Market Commentary
When Winning Looks Like Losing

"If we are victorious in one more battle with the Romans, we shall be utterly ruined."
Quote attributed to Pyrrhus after the Battle of Asculum (279 B.C.)
Plutarch, Parallel Lives: Pyrrhus

Greece reached the peak of its cultural influence and global power in the Hellenistic period that began with the death of Alexander the Great in 323 B.C. and ended about three centuries later with the emergence of the Roman Empire. Arts, science, mathematics, architecture and philosophy all flourished during this glorious age. Greek culture and language were vigorously exported through waves of colonization in Africa, Europe and Asia.

Global dominance came through conquest. Greek King Pyrrhus was one of early Rome's strongest opponents. His highly successful battles with Roman legions were sometimes achieved at a very heavy cost, however. That's where the term Pyrrhic victory originates.

Today, it looks like Greece is relearning the lessons of history. Recent news out of Europe strongly suggests that the best the country can hope for is a Pyrrhic victory in its negotiations with creditors.

If you're the Greek prime minister threatened with renewed austerity measures and denied explicit concessions on punishing levels of debt, what do you do? You sidestep your responsibilities and call a referendum, of course. This may be a case of brinksmanship – a ploy to push Greece's hardline creditors into blinking at the eleventh hour. Or, perhaps Greece is fundamentally questioning its place in Europe. Regardless of motivation, talks aimed at resolving the crisis have broken down and the situation is now in uncharted territory. The odds have risen that Greece will leave the eurozone.

All U.S. Signs Positive

May's bounce back in U.S. non-farm payrolls was encouraging, given some questions about the strength of the labour market after a soft first quarter. Wages are one of the key metrics that the U.S. Federal Reserve (the Fed) watches closely. Wage growth is picking up, a positive sign because higher wages bolster consumer spending. The numbers indicate personal spending has ticked up. This points to a greater chance that consumers will drive growth in the second half of the year. If

households start spending the money they saved on cheaper energy prices, U.S. corporate profitability should increase across consumer sectors of the economy.

Higher wages could pose a threat to corporate profit margins. A rise in productivity over the last couple of months appears to be preventing margin contraction, however. In fact, expectation is growing that margins will expand again by yearend after a couple of quarters of contraction due to the greenback's strength. Therefore, it's not unreasonable to expect earnings growth to be in line with the 6% to 8% longer-term trend that supports positive equity returns.

Could the Greek crisis impact U.S. monetary policy? At most, escalating events in Greece could delay the timing of the long-awaited rate increase. The risk of contagion to the U.S. is remote. Direct links to Greece are miniscule. U.S. exports to the European Union as a whole make up only 1.5% of GDP. The U.S. could even benefit from a breakdown in Greece: since U.S. treasuries would be in demand as a safe haven, this would effectively lower yields and borrowing costs. Ultimately, the Fed is going to base its rate decision on domestic economic data and fundamentals. An increasingly buoyant labour market and a pick up in inflation pressures make it hard for the Fed to justify keeping interest rate policy at emergency low levels.

Just to keep things interesting, in late June the U.S. territory of Puerto Rico announced that its debt load is unpayable. The timing was impeccable. Bond and stock market liquidity tends to be a bit thinner just ahead of the July 4 weekend. You can bet that credit markets will keep a close eye on peripheral municipal bond spreads in the U.S. The first hint that this could become a "mainland" problem will likely prompt the Fed to dial down any hawkish language about a September rate increase.

Europe – Has Greece Packed its Bags?

To no one's surprise, Greece failed to make its €1.6 billion June payment to the International Monetary Fund (IMF). The consequences of this are a bit confusing. On the one hand, Greece is now formally in arrears and cannot receive more financing. Yet, the missed payment is not likely to be treated as a credit event and should not trigger a default on Greece's other debts.

It's more concerning that Greece's second bailout programme from the European Financial Stability Facility has expired. The country is now without a support programme for the first time since the crisis began in 2010. That's a funding loss of €16 billion.

The Greek government's response was to ask the European Stability Mechanism for a new two-year loan programme worth €29 billion, with previous loans to be restructured and extended to avoid a default. The trade-off in this overture is significant. Greek Prime Minister Alexis Tsipras has conceded

that Greece is now prepared to accept almost all of the conditions imposed by creditors in the latest round of negotiations – with the exception of imposing a full VAT on Greek islands.

Greek voters must be scratching their heads. The government previously refused to engage in further bailouts, but has now structured a deal materially different from that which is proposed in the upcoming referendum. The move is likely intended to appease the ECB's Governing Council. The Greek government needs the ECB to maintain its support for Emergency Liquidity Assistance to Greek banks. If the referendum results in a Yes vote, it's not likely that the ECB will pull the plug on Greek banks in the near term.

Is a deal likely? It's certainly possible, but we can't assume creditors will accept a new two-year bailout – even though Greece agreed to cut pensions. Previous financings and minor debt restructuring make the challenge appear quite simple: the debt must be made sustainable. That seems improbable without a material debt write-down.

China's Economy Signals More Weakness

Sharp declines in Chinese equity markets are causing concern among policy makers there. During the last year, the Shanghai exchange soared by more than 150%, one of the world's fastest run ups. That was followed by a dramatic dive of 28% from its mid-June peak.

The concern goes beyond the desire for capital market stability. Equity markets are seen as an important policy tool to raise money for state-owned companies instead of using debt to raise capital. By month end, policy makers had not only made another cut to benchmark interest rates but also cut the required reserve ratio for some banks. While their explanation was consistent with the reasons for previous rate cuts – the desire to lower interest costs and improve distribution of credit – it was clear their motivation this time around was to help stave off slumping stock markets.

Past experience has not been kind to this strategy. The lesson from China's last equity bubble is that policy interventions tend to be short-lived once sentiment sours. Chinese equity markets are highly leveraged. The potentially bigger impact to the economy is that defaults on margin loans triggered by stock market losses could lead to two negative outcomes: increased risk to margin lenders and a seize up of credit markets. The government has tools to effectively respond, but the outcome would likely disrupt both markets and the economy.

Meanwhile, China's economy continues to slow. The persistent decline will no doubt keep commodities, particularly industrial metals, on a downward path.

Canada Waits for a Rebound

The 0.1% month-over-month decline in April's GDP was unexpected. Earlier economic figures were also revised downward, albeit slightly. That is the fourth monthly contraction in a row and the fifth in six months. The oil price shock appears to be larger than the Bank of Canada first assumed. A slowdown in resource extraction is mostly to blame for the sluggishness. Manufacturing activity also declined, which is a bit tougher to take. Given the benefit of a meaningfully lower dollar, export-driven manufacturing should be doing better.

Both residential and non-residential construction is showing signs of cooling as well. Not surprisingly, further slowdowns occurred in the energy-dominated engineering segment. Alberta's newly elected New Democratic Party majority is not making things any easier for the beleaguered energy sector. The government plans to forge ahead with corporate tax-rate increases and a review of crown oil and gas royalties.

We expect economic activity to pick up in the second half of the year as the U.S. expansion continues. Our forecast still calls for real GDP growth of 1.5% in 2015.

Our Strategy

Global equity markets retreated modestly in June, with North American indices down about 2.0% to 3.0%. Not surprisingly, the decline on European exchanges was a bit more pronounced.

We have no direct exposure to Greece in our international equity holdings. Indirect exposure, through the multinationals that sell to Greece, is negligible.

In June, the Canadian bond market behaved a lot like it did in April and May: shorter maturities again outperformed mid- and longer-term maturities. Short-term, investment-grade corporate bonds performed well.

Our investment strategy continues to favour equities across most portfolios. While equities are not inexpensive, bonds yields remain relatively low. Our preference toward stocks remains in place. We are watching the growing risk that the U.S. will raise interest rates as its recovery slowly gains strength. Our fixed income strategy continues to be defensively tilted toward shorter maturities in anticipation of a rate increase. We remain overweight in investment-grade corporate bonds to take advantage of the slightly higher yields those bonds offer, with an emphasis again on shorter, defensive maturities.

June's oil prices mimicked May oil prices, tending to stay within a band of about $4 to $5 and closing the month just shy of $59.50. These prices aren't high enough to stimulate new investment activity in the oil patch; the Alberta economy continues to slow.

The Last Word

Military strategy in the time of Pyrrhus was pretty simple: infantry advanced down the centre, the cavalry supported on the flanks. Gaining the high ground offered a strategic advantage. And it was pretty crucial not to be outnumbered, given the hand-to-hand nature of the encounters. Most engagements were settled quickly; the Battle of Asculum was over in two days.

Resolving all of the outstanding Greek debt problems will take a bit longer than that. Leaders on both sides will need intricate and well-executed strategies to produce a successful outcome.

Normally, a problem just gets worse if you delay dealing with it. In the case of Greece, though, kicking the can down the road actually helped. Spain and Italy had time to shore up their economies. As a result, they are less vulnerable to contagion. Policy makers in Europe have worked hard to cordon off the problem in Greece. Current bond spreads for most periphery countries indicate that, at least for the time being, the fence is holding.

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