



When Greece Defaults

By Keith Goddard
September 27, 2011

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives. The views of this article represent those of the author and do not necessarily represent the views of Capital Advisors, Inc.

Market prices for Greek government bonds imply a 100% probability of default. But this does *not* mean a Greek default is already priced into the global asset markets. Here's why.

The Greek default is indeed inevitable, but there remain two possible ways the world may learn about it, and financial markets will react very differently depending on which of these two processes for default occurs.

The first possibility is a "structured default" that would be announced on a Saturday or Sunday, when financial markets are closed. It would involve the simultaneous disclosure of at least three items:

1. The terms for restructuring Greek government bonds – i.e. the default.
2. A comprehensive plan for recapitalizing systemically important creditors (banks) throughout the euro zone.
3. A coordinated program among central banks, the International Monetary Fund (IMF), and sovereign wealth funds worldwide to support the government bond markets of other countries in the European Union (EU). This might not include every country in the EU, so it's possible that other countries in the EU might restructure their debt as part of this program.

Assuming investors perceive each of these three programs to be credible, a structured default would likely be a *positive* catalyst for global asset markets. If a coordinated plan for default in Greece is accompanied by a fourth announcement involving credible policies to stimulate economic growth throughout the euro zone, financial markets should recover hard and fast.

The second, more worrisome, possibility is a "messy default." Such a default could occur at any time, and any number of possible catalysts could trigger it. The tipping point for a messy default is not important. What matters is that *any* announcement of default will be messy if it is not immediately accompanied by a plan for restructuring euro zone banks *and* a program for defending the remaining sovereign debt markets in the EU.



In my opinion, the recent decline in equity markets has already discounted some of the downside risk associated with a messy default, but not all. Another 15%-25% downside in global stock markets is plausible in the event of a messy Greek default.

Double-dip recession? Probably

There is a high probability of recession in the U.S. economy in the next 12 months, but that won't affect the stock market much because the outcome of the Greek default process trumps everything. If we see a messy default in the euro zone, a double-dip recession will be effectively guaranteed, and the default combined with sour economic news will surely drive stocks down.

On the other hand, markets can probably perform reasonably well, even in the face of recession, provided a successful structured default process takes place in Greece. The decline stocks have already experienced is within the historical range of a "normal" recession. The S&P 500 Index is down nearly 20% from its April high, while the MSCI EAFE Index of international stocks is down nearly 30%.

Since stocks have already discounted a normal recession, a shallow recession will be a positive surprise. There is reason to expect any recession in the near-term to be shallow, if it happens at all. If so, many stocks are already priced too low.

Two things make the difference between a shallow recession and a deeper collapse. First is the magnitude of swings in the cyclical sectors of the economy, most crucially housing and autos. Today, activity in the housing market is already consistent with a full-blown economic depression. The housing sector might take years to recover, but a steep decline from here is unlikely.

In the auto sector, unit volumes were recently running around 12 million cars per annum, a level historically associated with a deep recession. Like the housing market, auto sales may stagnate at recent sluggish levels for a long time, but a sharp turn downward from today's level is unlikely.

The second factor reducing the odds of a deep recession is the absence of a massively over-built sector in the economy. In the recession of 2000-2002 the over-built sector was technology. More recently it was housing. Today nothing of consequence in the *private sector* economy shows signs of dangerous excess.

Unfortunately, the key term here is "private sector." There is one important corner of the economy that is massively overdone – sovereign debt. This brings us back to my original observation: The near-term future in the stock market is almost entirely dependent on the degree of structure and credibility that accompanies the inevitable Greek default.



Implications for Investors

“The end of the world only happens once, so it’s a very low probability event.” – Art Cashin

The best way we know for investors to prepare for binary outcomes in the asset markets is to prepare for both possibilities. That means building a cash reserve to cushion downside risk in the event of a messy default, and more importantly, to create “dry powder” to take advantage of investment opportunities that would emerge in a global market sell-off.

In addition to a cash reserve, investment portfolios should include a healthy dose of quality. In the stock market, quality means global companies with strong balance sheets, sustainable competitive advantages, and especially growing dividends. Viewed from a longer-term perspective of five years or more, common stocks of dominant global businesses are the best possible investment choice for preserving capital and growing purchasing power in an uncertain world.

The notion of quality in the bond market means high credit quality, prudent maturity limits (10 years or less), and opportunistic exposure to diversifying sub-sectors of the bond market like municipal debt, non-agency mortgage-backed securities and international bonds.

The third strategy for a binary risk environment is intensive preparation. Investors need to know what they would sell, and why, in the event of a messy default in Greece. Conversely, investors should prepare a list of buy ideas, and why, in case the weekend news includes a credible plan for a structured default that garners a positive reaction in the asset markets.

Keith C. Goddard is with [Capital Advisors, Inc.](http://www.capitaladvisors.com), a Tulsa, OK-based advisory firm, and is co-manager of the Capital Advisors Growth Fund (CIAOX). He can be reached at kgoddard@capitaladv.com.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>