The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

"*If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours*" - John Maynard Keynes

Greece, noise and limits

Greece's population is close to 11 million, some 3.2% of the 332 million people that live in the 17 countries that are members of the Euro Zone, and a mere 0.16% of the 6.75 billion person population of the entire planet.

The GDP of Greece for 2010 was US$305.4 billion; 1.88% of the European GDP of US$16.22 trillion and only 0.52% of the US$ 58.26 trillion GDP of the world.

The Greek public debt stands at US$382.7 billion. That pales in comparison to the US$13.82 trillion public debt for all the members of the Euro Zone, and the US$39.87 trillion debt for all countries in the world according to The Economist's global debt clock.

The position of many pundits to the entire Greek situation has been that Greece is just a blip in the worldwide economy as demonstrated by these numbers.

Yet, in the last few weeks, much of what we hear in the financial world are talks and fears of Greece defaulting and bond markets, as well as stock markets, nervously reacting to news coming from this region.

Human tendency to take a position on any situation that arises made many experts and laymen, academicians and college drop-outs alike, suggest all sorts of solutions for this crisis: from letting Greece go under and "make them pay"; to helping them restructure and "make them pay"; to forcing them to work harder and "make them pay".

Even after the newly announced US$157 billion bailout plan we think the situation in Greece and, worse yet, the contagion threat to other "high-risk" countries in Europe (Portugal, Ireland) and even "moderate-risk" countries like Spain (and to a lesser extent Italy) is going to be on the agenda for a while.

This is, in the end, predominantly a political crisis; granted, with economic reasons and obvious economic consequences, which will have political ways out but no easy solution.

A deterioration or improvement in the European sovereign debt situation will have an impact on the markets in the next months. Systemic risk is part of the new hyper-connected world and has shifted from country or region specific to global in nature.

The other topic in the news lately has been the debt limit, or ceiling, which is the amount that the US federal government is allowed to borrow to finance its huge and growing deficit. According to the US Treasury Department, the US Congress has acted 78 times in the last 51 years to raise, extend or alter the definition of the debt limit.

This brings to mind words of Winston Churchill that have been circulating in financial circles the last few days: “the Americans can always be counted on to do the right thing... after they have exhausted all other possibilities.”

As longer-term investors we strongly feel that we have to make a cognizant effort to filter out the noise and focus on the fundamentals, while mindfully understanding the short-term implications of natural, political and economic developments.

From its early April peak to its mid June trough, the TSX incurred a 10% correction. It has recouped around half of that as we write this update.

Attempting to identify the highs and lows to exit and enter the market is a dangerous game and one that only just a few highly-skilled traders are successful (or lucky) at, usually with other people’s money. It is neither our business nor something we would recommend that our clients do.

Market perspectives and portfolio positioning

The S&P/TSX lost 5.1% in the second quarter of 2011. The S&P 500 lost 0.7% (in Canadian Dollars), and the EAFE returned a positive 0.8% (in Canadian Dollars) for the three months ending June 30th.

We believe that the S&P/TSX is not overvalued compared to its long-term average P/E, dividend yield and earnings yield relative to 10-year government bonds, but we also understand that its high concentration in the material and energy sectors make it particularly sensitive to systemic risk.

We see significant value in both the S&P 500 and EAFE and expect that longer-term investors, positioned in solid companies with reasonable economics and prudent management, are going to be compensated handsomely for their patience in the next 2 to 5 years.

U.S. non-financial companies sat on a massive US$1.2 trillion in cash and short-term liquid investments at the end of 2010 according to Moody’s. That’s an increase of 11 per cent from the US$1.1 trillion at the end of 2009.

Government bond yields across all maturities dropped during the quarter as a flight-to-quality attitude dominated the atmosphere. Corporate spreads increased in Canada and are at a higher level than their historical standard, indicating increased fear in this risk on / risk off scenario.

We feel that inflation is still the number one risk for the long-term investor and are fully aware of the challenges that the current environment represents in the Fixed Income space. Though some people feel the pressure to get higher yields, we don’t necessarily agree with chasing yield as a solution. Giving up quality or extending duration for marginal yield without proper consideration and prudent risk management has ended up in tears more often than not throughout history.

We continue to believe that capital growth in the long-run comes from holding high-quality stocks, while liquidity requirements and stability has to be provided by a cautiously selected Fixed Income position in the portfolio.

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