



## December 2011



### Europe's Sovereign Debt Woes Continue to Take Center Stage

The Eurozone's debt crisis continues to create volatility for the world's financial markets. As our equity market has seen for much of this year, negative headlines regarding Europe's debt problems will cause stocks to sell off while positive news will give stocks a lift. November was no exception as the latest stock volatility began mid-month with a spike in Italian interest rates above 8% and the inability of Germany to complete its latest 10-year bond auction. European leaders responded to such an accelerating deterioration in the region's finances by exploring more forceful comprehensive actions, which gave stocks a boost toward month-end. On the final day of the month, when our Federal Reserve and other central banks announced a coordinated effort to ease pressure in global money markets, stocks soared 4%.

With all this volatility in the financial markets, it's difficult to see the forest for the trees at times. The real issue with the sovereign debt problems in the PIIG countries in Europe is that these countries have allowed their outstanding debt to grow to levels which can no longer be supported by tax revenues from the private sector. The most common prescription by policy makers for this ailment is to first, raise taxes and second, cut government spending if the tax increases don't work. As we have seen time and again, these policies are unsuccessful. For instance, Greece has raised taxes and pledged to cut its federal budget in order to receive a bailout from the European Union, yet its government spending is currently about 5% higher than last year. Meanwhile, the tax increases have brought Greece's economy to a standstill, reducing its tax revenues and exacerbating its debt problems.

All the solutions that we have seen so far from the European leaders can only provide temporary relief from the PIIG sovereign debt problems. Even the effort by the Fed and other central banks to make it cheaper for European banks to obtain dollars won't fix Europe's problems, although it is a prudent move to avoid a liquidity crunch. Perhaps the best alternative we've seen from Europe's leaders that actually has a chance of working is the establishment of a central authority that exercises control over the budgets of the PIIG countries. But there is only one lasting solution that will solve the sovereign debt problem and that is enacting policies that encourage growth in the private sector because that is where greater tax revenues will come from.

In the meantime, economic growth in the U.S. continues at a moderate pace, which would likely support stock prices at higher levels (without as much volatility) in the absence of the EU sovereign debt problems. Once the EU leaders get around to implementing pro-growth policies, the stock market could embark on a lasting uptrend. But we will likely see more volatility before that happens.

	11/30/2011	10/31/2011	12/31/2010	MTD Change	YTD Change
Dow Jones Industrials	12045.68	11955.01	11577.51	0.76%	4.04%
S&P 500	1246.96	1253.30	1257.64	-0.51%	-0.85%
Nasdaq Composite	2620.34	2684.41	2652.87	-2.39%	-1.23%
Russell 3000	1355.33	1362.46	1376.83	-0.52%	-1.56%
2-Year Treasury Yield	0.25%	0.25%	0.59%	0.00%	-0.34%
10-Year Treasury Yield	2.07%	2.17%	3.31%	-0.10%	-1.24%