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Greece Poses a Challenge for European Monetary Union; Probably Not Its Last

Our Fall 1998 *Quarterly* covered the introduction of the euro: the conversion of 11 European currencies into one. The formal foundation for the European Monetary Union was the 1992 Maastricht Treaty which set economic criteria for countries to qualify for membership and adhere to from that point forward.

Most analysts count the project a notable succes. But it is facing perhaps its greatest challenge to date in the form of the Greek sovereign debt crisis. The European Commission Report on Greek Government Deficits and Debt Statistics claims that Greece has misrepresented its public finances to the EMU and the world for several years. It now appears that Greece's public debt could surge to 110% of its gross domestic product (GDP), and its ongoing budget deficits to more than 14% of GDP, well above the EMU's limits of 60% and 3% for those two key measures.

Other European states' finances are prompting similar concerns. Specifically, Portugal, Ireland, Italy, Greece, and Spain have been lumped together under the unflattering acronym "PIIGS." As the crisis grabbed headlines the euro skidded against the dollar, and both gold and oil pulled back in dollar terms. Yield spreads widened between bonds issued by stronger EU countries and those that appear most fiscally challenged.

Greece represents less than 3% of the euro zone economy, and other member countries have exceeded those debt and deficit benchmarks. In fact, a snapshot of Greece's fiscal situation doesn't look much worse than Britain, Japan, or even the U.S. But it is the first major calling of a question at the heart of the EMU project: How does a common currency handle very divergent fiscal stresses among member countries?

The U.S., Britain, and Japan control their respective currencies and monetary policy. They may pay a long-term price for an expansive monetary posture, but at least they have that option. The European Central Bank, however, has the singular charge of maintaining a stable euro rather than tailoring policy to disparate economic and fiscal conditions across EMU countries.

Stronger members urge Greece to make painful tax and spending adjustments. Greece has responded with a proposed hike in its value-added tax rate and cuts to public employee payrolls. But raising tax *rates* in a tough economy does not always raise *revenues*. And the prospect of cuts to government wages and benefits has workers taking to the streets.

Greece seeks forbearance on those debt and deficit ratios as well as help from other EMU members, notably Germany. German voters are less than sympathetic although their economy has been a prime beneficiary of a more integrated European market.

Greece's status as a sovereign nation also opens the door to involvement by the G-7 group of major western nations and the International Monetary Fund which led bailouts of Iceland, Hungary, Romania, and Latvia. Whatever approach emerges with Greece may set a template for future sovereign debt crises, and so far the apparent preference is for a workout within the EMU itself.

The global downturn blew a big hole in tax revenue while boosting spending for countries that carry large public sectors and expansive healthcare, employment security, and pension promises. An outright

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Measuring Up (or Down) on the Debt Scale

	Net Govt. Debt as % of GDP	Net Interest as % of GDP
United States	65.2	1.9
Canada	32.6	0.6
Japan	104.6	1.1
Euro area	57.9	2.8
United Kingdom	59.0	2.8
Greece	94.6	4.7
Italy	100.8	4.9

Source: *OECD Economic Outlook*, December 2009

Looking for the Next Shoe to Drop

The economists at BCA Research recently put a gauge on the relative sovereign credit risk for 22 developed nations. They evaluated each country's underlying economic vitality, monetary and fiscal flexibility, dependence on external financing, and risk of more bank rescues.

No method is perfectly predictive, but BCA's analysis attached the *lowest* sovereign credit risk to Norway, Switzerland, Sweden, Finland, Austria, Canada, and New Zealand. At the upper end of the risk spectrum were Iceland, Greece, Portugal, Ireland, Spain, Italy, and the U.K.

The U.S. comes through the analysis a bit better than average, but there are many public finance strains looming for the U.S. Treasury. International fixed-income managers have lots to think about in managing around these risks. ■

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An Anniversary More to Contemplate than Celebrate

Give or take a couple days, this *Quarterly* marks the 10th anniversary of the peak of one of history's great investment bubbles. On March 10, 2000, the Nasdaq Composite Index closed at 5048. From that peak it would eventually fall 78%, to close at 1114 on October 9, 2002, crushing those who had caught the fever for technology, Internet, and high-profile growth stocks.

The big rally that started in early 2003 still only brought the Nasdaq Index back to 2859 at the close on October 31, 2007. The bear market of 2008-09 took it back down to a low close of 1268 on March 9, 2009, before this past year's surge back above 2300 at this writing.

Ten years ago the *Quarterly* highlighted the unusually narrow participation in 1999's stock rally. The capitalization-weighted Standard & Poor's 500 Index had gained 21%, but the median S&P stock actually had *lost* 2.1%. Just 10 top performers had accounted for 65% of the Index gain. Stocks with *no* earnings had risen an average of 52% while stocks *with* earnings had averaged a 2% *loss*. These anomalies hinted at how fully investors had succumbed to "new era" thinking, the hallmark of a historic peak.

Major modern bubbles… and their supporting rationale.	
Oil and precious metals in the late 1970s and early '80s…	Inflation was irreversible, so hard asset prices would only rise.
Commercial and multi-family real estate in the mid '80s…	Tax write-offs limited an investor's risk, especially with the use of high leverage.
Japanese stocks and real estate in the late 1980s…	"Managed industrial policy" had created an invulnerable export juggernaut.
Tech stocks and Internet IPOs in the late 1990s…	They were the vanguard of a great revolution in business productivity and profitability.
Houses and home mortgage securities in the mid-2000s...	Home prices always rose in the long run, and mortgage defaults had always been minimal.

That same issue of the *Quarterly* offered a few thoughts on the diversification value of bonds. In sharp contrast to surging stock indexes, the broad bond market had posted negative results for 1999. As noted then, "a fixed income allocation has a proven ability to buffer a portfolio." That proved out in spades through the 2001-02 bear market for equities. The accompanying Investment Performance Review table reflects a decade of healthy *relative* returns for bonds.

Recognizing bubbles in retrospect is easy. Limiting exposure in real time is trickier. A compelling story takes hold around a particular asset, ultimately attracting more capital than its own economic logic really warrants. Contributing factors include the "greater fool" theory and some source of liquidity that becomes unhinged from normal skepticism and market discipline. As early investors in a compelling story reap big gains, excess liquidity flows to those assets. The underlying rationale becomes self-fulfilling prophecy for a while.

The bubbles noted in the table above shared those characteristics. The housing bubble also had a big push from public policy. The recession of 2001 and an initially slow recovery prompted the Federal Reserve to hold short-term interest rates at very low levels for a considerable period. Meanwhile, government-sponsored enterprises Fannie Mae and Freddie Mac were pressed to buy more mortgage loans made to less credit-worthy borrowers.

It all helped drive a surge in home prices. The mortgages were packaged into securities widely assumed to carry implicit, if not explicit, federal backing. That made them a lure for the dollars swelling the coffers of China and other exporters to a free-spending U.S. consumer market. And it gave the housing and mortgage securities bubble global scope and impact.

Where today's bubbles and relative values may lie is a tough call. History doesn't repeat itself exactly, but as Mark Twain observed, it often does seem to rhyme. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Major Mutual Fund Categories *	**--- Annualized thru March 5, 2010 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	68.1%	– 3.7%	0.7%	0.1%
Mid-cap Stocks (Core)	86.8	– 2.7	2.6	3.3
Small-cap Stocks (Core) †	90.3	– 3.2	1.6	5.6
Foreign Stocks (multi-cap) †	71.7	– 4.7	3.3	2.7
Emerging Market Stocks †	109.4	4.1	11.2	8.5
Flexible Portfolio	40.3	0.8	3.6	4.0
General Bond	17.7	3.5	3.5	6.3
Int'l Fixed Income †	20.0	6.7	4.3	6.5
High-Yield Taxable Bond †	51.7	3.3	4.6	5.0
General Municipal Debt	13.8	2.4	3.1	4.7

* Source: Lipper, as reported in the *Wall Street Journal*, March 6, 2010. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

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Roth IRA Conversion Strategies for the Thinking Investor

Last fall the *Quarterly* previewed the new Roth IRA conversion opportunity for upper-income taxpayers: removal of the income cap on eligibility for converting Traditional IRA assets to a Roth.

The basic *appeal* of converting is the government's *pledge* not to tax future Roth IRA withdrawals of principal and earnings. The basic *deterrent* is the up-front tax bill on the amount converted. For most investors, that risk-reward proposition may be dubious. But there are strategies, conditions, and special situations to contemplate under the expanded conversion eligibility.

Key to most strategies is the ability to recharacterize a conversion if you change your mind. Recharacterization is generally available up to October 15th of the year *after* conversion. It recasts the assets to a Traditional IRA, cancelling whatever tax impact the conversion might have had.

This flexibility is a factor in just about any conversion strategy. Events can render a conversion less advisable than it first appeared, so if you do decide to convert, it makes sense to check with your advisor periodically while the recharacterization window is still open.

One related strategy would be to refocus the assets converted to a Roth toward the more aggressive end of your total portfolio allocation, while holding more conservative positons in other accounts. If the market environment is favorable between the conversion and the closing of your recharacterization window, you'll have gained an edge on the long-term conversion bet. If, on the other hand, the Roth investments decline over that period, you may want to recharacterize.

In fact, in converting a substantial amount of Traditional IRA assets, it may be advantageous to split those assets into two or more Roth accounts, one for the more aggressive positions and another for the conservative. If one of those suffers near-term losses, *that* Roth account could be recharacterized back to a Traditional IRA, while the winning Roth is left alone.

Another possibility for gaining some leverage on a conversion involves variable annuities in an IRA. After the volatility of recent years some contracts have guaranteed death benefits well in excess of current account value. If such a contract is converted to a Roth, the tax is based on current account value *plus* an actuarial calculation of the present value of the added death benefit. That total may *still* be considerably less than the guaranteed death benefit itself. An older taxpayer intent on holding the contract for that eventuality *may* be doing the beneficiaries a favor by converting.

Conversions done in 2010 get the added flexibility of splitting the taxable income between tax years 2011 and 2012. And that opens up additional strategic options. In other words, a Roth conversion is not necessarily a one-decision-one-time affair. Rather it may be just a first step in a fluid strategy with subsequent decisions driven by whatever circumstances unfold. ■

Checking on IRA Deductibility

With all the talk about Roth IRAs it's easy to forget that you may be able to take an up-front deduction for contributing to a *Traditional* IRA. Even someone covered by an employer-sponsored retirement plan can fully deduct an IRA contribution if 2009 Adjusted Gross Income (AGI) was less than $55,000 (single) or $89,000 (married filing jointly).

If only one spouse was in an employer-sponsored plan, the other spouse's 2009 IRA contribution is fully deductible up to joint AGI of $166,000. And that deduction represents a "bird in hand" rather than the *promise* of tax-free distributions sometime in the misty future. ■

Revisiting Financial Regulation

Recent market upheaval, financial institution failures, and scandals of historic proportion have cast a harsh spotlight on our system of financial regulation. From the activities of the largest banks and brokerage firms to the dealings of financial professionals with individual clients, proposals abound for remapping the oversight of market players and financial products.

The natural impulse is to look at what *can* be controlled – rules and regulations – in hopes of reining in that which has never been very effectively contained – the all-too-human cycle of fear and greed. That cycle pervades behavior across the spectrum from nations to mega corporations to the folks next door. Market manias, investment fads, and debt binges echo familiar themes. We all want to ride in the sun on parade day but be safely sheltered from any sudden cloudbursts.

Whatever new regulatory structure emerges, it is unlikely to square that circle. Certain truths remain: All investments carry some risk of loss of principal and/or purchasing power; historical investment performance is not indicative of future results. Those words may sound familiar; they are two of seven key points on the Client Information form by which an investor is introduced to KMS Financial Services.

Financial markets and products already live in a thicket of regulation. But the best protection stems from candid, informed discussion of investment choices, costs, and primary risks. Your Representative is committed to such discussions as part of the collaborative effort to meet your investment objectives. Understanding those basics is a shared responsibility. ■

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Remembering *The Who* (And Other Loosely Related Indicators)

If you watched the New Orleans Saints beat the Indianapolis Colts in this year's Super Bowl, you were part of the most watched broadcast in TV history, a title grabbed from the 1983 finale of the long-running comedy series M*A*S*H. And if you were a fan of M*A*S*H in its *original* run, you probably greeted the Super Bowl halftime appearance by The Who with an exclamation (Hey, it's The Who!) rather than a question (Uh, it's the who?).

Peter Townsend and the rest of those iconic 60s rockers are now sixty-something themselves, reminding us of our near future. Between now and 2050 the share of the world's population over 60 will double from 11% to 22%. About 10,000 Americans become eligible for Social Security and Medicare every day for the next 20 years or so. Within 15 years those entitlements are projected to reach 20% of gross domestic product versus just 9% today. By the way, 20% of GDP is nearly the average of *total* federal spending over the 40-year period 1969-2008.

Local and state governments also face surging retirement benefits due their employees. The nation's largest public pension fund, the California Public Employees' Retirement System ("Calpers"), manages over $200 billion to fund benefits promised to an army of public employees across the golden state, and the strains are intensifying.

Since 2003 Calpers has assumed a long-term portfolio return of 7.75% to gauge the adequacy of its funding. But recent losses, rock bottom interest rates, and sluggish growth prospects have officials wondering whether that's achievable. Some advisers are urging Calpers' board to ratchet it down to the 6% range. That would boost current funding requirements for a host of cities, counties, and other public entities even as they struggle to bridge operating deficits.

This may all sound pretty familiar, as millions of Americans wonder what return *their* nest eggs can achieve to help cover the retirement benefits they've promised *themselves*. And most of us don't have the luxury of "smoothing" our results over multiple decades.

These trajectories augur some big adjustments for retirees, working Americans, businesses, and government. Policymakers need to preserve the rejuvenating capacity of a dynamic economy, while individuals face a simple imperative: Try to put more capital to work. ■

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Challenge for the EU...

debt default by Greece may well be avoided, but *someone* ultimately pays for unfettered deficit spending. One of 2009's big global stories involved governments propping up economies and financial institutions. Those governments could use a return favor from a broad economic recovery. ■

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