R I V E R P O I N T R E P O R T

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GREEK TENSIONS STOKE FEARS OF EUROPEAN CONTAGION

On May 6, the whole world saw first-hand the tensions in Greece as news outlets broadcast footage of protests outside the parliament building in Athens. Police in riot gear squared off against thousands of angry protestors, giving people a bird's eye view of the severity of the situation in Greece. On the heels of deadly violence the day before, the potential for Greece's problems to spread across borders rose as tensions mounted. In this special edition of the *RiverPoint Report* we will share with you our outlook on the situation in Greece and the implications for our investment strategy. We will also discuss how these problems could spread into other European countries and the global economic implications of this contagion, as well as what all of this means for our clients' portfolios.

The problems in Greece are manifold, but the overriding issue is that the country has saddled itself with too much debt and the government is in danger of not being able to pay back what it owes. By itself, a Greek default would not have a large impact on the global economy – according to 2009 International Monetary Fund data, Greece is the world's 28th largest economy, contributing less than 1% of global gross domestic product (or G.D.P., which is a measure of total goods and services produced by a country). However, by virtue of its membership in the European Union, Greece cannot be viewed by itself. Due to the level of economic interdependency and shared currency among its members, Greece's problems have put the whole European Union underneath investors' collective microscope.

One of the biggest problems with how the European Union (E.U.) is structured is that it lacks a centralized policy maker capable of implementing policy actions for the entire group. Instead, the individual countries have to agree to work together in order to solve the group's problems; the negotiations in recent weeks have exposed flaws in this set-up, as Germany and France have begrudgingly taken the lead on Greek rescue efforts. The European Central Bank (E.C.B.) has limited powers over the members of the European Union, but it could provide some help through some open market actions (i.e. buying Greek debt). Even something as simple as a public reassurance that "everything will be okay" would be helpful, but E.C.B. Chairman Jean-Claude Trichet has been mostly silent through this whole crisis to date. This silence is very disconcerting to investors.

In our March 1 *RiverPoint Report*, we said that a Greek default was unlikely, and we still hold that belief. Now, however, the odds of Greek problems carrying over into other European countries have increased. In financial circles, the term "contagion" is used to describe how difficulties or concerns in one area can bleed into another area. Greece's economic difficulties have caused the yields on its bonds to skyrocket to levels much higher than some smaller and less-developed countries, like Pakistan. This is because investors are very hesitant to invest in Greece and are highly uncertain as to what will happen in the future. These higher bond yields will make it more expensive for Greece to borrow money, which will make it more difficult for them to dig themselves out of this hole. Since Greece can't borrow its way out of this mess, it will take longer for the economy to fix itself through budget reductions, benefit cuts and tax hikes (which make up the meat of the hotly debated "austerity plan"). A prolonged recovery will lead to a greater risk of Greece defaulting on its debt, which causes investors to sell the country's debt, which causes interest rates to rise and the whole cycle repeats itself….

Investors look at this situation in Greece and ask, "Who's next? Which country could be the next to have such severe economic problems?" As a result, investors begin to sell bonds of the other "P.I.I.G.S.," (an acronym for the most debt-laden European economies – Portugal, Ireland, Italy, Greece and Spain) raising the cost of borrowing for those countries. The vicious cycle spelled out above then takes hold, and these countries are now facing more severe economic issues. This is how "contagion" would spread – after seeing the problems in Greece, investors get worried and proactively try to avoid the "next Greece."

If the other "P.I.I.G.S." fall victim to Greek contagion, the whole of the European Union will be left with a very difficult decision to make. One option would be for the E.U. to forget about the idea of the unified Euro currency and have each member fend for themselves. We do not believe that this option is very feasible, given the level of dependency among the group's economies. True, Germany and France may be able to fare better than other EU members, but both of their economies are heavily dependent on exports to the other E.U. countries. If all of their neighbors are destitute, who will be left to buy BMW's and Louis Vuitton handbags? The other option available to the E.U. is to grit its teeth, re-group, cobble together a rescue package for its struggling members and mend itself through strict fiscal discipline. Less government spending, lower benefit payments and tax hikes will have the combined effect of slowing E.U. economic growth to a halt at best, with a potentially severe recession the more likely outcome. As a whole, the E.U. represented 28% of the world's G.D.P. in 2009. With more than a quarter of the world's G.D.P. in a recession, the impacts on the economic growth rates of other countries would be material. With 20%-30% of S&P 500's earnings coming from European business, a slowdown across the Atlantic would have a large impact on how stocks are viewed in the U.S. In addition, a falling Euro currency and strengthening U.S. dollar makes American goods more expensive relative to comparable European products.

In response to growing concerns about the health of the European economy and the effects on the global economy, we have decided to reduce equity exposure by approximately 5%. We have sold shares of companies that have experienced sharp rallies off of the 2009 lows and that realize a large percentage of their revenues from European operations (like 3M Corporation and Intel). As the European economy slows, revenues at these firms will likely decline more dramatically. As the European economy weakens, investors will shift into "safer" assets which will likely mean lower U.S. Treasury yields and a stronger U.S. dollar. When the U.S. dollar strengthens, the price of oil typically declines (we have already seen some of this action). As a result, we have also decided to reduce our exposure to the Energy sector as well.

While the prospect of Greek contagion is unnerving, the U.S. economy has shown enough strength that we are confident it will continue to recover (albeit at a potentially slower pace). Recent evidence, including increasing consumer confidence, upbeat first quarter corporate earnings, and positive jobs data, demonstrates that our economy is on its way to recovering from our recent recession. We hope that this special *RiverPoint Report* was helpful in conveying our thoughts and how we are positioning your investment portfolio. As always, do not hesitate to call a RiverPoint Capital Management professional should you have any questions or comments.

QUICK COMMENTS ON THE MARKET VOLATILITY ON MAY 6: The footage of the unrest in Greece solidified investor concerns about the severity of the situation and its potential to spread. These concerns led investors to sell equities and buy less-risky assets (i.e. U.S. Treasuries and U.S. dollars). As more investors became concerned, the selling picked up steam. At this point, Financials and Tech stocks were leading the way down. Then, a little after 2:30 PM Eastern Time, all heck broke loose and the Dow Jones Industrials plummeted 500 points in a matter of minutes. Stocks like Procter & Gamble (PG) suddenly lost over 20%, and some large companies, like Accenture, were quoted at prices as low as $0.01. Then, as quickly as stocks fell, prices rebounded and recouped much of their losses. Reports today indicate that fears about Greece and the EU fed the initial sell-off. As the selling continued, electronic trading programs designed to limit losses were triggered and the selling pressure increased. These automatic sales led to more selling as lower price targets were met. As more automatically-generated sales flooded the market, buyers were heading for the sidelines to

see how the afternoon would play out. At this point, the sellers couldn't find buyers on the large exchanges, so these orders were redirected to less active regional exchanges. It was on these regional exchanges that the shares of large, stable companies like PG hit their lows for the day (PG traded at a low in the mid-$50s on the New York Stock Exchange, while it traded in the low-$40s on other exchanges). An element of human error may have added to the negative momentum, as reports of a trader essentially adding a few zeroes to a sale order – the difference between one hundred thousand shares and ten million shares. By the end of the day, some semblance of order had been restored but the stock markets had still taken it on the chin as investor fears about Europe became more pronounced.

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