<u>Monthly Outlook: July, 2015: "Deal or No Deal"</u>

Traders and the news media appear to be ***fixated*** on the perpetual crisis in ***Greece,*** a "market meltdown" in China and the interminable negotiations between the ***U.S.*** and ***Iran*** on nuclear arms. It's times like these when we wish the different sides were participants on the television show ***"Deal or No Deal"*** where an agreement had to be reached within a one-hour time slot – making life so much easier for the rest of us! Unfortunately, that is not the real world. In the real world, deals are hammered out just as the clock strikes Midnight (***or even later***), and the consequences of miscalculation are infinitely more ***substantial***.

US economic data have, on balance, been reasonably positive: The Department of Labor reported that the economy added ***223,000*** nonfarm jobs in June. Although weaker than expected (consensus expectations were for 230,000) the second quarter's average monthly payroll gain of 221,000 was ***much better*** than first quarter's 195,000; this is in spite of ***unusually large revisions*** to May and April's numbers which resulted in a downward revision in aggregate of 60,000 jobs. Average hourly earnings were flat on a month-to-month basis and wages were up 2.0% over the past year.

The bulk of employment gains during June were in ***professional and business services*** (+64k), health care (+40k), and retail trade (+33k). The mining sector continued to ***detract*** from employment growth, losing another 4k jobs, and off 71k since December 2014. The unemployment rate dropped two-tenths to 5.3%. However, this number by itself masks the weakness exhibited in the labor force participation rate, currently at 62.6%, long-term unemployment (at 2.1 million) and the more robust unemployment measure, the U-6, at 10.5%. The ***degree of softness*** suggests that the labor market is on an improving trajectory, albeit at a slow pace.

We keep waiting for consumer spending to pick-up especially in light of the decline in gasoline prices, but so far this has been ***elusive***. Instead of increasing spending at retail stores, consumers seem to be paying down debt, or increasing their "savings". The catalyst for stronger consumer spending will either be ***higher wage growth***, or improved confidence among consumers and businesses. Data from the manufacturing sector continues to show ***modest growth***, as implied by the Institute for Supply Management's manufacturing composite index. The improving trend has been in place now for ***30 consecutive*** months.

First quarter U.S. GDP was revised to ***-0.2%*** from a previous reading of -0.7% (q/q, saar). The third and final estimate will come out later this month, but expectations are for no change to the -0.2% number. As explained before, the main drivers of the negative growth in Q1 can be attributed to a harsh winter in many parts of the country (which seems so far away given our current summer temperatures!), west coast port strikes and a stronger dollar. We remain optimistic that 2Q GDP will come in stronger than expected – suggesting a better trend in GDP growth going forward.

Earnings season begins anew this week: Expectations for second quarter earnings are for a ***decline*** of 3.0% – 3.5% on a year over year basis. While we expect earnings growth to generally soften, we think analysts are being ***overly pessimistic*** and managements seem to be biasing expectations downwards as well (this by the way, appears to be standard operating procedure). For all of 2015, earnings of S&P500 companies are expected to grow a paltry 2.2% according to current consensus estimates – a low bar indeed!

In June's Monthly Outlook we made a ***not-so-gutsy*** call that the ***stock market "bonanza"*** taking place in China was ripe for a sharp pullback, and in the past month that is exactly what happened. The Shanghai and Shenzhen composite indexes are down 32% and 38%, respectively, over the past month, at the time of this writing. Of course both indices are still positive for the year to date period, but the recent sell-off has ***spooked*** the Chinese government into action.

For an ***anti-thesis to a free market system***, just look at China: The central bank cut interest rates and also lowered reserve requirement ratios for banks to attempt to stop the panic selling, but to no avail. The finance ministry then took the additional step of ***banning*** the selling of stocks by pension funds. Authorities also postponed a number of initial public offerings. And earlier this week, China banned the use of terms such as "equity disaster" and "rescue the market" in internet forums and news outlets.

Will all these moves stave off a market collapse and restore order? Perhaps. While the Shanghai and Shenzhen stock exchanges have rebounded recently, we suspect that the final chapter in this saga has not yet been written. Much of the outcomes are also inextricably linked to the success of the Communist Party and their ability to continue to hang on to power even in the face of many of their citizens ***adopting western ways and capitalistic ideals***. In our considered opinion, ***"managed capitalism"*** is an oxymoron that is unlikely to end well!

A game of ***destructive brinkmanship*** is being played between Greece and its creditors. Last Sunday, Greek citizens went to the polls and voted ***"OXI"*** (which is "***NO***" in Greek) to the terms of the country's bailout offered by its creditors (including austerity and extending the maturity of Greek debt). The results of the referendum were ***unexpected***, as more than ***61%*** voted "NO" despite much of the business community championing the cause of ***"Nαe"*** (or ***"Yes"***).

We wonder if Greek citizens actually knew what they were voting for: The referendum question was quite ***convoluted*** and the referendum itself was hastily called for by Prime Minister Alexis Tsipras. The "NO" vote also pushes leaders of the EU to a ***point of "no return"*** – as the patience of creditors continues to wear thin – especially since the behavior of some of the Greek leaders has been obtuse to say the least!

We still think there is a possibility of ***some sort of deal***, but failing that, Greece could ultimately be kicked out of the EU and forced to revert to the Drachma as its currency at a much lower value (perhaps a discount of upwards of 50% to the Euro). The ***consequences*** of Greece leaving the Euro and the EU would be devastating to that country. Greece simply has ***too much debt*** to be bailed out by the rest of Europe. Besides, the government has failed to cut pensions for public workers, increase tax collections, or privatize government enterprises – all laudable objectives, but would warrant tough ("almost suicidal") political steps.

The interminable negotiations between the U.S. (and five other nations and the EU) and Iran on a framework for peaceful nuclear development continued with ***another deadline*** set for this Friday. Whether a deal gets done at all does not matter: What matters is whether Iran (a known state sponsor of terrorism) will change its stripes and become a model citizen of this world. More important, what matters to investors, is the impact on the price of crude oil. It is ***impossible*** to know with ***much certainty*** how this will all play out, but we continue to watch the events unfold, and seek to capture underpriced assets if and when an opportunity arises.

Lots of movement, but little headway… that phrase seems to sum up the first half of 2015. One thing is certain: There are lots of uncertainties and with uncertainty comes higher volatility. It is understandable to be worried about volatility returning to financial markets – lulled as we have been by all the excess central bank liquidity sloshing around in the global financial system. However, we believe that ***volatility presents opportunities*** and our niche managers are well positioned to be able to navigate these tumultuous waters providing our clients with a ***better risk/return profile*** over the long haul.

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