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Flash Update: Greece - *No Panic Here*

The Greek default is garnering all the headlines lately. But their situation is no surprise to Cornerstone; we have been expecting it for a very long time.

At this point Greece has no good options:
1) They can accept austerity measures (which they have yet to do for the past few years).
2) Their creditors can continue fooling themselves into thinking Greece will change on their own, essentially kicking the can a little further down the road.
3) The nuclear option – Greece can exit the EuroZone and the Euro. This throws everything up in the air, and calls into question whether Greece will pay their creditors at all. The viability of the Euro could also be called into question, which opens the door for other countries to get out from under their debt by exiting the Euro to.

How does this impact your portfolio?
Direct Impact – Unless you are invested in Greece or their debt, you will not be directly impacted. Cornerstone clients do not hold any Greek investments.

Indirect impact – At a minimum, you will notice an increase in Global volatility: that's a euphemism for "markets tanking." If Greece is able to "get away with" this, then other countries may be so inclined. Italy, Spain and other European countries may follow Greece's blueprint. This would be disastrous for Europe and likely tear apart the European Union and the Euro would no longer function as a currency.

Eventually, everything could settle down into a "New" Europe. Some sort of European Union might still exist, while the outcasts would be on their own. Those "outcast" countries might experience economic turmoil for a while until they put some controls in place to contain the fiscal irresponsibility that they were not able to contain before. The timing of these events could be measured in many months if not years.

Trading opportunities will very likely appear in the wake of these changes, but the predictability of those opportunities will be more speculation than investing.

Geopolitical Impact – China has been having a severe correction over the past few weeks and there is no reason to expect it to stop anytime soon. They have a debt problem, but more importantly, in our opinion, the government does not understand free markets and capitalism the way the previous administration did. They are making rule changes that send the markets lurching to and fro. Since the Chinese market ran up so much in the past 12 months, (about 100% according to StockCharts.com) a correction of a significant magnitude would be expected anyway.

There are a number of other countries that are barely holding it together right now. Finland, Brazil, Puerto Rico and the US all have fiscal and economic problems; a Global selloff could be just the push needed to send these countries "over the edge."

What is Cornerstone doing about this?
A sizeable percentage has been allocated to cash for some time. These global events were not unexpected. Only the timing was in question. The securities we do own are mostly US based and pay a decent dividend, which can cushion a decline in the US markets. The cash position is earmarked for purchasing fundamentally sound, dividend paying stocks that others are selling.

Is Cornerstone using any hedges or inverse ETF's to protect the portfolios? Not yet. That does not mean we will never use them, but at this point, we cannot trust the Federal Reserve. In a misguided attempt to delay the inevitable decline, the Fed could step in with Quantative Easing Infinity and drive the market up 1,000 points. If the Fed were to do this, inverse ETF prices might collapse.

It is for this reason that we are very cautiously looking at Inverse ETFs and will wait until we get a clear indication that the Fed will not meddle in the markets. While many may think that the Fed's meddling is good, because they are keeping the market from going down, it is actually detrimental to the long term health of the economy for a few reasons:
1) It creates a moral hazard: investors no longer have to consider risk if the Fed is always going to come to the rescue and keep the market from dropping.
2) It delays the inevitable normal cycle of the markets: bulls are followed by bears. It has always been that way.
3) It increases the probability that the bear market that is delayed could end up being a much worse bear market. Excesses from a bull market are normally worked off in a bear, the more the excess - the worse the bear. The current US market is the second most overvalued it has been in the past 100 years, depending on the valuation numbers you look at.

Is the Greek default going to trigger a Global selloff, similar to 2008? Possibly. Will the Fed be able to come to the rescue as they did from 2009 – 2014? Not likely. Rates are already near zero, they have no room to lower rates and make a long term impact in the economy and markets. That does not mean they will not try something that could have a short term impact and that is why we are not using hedges and inverse ETFs at this time.

Now more than ever, investors need risk management. At this point, we are using cash as our safety net and are ready to deploy strategic hedges to profit from the downside. Staying fully invested, especially in Index funds could prove to be a strategy many will regret.

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