Cyprus Crisis Aftershock

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Over the weekend the Mediterranean island of Cyprus took center stage in the financial news. The island nation, while a part of the European Union (EU), has a population of less than 1 million people. Despite its diminutive size (it is the 3rd smallest country in the EU in terms of GDP), the country’s need for a bailout may have repercussions throughout the rest of Europe and also in the United States.

Like the PIIGS (Portugal, Italy, Ireland, Greece and Spain), Cyprus’ problems stem from having too much debt and its inability to devalue its currency. In the end, the country found itself negotiating for a 17 billion Euro bailout. Given that the country in 2012 only produced 17.8 billion Euros worth of GDP, there is clearly a problem.

While European finance ministers were sympathetic to the plight in Cyprus, they demanded a high cost before they would help in the bailout process. The cost was a significant 7 billion Euro down payment coming from unsuspecting bank depositors. Different terms and levels are being bandied about by government leaders in Cyprus, with one proposal confiscating 15% of deposits for those with over 500,000 Euros on hand. It is said that about one-third of the bank deposits are from non-residents, with Russian deposits representing about 30 billion Euros.

These types of actions can easily create a run on the banks. After all, who wants to face significant losses on what should be a relatively safe investment for cash? Already other, less economically stable European countries, look about nervously wondering if this deposit tax-for-bailout plan will come to their shores. What are the ramifications?

The Cyprus crisis is likely to depress the value of foreign stocks and many foreign bonds. Low quality bonds, especially foreign bonds, are apt to underperform. Some US equities and high-yield bonds might correct lower.

Regardless of Cyprus and Euro problems, the US will not default in repayment of dollars. The US dollar is a reserve currency. US debt is denominated in dollars. We have a very BIG printing press. Printing money leaves the door open for inflation in the future.

The value of the dollar will rise against international currencies such as the Euro and Pound. The stronger dollar is apt to push many commodity prices lower. Business firms who use commodities will benefit.

Political opinion inside the US is likely to swing in a more conservative direction. A balanced budget may have more appeal. Problems with “excessive debt” are illuminated. Reduced entitlement spending may become feasible.

James’ Balanced accounts are well situated for this kind of a crisis: Low holdings in at-risk international securities. Good positions in US Treasury bonds or the equivalent. Moderate positions in equities in balanced accounts.

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