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Truth, Knowledge, Experience — *3rd Quarter 2015*

Hurricane Season and the Redefinition of Europe

Presented by Stephen A. Geremia

Hi Everyone,

Summer is a great time to gather with friends and family. Enjoy your vacation time!
The recent market volatility is to be expected at this point in the cycle. Don't get distracted.

Sincerely,
Steve Geremia

In This Issue:

This summer, we seem to be entering another period of stormy weather; in fact, a series of storms, ranging from tropical depressions to full-blown hurricanes, looks to be approaching. Since this is at least the third year running that we may experience a series of market storms, it seems appropriate to treat this turmoil as an unfortunate but regular event—a hurricane season.

While we don't want to carry the Weather Channel metaphor too far, we can attempt to forecast where we are in the storm system and what we can expect both now and later in the season.

Tropical Storm Greece: Ready to surge again?

Greece has been the leading edge of the past couple of storm seasons, similar to a tropical storm that bounces around the Caribbean, never quite making landfall and doing damage but never dying down, either. When Greece finally did make landfall, it proved to be more of a tropical depression than a hurricane; the damage was real but relatively minor compared with what investors had feared. Indeed, much of the damage resulted from the panic the storm aroused, not its actual impact. To put that in concrete terms, while the default was real and investors did lose, defaults happen all the time. The damage to the rest of the markets was a product of fear—fear that this small storm was really a harbinger for something bigger and worse.

Unfortunately, that does seem to be the case. As we know, Greece eventually did default, but a deal was reached and the problems seemed to be solved—until they came back, more powerful than ever. Greece's government fell, and the new government may deny the deal previously cut, depending on the outcome of elections in mid-June. Now, officials are talking openly about a Greek exit—a "Grexit"—from the eurozone, and the storm is brewing again. It's reasonable to expect, however, that any damage when it lands will be contained, largely because of the preliminary de-risking work that ongoing fear has inspired.

On the horizon: Hurricane Spain

In the meantime, Spain, the next country in line for restructuring or default, is dominating everyone's attention. If Greece was a tropical depression, Spain is now a tropical storm and may be upgraded to full hurricane status fairly quickly. In essence, Greece's prob-

"If you feel you can dance in and out of securities in a way that defeats inflation and taxes, I would like to be your broker **but not your partner**."
Warren Buffet

Unlike Greece, Spain is shaping up to be a huge storm, one with the potential to cause a great deal of damage. What matters is where it hits—does it stay offshore and blow itself out, or does it head straight over Miami and up the coast?

Furthermore, central government spending isn't the primary cause of Spain's woes. Spain is more like the United States in that its banking system financed a huge real estate bubble—bigger proportionately than that of the U.S.—and still hasn't fully addressed the problem by writing down bad loans or raising capital. In addition, Spain has governmental spending problems at the regional and local level. As the central government has tried to deal with these issues, its own finances have weakened, and investors now doubt that Spain can meet its obligations.

In response, the Europeans have decided to solve the most immediate problem and bail out the Spanish banking system. This bailout deal is much better than past efforts, in that it's both reasonably timely and appears to be large enough. But, while it may solve the banking problem, it doesn't address the larger issue of Spanish central government finances. The markets voiced their doubts loud and clear in the days after the announcement, with Spanish interest rates nearing 7 percent—the point widely perceived as the red line where a full bailout will be necessary.

A bailout in the forecast?

At this point, the debate centers on whether the EU will provide funding to bail out Spain and, if so, how much is needed and what the conditions will be—in other words, the same discussions we saw when it was Greece on the firing line. Many of the issues are similar, with Spain denying an obvious problem and rejecting outside oversight. So far, so familiar, but now there's another layer: the money may not be there.

The EU nations' ability to rescue Greece, if they chose, was never in doubt. The debate was over whether they should, not whether they could. But Spain is a much larger economy, with much larger problems. Now the question is about *could*, not *should*. Worse, Spain may not be the last problem country. Several smaller nations—Cyprus, Portugal, and Ireland—are also at risk either economically or politically, and some of the larger countries—Italy and even France—could be as well.

A Spanish rescue, or, even worse, an Italian or French rescue, could well overwhelm the available money. Even for Spain alone, a credible bailout would probably require a considerable expansion of the EU's available resources. Beyond writing the checks, large structural changes would be needed in the eurozone and possibly in the structure of the European Union itself. The changes on the table at the moment go well beyond what was thought possible even six months ago: common banking regulation and supervision; common issuance of bonds, known as eurobonds; and mass expansion of the money supply by the European Central Bank—in short, a large expansion of the EU's authority at the expense of national sovereignty.

Thus, with Hurricane Spain, Europe is being pushed to the edge of self-definition. A monetary union without fiscal union is at the breaking point. Independent national banking systems, without cross guaranties, are poised to fail. Nation-states, left to themselves, are on the brink of bankruptcy. Each must now decide whether it wants to be a sovereign state with control over its own financial affairs.

The alternative is for those nation-states to give up much of their sovereignty. This is the issue Greece will be voting on—whether, in effect, to let the Germans collect the country's taxes and set its spending. This is what Spanish officials are now trying to negotiate—whether to let the Germans run their banking system. This is what the French seemed to reject when they elected a Socialist president who explicitly rejected the austerity consensus. And this is why we are entering hurricane season. One after another, European countries are set to run into trouble, and in each case, that country and the EU will have to decide: in or out? We can expect a rerun of the Greece and Spain market contortions several times over as different countries hit that decision point.

The outlook for the U.S.

Here, the news is better than you might expect, though not necessarily good. While Europe continues to struggle, the United States will likely benefit. We've seen this in the continued decline in U.S. Treasury interest rates, as investors seek per- ceived safety and pull mon- ey out of Europe and other risky as-

An investor's **Worst Enemy** is not the Stock Market, but his **Own Emotions**.
- Transamerica

Of course, there are and will continue to be negative effects, as financial instability ricochets around the world and affects all markets. Exports to Europe are already dropping. The current slowdown in employment growth is due at least in part to the uncertainty generated by the euro mess, and we can certainly expect that to continue.

Nonetheless, the U.S. is among the best places to be over the next couple of years, relatively speaking. We can continue to expect ongoing volatility and screaming headlines. But we can also expect that the country will continue to perform well, in relative if not absolute terms, and that the U.S. situation will very probably continue to improve. While hurricanes are scary, generating much fear and sometimes real damage, they are survivable. Florida is still there, after all, and the world will certainly survive one more hurricane season.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

Authored by Brad McMillan, CFA®, CAIA, MAI, AIF®, chief investment officer, at Commonwealth Financial Network.

"If you think nobody cares if you're alive, try missing a couple of car payments."
-Earl Wilson

Making Sense of Gains and Losses in Mutual Funds

Presented by Stephen A. Geremia

Driving in Massachusetts can be confusing. South Boston, for example, is actually east of the city, while East Boston is to the north. And the road labels can be just as bad. There is a section of a major highway, where two roads converge, where you can actually be headed south on one highway and north on another at the same time.

Hard to believe—and even harder to describe when you try to give directions—but true. Don't try this if you're not from around here.

Navigating mutual fund results

Mutual fund results can pose similar problems. For example, how can a fund make taxable distributions of profits from specific share investments at the same time the fund itself is down for the year? Isn't this like heading south and north at the same time on the same road?

Not exactly, but to understand why, we have to go back to how mutual funds work. Essentially, a mutual fund is a collection of investments in different stocks or bonds, bought and sold at different times as the manager decides, all for the benefit of individual shareholders, who own a piece of the entire portfolio.

The way this plays out for those shareholders depends on the results of individual companies the fund invests in, but those results will differ from the results of the fund as a whole. In exactly the same way, the buy and sell dates of the shares the fund owns will differ from the performance dates the fund reports. It is indeed possible for a stock to have headed north at the same time a fund has gone south.

Here's an example: Suppose a mutual fund owns only one stock, of company ABC. It buys a share at $100 on January 1, 2000. Because the fund managers are good analysts, they buy right, and the stock soars to $150 on December 31, 2000. Both the stock and the fund are up.

Then, in 2001, the stock drops to $125; at the end of the year, the fund managers decide to sell at $125. For 2001, the fund's shareholders would see the following:

- First, the sale of the stock would trigger a taxable distribution on the $25 gain.

So, the fund ends up heading south while the stock itself, over the holding period if not the past year, heads north. In real mutual funds, of course, the dynamics are more complicated, but the underlying process is the same. The results of individual investments over different holding periods can be substantially different from that of the fund itself over a time period.

lems were fairly simple: its government was spending more than it was taking in and borrowing the difference. The problem was rooted in government debt. Given the small size of the Greek economy, though, this was a solvable prob-lem; in fact, the eurozone governments did come up with funding to resolve it, or so they thought.

Another way of looking at it

Although it can be frustrating to see both a tax bill and a loss on an investment, think of it this way: the tax bill has come later than it might have. You enjoyed the gain in a previous year in that fund but haven't had to pay taxes on it until just now.

Like many investment facts, this sort of result appears counterintuitive until you look at the underlying reasons—and then it makes perfect sense. Unlike, of course, the roads in Massachusetts, for which I've yet to find a good explana-tion.

Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than their original value. Some investments are not suitable for all investors, and there is no guarantee that any investing goal will be met. Past performance is no guarantee of future results. Talk to your financial advisor before making any investing decisions.

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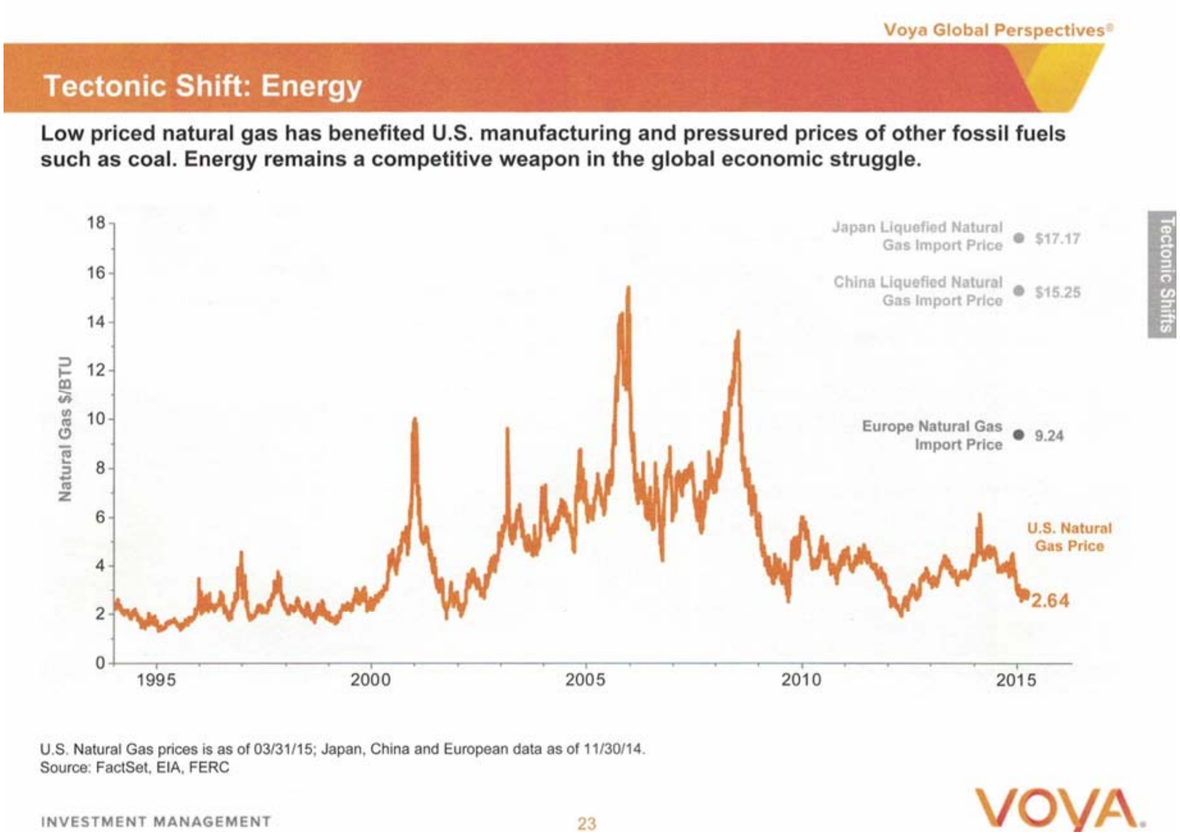

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