The Impact of the Sovereign Debt Crisis
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Now that the end of QE2 has been priced into stocks, the markets are grappling with twin sovereign debt issues – ours and Europe's. The near-term battle line for addressing U.S. deficits and debt is keyed in on the debt ceiling expiration on August 2nd. Europe's sovereign debt crisis is again focused on the country where it all began a year and a half ago – Greece.

The debt crisis in Europe that began in January 2010 has continued to teeter back and forth between turmoil and stability, with the financial markets worldwide reacting accordingly. Greece, then Ireland, and then Portugal all had their moments in the spotlight, culminating in a bailout provided for each country by the European Union (EU) and International Monetary Fund (IMF). These bailouts have not solved the problem, but have effectively kicked the European sovereign debt can down the road.

Greece recently stepped back into the limelight as it needs its next tranche of the EU and IMF bailout funds. The real attention, however, should be on the 800-pound gorilla in the room. A default for Greece is not a matter of if, but when. Further bailouts can at best postpone, but not avert, the day of reckoning. The country is not facing a liquidity issue, it is simply insolvent. Greece's debt-to-GDP ratio exceeds 150%, with the problems there getting worse, not better. Austerity measures have been met with stiff opposition from the Greek population, while citizens of Germany and other countries are becoming more uncomfortable with the burden they will bear as a result of the bailouts provided.

If it was as easy as letting Greece default and that was the end of it, the problem as it pertains to Europe and financial markets worldwide might be more easily contained. The real problem is contagion - the chance that the crisis in Greece is followed by more defaults, or debt restructurings, or debt reprofilings (pick your euphemism) in the other PIIGS countries. By the time you get to Spain, with an economy twice the size of Greece, Portugal, and Ireland combined, or an even bigger economy - Italy, the problem will easily exceed the capabilities of the bailout facilities put in place. Spain and Italy are too big to fail and too big to save. Therein lies the makings of a second financial crisis, this time coming from Europe.

Greece was not just the canary in the coal mine for Europe, it serves as a warning for many countries around the world unable or unwilling to address their long-term structural debt issues. This includes the United States. The markets are justifiably worried about this real and present danger for our economy and the financial markets. Government action over the past several years has not worked toward solving the problem, but instead has made it worse. If we do not address this crisis in a meaningful way, the cost of servicing our national debt will become insurmountable. The markets understand this all too well, and will react to whatever form of action or inaction government officials take leading up to the looming showdown on the debt ceiling in early August.

The two political parties could not be further apart on this issue. The Republicans want to reduce the deficit with trillions of dollars in spending cuts. The Democrats, on the other hand, want to reduce the deficit mostly through trillions of dollars in increased taxes. Therefore, the chance of a meaningful solution to solve the problem anytime soon stands to elude them, and the anxiety over this looming crisis for our country will continue to trouble the markets.

While fiscal discipline is certainly needed over the long-term to address the structural problems in the U.S. and Europe, austerity measures could prove problematic for economic growth in the near-term. "Fiscal austerity" means "fiscal tightening". While philosophically I could not agree more that it is necessary and essential for the long-term health of the economy and our country, it may be a hard pill to swallow during a soft patch in a fragile economic recovery.

Mainstay Capital Management is following these events very closely. We realize that Europe and our own government's actions, or lack thereof, to address sovereign debt issues are very important factors in our near-term and longer-term investment strategy. We have already witnessed how much these issues can impact investor sentiment and the markets in the near-term.

In addition to the sovereign debt issues, we are closely monitoring and analyzing all of the dynamics in our economy and around the world that affect the financial markets in our ongoing process to determine the optimal tactical asset allocations for our clients' portfolios. Our aim is to look through the day to day swings in the markets driven by each headline grabbing news event. Certainly, rioting in the streets in Greece or a revolution in Egypt can be unsettling. Mainstay's goal is to analyze the potential intermediate-term and longer-term impact on the financial markets and determine if adjustments in our investment strategy and portfolio allocations are needed.

In the current environment we believe a defensive, but not outright bearish, approach is warranted. Keep in mind that stocks are not expensive based on historical valuations. Fed policy is and will remain very accommodative for stocks and other risk assets for some time to come. Earnings growth may decelerate, but should remain robust for the foreseeable future. It is also important to remember that as tactical asset allocators our clients' fortunes are not solely dependent on the performance of the S&P 500. Our strategic and tactical use of certain bonds, commodities, cash equivalents, alternative investments, and alternative strategies can mitigate risk, diversify portfolios, and provide hedges against stock market volatility.