

## Second Quarter 2015

This quarter with Greece once again dominating the headlines we discuss the amazing tool called credit and how it can be used to benefit economic systems or, if misused, can wreak havoc. We also offer our views on markets and the economy and share a story of helping a client through the loss of a loved one in our Client Corner. Finally in Albion News we report on our inclusion in this year's list of Top Advisors by Barron's magazine and introduce you to our *Business Conversations Podcast* available through our website.

We hope summer finds you rested, refreshed, and enjoying the benefits of the season.

### A Tool Called Credit

Credit is an essential tool to modern economic systems. Used properly it helps expand prosperity for all of us. Yet it takes but a cursory review of the headlines to see that overuse of credit has led to some of the more significant economic problems of our age.

The key to credit is this; someone with extra money and no compelling investment opportunity wishes to earn some return greater than zero while someone else with a compelling need for additional money is willing to pay for the use of such funds. The lender and borrower agree to the terms of the loan and voila; the lender now will earn a return and the borrower has the funds they require. The borrower spends the funds thus driving economic activity in a compounding cycle.

*"Remember that credit is money."  
- Benjamin Franklin*

Imagine the following flow multiplied by the millions of transactions that take place each day. A company borrows to build a new plant. A portion of the borrowings are spent on construction contractors and materials suppliers. The construction contractor pays wages to their employees. An employee, feeling good about his job prospects, buys a new car. The car company, feeling additional demand from this individual and thousands of others, adds a night shift to one of their manufacturing plants for which they must hire additional workers. The links go on and on. Credit is a powerful force in economic expansion.

But how does credit go bad? Taking the example above, suppose the company that borrowed to build the new plant does not meet sales forecasts. Over time they find themselves squeezed so to conserve cash and meet debt payments they lay off workers. The laid off workers don't have money to spend and thus reduce their spending on a variety of goods. The slowed spending circles back and causes even further reductions in demand for the products of our initial borrower. Soon the borrower cannot meet the debt service obligation and requires additional loans just to keep the doors open. Lenders are hesitant; they see a company already struggling to survive. The company, to attract the money necessary for survival, must pay a very high

interest rate for additional funds thus putting even greater pressure on the corporate income statement.

*"Credit is the grease that greased Greece."*

- John Bird

And this brings us to Greece. Inclusion in the Eurozone brought incredible benefits to Greece for the first several years of participation. They were able to borrow funds based not exclusively on their own creditworthiness but on a more generalized creditworthiness of the European Central Bank. This was, at the time, cheap money. Further, they were able to use these monies to fund current consumption. Per the Heritage Foundation, overall tax revenue in Greece equals 38.5% of gross domestic output while public expenditures account for 58.5% of domestic output. The Greek Government has been borrowing funds to plug this gap for several years but now lenders, who have expressed concern about being repaid, are hesitant to throw more good money after bad. Of course there are many complicating international, national, societal and cultural factors at work here but, in essence, it is the unwillingness of creditors to make high risk loans that is bringing the Greek crisis to a head.

There is plenty of precedent for countries defaulting on their debt. What makes this case unique is that it is the first to happen in the context of the common Euro currency. Typically a defaulting country would see the value of their currency plummet – a response that is not possible here. The Greek crisis is evolving so rapidly that anything written here will certainly be outdated before it gets to print. However regardless of the terms of resolution it is unfortunate and certain that the Greek citizenry have many challenging years ahead.

*"Once a nation parts with the control of its credit, it matters not who makes the laws."*

- William Lyon Mackenzie King

Credit is a tool. Like any tool if used effectively it can enhance productivity. Yet if misused it can wreak havoc. As we analyze companies, sectors and countries we keep in mind the critical role of credit and work to ensure that we invest in those entities that minimize the risk of misusing the credit tool.

### Economy and Markets

*"Neither comprehension nor learning can take place in an atmosphere of anxiety."*

- Rose Kennedy

In our last letter we examined the growth hiccup in the first quarter for the US economy, which we believed to be transitory due to certain short-term factors (e.g., adverse weather, port slowdown, etc.). We explained that despite these problems the American economy remained supported by steady job growth, recovering confidence, improved private sector balance sheets, and stable household consumption. Indeed, these fundamentals remain the cornerstone of the low to mid 2% GDP growth path.

As we review second quarter data, with the first quarter's fleeting shackles removed, the economy appears to have responded in the way we anticipated with underlying fundamentals

and GDP tracking closer to trend. Job growth during the second quarter was solid, confidence was steady, and consumption experienced a resilient bounce back. A continuation of these fundamentals coupled with a general state of low inflation (including still-lower energy prices), strong corporate earnings, some early signs of rising wages, and accommodative monetary policy augurs well for general economic activity over the near-term.

In international economies there remain pockets of good and bad. Growth's green-shoots continue to emerge in Europe despite the Greek morass. European policymakers are throwing everything they can at the drama that is evermore unfolding like a Greek tragedy. While the risk of a "Grexit" (Greek-exit) from the Eurozone project has gone up since the referendum we continue to believe that cooler, rational heads will ultimately prevail resulting in the euro remaining intact (at least for now). And even if this view proves to be a misjudgment, Europe has spent the better part of the past three years putting into place a policy-driven firewall to stem grave economic and market contagion from a Greek debt default. Either way, we do not believe that this situation is a reason not to own stocks.

Over in Asia, the last month of the quarter ushered in a bear market for Chinese stocks after a dizzying twelve-month surge. While this rapid decline is a bit troubling, at present we do not expect this to be a major adversarial event for US stocks. Meanwhile, Russia and the Middle East remain hot zones of headline-grabbing anxiety as these regimes continue to kick sand in the eyes of those they disagree with or who are oppositional to their quest for power. And while developments here can often create volatility in financial markets, we do not foresee them cracking any of the four pillars that buttress US stock prices: the economy & earnings; inflation; interest rates; and valuation.

Broad-based US stock indices were once again essentially flat during the second quarter. While the bedrock of the economy & earnings remain steady and inflation is low, our view is that there are two key factors that have restrained the stock market so far in 2015. First, investors are wringing their hands over when the first Fed rate hike will be. Second, many continue to believe that valuations for stocks remain elevated. The confluence of these two concerns has provided enough motive to pause the bull rally. We trust however that looking out longer-term what matters more is not the *timing* of the first rate hike but the *path* to rate normalization. Equally as important (and as we have discussed in prior letters), despite the verbosity to the contrary, stock market valuations by our assessment are not exuberant when viewed through the lens of corporate earnings, low inflation and interest rates. Against this core backdrop we believe it is appropriate to maintain stock allocations and we remain diligent in our efforts to discover and own great companies at reasonable prices.

### Client Corner

The work we do on behalf of our clients is essential and makes a big difference in their lives, but on occasion it happens in sad circumstances. Several months ago a family came to us seeking our assistance. The patriarch of the family had passed away a few years prior and before passing had let his family know that should anything happen to him all the information was in the family filing cabinet. It took quite some time for the surviving spouse to become emotionally ready to face what had to be done. Finally she accepted that she needed to take the necessary steps, tie up the loose ends, and transition to the financial life of a widow.

While she was emotionally ready she had no idea where to start or what to do. She had only been superficially involved in family finances and did not feel she had the knowledge to determine what was required nor the energy to complete the tasks. She and her family turned to Albion.

In the weeks that followed we went through the metaphorical filing cabinet, created a clear and comprehensible outline of what needed to be accomplished, and methodically worked through the steps all the while keeping the surviving spouse and her family apprised of the progress. Accounts were uncovered, transferred and retitled. Trust provisions that were triggered at the death of the first spouse were implemented and insurance proceeds were tracked and gathered. It took quite some time to wrap up the process but today, with the job complete, our client can move ahead confident that her affairs are in order.

### Albion News

We are pleased to share that Albion Financial Group was named by Barron's Magazine as one of the Top Financial Advisors in the country and the highest ranked fee-only advisor in Utah. While we appreciate the external validation provided by Barron's we recognize it would not have been possible without you, our client, allowing us to stand by your side on your personal financial journey.

Last quarter Albion launched *Business Conversations Podcast*. These podcasts are available through our website ([www.albionfinancial.com](http://www.albionfinancial.com)) and feature intelligent, thought provoking conversations with business leaders of local and national interest.