



Elhoff Financial Counseling
Charles Elhoff, CFP®;ChFC;CLU
1000 Ballpark Way
Suite 214
Arlington, TX
817-795-1095
fax: 817-197-4799
chuck@celhoff-financial.com
www.celhoff-financial.com



Why Europe Matters to Your Portfolio



Ever since the possibility of default on Greek sovereign debt has become headline news, a lot of people have found themselves wondering, "How is it possible for the financial problems of a country so small and so far away to create such turmoil in the world's markets?" What's happening in Europe is probably affecting your portfolio right now, regardless of the quality of your holdings or how well diversified you are.

Just what is all the shouting about? It's no secret that the so-called PIIGS nations (Portugal, Italy, Ireland, Greece, and Spain) are having difficulty coping with the debt that years of deficit spending have created. A robust global economy helped to mask the problem, but in recent years the burden of sovereign debt--bonds issued by sovereign governments--has become increasingly unsustainable. With debt at roughly 140% of its gross domestic product,* Greece is particularly troubled. Imposing austerity measures required by its European colleagues has added to the country's recessionary woes. That in turn has made it even more difficult to achieve mandated deficit reduction targets in order to qualify for additional installments of financial aid from the European Financial Stability Facility (EFSF) set up last year by 17 eurozone countries.

Bank exposure

One of the chief concerns about the possibility of default on sovereign debt has to do with the financial stability of banks that hold it. Some of the largest French banks have already suffered downgrades of their credit ratings because of their extensive holdings of debt from troubled European countries, particularly Greece. If a Greek default made banks reluctant to lend to one another, that could affect credit markets worldwide.

American banks hold very little Greek debt compared to European banks; however, they could face a different challenge. Understanding why requires some basic awareness of a type of derivative known as a credit default swap. Investors with large bond holdings from a particular borrower often try to protect themselves against the possibility that the borrower will default by buying a credit default swap on that debt as a type of insurance. The company that issues the credit default swap agrees to cover the bondholder's losses in case of default. The more risky the issuer--for example, Greece--the more likely bondholders are to try to protect themselves with swaps. However, in some cases, a company may have issued so many default swaps on a particular issuer that it could be overwhelmed by the claims resulting from the issuer's default.

Such derivatives can create a ripple effect in financial markets. If the company that issued the swaps can't make good on them, the institutions that relied on that protection also can find themselves in trouble, which multiplies the impact of a major default. U.S. financial institutions are major issuers of credit default swaps, and the potential impact of a Greek default on them is unclear. However, since the 2008 financial crisis, U.S. banks have been forced to hold greater capital reserves to deal with contingencies, and Treasury Secretary Timothy Geithner recently said that banks here have reduced their exposure to the debt of troubled countries.

Potential for tighter credit leading to recession

Lending worldwide hasn't fully recovered from the last financial crisis, and has helped keep global economic recovery sluggish. Fiscal austerity measures taken to try to reduce deficits have also taken their toll, hampering economic growth and making it even more difficult for countries such as Greece to balance their budgets. If banks' lending ability were impaired further by a financial crisis brought on by a default on sovereign debt, tighter credit could increase the odds of renewed recession.

Also, Europe represents a major market for many American companies, and a recession there wouldn't help an already slowing global economy.

Greece could be the tip of the iceberg

Even though Greece is the immediate concern, larger economies in Europe actually could represent a bigger threat. Italy and Spain both face sovereign debt burdens and deficit problems. Italy's economy is more than five times that of Greece; Spain's is more than four times bigger.* If either country were to decide it needed to restructure its debts as Greece is attempting to do (which ratings agencies could see as a form of default), that would have a much bigger impact than Greece. If a Greek default would have a ripple effect, a default by either Spain or Italy could cause waves.

To compound the problem, as investors have become increasingly concerned about the possibility of debt contagion in Europe, borrowing costs for both Italy and Spain have risen. At recent auctions, nervous investors have been demanding higher interest rates to compensate them for the higher perceived risk of buying that sovereign debt. As any credit card holder knows, having to pay a higher interest rate makes paying off debt and balancing the budget more difficult. A Greek default could make investors even more nervous about buying other troubled countries' debt, and being frozen out of credit markets would likely aggravate fiscal problems abroad.

All politics is local

There have been signs in recent months that voters in stronger economies such as Germany are beginning to question why they should continue to support countries that have not been as disciplined about balancing their budgets. Also, investors worry that the financial support available from the EFSF may not be sufficient or available quickly enough to avert problems. Though there has been no shortage of suggestions for how to deal with the situation--issuance of euro bonds backed by all eurozone members, leveraging the EFSF's existing assets, greater fiscal integration among countries, Greece returning to its own currency--questions about the ability and willingness of other countries to support the eurozone's weaker members have caused investor anxiety worldwide.

Financial markets hate uncertainty, and the situation has contributed to the recent volatility across a variety of asset classes that don't usually move in tandem. However, Europe has the benefit of having watched the United States deal with its own difficulties during the 2008 crisis. Also, European leaders have generally reaffirmed their determination to defend the euro at all costs.

Uncertainty about Europe could persist for months, but it's important to keep it in perspective. While you should monitor the situation, don't let every twist and turn derail a carefully constructed investment game plan.

*Source: *CIA World Factbook 2011*

Securities and Investment Advisory Services offered through VSR Financial Services, Inc. A Registered Investment Advisor and Member of FINRA SIPC. Elhoff Financial Counseling is Independent of VSR.