July 6th, 2015

Don't lose sight of the forest through the trees…
The ongoing Greek 'drama' (or wait, is it a 'saga', or has it now evolved into a 'tragedy'? I don't know) continues to weigh on global capital markets, which is a shame because it is masking some rather constructive economic data (more on this later). On the week, the Dow fell 216 points or 1.2%, the S&P 500 gave up 24.71 points or 1.18%, and the Nasdaq Composite slid 71.29 points or 1.4%. At just over the half way point of the year the Dow and S&P 500 are hovering near the flat line while trading in a very tight 7% range so far in 2015.

While Greece is on the forefront of most investor's minds, it's not the only macro-economic issue causing an increase in risk aversion, with Puerto Rico's roughly $70 billion debt load finally coming to a boil and the bond market pricing the commonwealth's debt as if a default is a matter of when and not if. Puerto Rico debt will surely have to be restructured and there is no congressional support for any bailout. Additionally, China's equity market has officially crossed through the 20% decline threshold (down nearly 30% from its mid-June peak) taking it into bear market territory, although this market is still up more than 100% over the last twelve months and 30% on the year, which could mean there remains a lot of air left in this balloon if it were to truly pop. An indication of the euphoria that has gripped Asia investors is the fact that 12 million brokerage accounts were opened in May alone, which is a number that exceeds the entire population of Greece.

This roughly three week sell-off instigated action on the part of Chinese officials in an effort to stem the tide as they announced over the weekend a massive injection of funds into their financial system in what they term as a way to "provide liquidity assistance". Under the planned move, China's central bank will indirectly help investors borrow to buy shares in a market that has erased about $2.4 trillion in this latest sell-off. This is the first time that funds from the central bank will be directed to institutions other than banks and this directed policy tactic is coming at a time when estimates of margin debt in the Chinese equity market are equivalent to 15% of the value of China's tradable shares. For context, back at the peak of China's equity market in 2008, margin debt was zero – as in, it didn't exist. Just another example of what has become a staple in this recovery cycle – central banks stepping in to become a lifeline for troubled stock markets.

You have to keep in mind that China, while the second largest economy in the world, is still a developing market (so are its capital markets) and as such these types of price swings are just par for the course in the developing market asset class. The metamorphous of this economy from one which was highly dependent on exports and infrastructure spending to an economy more reliant on consumer spending and services remains underway and nothing in the data to this point suggests this transformation is not succeeding. Yes, it will come with fits and starts and be subject to the typical machinations of economic cycles, but this population pool will continue to be a dominant force on many fronts in the global economic landscape.

As for Greece and the Troika, it's not difficult to step back and objectively view each side's perspective and the culmination of events that have got us to this point. From an EU perspective they are at a point where they now question whether they should continue to throw good money after bad. After all, the Greek economy is in such a hole after six years of depression, GDP down 25% and unemployment north of 25% that it would be illogical for anyone to conclude that all of this debt ever gets paid off. However, the EU realizes that it is walking a fine line – not in regards to finances or economics, but in regards to geopolitics. The geographic location of Greece makes it a very valuable property with uninhibited access to the Aegean, Ionian, and Mediterranean Seas which incorporate key shipping channels for global trade. Furthermore, Greece has close ties with Russia, Iran, and China and improved relations with Turkey – any of which would gladly welcome creating a new strategic relationship in the interest of procuring access to all Greece has to offer (not to mention its vast energy resources) by throwing them a financial lifeline.

Lastly, Germany and Angela Merkel know all too well that they just may need Greece in the EU more than Greece needs to be in the EU. You see, an exit by Greece from the Eurozone may very well establish a road map for other financially stretched Eurozone periphery countries (Italy, Spain, and Portugal) to embark upon some time down the road if they find themselves unable to meet the financial commitments of Eurozone membership. Yet, all of these debt laden economies keep a ceiling on the Euro currency relative to other currencies, therefore allowing the German economy to prosper on its superior manufacturing prowess and export dependence. Whereas if Germany were to go back to using the Deutsche Mark, its export competitiveness would quickly decline given the level this currency would trade at in the public markets.

From the Greek perspective, austerity has done little for the country other than mire it in seamless never ending state of depression and making it even more cumbersome to service its mountain of debt – let alone pay it off. None of the deals past or present ever offered the possibility of long-term stability or sustainability, they've been about lending more money to a country to pay off old debts while resetting the timetable on new debts – sounds a lot like a mouse stuck in a wheel destined to get somewhere, but never going anywhere.

The missed $1.7 billion debt payment by Greece to the IMF last Tuesday is merely a sideshow relative to the roughly $400 billion in total outstanding Greek debt which is a massive sum for a country with a population of around 11 million people. On this front, the people have spoken and adamantly voted 'no' (more than 60% is a landslide in almost any political circle) to the referendum over the weekend where Greek pride perhaps superseded financial acumen.

I've seen numerous media headlines over the last week indicating that this was a vote for Greek citizens to decide whether they wanted to remain in the Eurozone or exit, and I couldn't disagree more with this perception. This was a vote strictly on the issue of continued austerity measures that are being imposed on the Greek economy by the EC, IMF, and ECB in the latest deal. Read the referendum for yourself and please send me an email if I'm missing something:

> *"Should the proposal that was submitted by the European Commission, the European Central Bank and the International Monetary Fund at the Eurogroup of June 25, 2015, which consists of two parts that together constitute their comprehensive proposal, be accepted?"*

The stage is now set for the next act as the two sides attempt to hammer out a compromise with the next significant debt payment due by Greece to the ECB coming on July 20th. If a deal is not struck in short-order then the probability of Greece exiting the Eurozone dramatically increases as the Greek government is running out of money and fast. With banks still closed for fear of a run on the banks, capital controls in place, daily ATM withdrawals limited to €60, depositors worried about a "bail-in" of their balances (haircuts of as much as 30% on what they hold in the bank), and rumors of IOU's being issued for future payment, there is no doubt that the stakes are high for a deal to get done.

However, if the last several years have taught us anything about how European policy works, the missed IMF debt payment and referendum vote (remember the call by former Greek PM Papandreou to hold a referendum in 2011, where ultimately it was the bailout deal that survived while his political tenure did not) suggests that these maneuvers were just pawns being moved across the chess board – surely more negotiations lie ahead, but make no mistake this drama is reaching its climax.

I'll say one thing: you've got to give PM Tsipras some credit for bringing all of this to a head, as he was elected to push back against further austerity measures by the Troika and the latest proposal by them (which looked as though it would be accepted just last week) was for the most part more of the same. Tsipras knew he reached the end of the line in the latest negotiations and would not be able squeeze any more concessions out of the EU, yet he could not sign on the dotted line for a deal that carried with it considerable austerity measures given his election pledge to the contrary.

Perhaps the sun is now setting on his reign if he is unable to work out an agreement with the Troika before Greece's finances get even worse over the ensuing weeks. Given that the polling numbers suggest the majority of the Greek population would like to remain in the Eurozone, if Tsipras is unable to find common ground with the Troika and a 'Grexit' becomes a reality that could set the stage for his removal and his Syriza party. Tsipras knows this is the perception and he is also aware that he had no mandate for an exit from the monetary union, but this is how the chips so happen to be falling. Maybe this is the hope of the leadership officials in the EU and why they had little to say after the latest proposal was rejected while allowing this weekend's vote to run its course.

From a markets standpoint investors need to keep in mind that this situation is not about Greece's economic prowess, after all total U.S. exports to Greece amount to $770 million annually (0.004% of U.S. GDP) while on a global scale Greece accounts for 0.4% of the global economy. It's about the tertiary effects of a possible Greece exit from the Eurzone and what precedent such an event could set for the future of the Eurozone – these unknowns are what is causing the volatility in global capital markets and what markets are in the process of trying to price in. However, this isn't the first time in this bull market cycle that Greece was in the headlines, as similar headlines gripped the papers in 2010, 2011, and 2012 where on average we saw European equities correct 8% (as of the trading levels early Monday morning European equities are now down more than 10% from their recent highs).

What is different this time relative to past episodes is that the ECB is all in and Mario Draghi is on guard to stand by his call from a couple years ago to do "whatever it takes" to preserve the Eurozone. In my opinion it behooves investors to not underestimate the ECB's ability to circumvent the rules – kinda like the Fed did during the credit crisis with the "Maiden Lane" assets – to keep the Greek banks technically solvent in the name of ensuring financial stability. This is not Lehman Brothers part deux as Draghi has a bazooka that can prevent financial contagion risks to the rest of the European Monetary Union.

Greece, Puerto Rico, and China remain legitimate macro risks to monitor and risk assets are reacting in logical fashion by selling off, but I'm of the opinion that when you dig into the fundamentals of each of these macro factors, the fallout for investors with a time horizon beyond the next month should remain 'local' (meaning a further deepening of the Greece situation is bad mostly for Greece, Puerto Rico defaulting would be mostly relegated to the municipal bond market, and a continued weakening in the Chinese stock market would be relegated to Asia).

The U.S. economic data has been rather strong over the last month with positive surprises outnumbering negative surprises by a margin of two-to-one. Autos and housing are classic early-to-mid cycle indicators and these two industries are near (in the case of the former) or at (in case of the latter) cycle highs. Auto sales have topped 17 million SAAR now for three straight months. Jobless claims continue to remain at sub 300k levels, construction spending doubled consensus expectations last month – reaching a level not seen since October 2008, the latest consumer confidence data is closing in on its post-recovery high reached in January, inflation remains tame, manufacturing data via the latest ISM and PMI surveys has come off peak levels but remain at very solid expansion territory in the low 50's, and the employment backdrop remains in a "not too hot, not too cold" state as can be seen from the latest jobs report.

The June employment report was right in the wheel house for investors as the headline number of 223k jobs created was good for growth, but other parts of the report – like wages – were soft, which is good for corporate profit margins and may keep the Fed on the sideline for a little longer, which is good for liquidity. When looking at the employment report in totality, it was a bit disappointing. While the 223k in total payroll growth for June was only a little shy of the 233k consensus estimate, the 60k in backward revisions for the prior two months was less than constructive and was the first time we've seen downward revisions since February.

The unemployment rate fell to a new seven-year low of 5.3% from 5.5% in May, but this decline is a bit misleading given it was the result of a 432k plunge in the labor force and dragged the participation rate down to 62.6% to stand at its lowest level since October 1977. The broader U-6 gauge of employment fell to 10.5% from 10.8% in May and is at its lowest level since June 2008. However, somewhat negating the constructive move lower in the U-6 level was a dip in the employment-to-population ratio (a favorite indicator of Chair Yellen) to 59.3% from 59.4% in May.

All noise aside, and I am not being blindly dismissive of the major macro events that are currently playing out, but it's hard to ignore the fact that the S&P 500 is only 3% off its all-time high. I must admit that I'm rather impressed with the resiliency of stocks and the fortitude of investors to stay the course in what has been some rather dramatic headline risk. With the S&P 500 roughly flat on the year, fundamentals are set to play some catch up with where prices have been bid up to over the last three years of this bull market. Economic growth is tracking a 3-handle for the second and third quarter, earnings growth in Q1 were roughly flat and expectations for Q2 have been ratcheted down to -4.5% – setting the bar very low for companies to beat, and investor sentiment has been floundering with the latest Investors Intelligence survey showing the percentage of investors bullish on equities falling below the 50% threshold.

Fundamentals improving, low sentiment, and negative global economic headwinds – that's a good recipe for a rally if some of these variables surprise in a positive way. Anyone who's been reading this commentary through the balance of this year knows that I haven't been overly optimistic on the investment set-up for stocks or bonds for most of the year. However, that hasn't precluded us from staying the course with our investment strategies and making adjustments to take advantage of opportunities where we see value.

Full valuations remain a headwind for both stocks and bonds and continue to corral my optimism from getting more excited about the investment landscape. The Fed and other unprecedented central bank actions still remain a wildcard which also tempers my bullishness, but the set-up (in my opinion) going into the second half of the year has on margin improved over the last couple of months, not deteriorated. I'm not suggesting that investors should load up on risk and back up the truck, but having some skin in the game may be more rewarding in the second-half of the year than it has been in the first-half. Focusing solely on the headlines can cause many smart investors to lose sight of the forest through the trees.

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