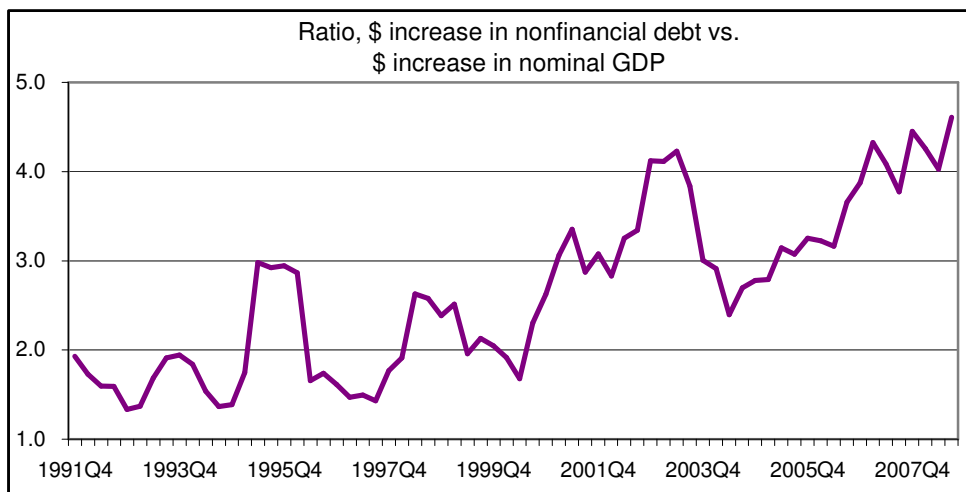


## Beware of Greeks Bearing Bonds

Our apologies for the clumsy adaptation from *The Iliad*, but the ongoing virtual implosion of the Greek economy looks like a modern-day version of a Greek tragedy: the protagonist (Greece) persists in behavior that ignores the rules (*hubris*), leading inexorably to an ultimate downfall. And, just as with classical Greek tragedies, the audience (the rest of the world) knows what will happen, can see it unfold, and yet continues to watch with fascination.

In the current version of the drama, Greece (and some others, mostly Mediterranean countries, to a lesser extent) persisted in maintaining an economic system heavily overloaded with government employment and underweighted with the private-economy sectors which can actually create wealth (and tax receipts), and kept the system afloat (nominally) via increased borrowing -- until bondholders finally woke up, however, and recognized that the Greek bonds they had bought were worth only a fraction of their nominal value. And in the case of some European banks (in France, notably) this adjustment creates a substantial hit to already-weak capital ratios.

In a sense, the Greek need to take on debt is simply an extreme version of our own excessive dependence on borrowing to finance economic growth, as we discussed in recent newsletter (*The Dark Side of Leverage*). The chart below, copied from that report, shows the unhealthy reliance on debt in the U.S.; we don't have the equivalent data for Greece, or for other problematic economies such as Portugal or Spain, but we're pretty sure that their charts would look drastically worse.



Source: Federal Reserve Board data, Oak Ridge calculations

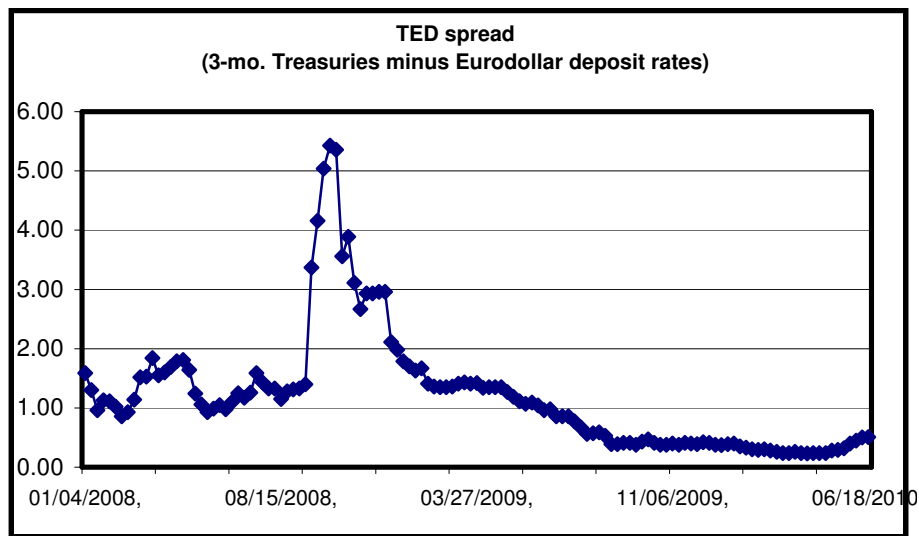
Ultimately, of course, the inherent weakness in the system comes to the fore, and the story reaches its tragic end, in Greek dramas as well as in the current Greek situation. Unfortunately, as we noted in our previous newsletter, there is really only one way out of this – a severe slowdown in spending in order to allow a reduction in debt and a return to a healthier balance sheets, probably accompanied by some virtual or actual debt defaults and painful losses for debt holders. Profligate countries such as Greece, Spain, Portugal (indeed, most of Europe excluding Germany) are now being reined in by the newly-alert world capital markets, and those countries are going to need to take some pretty bitter medicine (e.g., austerity programs) to bring their spending and their balance sheets back into some order. And this can only be accomplished if

the players in the drama are willing to recognize that their former existence was based on a false understanding of the world, and must be changed.

In that vein, we were struck by a phrase used by the author Thomas Friedman, in an interview with Charlie Rose: *“the tooth fairy died”*. No one is going to leave free (or at least severely under-priced) money under our pillow anymore, and we’re all going to need to get our financial houses in better order and figure out what we need to do to stimulate true economic growth in order to pull ourselves out of this unbalanced situation. And while U.S. community bankers may ask why they should be concerned about developments in Greece (they obviously hold no Greek bonds), world economies and world-wide financial systems are closely-intertwined spider webs; a hit in one part of the net is felt throughout the structure. Whether through reduced exports, higher risk premiums within interest rates, or a slowdown in total world GDP, we will all experience some degree of pain, economies and investors alike, and the Greek, Spanish, Portuguese *et al* problems cannot be contained within their boundaries, or even within just Europe.

### But It’s Not Subprime Mortgages Redux

On the other hand, we are not inclined to favor the doomsday view of what the impact of this will be on the countries themselves and their trading partners such as the U.S. We believe the countries’ leadership will opt for more pro-inflation policies (though difficult to pull off within the constraints of the Euro system) in order to stimulate nominal, as contrasted to real economic growth; since nominal GDP adjusts with inflation, but debt does not, this makes it appear as though debt burdens are becoming more manageable. Furthermore, we suspect that austerity programs will be moderated enough to spread out the pain (but also the recoveries). Our less-than-cataclysmic, “muddle through” view seems to be in concert with the collective view of the capital markets, as indicated by the following chart. The so-called TED spread (Treasury rates minus Eurodollar deposit rates) is generally seen as an indicator of investor confidence in the banking system, in particular the European banking system, and while the spread has widened slightly of late, it is nowhere near the gap seen in the tumultuous times of late 2008 and early 2009.



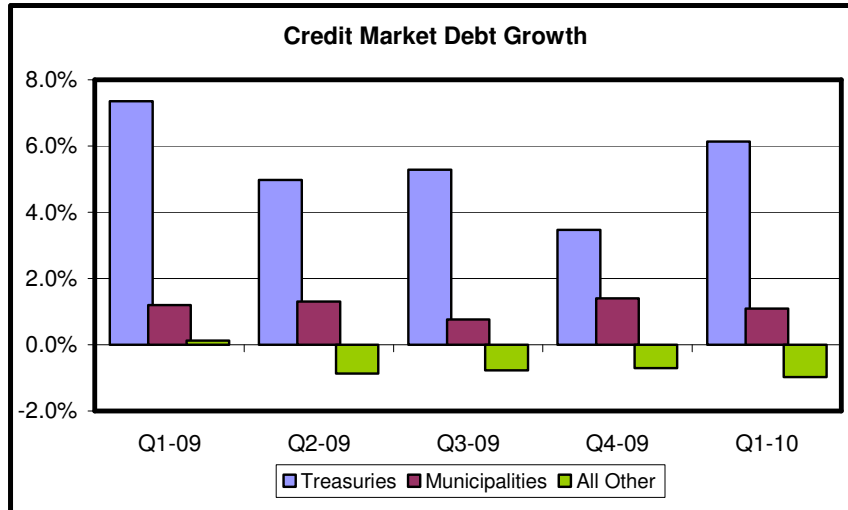
Source: Federal Reserve data

So we may indeed work our way out of this mess without a wrenching turmoil that triggers drastic asset write-downs and threatens another round of banks. Nevertheless, we cannot think of a way that gets us solidly out of this mess without an extended period of budgetary restraint, which implies an extended period of clearly sub-par economic growth in Europe and to a lesser extent in the United States. Indeed, this would seem to be the best-case scenario, as it would avoid another near-term recession and the potential for deflation. Unfortunately, the prospects for an extended period of slow growth suggest that our banks will be hauling around some ankle chains (in the form of nonperforming loans, excess real estate holdings, and sluggish loan demand) for the foreseeable future.

## A Dangerous Ripple

Overly optimistic homeowners and growth-obsessed Mediterranean countries were not the only ones taking advantage of under-priced credit in the last decade – U.S. municipalities jumped at the chance to gather in the cheap financing that Wall Street offered, apparently overlooking the risk side of increased leverage. On the other side of the equation, yield-hungry investors seem to have paid scant attention to the weakening financial condition of many municipalities, whose income is typically generated by real estate-related taxes that are based on the value of the underlying real estate. In effect, we are seeing a secondary ripple resulting from the “correction” in residential real estate values.

So with income down, and expenses sticky, municipalities have continued to borrow, while the private sector de-leverages. And while the Federal government has many tools to manage its highly-leveraged position, municipalities do not.



Source: Federal Reserve, Flow of Funds

As you view this chart, keep in mind that the percentage changes are sequential, not annualized, so the municipal government debt growth trend is quite robust. Not surprisingly, numerous municipalities are struggling financially – cities in Rhode Island and Pennsylvania are apparently considering municipal-bankruptcy filings, for example. More broadly, communities are aggressively casting about for ways to bring their budgets and balance sheets back into proper condition, leading them to talk of raising taxes, trimming services, curtailing projects, and even giving a haircut to pension benefits for existing as well as future retired municipal employees (many municipal pension plans are seriously under-funded). Obviously, these would all be negative in terms of local economic activity. And while some think that state and federal government funds might be available to fill the gaps, this seems pretty unlikely, given their weakened financial condition.

As with the subprime mortgage issue, there may not be a huge direct impact on community banks, since it does not appear that most of them carry significant balances of muni bonds on their balance sheets – roughly 20% of their investment portfolios, which in turn account for about 20% of their assets, based on our survey of mostly Midwestern community banks. Nevertheless, weakness in any asset class is an issue for banks, which are highly leveraged entities. Perhaps more important is the probability that retrenchments in municipal spending are bound to have a dampening impact on the local economies upon which community banks depend.

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