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## "Greece has left the building"

For those of you old enough to recall the pop culture catch phrase, "Elvis has left the building," you may remember that it was used as a way of indicating to the audience that the star attraction was no longer playing encores. A not-so-subtle way to suggest to the crowd that it was time to disperse and go about their business. We wish there were some global public announcement that would help the world's media come to the same conclusion on Greece.

Thus far, Greece's exit (or "Grexit") from the Euro has been a non-event. At the end of the quarter, Greece's market is down a mere -2.3% for the year. While the first quarter was negative (-5.9%) the second quarter actually registered a positive return (+3.9%) when negative news flow was strongest. Greece makes up a paltry 1.8% of Eurozone GDP. In comparison to the U.S., Greece's ~$242B GDP would put it somewhere between Oregon and Louisiana in terms of production ($229B and $257B respectively). Greece represents approximately .3% of total world output. While Greece has a material amount of debt (~$353B) relative to its size, in 2010 and 2012, this debt was transferred from Europe's banks to primarily sovereign entities where it is dwarfed by other obligations.

Ever since Greece's referendum vote on July 5th, Greece's leadership has become more flexible with regard to the terms they're willing to accept. The Troika (European Central Bank, European Commission, and International Monetary Fund) has the benefit of time and resources on its side while the Greek economy (and populace) suffer due to bank closures. At the time of this writing, a new deal has been agreed upon, and the prerequisite reforms have been approved by Greece's parliament. Of course, they have approved reforms that have not worked in the past. Somewhat strengthening Greece's position is a recent announcement by the IMF "demanding" debt relief for Greece as a condition for a bailout. We tend to agree with this position and note that any deal that continues to "extend and pretend" is likely to fail in the long run. As former German Economic Minister Karl-Theodor zu Guttenberg quipped: "Europe hasn't been kicking the can down the road, it's been kicking it up a hill and wondering why it keeps rolling back on its foot."

Ultimately, the biggest concerns stemming from Greece are not related to fiscal-contagion a la a "Lehman

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moment" or the like; they are mostly political. As mentioned in our last review, Eurosceptic populism is making a run for greater influence in similarly strapped countries around the Eurozone. There is reasonable concern that should the Syriza party in Greece win lasting and meaningful concessions, other populist groups may feel emboldened and attempt their own referendums against austerity and potential Eurozone inclusion. We believe this is exactly why the Troika will continue to take a hard stance against Greece.

In November 2014, Mario Draghi was quoted as saying:

> *"It would be natural to reflect whether we have done enough in the euro area to preserve at all times the ability to use fiscal policy counter-cyclically. But it is also clear that such a reflection would have to be part of a larger discussion on how to reinforce common decision-making over fiscal policies and strengthen accountability arrangements. In other words, this could only take place in the context of a decisive step to a closer Fiscal Union."*

Effectively, with the exception of Germany, the rest of Europe has little control of their currency/monetary policy; over time, that has to be resolved one way or the other. We just do not see the equivalent of a civil war establishing the "United States of Europe" in any time frame that matters, so we doubt fiscal integration as practiced in the U.S. will prove to be the solution. We can't know how this will ultimately resolve—but we just don't see how the current situation is sustainable in Europe. Obviously the euro, and even the various European trade zones, are fairly young, and much time is likely to pass before Europe arrives at a solution one way or the other.

## Puerto Rico: On the road to Greece?

There is a similar situation going on to our south and east in Puerto Rico. Like Greece, Puerto Rico has huge unfunded liabilities, and like Greece they cannot print their way out of debt, nor declare bankruptcy. That leaves them a Hobson's Choice: default. What makes Puerto Rico unique is that they are neither a state nor an independent nation, but a United States territory. A Puerto Rican is technically a natural-born citizen of the United States and can cross to the mainland freely, with only limited challenges due to language. This facilitates a flight of the young and talented, which has had a deleterious effect on the island's productivity.

Like Greece, decisions on remedies are being determined by the creditor, in this case the U.S. Congress (where Puerto Rico has only non-voting representation). In June, Governor Alejandro García Padilla and Puerto Rican lawmakers passed a law that would allow for public utilities such as Puerto Rico Electric Power Authority to negotiate with bondholders to reduce debt. This law was successfully challenged by a number of investment funds that hold their debt, arguing that the U.S. Constitutional authority to determine bankruptcy laws confer to Congress and thus supercede the Commonwealth's authority. Despite this fact, Governor García Padilla has hired the former U.S. bankruptcy judge who oversaw Detroit's bankruptcy, Steven Rhodes.

There is some concern that Governor Padilla may attempt to invoke his right to protect the health and safety of the public and seek to divert revenue to essential services before servicing debt. We give him credit for being forthright: "There is no other option," García Padilla said, according to The New York Times. "I would love to have an easier option. This is not politics; this is math." Like Greece, adding more debt to an already unsustainable debt-load does not solve the problem.

## China: Investors heading for the exits

Another headline grabber for the quarter was the stunning gyrations of China's most prominent stock market, the Shanghai Composite. After holding between a value of 2,000 and 3,000 since 2011, the Shanghai market more than doubled from July 2014 to June 2015, reaching a peak value of 5,178.19. Since that peak, however, the Chinese market is down almost 30%—with high single-digit declines on an almost daily basis.

But as amazing as this volatility has been, the more significant issue to us has been the People's Bank of China's (PBOC's) ongoing efforts to manipulate market outcomes through a host of monetary and market-regulation changes. Over the past few months, the PBOC has cut short-term interest rates four times, relaxed margin requirements (e.g., allowing personal real estate as collateral), and encouraged direct equity purchases by state-run enterprises. Meanwhile, China's Securities Regulatory Commission has tightened regulations against shorting securities, frozen trade on over half the securities on the exchange, and vowed to go after "market manipulators."

Many pundits see these efforts as a sign of pending doom in China's economy; we see it mostly as a symptom of excessive speculation on behalf of Chinese nationals, and as a consequence of a heavy-handed Communist market regime. How can capitalism thrive and markets function efficiently when the rules are constantly changing? These types of policies will likely reignite concerns about the presumed slow and steady march towards a "free-market" China. That said, the fact that these gyrations have occurred indicate that "free-market" forces are beginning to get the upper hand. The political, read control, issues in China are at increased risk with the increased size and participation in these markets.

## Much Ado Redux

Despite all this "news," our last missive on the market entitled "Much Ado About Nothing" appears to be an appropriate moniker for the second quarter as well. That is, over the last six months, the S&P 500 has returned a paltry 1.23%, registering a .95% return in the first quarter and a .28% return in the second quarter. Even overseas equity markets, while relative winners, have seen similarly modest single-digit returns. Year to date, the MSCI EAFE, a cap-weighted index for Europe, Australasia and the Far East, is up 5.5% through the end of the quarter (up slightly more for non-U.S. Dollar investors).

It is useful to note that, as we often see in the market, last year's winners are this year's losers: Non-U.S. equities are beating Large Cap U.S. equities; Small Cap equities are beating Large Cap equities; non-interest rate sensitive industries like Healthcare and Consumer Discretionary are outperforming interest rate sensitive sectors like REITs and Utilities; and short-duration fixed income is outperforming long-duration fixed income.

In a recent paper written by our long-time consultant Ernie Ankrim, PhD (and recently shared with Halbert Hargrove clients) he states:

> *"As the US Equity Markets continue to reach new high values in May, many voices were calling for a correction. They may be correct. However, the indicators I offered here lead me to be more concerned about the fixed income portion of my portfolio than the 'risk assets' like Large Cap US stocks. The US economy is showing increasing momentum in a variety of indicators and the costs of*

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*'safety' may be double barreled. With interest rates rising and economic strength and confidence growing, these trends could lead to lower bond returns and higher equity rewards. Watch closely, we may not be going through anything that resembles NORMAL."*

Ultimately, we want to highlight that Ernie's take on the U.S. is at the very least "Neutral to Good"—in other words, it is not time to panic. With that said, generally speaking, the economy does not lead the market—it's usually the other way around.

We do not currently see any of these above-named factors suggesting a material adjustment to strategic allocations in our portfolios. If we see continued negative developments in these areas, in the aggregate, they could cause some weakness in risk-assets. As such, we continue to maintain a healthy representation in non-traditional investment arenas like volatility risk harvesting, non-market risks, and trend-following strategies in an attempt to diversify away from purely equity market risk.

These days, we are bombarded by a contemporary version of yellow journalism—except William Randolph Hearst is now Rupert Murdoch, and they're selling their Nielsen ratings, page views and hashtags instead of one-cent newspapers. The 24-hour news cycle would suggest that there's still plenty to worry about: U.S. economic weakness, QE divergences across regions, relatively high valuations in developed markets, rising rates, Puerto Rico, Greece, China: Lions and tigers and bears—oh my! As we've mentioned in prior Insights, however, the issues that everyone is talking about are rarely the issues that lead to significant surprises. And for the moment, Greece has left the building.