
• ABREAST OF THE MARKET

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When a Little Greece Goes a Long Way

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Should the woes of a country with fewer people than metropolitan Los Angeles really roil the massive U.S. financial markets?

This is a hotly debated question after worries about Greece's debt woes sparked wild swings in the U.S. stock market last week. Signs that the trouble in the Greek bond market was infecting others in Europe helped send the Dow Jones Industrial Average into a spiral Thursday and most of Friday before a late-day rebound turned the market back to positive territory.

For some, the bond-market woes afflicting Greece and other European countries provide real reason for worry. They argue that while the debt problems seem contained now, they can easily spread. Greece is just one of many economies today—including the U.S.—carrying hefty debt loads as a legacy of the financial crisis.

Even if sovereign-debt issues among southern European countries, Ireland and the U.K. don't flare up to a full-fledged global contagion, the wary say the result is still likely to be higher borrowing costs in Europe that would slow the economic rebound both on the continent and elsewhere around the world.

Greece "is a shot across the bow," says Henry McVey, head of global macro and asset allocation at Morgan Stanley Investment Management. Now that financial institutions have reduced debt, "investors are now focused on which governments are over-leveraged," Mr. McVey says.

Regardless of whether the reaction to Greece was warranted, last week's turmoil reflected the tenuous nature of the stock market's bullish sentiment. Investors came into 2010 generally optimistic based on expectations for a "Goldilocks" global recovery where growth improved but at the kind of slow pace that would allow interest rates to stay low.

The first snag was hit in mid-January when China moved faster than expected to restrain bank lending. Now the debt crisis in Europe, although long in the making, suddenly throws another monkey wrench into the works.

"What a couple of weeks ago looked like a perfect economic-recovery scenario has been blown out of the water," currency analysts at BNP Paribas wrote Friday.

As a result, investors last week rushed back out of risky assets, which also included commodities and corporate bonds. Meanwhile, the dollar strengthened—a negative for U.S. exporters—as investors bailed out of euros. For many investors, the destination was U.S. Treasuries.

The fears run the gamut, from a simple slowing of the economic recovery to more extreme scenarios such as a new credit crunch in Europe as banks contend with losses on big holdings of government debt or a withdrawal of countries such as Greece from the European Union. The overarching fear is contagion, that the woes in troubled economies will spread as

investors rush to sell investments in more accessible but otherwise healthy markets to offset losses in places like Greece.

But for some, it is a tempest in a teapot. While not dismissing the challenge facing those countries, some say it is simply not a material problem for the U.S. markets, especially stocks. They say last week's tumult was driven by short-term hysteria about a tiny bond market to which U.S. companies, especially banks and other financials whose stocks were hard hit last week, have very little direct exposure.

Investors should instead focus on the improving U.S. economy and another round of better-than-expected corporate profit reports for the fourth quarter. If anything, the U.S. should continue to provide a safe haven for investors.

"What we're seeing is noise," says Aaron Gurwitz, head of global investment strategy for Barclays Wealth.

Michael O'Rourke, market strategist at broker dealer BTIG, notes that the Greek stock market's capitalization is only slightly bigger than Citigroup's. Adding together all the troubled economies in Europe, "they will equal the size of one systemic institution in the United States." Mr. O'Rourke writes. Supporting the outlook for U.S. stocks, "most S&P 500 companies have better balance sheets than most sovereigns, including the United States."

Against a backdrop of a "V"-shaped recovery in corporate profits, expectations of continued low short-term interest rates and reasonable valuations, Barclays Wealth has been recommending investors overweight stocks. Mr. Gurwitz says the Europe situation doesn't change their strategy.

Mr. Gurwitz puzzled over the fixation on Greece when U.S. investors have an even bigger problem in their own backyard that so far most are ignoring.

The California situation is much more important than Greece," he says. Greece comprises about 2% of Europe's gross domestic product, while California—struggling to pay its debts—represents more than 10% of the U.S. economy, he says. "Yet nobody's talking about California," he says.

Morgan Stanley's Mr. McVey acknowledges that at some \$350 billion, Greece's bond market is tiny, but he says that is missing the point. The turn of events in Europe "is no different than what you saw at the investment banks: the market doesn't want to do business with over-levered entities," he says.

The result, he says, is an even more challenging economic recovery. "Investors are going to increase the cost of capital for over-leveraged entities—governments or corporations, particularly financial institutions that do not get their financial houses in order quickly," he says.

John Brynjolfsson, head of investments at hedge fund Armored Wolf, sees two reasons that the Greece situation presents real issues.

The first is the degree to which the global economic recovery is still reliant on massive stimulus efforts. "Everyone is depending on sovereign and fiscal authorities to keep the music going," he says. However, because the huge government deficits eventually act to slow economic growth, "people know that eventually the music is going to stop playing."

The key unknown is at what point do the bond markets force governments to cut back on the stimulus. The answer, Mr. Brynjolfsson says, "is purely a function of confidence." Greece, he says, may "accelerate what could theoretically happen over a five- to 10-year horizon and instead make it happen within a three- or six-month period."

The other problem is the potential for a meaningful rise in inflation, Mr. Brynjolfsson says. "We know there has to be an end game and one of the outcomes would be this miraculous surge of productivity, profits, income and growth to get us out of these problems—and frankly that's a stretch."

More likely is default or inflation, and of the two, inflation is the most palatable. "It's not a question of if but of when," not just in Europe, but in the U.S., Mr. Brynjolfsson says. "As long as [Fed Chairman Ben] Bernanke has ink, paper and printing press, we can assume that the Fed will try to offset any amount of de-leveraging going on."

All this could play out with central banks keeping short-term interest rates low, while intermediate and long-term interest rates rise, he says. At the same time, the "printing press" method of dealing with the budget deficits would erode the value of the dollar, yen, sterling and the euro.

That is leading Mr. Brynjolfsson to employ bearish trades on developed country stocks while owning emerging-market stocks. He is also holding commodities and betting on a rise in the VIX, a measure of stock-market volatility. Amid the uncertainty, the VIX surged more than 20% Thursday.