regarding the Greek financial crisis? The answer is two words: financial contagion. The financial collapse of a sovereign such as Greece would certainly seriously infect many European banks and, thereby, European governments as well due to those governments' incestuous investment and ownership in their banking and financial systems. Likewise, global financial institutions, including several large money center U.S. banks have meaningful exposure to these same European governments and their financial institutions. Large defaults of any kind could start the domino effect of lowering the value of bank asset values. The global banking system would likely be shocked, once again, should the ripple effects of a sovereign's default begin to weigh on their balance sheets.

In fact, we believe that the main culprit in the stock market's -20% correction since early July 2011 has been the worldwide banking system teetering on the brink of a potential major shock from such a Greek default. Investors' concerns for the worldwide banking system spilled over into the broader investment markets. The increasing uncertainty over the past 120 days has resulted in investors' risk premium expectations rising and lead many investors to liquidate stock positions and invest, for the most part, in perceived low risk fixed income securities (e.g., money market funds, U.S. government bills, notes, bonds, etc.) The perceived financial woes in Greece, or Italy, or Spain, or Portugal, or Ireland do not remain isolated to those countries but affect all financial markets in today's global economy. Thus, no man is an island unto himself in our global financial market.

What about a 'Double Dip' Recession in the U.S.??

The other factor that has weighed on stock prices in the U.S. has been the slowdown in the domestic economy. While serious debate continues regarding a possible "Double Dip" economic recession in the U.S., recent economic indicators do not necessarily indicate or confirm that a recession is on the horizon for 2012. There are many data points that support the argument that the U.S. is headed for a "double dip recession", but there are also numerous data points that do not support that argument. By and large the economy is stable, just not growing. As others have stated it recently, the U.S. is definitely in a "recession of confidence", but whether or not we truly slip back into a classic economic recession is yet to be seen.

Chairman Bernanke speaking for the U.S. Federal Reserve indicated that the Fed will continue to be as accommodative as possible in an effort to stimulate economic growth and job creation. The Fed Chairman strongly lobbied Congress to join his efforts by alerting them that the "U.S. economy is close to faltering" as he encouraged our political leaders to do their part in controlling deficit spending and additional Federal debt. The Fed is truly pulling every tool out of the tool chest in an attempt to stimulate the economy. There are large questions as to whether or not they will be successful, this time, in truly encouraging job growth and capital spending, but they are definitely trying.

All eyes will remain on the various economic indicators, but ultimately the main focus will remain on jobs. Job growth is still insufficient to erode our U.S. unemployment and underemployment issues. With 9+% of our population unemployed and another 7+% of our underemployed in the U.S., there must be progress made on the jobs front in order to get meaningful growth. That said, there are solid underpinnings in the economy that are still in decent shape. Company balance sheets and profits remain strong, and there is significant capital that is waiting for the "all clear" signal. When they feel they receive it, that capital will get put to work.

Our Market Outlook

Stocks are not overly expensive at these levels. They are not cheap, but valuations are not the reason for our cautious stance. We stand ready, willing and able to become more bullish on our outlook. If we can get some clarity on the European situation, along with some meaningful guidance from Washington on the direction of health care costs, taxes and regulation it would be very easy for us to become much more optimistic.

We believe that the bond market, and especially the U.S. Government bond market, is overvalued. Interest rates are at historically low levels meaning that bond prices are therefore at historically high levels. The next major move for interest rates is likely to be up, which means the price or value of the fixed income securities will be under pressure and subject to significant decline. It is very difficult to estimate when this move higher in rates will occur. As this letter is drafted, the 10 year Treasury is hovering around the 1.80% level. To borrow a phrase from a previous letter, as sure as the sun will come up in the East tomorrow, interest rates are going to go MUCH higher from current levels. We would be shocked if they don't more than double in the next 5 – 10 years. This may not happen for months, or even years, but investors must prepare their portfolio for that likely event.

In those common stock portfolios where we have the latitude to do so, we have accumulated significant [i.e., 20+%] money market fund balances in lieu of being fully invested in the common stock market. The uncertainty regarding the economic outlook has significantly diminished the number of buying opportunities fitting our purchase criteria. As usual, we will diligently watch for investing opportunities when / as they arise. Until then, we are comfortable holding money market funds in reserve as we await better buying opportunities in the stock market.

Year End Tax Planning

As we enter the fourth quarter of the year, now is a good time to discuss your 2011 projected income tax situation with your tax advisor. Attention should be focused on the amount of any capital loss carry forwards that you might have and your projected realized capital gains and losses for 2010. Please let us know if we can assist you in any way or if there are specific action items that you would like us to take for the purposes of your planning.

Thank you, once again, for the confidence that you continue to display in our firm by allowing us to serve as your investment advisor. 2011 marks CAZ Investments' 10 Year Anniversary. Thank you for being part of our successful history! We are excited about what the next 10 years will bring and look forward to serving you for many years to come.