A Quarterly Newsletter Bringing you Financial Insights from the Leaders

June 2012
Volume 5, Issue 2

THE SEIA REPORT

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A MODERN GREEK TRAGEDY
2012: "A Midsummer Dream or Nightmare"

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THE SETTING: Europe matters once again—and once again the problems center on Greece. At its core, the European sovereign debt-crisis (ESDC) involves debt ridden countries (Greece) that are no longer able to refinance their own government debts without assistance and loans from a third party (Germany). In exchange for the loans, austerity is promised in order to reduce spending and deficits, however, it's not working. The defensive posture we outlined here late last year began to take shape in early April as fears over the European-debt crisis began to flare up—again. Recent elections across Europe have reignited fears and have seemingly expedited the eventual endgame. Now at two years old, the crisis has morphed yet again and investors the world over are now waiting for Act III, the final climactic act in this contemporary Greek tragedy.

Germany, the largest economy in the European Monetary Union (EMU), wants the EMU to remain intact to support its export-driven economy. However, the crux of the whole problem centers around the question of how much should the Germans pay for the benefit of a unified marketplace with a common currency. Capital markets react to every whim coming out of Europe *but why do investors care*? Or more to the point, why do U.S. investors care? The economy of the European Union is the largest economy in the world—more than the U.S. and 2-3 times that of China—so what happens in Europe doesn't stay in Europe, it affects the globe. Investors care because Europe is on the cusp of recession and Greece is simply on the cusp. The ESDC poses risks to the global economy and they are mounting. One of three scenarios is most likely:

1. Europe muddles-through with flat-line GDP growth (best case scenario)
2. The continent drags down the rest of the world into recession or worse yet
3. The crisis in Greece spirals downward, contagion spreads and influences the entire financial system

This begs the question, how can the world's 35th largest economy bring down an entire system? The answer is actually simplistic and can be summarized in one word—fear. Recall 2008, before the great recession gripped the masses, corporations experienced a massive credit crunch as entities no longer trusted each other. Fears trumped reality. The counter-party risk (the risk to each party of a contract that the other will not live up to its obligation) clogged-up the gears of the system, grinding everything to a halt. When trust disappears, credit vanishes. When credit dries up, markets seize up. And when markets are in turmoil, trust further erodes and the whole toxic cycle repeats itself. It is in these times when the role of government can actually assist capitalism (In 2008, the bank-centered credit crunch led the huge industrial conglomerate non-bank General Electric to the brink of failing to meet payroll. It was only the intervention by the U.S. government that greased the gears of the financial system and got things rolling again.). We are getting to that point in Europe.

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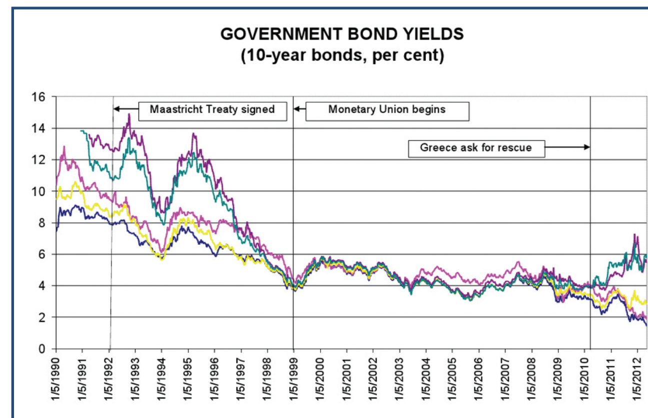
The problem, however, is that there is no federal government of Europe. And back to our original question—if the old world grinds down to a halt, it is hard to imagine a scenario where the US banking system and capital markets are immune. The resulting contagion would spread across the globe and affect all actors and all sectors. ***Similar to 2009, investment opportunities will present themselves amidst the fear; portfolios should adjust to profit from the eventual return to reality.***

THE PRELUDE: How did this Greek drama begin in the first place? Greece, member of the EMU, shares the euro as their currency. While many think of the euro's birth date as January 1999, the common currency was conceived as far back as the 1940s. After the devastation of both world wars, a number of European policymakers were searching out ways to tie the countries of Europe closer together—specifically Germany and France. The two former military adversaries now shared common motivations—to not only counter-balance the powerful relationship enjoyed between Britain and the United States but to also provide a common political voice in global pan-European matters. Finally, it was felt that a greater economic integration could help prevent further military conflict. Treaties in the 1950s established the European Economic Community (EEC) and additional treaties followed culminating in 1993 with the European Union (EU) which now has 27-member states. The subset 17-member European Monetary Union (EMU) followed with all sharing a single currency and single monetary policy. After several decades of working towards this common goal, the special relationship between the German Chancellor and the French President had become an accepted fact.

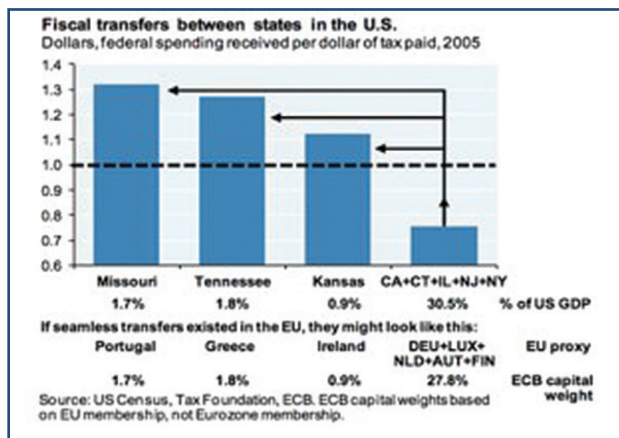


In the years that followed, smaller "peripheral" countries were being viewed through the same lens as the EMU economic kingpins Germany, France, and Italy (the 4th, 5th and 8th largest economies in the world according to the IMF). Sovereign debt yields converged towards Germany's allowing these smaller countries to issue debt at extremely attractive prices.

The corresponding spending binge in conjunction with market-unfriendly socialist economic policies created debt burdens that have now become too large to handle. But the problems are not new—they are just now coming to a head. As far back as 1997, an EMU pact outlined sanctions for countries that failed to follow budget-deficit guidelines and debt/GDP rules. While Greece and Spain dominate today's headlines, even the EMU's cornerstone Germany has run budget deficits greater than rule guidelines 42% of the time (5 of the last 12 years) with no consequences.

THE ACTORS: It is obvious that Europe needs a stronger ability to oversee member states and enforce rules. To accomplish this, Europe needs greater integration. If it were easy, it would have already been done. The existing structure of the EMU experiment along with Europe's own history and makeup make it extremely difficult. Consider the following;

First, one notable exception to the EMU is that it is not an EMFU—a European Monetary and Fiscal Union. To illustrate, the union of the United States is both a monetary and fiscal union. Citizens of California, Connecticut, Texas, New Jersey, New York, Massachusetts and Virginia don't protest when their tax dollars are used in a different state—that is not true of Germany and Europe. If Mississippi has a bad year (or century), Washington DC doesn't debate whether we should force the state to raise taxes or cut spending to become more competitive. In short, we don't impose austerity. The U.S. calmly writes checks to Mississippi in the form of Medicaid and unemployment insurance, no questions asked. Europe has no



comparable "econo-aid" for its weak peripheral states (Greece, Portugal, Spain, etc.). Richer countries do not automatically send poorer countries additional tax dollars year after year. Germany is obviously reluctant to establish any sort of permanent "econo-aid" which would essentially be a permanent wealth transfer program from the core to the southern periphery states. German citizens (read: voters) call this sort of thing a "permanent bailout." Instead of a seamless transfer of payments, Europe has ongoing debates at best and chaos at worst.

Second, consider regional differences between northern and southern Europe. Sending hard earned tax dollars elsewhere is never an easy pill to swallow but when the tax-payer "works" in the colder, industrialized north and the aid receiver "plays" in the warmer laid-back beach climate of the south, the transfer is all the harder. Whether the differences are real or not, the perception of German tax dollars funding ill conceived spending habits of "Club Med" countries is politically sensitive to German Chancellor Angela Merkel to say the least.

Third, consider European history. Germany being the industrial economic juggernaut of the region would demand and gain more control of many aspects of a unified EMU—otherwise the country could go it alone and prosper mightily (In fact, many German citizens are already displeased with rebuilding another country so soon after they rebuilt East Germany after reunification. Although it would hurt exports, many Germans would be happy to see the re-adoption of the Deutschemark and have life savings revalued upwards in the new strong currency.). Germany would dictate—but to whom? Would Italy want to cede partial sovereignty to Germany? Again cultural differences would be a monumental task to overcome. For that matter would France cede to Germany? Although now several generations have passed, memories of an occupied Paris may still be too fresh and may be a political non-starter.

Fourth, consider the two power horses, Germany and France. They have become more economically entwined over the past forty years but since the onset of the great recession, the difference in cultural and economic personas have grown more pronounced. France and its 35-hour workweek has lagged while the industrial machine of Germany has exported its way to prosperity becoming the global leader in the infrastructure build out of the Emerging Markets. The widening gap between the two threatens to tinge the Franco-German détente that was so important to the original development of the EEC and EU. The recent French election only heightens that concern.

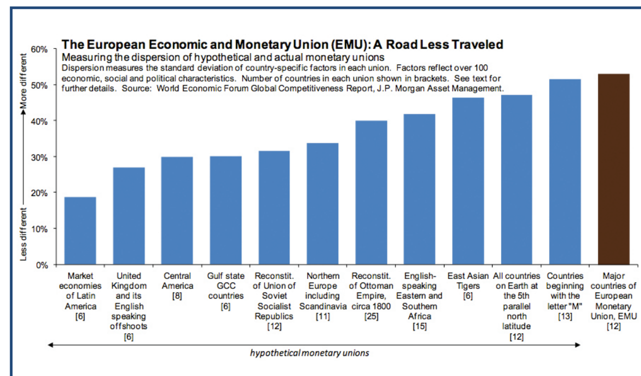
Last, consider homogeneity. The US Congress has not been a powerful role model as of late. The EMU must coordinate 17 different political houses—all with different political party struggles, timelines, agendas, and personalities. Passage of any new lay or treaty would not be timely by any measure. Politicians aside, one of the funnier charts we have seen compares more than 100 factors measured by the World Economic Forum Global Competitiveness Report. JP Morgan calculates that the major countries on the euro are more different from each other than basically every random grab bag of nations including all countries on Earth at the 5th parallel north. They note that, "a monetary union might make more sense for every nation starting with the letter "M" than it does for the euro zone".

Integration faces many problems. Unlike 1770s America, many European states fear that ceding sovereignty to supranational bodies will erode century old local cultures. The U.S. by contrast started from scratch and had a common language to its advantage. It simply did not face such fears when trying to rework the Articles of Confederation. Also, the process for Europe will take place in real-time, with global markets reacting to every policymaker utterance—unlike the closed door secret meetings used to prepare the U.S. Constitution. Although U.S. voters will be bombarded with our differences in November, we actually have much more in common than we realize with a shared military history, a common language, and a similar work ethic. The chants "USA! USA!" in London this summer will only reinforce that notion.

ACT I: *"Austerity: Athens vs. Berlin"*

Austerity has been the major tool used so far in debt reduction but unfortunately, there actually has been very little austerity in most European countries. The austerity measures in France consist primarily of raising taxes and increasing the retirement age starting in 2017—not the severe cutbacks in social services as commonly assumed. Two years of austerity has only led Europe to the brink of recession. While austerity might get the blame for recession, the real problem is that Europe is not globally competitive. Their companies are saddled with high labor costs and restrictive regulations. Labor mobility is near impossible (i.e. Spaniards cannot easily move to Germany to get a job). The culture in much of Europe is in favor of a lifestyle supported by the government rather than entrepreneurship, industriousness, and hard work—traits which historically have led to growth.

Growth programs were notably absent in Act I. However, growth can cover many mistakes. Growth in sales-tax receipts can help California municipalities close ill-advised budget



or Nightmare"

gaps. Growth in capital markets can help insurance companies and pensions close unfunded liabilities. A little growth can go a long way—the problem is that Europe has none of it. Twelve European countries are currently in recession including Spain, Denmark, Italy, The Netherlands, Ireland, Portugal, and the UK. The Eurozone economy as a whole posted aggregate 0.0% growth in the first quarter of 2012 and only Germany's 2.0% growth kept the continent from going negative.

The current sluggish growth would normally bring about policy responses for additional stimulus. But due to the union, fiscal policy (tax-cuts, government spending, etc.) is not an option for the EMU as a whole. Therefore, any fiscal stimulus policy must be up to the individual countries—but deficit spending is not a viable answer as it is the debt-ridden countries that are in trouble in the first place. More debt is not the answer for a debt problem.

If fiscal stimulus is not an option, how about monetary stimulus from the Central Bank? The ECB recently kept interest rates at 1% and offered no indications of any rate cuts soon. Why? Consider history. The prudent Germans are not in recession and are wary of any possible inflation that extra stimulus could bring—mainly due to the horrors of 90 years ago. German monetary policy is highly influenced by the events of the 1920s when hyperinflation in the Weimar Republic wreaked havoc on the country's fortunes. It is also widely believed that hyperinflation contributed to the rise of the National Socialist Party's takeover of power. While the German desire for sound monetary policy is rationale within Germany, the 12 countries already in recession could use the stimulus and perhaps more importantly, could use a weaker currency that might correspond with lower interest rates. A weaker euro could immediately help manufacturers in Greece, Spain and Portugal become more attractive as their goods become cost competitive on a global scale. But all for naught, in essence German history is hurting Greek/Spanish/Portuguese exporters.

Austerity gets the headlines but it may be the lack of growth that is the root cause—and that brings us to Act II.

ACT II: *"Growth: The Pivot & the Catalyst"*

Like any Shakespearean tragedy, a new Act includes new antagonists with new agendas and this 21st century version is no different. The beginning of Act II began with the spring 2012 elections. The electorate believed that austerity programs of the last two years have only worsened the Greek recession, thus preventing the Greek government from improving its fiscal situation. Therefore, anti-austerity swept through the continent and old leaders were cleared out. The elections were not merely anti-incumbent, they were anti-anything and unambiguously show that the electorate is angry and has lost confidence in the ability of traditional politicians to solve the region's crisis. France elected Francois Hollande, the first Socialist leader in 20 years. Greece moved away from the two parties that have governed the country for 40 years bringing to power the radical left fringe party Syriza, led by Alexis Tsipras. Both promise more growth solutions to the crisis. This pivot from austerity to growth and corresponding shift in power translates into a more fragmented European political process. It will now be even more challenging to reach common ground on a range of important issues. Markets don't like uncertainty and thus have negatively reacted to the "pivot" which has thrown two years of "progress" into a state of flux.

The uncertainty could last awhile as Greece will need to host elections again in June to form a unity government. If power is concentrated with Tsipras and if he follows through on election rhetoric, Greece will reject austerity whole heartedly—leaving the troika of the European Commission (EC), the International Monetary Fund (IMF), and the ECB (read Germany) no choice but to reject the next sleeve of bailout money. An ensuing Greece exit (or "Grexit") from the EMU and (re)default on debt would cause further turmoil and worst of all, unknown ramifications.

Financial institutions, the major holders of Greek sovereign debt, would take major losses further impairing their already stretched thin Balance Sheets. Although a "Grexit" would lessen the country's debt burden, cheapen the currency thus reinvigorating Greek industries (exports, tourism, etc.), it would wreak havoc in the short-term as life-savings would be nearly wiped out in the new devalued currency. The fear of this overnight switch back to the drachma is not merely causing a bank-run but rather a "country-run" as billions of euro are fleeing the entire Greek banking system. The fear of depositors in the periphery is not simply one of bank failure but rather fear of devaluation and exchange-rate risk.

Deposit insurance helped stem bank runs in the U.S. Great Depression. But exchange-rate risk makes it much more complicated since it is very difficult to offer guarantees against future exchange-rate losses. Who would or could insure that? Germany does not

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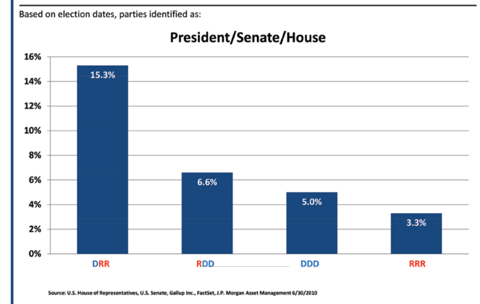
How will this year's presidential election influence the financial markets?

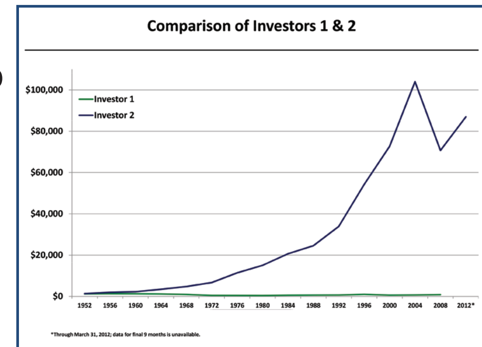
Brian D. Holmes, MS, CFP®, AIF®

Every presidential election highlights stock market performance as a function of whichever party is in office. Contrary to belief, the market has historically fared better during Democratic administrations. Since 1940, as Chart 1 illustrates, the worst performing years have occurred during a GOP-controlled presidency, House, and Senate (3.3 percent annually). The best-performing years have correlated with split control, especially with a Democratic president and Republican-controlled House and Senate (15.3 percent annually). Prognosticators believe 2012's elections will bring what the markets historically like best: A Democrat, President Barack Obama, will be re-elected, and Republicans will take over the Senate. This fall, 33 Senate races are up for grabs, and Republicans stand to pick up as many as six seats, for a 53–46–1 majority, with one independent. The House, now under GOP control, 242–192, will likely not change.



If the stars align this way, additional good news is likely: Since World War II, whenever an incumbent has won the White House, the markets have averaged over 9 percent, versus 2 percent with a loss. Even more astonishing: Market bottoms have occurred only once during the fourth year of the presidential term (2008). The market bottom has averaged 1 year, 6 months into the presidential term, and 13 out of 18 times during the president's second year in office.

There could, however, be storm clouds in 2013–2014. Chart 2 shows how, since 1952 (when the modern Fed began influencing the economy), had Investor #1 invested in the S&P 500 the first trading day of an inaugural year and liquidated September 30 the second year (21 months later), his/her portfolio would have earned minus 13 percent. Had Investor #2 bought over the next 27 months, from October 1 of the second year through December 31 of the fourth year, he/ she would have earned over a total 8,595 percent*.



In short: Virtually all gains in the S&P 500 over the past 60 years have been earned during the last 27 months of the various presidential cycles. Certainly, history has favored a Democrat in the White House and Republicans in the House and Senate after typically treacherous early months. Several business cycles must occur for a full-blown effect on the markets. Yet, as long as investor sentiment continues improving, barring unforeseen headwinds (a worsening European crisis), we could be in store for another positive fourth year of the election cycle.

**Calculated through March 2012, missing the final nine months of the current presidential cycle.*

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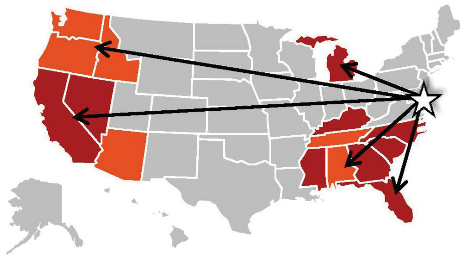
A MODERN GREEK TRAGEDY

Example of Fiscal Redistribution in the U.S.



The E.U. Lacks a Similar Fiscal Mechanism

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want to stand behind such guarantees to Greek citizens because where would it stop? A "Grexit" would likely then cause a run on Portuguese and Spanish banks—if not Italian and French institutions as well. Account holders would continuously scramble for safer and safer havens to deposit. The fact that the eurozone is not a single nation state, even though it does have a single central bank, is causing bank-country runs. To fix the problem, belief in the integrity of the euro as a single currency needs to be restored—the bank run (country run) is the catalyst for Act III and is bringing matters to a head.

Politically stable countries need well functioning economies. In nations gripped by deep recessions or outright depression, in nations where 50% of the men under age 25 are unemployed, in nations filled with desperate people looking for some hope—you do not want fringe parties gaining power. If anyone knows this, it is Germany. Memories of the Weimar Republic leading to 1930's Germany might actually save the euro and with it, save the Greek/Spanish/Portuguese bankers.

ACT III: *Europe´s Options*

Europe cannot continue as it is currently structured, or so says Mr. El-Erian the CEO of PIMCO. It must evolve into one of two "equilibrium states" either by forcing out two or three of the weakest countries or by providing fiscal support to all 17 current members. Either way Germany must pay the price—by either confronting the major instability that would follow a breakup of the Eurozone (weaker global economy leads to weaker exports, fear of contagion and further bank runs, etc.) or by funding the liabilities of the periphery (bailout, fiscal union, transfer payments, etc.).

In a breakup, the ECB could be expected to take whatever steps necessary to protect the banking system. Costs would be large and the resulting European (global?) recession would be deep but in the long run there may be some benefits. The potential tragic lessons of Greece might in the future encourage weaker nations and European leaders to get their act together—to balance budgets, reduce debt (leverage), curtail pensions, limit healthcare costs, and reform labor policies. The ideas here are not unlike that of corporate America. Recent bankruptcies including General Motors can actually improve the prospects of the company. Other bankruptcies like Lehman Brothers provide warning signs that may actually curtail future investment banks from similar activities. The experience of Iceland and many emerging markets over the past 20 years shows that nominal depreciation and orderly restructuring and reduction of foreign debts can restore debt sustainability, competitiveness, and growth. As in these cases, the collateral damage to Greece of a euro exit will be significant, but it can be contained—perhaps.

But most feel that the costs of dismantling the euro are so high, that the ramifications are so unknown, that the Europeans will do whatever it takes to prevent it. In the end, there is just no absolute way of knowing whether the Grexit starts the Portugal, Spain, Italy domino game. No one has tried to break up a shared currency before. Money may start to flee out of every country at risk and with help from Twitter and Facebook, a full-scale continent-wide bank run could easily get out of control and blow up the best-laid plans in mere hours. What follows? With youth unemployment at 50% in Greece and Spain, law and order could break down. Floods of refugees may start to stream across borders. Germany would not be immune and worst yet—Germany would probably get the blame for the whole darn thing. *But will it happen?* The run on Greek banks may get Tsipras back to the table to eventually break election promises and compromise (gasp!). Austerity will remain but it will get modified to include a modest amount of growth programs. Germany gets austerity, Greece gets growth and everyone saves face. ***This climactic start to Act III should then precede a global rebound in capital markets and investors worldwide will rejoice.***

At the end of the day, it is not in Germany's best interest to blow up the euro—and a breakup is not something Chancellor Angela Merkel wants in her Wikipedia entry especially after 60 years of treaties, economic triumph, and accomplishment of the original goal—peace. In the short-run, Germany and Greece come together. In the long-run (the core of Act III), Europe slowly transitions to a fiscal federal system where there are no longer debated bailouts but instead automatic transfers to weaker and poorer nations. What exactly should we expect? Hopefully sooner than later, major programs will be announced that will further integrate the union, namely;

1. An FDIC-like guarantee that EMU bank deposits are forever to be held as euro
2. A TARP-like EMU wide program of direct capital injections to recapitalized European banks
3. The implementation of the "Eurobond" that is collectively underwritten by all countries—which in turn is backed by the full faith and credit of the German government
4. A European financial authority/treasury that can gradually accumulate a war chest (of real cash, not promises) for future dealings

Berlin probably knows further integration is coming but politicians dare not spell it out explicitly, because the bill for the German taxpayer will be quite large with some predicting 5% to 8% of gross domestic product every year for the foreseeable future. Remember, the principal beneficiary of the euro is German business and as long as Corporate Germany appreciates having the common currency (and enough German voters understand or have residual guilt about 20th century history) the Germans will pay.

Due to the complexity of the subject, many contributors assisted in this outline. We thank them for their support. We thank you for your continued support as well. Have a great summer.