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GRECCIDENT OR GREXIT INVESTMENT STRATEGY JUNE 30TH, 2015

A Greccident:

The unexpected move by Greece's Prime Minister, Alexis Tsipras, to reject Europe's rescue package and call for a referendum on July 5, is what some call a Greek accident (or Greccident). Although it adds another layer of complexity to Greece's dire situation, we don't believe it will translate into a Greek exit (or Grexit) from the Euro Zone. Instead, we suspect the Greek population will vote in favor of the proposal and thereby weaken Tsipras hand in the upcoming negotiations. The immediate impact of the Greccident is that the Greek banks and stock market are closed during the week leading up to the referendum and that Athens will not make its €1.6 billion payment due to the International Monetary Fund (IMF) today. Their failure to pay does not automatically mean that the country is in default. Instead the IMF has about one month to decide whether to let Greece make the payment in arrears or actually call it a default. In the meantime though, on July 20, the country has to make a €3.5 billion payment to the European Central Bank (ECB).

Although Greece will be forced to implement further austerity measures going forward, the total fiscal rag in the Euro Zone is fading. The drag has come down from around 1.5% of GDP at its peak in 2012 to no drag in this year. With this headwind removed and the positive implications of (1) low oil prices (the Euro Zone produces almost no oil), (2) a weaker Euro which supports exports, and (3) the ECB's quantitative easing (QE) program, the European Union should be able to eke out at least a 1.5% growth print for the year. Therefore, we are inclined to use any upcoming market volatility due to the Greek negotiations to add to our European positions.

Three Steps and Stumble:

Three steps and stumble is an old saying on Wall Street meaning that equity prices typically fall significantly after the Federal Reserve (Fed) raises rates three times in a row. The first step, which by the way would be the first rate hike in more than nine years, will probably happen this fall, most likely in September. Considering the slack that still can be found in the economy and the soft inflation picture we expect this to be a very slow tightening cycle. For example, although the unemployment rate has come down to a more normal 5.5% level, the U6 "count" which includes those that are marginally attached to the labor force and those that work part-time for economic reasons, is still running almost 3% more than the prior cycle bottom. Similarly, the current capacity utilization level of 78.1% is well below its longer term average of around 80.5%. As a result, most inflation readings are still comfortably below 2% and therefore the Fed's overall monetary policy should continue to remain supportive for stock prices.

Now even if inflationary pressures from rising energy prices, average hourly earnings, and unit labor costs produce increases in inflation that are greater than currently expected, they do not necessarily translate into a major P/E ratio contraction. Instead, while history tells us that 0-2% year over year inflation is the sweet spot for US equities earnings, multiples typically hold up well in the 2-4% inflation range too. Furthermore, with the ECB set to continue its QE program at least through September next year and with the Bank of Japan (BOJ) in the midst of its QE program, the US dollar should remain strong and thereby dampen the inflationary impact of any unexpected price pressures.

Consumer Confidence:

Following the most recent increases in the personal income, personal spending, and consumer confidence data combined with the expansion of the household balance sheet and auto sales we are starting to wonder if domestic consumer spending finally has reached an inflection point. While the consumer confidence surveys have an uneven record of predicting future spending, we see the fact that auto sales have averaged above 17 million for the last three months as an indication that consumers are confident enough to buy big ticket items. Similarly, we note that household liabilities have increased three of the last four quarters also suggesting a more confident consumer. Furthermore, some of the early defaulters during the Great Recession are about to see their credit scores reset and concurrently there are tentative signs that the banks are easing their lending standards. Thus, we would expect to see some further improvement in consumer spending.

Chinese Market Volatility:

The Shanghai Composite finished the quarter with a more than an 11% intraday move. That move nicely sums up the volatility we have seen over the last year. By early June, the Index had risen by more than 150% in less than one year and then gave up around 20% over the next several weeks. Much of the recent volatility is due to momentum driven retail investors trying to anticipate the country's next policy moves. To that point, earlier this week the People's Bank of China (PBOC) reduced rates for the fourth time since November last year and lowered the reserve ratio in an attempt to boost economic growth. Simultaneously, policy makers are trying to restructure the country into an investment and consumer driven economy without slowing economic growth too much in the process. In addition, an external factor adding to the uncertainty surrounding China is the recent strength of the US dollar. Since China remains an export driven economy, and since the Renminbi is pegged to the US dollar, China's exports are facing significant headwinds. All in all, the Chinese market volatility has been mostly uncorrelated with the major global markets and we would like to see more of the speculative players exit before we build positions in China.

In short, neither the US economy nor the global economy are even close to being overheated, and as a result inflation continues to be modest world-wide, with a few exceptions. Looking forward, we see global economies as just beginning to recover their "economic" stride which had been broken by the global financial crisis. We believe we are in the 6th or 7th inning of the recovery, not the ninth, in spite of the fact that the recession ended six years ago. We believe the recovery will be an extended one because it has been so weak by historical standards.

What to Do?

We find the US market relatively fairly valued considering where we are in the business cycle. Having said that, we may add to our financial sector holdings as the yield curve continues to steepen. Many of the large banks generate about half their revenues from the net interest margin and even though the 10-year yield has risen a bit recently it is still nowhere near the nominal GDP growth level (which we consider a more normal level). And with a more confident consumer, loan demand should pick up. At the same time legal expenses from mortgage claims dating back to the pre-financial crisis era should decline.

In Europe, we look to use the upcoming volatility from the negotiations with Greece to add both European stock market indexes via exchange traded funds, and in some cases through high quality companies that stand to benefit from a weaker Euro (i.e. derive part of their revenues from outside of currency union). Given that much of the Greek debt is now held by the Troika (ECB, IMF, and European Commission) and that other peripheral countries are implementing structural reforms, we believe the contagion risk associated with Greece is significantly reduced from where it was a few years ago.

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