U.S. Stock Stable in Wake of Greek Storm

As the first half of the year drew to a close, the stock market hit a patch of turbulence and heightened volatility in the wake of renewed fears for a Greece exit from the Eurozone and the bursting of the Chinese equity bubble. While these two international developments took center stage over the last few weeks and offered an already-jittery market cause to pull back, the fundamentals here in the United States remain solid and support a continued positive outlook for the balance of 2015.

It should not come as any surprise that Greece is an economic mess. At 173% of GDP, Greece's $390 billion debt burden dwarfs its $225 billion economy. Government spending accounts for 50% of Greek GDP with pension benefits alone representing 15% of GDP. The country's tax collection system operates like a black market and is rife with corruption. While Greece represents a mere 3% of Eurozone GDP, it holds much more geopolitical weight due to its strategic gateway location and vast natural gas assets. With all the political posturing and brinkmanship, the lurking threat of Chinese and Russian influence gives the Greeks considerable bargaining power.

Indeed, Prime Minister Alexis Tsipras was able to negotiate a fresh $96 billion bailout that will also include some form of debt restructuring or "reprofiling". By calling for the "no" referendum that preceded the present deal, Tsipras was able to build broad political support in part by showing his people what a *Grexit* might look and feel like. As the EU temporarily withdrew its support, Greece soon grappled with capital controls, bank closures, economic devastation and calls for humanitarian aid. While it remains to be seen whether Tsipras can actually deliver the pension overhauls and sales tax increases required by this latest deal, the worst case scenario has again been taken off the table, at least for now. Until such pro-market structural reform that reshapes Greece's economy away from government entitlements takes hold, this is a Greek drama destined to be replayed.

As for the collapse in the Chinese stock market, it is still too early to predict any potential shockwaves that may impact the global economy. For now, the damage appears to be contained and the Chinese government seems willing to do what it takes to keep it that way. That the approximate 30% decline in Chinese stocks since mid June wiped away $3.5 trillion of value is testament to how massive the Chinese economy has become. After all, this $3.5 trillion loss of wealth is greater than the entire economy of India. While this loss is substantial, the Chinese stock market is still in its relative infancy and represented only 30% of Chinese GDP at its peak compared to other industrialized countries where the ratio of stock market capitalization to GDP typically approximates 100%. Equities are held by only 7% of the Chinese population and comprise only 15% of total household assets. While margin debt played a substantial role in financing the bubble, margin debt represents only 1 ½ % of assets for Chinese banks. American exports to China are $124 billion or 7.6% of total exports, so our direct exposure is important but manageable if China's economy were to suffer a serious pullback. Finally, foreign investors own less than 2% of outstanding Chinese shares.

The whirl of events in Greece and China have all eyes riveted on Janet Yellen and the timing for the Federal Reserve's long anticipated first rate hike. In a closely monitored recent speech, Yellen stated that she "expects it will be appropriate at some point later this year to take the first step to raise the federal funds rate and thus begin normalizing monetary policy". In that same speech, she also made sure to "emphasize that the course of the economy and inflation remains highly uncertain, and unanticipated developments could delay or accelerate this first step". In addition to Yellen's dovish comments, recent minutes of the Fed's June meeting reveal concern over the potential spillover effect of Greece and China on the global economy. After the June minutes were published, expectations for a September rate hike have greatly diminished. The fed fund futures market now expects a rate of only 0.75% by the end of 2016, an expectation of only three quarter point hikes over the next eighteen months. The odds favor the Fed to remain highly accommodative for the foreseeable future.

Meanwhile, fundamentals here in the U.S. remain sound. The private sector has been adding new jobs at a 2.5% annualized rate over the last four years and that pace has continued in the first half of 2015. New mortgage applications have risen 15% in the past three months and home prices have risen over 30% in the past three years. The U.S. consumer is in fantastic shape with credit card debt down to only 4.5% of personal income and bank savings deposits approaching a remarkable $8 trillion. Total household leverage has dropped from a high of 22% in 2009 to 15% today which approximates the same percentage of leverage going all the way back to 1990, and U.S. household net worth recently reached a new all-time high of $84.9 trillion. Banks are rock solid with $2.5 trillion of excess reserves and Corporate America boasts over $1.7 trillion cash on its collective balance sheet. Inflation remains subdued and has been running at approximately 2%. And the important ISM manufacturing and services indices indicate continued modest growth for the remainder of the year. That the yield curve has steepened in recent weeks in the wake of global turmoil increases our confidence that the risk of an imminent U.S. recession is low.

As seemingly countless candidates enter the campaign fray to become our 45th President, Greece serves as a stark reminder of how excessive debt can cripple a nation. Since the Great Recession of 2008-09, the U.S. economy has managed to plod along with modest 2% growth as government expenditures have shrunk from 25% to 20% of GDP, now only 40% of the ratio in Greece. Federal government spending has remained flat over the last six years as tax revenues have risen sharply and the federal budget deficit is now down to 2% of GDP from 10%. While the current trends are encouraging to be sure, we are hopeful that the coming Presidential campaign cycle includes thoughtful consideration of additional fiscal measures (corporate tax reform, entitlement reform, capital gains tax reduction) that might stimulate growth, reduce government expenditures and more rapidly reduce our debt burden. With the Federal Reserve set to normalize interest rates over the coming years, fiscal stimulus will become increasingly important for the U.S. economy.