



Third Quarter 2015 Outlook and Commentary

The Great Recession that followed the 2008 financial crisis wreaked havoc with government finances around the world, causing budget deficits and debts to soar. Nowhere has the problem been worse than Greece. Twice in the last six years it appeared the country might default on its debt and be forced to exit the euro (a “Grexit”), a prospect greatly feared by global capital markets. Each time, the International Monetary Fund, the European Central Bank and the European Commission (the “Troika”) came together to bail Greece out.

Two bailouts have fixed little; anticipated reforms such as clamping down on tax evasion and privatizing assets proved elusive. Athens did cut spending sharply, but that caused the economy to shrink further. Eventually painful austerity led voters to embrace the radical Syriza party, which promised to force a better deal from creditors. After Syriza came to power in January talks with European leaders went nowhere fast, then veered into crisis mode late last month as the coffers in Athens began to run dry. Matters went from bad to worse when Greek Prime Minister Alexis Tsipras broke off negotiations to put the latest Troika proposal to a referendum. Since then, fears of a Grexit have gripped investors and most of the ups and downs in global stock and bond markets have correlated to twists and turns in the crisis.

By the time you read these pages the outcome of the standoff may be clearer. A €3.5 billion payment to the European Central Bank (ECB), due on July 20th, is likely to force a resolution if the ECB’s squeeze on Greek banks doesn’t do the job first. But as we compose this commentary in the initial days after Greek voters delivered a resounding “No!” to its creditors’ proposals, the picture is rather muddy.

In the wake of the stunning vote on July 5th it’s difficult to see how the two sides will come together. Tsipras may feel emboldened by having 61% of voters follow his lead in rejecting the demands of the Troika. The creditors, meantime, are still seething from Tsipras’s decision to break off negotiations. The ECB may be the most critical player in the days ahead as Greek banks are completely reliant on its emergency liquidity assistance program. The day after the referendum the ECB maintained Greek access to the program but increased collateral requirements. It’s not clear how long the banks can hold out. If the ECB squeezes hard enough, Greece will be forced to establish some sort of “scrip” to keep a semblance of an economy afloat, a step that may make a Grexit inevitable.

It’s a bit hard to know, perhaps even for the parties involved, what the two sides really want. Tsipras has been steadfast in saying that he isn’t looking for Greece to leave the euro—he just wants better terms on a third bailout. But the case for leaving the euro seems compelling. Greek GDP is approximately 75% of what it was before the financial crisis. Under continued austerity—and any deal that gets Germany’s blessing will include plenty of austerity—the recovery from that level will be painfully slow. The extent of Greece’s depression already rivals (exceeds by some accounts) the U.S. experience in the 1930s. Left inside the Eurozone there is no end in sight. As

painful as a departure from the euro would be (especially given the limited abilities of the Syriza-led government and the technical challenges involved), once armed with a new currency, Greece could allow/initiate a devaluation and quickly become competitive in export markets¹. The prospects for the Greek economy four or five years hence would be quite good. Knowing this Tsipras may want to have his cake and eat it too: escape the chains of the euro but appear to have been pushed out so that the hellish transition can be blamed on Germany.

From the perspective of pure economics a Grexit doesn't look terrible for the rest of Europe either. European banks have offloaded the vast majority of their Greek assets and are much better capitalized than they were five years ago. The ECB has developed a deep set of tools to contain any financial market volatility that might result and won't hesitate to use them. And as measured by GDP, Greece represents less than two percent of the Eurozone economy. Markets would need to be persuaded that Spain, Portugal and Italy won't be next in line but with the fiscal situations in those countries vastly superior to the mess in Greece, that seems doable. On that subject, many hard-liners in Europe believe that pushing Greece out of the euro would send a useful message to voters in those three countries about the risks of electing a radical party (Podemos in Spain causes conservatives particular consternation) that might veer from the fiscal straight and narrow.

Quantitative easing by the ECB has created a bit of momentum in the European economy. After some initial disruption from a Grexit, it's more than conceivable that growth would resume. On the other hand, even if the European economy did hold up in the wake of a Greek departure from the euro, there would be a longer term price to be paid. The integrity of the euro would always be a little suspect and fears of other departures would always lurk. In any case nothing about the euro or the broader European Union is a financial matter alone. For over six decades politics on a continent scarred by two world wars has been dominated by the effort to knit its disparate countries into an unbreakable union. Creation of a single currency was to be the piece de resistance in the "European project." The psychic toll of conceding a measure of impermanence in the currency union, no matter how limited, can't be dismissed.

In the event it left the euro, Greece would likely be able to remain in the larger European Union but that is harder to predict. Vladimir Putin would no doubt go to great lengths to secure a new ally. Given the radical nature of the Syriza coalition, Putin's overtures might have a receptive audience. German Chancellor Angela Merkel may have some sleepless nights in coming days as she contemplates the thought of Greece turning into a Russian puppet on her watch.

One irony of the current situation is how close the two sides were to a deal when Tsipras called the referendum. The areas of disagreement were primarily how pain would be divvied up between pensioners and businesses and whether there would be some element of debt forgiveness². As close as the two sides were though, they were also gripped by emotion. On the part of the Troika, as the spring wore on and discussions with the Greek government were long on lectures and short on specific ideas, exasperation turned to outrage. Tsipras, meantime, perceived Germany's hard-line position on repaying the debt in full as gratuitous humiliation. After months of stumbling that cast doubt on the government's basic competence, Greece finally delivered a

¹ The situation is arguably a bit more complex: a positive outcome depends to some degree on Greeks using the new currency. If the government didn't force a conversion of deposits in Greek banks, the economy might continue to run primarily on the euro even if it wasn't the country's official currency.

² Hard-liners such as German finance minister Wolfgang Schauble bristle at the idea of debt forgiveness. Thomas Piketty has pointed out the irony in this stance considering that Germany's path to economic power was based largely on a 1953 deal in which Germany's creditors forgave 50% of the debt it had accumulated over the course of two world wars. A key element of the forgiveness deal was linking repayment of the remaining debt to German exports, giving creditor countries a powerful incentive to buy German products and laying the groundwork for the export powerhouse that Germany has become. Come to think of it, this might be a good template for the situation in Greece, which, Piketty happily points out, was one of the creditors that forgave German debt 62 years ago!

concrete offer on June 22nd. The Troika viewed it favorably and responded with a heavily marked up counterproposal. In the discussions that followed Greek Finance Minister Yanis Varifoukas continued to bring up the idea of partial debt relief, a concession his team thought essential to getting the deal through the Greek Parliament. Finally, one of the lead negotiators, Varifoukas's Dutch counterpart, spoke up. "It's a take it or leave it offer, Yanis, the Dutch official said, peering at him through rimless spectacles.³" The creditors were shocked and infuriated when Greece interpreted "take it or leave it" literally and called the referendum that led to the current impasse.

Were it not for the drama playing out in Europe, capital markets might be gripped by the spectacular decline in Chinese equities over the last several weeks. After rocketing nearly 70% in around four months, the Shanghai Composite Index plunged over thirty percent between mid-June and early July. It's important to note that many Chinese equities are listed in Hong Kong ("H shares") as well as Shanghai ("A shares"). It is difficult for individuals outside of China to access the Shanghai exchange, and U.S. investors' exposure to China tends to come from the vastly more sedate Hong Kong exchange. By way of comparison, while A shares were soaring 70% H shares were up a much more modest 20%. The difference is accounted for partly by the inclusion in Shanghai of more speculative, faster growth companies, but also by investor behavior. With A shares we are witnessing the downhill side of a classic bubble.

The fact that the Shanghai exchange is largely walled off from other markets helps to limit concerns about any knock-on effects of the precipitous market tumble. Perhaps most worrying is that Chinese authorities appear trapped in a never ending cycle of market intervention. From infrastructure to housing to credit to the stock market, the government alternates between measures designed to stimulate and actions intended to restrain. The general trend of the Chinese economy has been deceleration from over ten percent GDP growth several years ago to seven percent more recently and most likely a bit lower right now. Even five or six percent growth should be enough to keep China from dragging down the global economy. With Shanghai shares still significantly higher than they were a year ago, it seems unlikely that the stock market swoon could have an impact of that magnitude. There are independent signs, however, that the slowing of the Chinese economy may be worsening. Most likely, actions in Beijing will prompt that to reverse but one does wonder when the cycle of herky jerky market intervention ends.

As discussed in these pages, U.S. stock market, and to a lesser degree equity market valuations around the world, look a bit stretched. It's been over three years since the S&P 500 had a 10% correction. That's significantly longer than the usual time between corrections, so we wouldn't be too surprised if the drama in Europe or the wild swings in Chinese stocks prompt a pullback.

With the possibility of Greece leaving the euro there may be some nerve-racking days ahead that raise the question of whether we will see a market free-fall akin to 2008. That seems very unlikely. Notwithstanding the possibility of a Grexit the global economy is on reasonably strong footing. U.S. GDP declined slightly in the first quarter but that was due to two temporary factors and a technical issue. The temporary factors were the severe winter in the Northeast and dramatic cutbacks in oil drilling due to a late 2014 price collapse. The technical issue is that, for whatever reason, since the Great Recession the seasonal adjustments that the Bureau of Economic Analysis makes in calculating GDP are broken, with first quarter growth consistently reported much lower than the remaining nine months. Meanwhile, the labor market continues to be very strong; job creation continues to trend above 200,000 per month while job openings are at the highest levels ever recorded. Wage growth is finally showing some halting signs of picking up, which is one reason why, in spite of the threat of a Grexit, U.S. Treasury yields are up significantly in 2015. We may sound like a broken record on this topic, but when the dust settles in Europe

³ Landon Thomas, Jr. July 2, 2015. "Hopeful Start to Greek Debt Negotiations Quickly Soured." *New York Times*.

(which could take several months in the case of a Grexit), we still expect rising interest rates to pose the biggest challenge to the U.S. stock market. For the time being, however, all eyes are on Europe.

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Boston, MA*

Late update: On July 12th, Greece capitulated to virtually all of its creditors' demands as part of a three-year deal. The plan has been ratified by the Greek parliament and other key legislatures. New funds were disseminated to cover Greece's July 20th payment to the ECB. Some details remain to be worked out but the plan appears likely to hold. Unfortunately, the painful process of forging a deal revealed deep divisions across Europe. There is a widespread view that Germany dealt with Greece too harshly, a sentiment captured by Italian Prime Minister Matteo Renzi's statement that "to Germany I say enough is enough." For its part, Germany, supported by many countries in northern and eastern Europe, is unapologetic; Wolfgang Scheuble, German Finance Minister and champion of the hard-liners, accurately but rather provocatively, commented days after the deal had been reached that perhaps Greece would be better off leaving the euro after all. The emerging rift may not lead to a crisis any time soon but it will likely fester.

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