Investment Perspective

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CAPITAL MANAGEMENT

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THE MUDDLING OF THE BULLS

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Vote slowly

The third year of a U.S. presidential cycle is typically characterized by robust stock market performance. Yet equities have made little progress so far in 2015. In fact, according to Ned Davis Research, we have just witnessed the worst start for any pre-election year since 1947.

It is also unusual that stocks have remained in such a tight trading range. At no point during the first half of the year did prices for the S&P 500 move 5% (up or down) from the starting point. In the post-World War II period, stock prices have been this "quiet" only three other years.

So what could be going on? It is hard to find much conviction among the investment community. From concerns about Greece's potential European Union/euro exit, to changing Fed policy, from sluggish corporate earnings growth to high(ish) stock valuations, investors have a lot to digest.

Tough or tired?

On one hand, stocks seem to have hit a ceiling, but on the other, the major averages are within striking distance of all-time highs. Are we witnessing a *resilient* stock market or one that is *exhausted*?

Watching the Greek drama unfold, seven years after the nadir of the global financial crisis, is like attending a play that never seems to end. Media and financial outlets, bloggers and tweeters have all been consumed by the Greek crisis.

For the Greeks themselves, this is indeed a tragedy. They must feel like the mythical King Sisyphus, condemned for eternity to carry a boulder up a hill only to see it roll back down. The country's fiscal position had been stabilizing, but the social costs of IMF-mandated austerity programs have been severe. Unemployment remains above 25%. The election of Prime Minister Alexis Tsipras and his Syriza party in January has led to a pushback. In a July 5th referendum, Greek voters rejected the bailout plan proposed by creditors.

Greek dominoes

So the deadlock between the Greek government and European counterparts has rattled investors. But in terms of economic heft, Greece is to the Eurozone as Atlanta is to the United States. The real risk of a Greek implosion involves its *indirect* impact on the European banking system and capital markets; specifically, the threat that Greece could prove the spark that causes a bank run and liquidity freeze in other countries with high debt-to-GDP levels (e.g., Italy and Spain). If one of those larger, more economically connected nations should come under duress, things could get ugly.

That outcome seemed a distinct possibility back in 2012 during the last sovereign debt flare-up. At the time, as yields on Greek government bonds spiked, so too did those for other peripheral countries. For instance, the spread (difference) between yields on 10-year Spanish and German bonds widened by 3 percentage points, with the yield on the former rising to over 6%. Bond markets signaled the threat of contagion.

Besides possible wider financial stress, a Greek exit from the euro would further call into question the sustainability of a common currency across such disparate economies and cultures. Political turmoil on the continent could then feed through to business and consumer confidence.

Buffer zone

Today, yields on 10-year Spanish and Italian bonds stand at about 2.3%, right around corresponding U.S. Treasury rates. Their spreads have in fact widened vs. the German bund, but only by about half a percentage point. So bond markets are implying a bit more credit risk, but nothing substantial.

The difference is that the European Central Bank now has initiatives in place, including a bond-buying program, to support EU members' liquidity needs and keep pressure off sovereign debt markets. Aggressive monetary policy will likely stay in place for several more years, acting as a backstop for the regional economy. Additionally, because the vast majority of Greek debt is now held by public institutions, the hit to private-sector balance sheets of a default should be limited.

Deeper and deeper

It is hard to envision how the Greek conflict will end. The country cannot hope to repay all of its public debt; at some point debt-holders must recognize that reality and write it down. The dilemma is not unlike the struggling individual (often self-imposed) who pledges the title to his car for quick relief, then must continue to borrow more to meet the repayments. Sooner or later the car is repossessed. Good luck getting to work to earn income to repay *any* of the debt.

And despite the posturing by both sides, the path for a Greek exit from the European Union and/or euro has no precedent. There is no mechanism to arrange for an exit, because the founding fathers failed to envision it. Any break would have to be negotiated, and that could take years. Absent a break, an agreement must ultimately be reached to balance debt relief with cutbacks. The Greeks need more time to extricate themselves from this mess assuming they are willing to take some medicine to do so.

Looking up elsewhere

With all the focus on Greece, few pundits are talking about the gradual improvement in the broader euro area economy. Eurozone growth rose to a four-year high in June, according to the Markit Purchasing Managers' Index, with continued strength in new orders and employment. The International Monetary Fund forecasts growth of 1.5% this year, twice the rate of 2014. The stimulus from the European Central Bank has kept interest rates low and weakened the euro. The more competitive currency in turn has aided exporters while discouraging imports.

Meanwhile, in the United States, economic growth appears to have picked back up after a weak, weather-influenced performance in the first quarter. This same phenomenon occurred in the first three months of 2014. Nevertheless, the pace of growth is still mediocre, particularly considering how much time has passed since the recession ended. The IMF now sees U.S. output expanding 2.5% in 2015, down from an expectation for 3.1% growth as recently as April.

Chinese bubbles

As for potential disappointments, China may be the region to watch. Like the U.S., the Middle Kingdom seems to have hit a soft patch. Economic growth has been slowing and could come in at the lowest rate since 1990. Between mid-June and early July, Chinese stocks had an epic meltdown. The Shanghai Stock Exchange Composite Index dropped 28%, wiping out $4 trillion of market value. Note, however, that the index is still up 80% over the year, even after that plunge. Clearly, mainland-traded Chinese equities have been in a bubble, propelled mostly by smaller retail accounts. There is a chance that market weakness could flow into the underlying economy.

Investors have lamented the recent decline in U.S. corporate earnings, but that too should be qualified. In the aggregate, S&P 500 earnings fell 5.5% during the first three months of the year. But the sharp drop in profits by the energy sector has overwhelmed growth in other sectors. J.P. Morgan estimates that first quarter EPS growth for the S&P 500 was actually up a respectable 8.5% outside of the energy group.

Early July marked the annual feast of San Fermin, the patron saint of Spain's Navarre region. Most know the 9-day event for its *Encierro*, the famous running of the bulls in Pamplona. With great exuberance and much risk to their own well-being, young men race ahead of the charging bulls as they run 900 yards from the corral to the bullring.

Mulling the midsummer muddle

Investors do not seem to be sharing such exuberance. The American Association of Individual Investors surveys its members for their views over the following six months. Recent readings indicate that the proportion who are "bullish" is at low levels not seen since the financial crisis.

Merrill Lynch's measure of institutional investors' sentiment also points to wariness with Wall Street strategists' recommended equity allocations at relatively low levels. These gauges of investor sentiment, however, often serve as contrarian indicators. In other words, broad-based investor pessimism can actually be a welcome sign for stocks.

So in light of all the headlines that could pop up on a given day, the U.S. stock market has been fairly resilient — and probably more so than many realize. That is not to say that stocks will not undergo a temporary pullback sometime in the foreseeable future. But absent a global economic downturn or a surge in interest rates — both seemingly remote possibilities — stocks should continue to muddle along.

— Christopher J. Singleton, CFA, Managing Director

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