

# Congress Asset Management Company



## Economic and Market Outlook

Fourth Quarter, 2011

Volumes have been written about the euro zone sovereign debt crisis. Despite the widespread awareness and growing seriousness of the problem, little has been accomplished either in addressing the immediate need of a second installment of bailout funds for Greece, or the long term structural weakness within the European Treaty itself. This congenital weakness, whereby any disbursements of euro zone funds must be approved by all seventeen members of the currency union, makes timely action virtually impossible to accomplish. Throughout the early summer there was hope that the second installment of aid to Greece would be approved especially after Greece agreed to further cuts and conditions. This proved to be a false hope. News that Greece's budget deficit was far worse than the country agreed to maintain less than one year ago, and a growing sense of "deficit-fatigue", has stalled the bailout process. Delay has only magnified fears that other deficit-ridden countries would be dragged into the pit, notably Italy and Spain, two very large and foundational members of the European Union. In response, Germany and France negotiated a new agreement designed to provide Greece with a new round of financing and contain the broadening crisis.

The centerpiece of the new arrangement, signed on July 21, 2011 by Germany and France, was an agreement to expand the European Financial Stability Facility. This Facility was originally set up in May, 2010, to facilitate low cost loans to struggling euro members in dire need of a short term fix. Funding for the Facility would come from each of the seventeen members on a pro rata basis. Like the earlier agreement, the proposed Facility would be combined with funds from the International Monetary Fund and the European Commission, to enlarge the amounts available to finance the deficits of Greece and others in distress, until they could regain access to the capital markets. Importantly, the expanded Facility would be available to purchase government bonds of all countries if necessary, and to provide money to

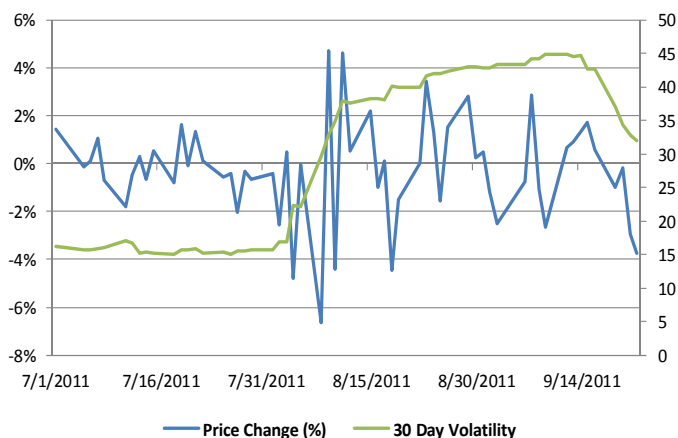
banks. This provision is clearly aimed at shoring up the financing ability of Italy and Spain also.

Despite initial enthusiasm few countries have ratified the new attempt to reach a consensus agreement on a rescue package. Inaction by members, disingenuousness on the part of Greece in meeting the terms of the original bailout, resentment by some members at the constant dunning for money, highly derogatory comments from some Finance Ministries, have frayed any unity of purpose that many euro nations felt toward the broader union. Credit default swaps are signaling a near 100% probability that Greece will default, with Portugal and Ireland in train. Italy and Spain are not far behind. The crisis has now spread to major German and French banks, major holders of the sovereign debt, with banks fearful of lending to one another. A liquidity crisis was averted a week or so ago only by the direct intervention of the central banks of the United States, England, Japan and Switzerland, who collectively advanced dollars to European banks to meet requests for overnight loans by corporations. The swap arrangement, however, is neither a permanent nor even a desired solution to the growing banking crisis in Europe.

This very painful episode will be settled in the near term. Greece faces a mid-October deadline to qualify for the second installment of €8 billion, without which it will certainly default. Despite the ominous signals we think the euro nations will provide the next installment to Greece. A near term default will be averted. This, however, will be only a stop gap measure leaving a permanent solution to the sovereign debt crisis to future actions. The sovereign debt crisis does not exist in a vacuum. A default by Greece or any other member country would be economically devastating to the entire region, and cripple the banking system. Wealth destruction would be on a massive scale. We take the leaders of Germany and France at their words that Greece will remain in the union and steps will be taken toward a permanent strengthening of the governance issues. In the meantime, however, the euro zone is probably

headed toward a recession, and to a lengthy period of introspection and withdrawal from the world stage until it finds a new and more solid path to grow.

**3Q Market Price Change and Volatility**



We apologize for the lengthy explanation of the situation in Europe. It is necessary because it is the primary cause of the record levels of volatility and turmoil experienced by our markets over the past quarter. This volatility will remain until confidence in a political solution in Europe is gained. In this respect, there is an unfortunate semblance to the situation in our country. The political economy in the U.S. is far shakier than the real economy. Our economy has slowed meaningfully but remains on a positive track. The odds of a continued slide into recession are lower than many are willing to admit, including politicians who perceive electoral gold in advancing government spending initiatives. Real consumer spending, business investments, exports, have stabilized and in the case of exports appear to be turning up. The U.S. economy is reasonably isolated from the problems of Europe, absent a deep and prolonged plunge into depression in the euro zone. Our banks are only lightly exposed to the risk of default in Europe and counter party risk, cited by many as the real hidden danger to our banks, is simply not a realistic fear.

It is not trite to say that confidence is the major ingredient which will determine the near term course of our economy. Confidence is measured in many ways. It is evident in the \$2.1 trillion cash on

corporate balance sheets, an all time record relative to GDP. Reticence by managements to commit their cash hoards to long term projects reflects uncertainty about the direction of government policy. At its basic level, confidence of businesses and individuals is evidenced by a willingness to take risks to achieve personal success, willingness to sacrifice immediate rewards to work toward a goal, diligence, an attitude which overcomes obstacles, all these have combined to form what have been described as the American Experience. Although government policy has waxed and waned on this issue, over the years policies have been generally supportive of the dominance of the private sector. New businesses have sprung from this fertile ground. Many fail, but better that than a life dependent upon government largess. We do not dispute the good intentions of many among the political elite. The fact remains that traditional American virtues which encourage risk taking and rewards success are denigrated by government policy today. A culture which devalues hard work, where efforts go unrewarded, and material success is deemed suspect, such as that which has devolved in Europe, is not the path to grow and create new jobs. The problems of the U.S. are solvable and within our ability to rectify, unlike those of Europe. Our firm belief is that our basic instincts will reemerge. We remain firm in our belief that high quality American equities remain significantly undervalued and are extremely attractive in the current environment.

**Investment Policy Committee**  
 Alfred A. Lagan, CFA, Chairman  
 Daniel A. Lagan, CFA, President  
 September 21, 2011

