Trojan Horses Couldn't Drag Me Away

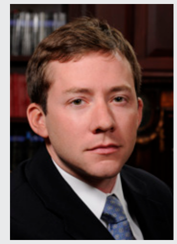
By Richard Thies

As the story goes, frustrated by a 10-year endeavor to enter the city of Troy, the Greeks, led by Odysseus, devised a final effort to pass the city's impenetrable walls and reach the beautiful Helen who rested within. The Greeks appeared to have given up the struggle and conceded, leaving the now-famous wooden horse behind as a tribute to Athena. The Trojans, who would never desecrate such a tribute, brought the horse into the city, helping to seal their fate. What actually sealed their fate was the supposed excessive drinking and celebrating that accompanied what they thought was the conclusion of a long-fought war, leaving them to lose that night to a force that was minute enough to fit inside a wooden horse.

The parallel of this story to our current situation, including the ever-appropriate 'beware Greeks bearing gifts', depends on your perspective. The German position would have benefited from a little more humility and a little less celebration as Greece stumbled its way toward a eurozone exit. The Greeks were ultimately vindicated by their seemingly insane decision to have a referendum, proving that the best strategy when you're out of palatable options is to do something insane (see: wooden horse with people in it). Most importantly, for us as investors, the message is to not be distracted by the fascinating spectacle of the Greek Trojan horses but to maintain focus on the things that matter when far more important issues are bubbling just below the surface across the world.

The most recent episode of the Greek story does have important implications. They just aren't, in our view, about whether a country with an economy smaller than our fair city of Chicago will leave the eurozone. The first is that while we agree with Germany's frustration with the Greeks and their correct (in our view) assumption that a 'Grexit' scenario would not be that disruptive for financial markets, German political leaders failed to learn one lesson from the Greek history, which is the danger of hubris. Specifically, their brash confidence and what appeared to be a desire to punish the Greek government following the referendum, alienated many countries—many of whom internally wonder if they could be next—thereby costing themselves the opportunity to kick Greece out. The Germans clearly view a Europe without accountability and fiscal control to be much more dangerous than a Europe that has to endure a Grexit, but yet, they now have the former.

Secondly, this episode raises the obvious question of what it might possibly take to get kicked out of the eurozone. If requiring several bailouts, not completing the program goals, insulting the donor nations, and finally, negotiating in very bad faith prior to surprising the eurozone political leadership with a referendum at a time when the European financial system is strong enough to withstand the volatility is not enough, then nothing is. That, in itself, is a good thing. The supposed 'sanctity of the euro' crisis risk is not real, in our view. It also means that fiscal policy (the biggest drag



About the Author

Richard Thies is an assistant portfolio manager. He provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. Also, at the request of portfolio managers and analysts, he provides in-depth analysis of specific events and potential scenarios at the region, country and sector levels.

to growth from 2010-2014) will ease even more than expected in the coming years as governments will correctly fear the effect of too much austerity. The likelihood of a 'good' country voluntarily showing itself to the exits is now higher than a non-peripheral country (Greece excluded, of course) getting the boot over the next several years. On the less positive side, and much more importantly, it lessens the likelihood that the ongoing push for structural reforms in Europe maintains its pace. Reform has already had a big effect on those countries that have actually engaged in it, and is a reason that Spain and Ireland are doing so much better now.

Finally, something much harder to handicap is how this episode has highlighted the fundamental breakdowns that eurozone membership causes on democracy—specifically, with members of the European core ostensibly campaigning for the fall of an elected government in a peer nation. This is a poor precedent and makes one wonder if Germany really wants the latest Greek deal (and future debt reduction) to be enough to set the latter on a sustainable path, given the signal it would send to other profligate governments.

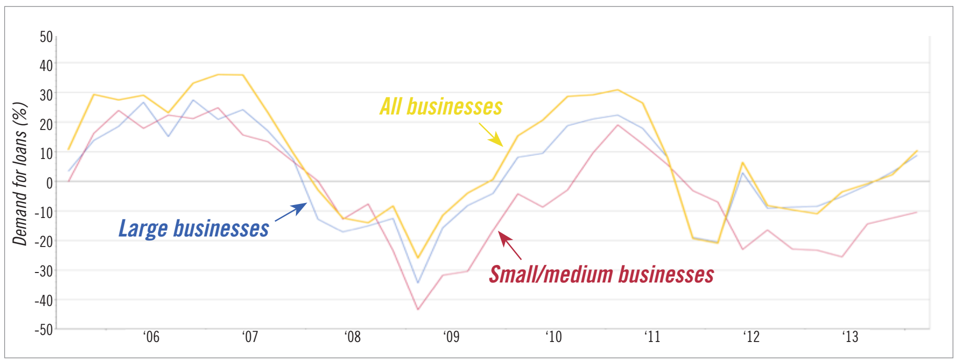
The good news is that none of these legitimate longer-term concerns could drag us away from a constructive medium-term view on both European growth and equity markets. The underpinning of this view remains based upon the relative changes in credit conditions and the fact that central bank policy is providing legitimate stimulus to the real economy (Exhibit 1).

The presence of the ECB has already helped the relative performance of European equities significantly and boosted liquidity in the eurozone. What's less appreciated is that credit demand is starting to react positively.

Exhibit 1: Credit impulse in the European Union (blue) suggests far better near-term growth momentum is likely in Europe than in the US (red)

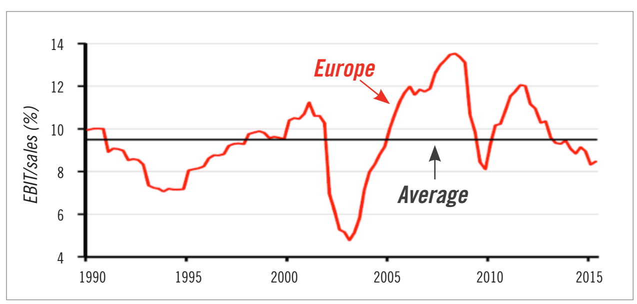
Source: FactSet, Driehaus Capital Management

Exhibit 2: Credit supply has been eased by the ECB and now credit demand is starting to follow through



Source: FactSet, Driehaus Capital Management

Exhibit 3: European margins have been very depressed, in contrast to other developed markets, and finally look ready to improve



Source: Thomson Reuters Datastream, HSBC

The latest lending officer survey shows a uniform improvement in loan demand, led by increased drawdowns on credit lines, a reliable indicator of an early-stage expansion (Exhibit 2). We also remain optimistic that earnings are reaching a cyclical trough, led by an expected improvement in operating margins and assisted by improving top-line growth (Exhibit 3).

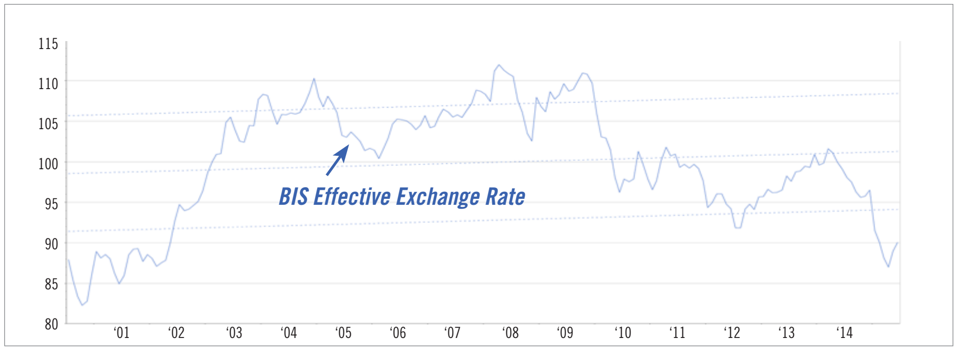
Finally, we again note the importance of Europe having a currency whose value helps, rather than restricts, its manufacturing and export base. The euro is the cheapest it's been on a fundamental basis since the eurozone's first days, reversing an oft-overlooked major constraint to European growth over the past decade (Exhibit 4).

Looking ahead

There are three things the Greek drama may have taken attention away from, which we view to be of primary importance for how the second half of the year unfolds. In many ways, these three issues are conveniently intertwined. The first is the exceptionally poor performance of global trade this year, the surprisingly scant attention paid to it, and its effect on global liquidity. Secondly, is the continued underperformance of US consumer spending, what we can expect going forward, and its effect on the global economy. Lastly, is the Chinese economy and equity markets and their effect on the global economy and markets in the coming quarters.

It hasn't received the attention it deserves, but global trade trends have looked poor thus far this year. There are some good and easy explanations for this, which don't minimize the importance. First, the strength of the US dollar has depressed the value of trade given how many traded goods are priced in dollars, but volumes too have been weak, suggesting elements of demand weakness (Exhibit 5). We attribute those to the weak demand during the first half in the US and China. The entirety of the post-crisis recovery has been particularly nontrade intensive relative to history, but this year has been extreme.

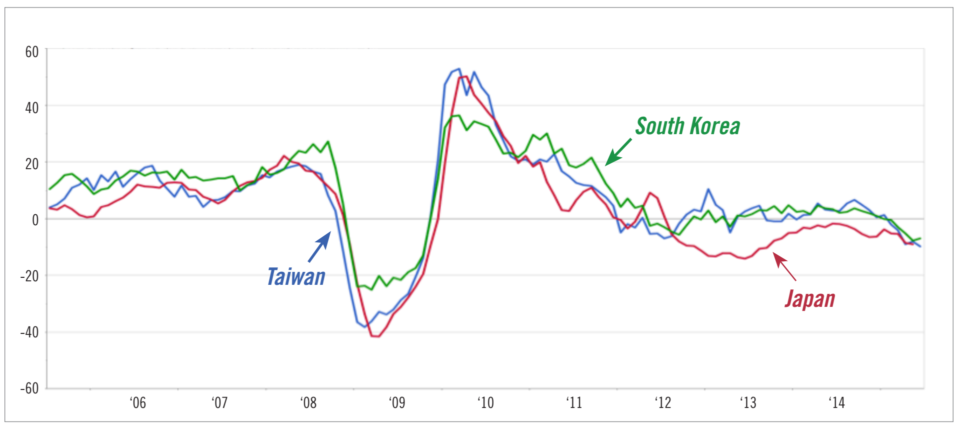
Exhibit 4: The euro is now cheap enough on a real basis to act as a stimulant to European growth, rather than a drag as it has been for the past 13 years



Source: FactSet, Driehaus Capital Management

Exhibit 5: Global trade has been weak this year with trends looking more pre-recessionary than a global economy on the brink of above-trend growth

Exports, year-over-year % change, monthly



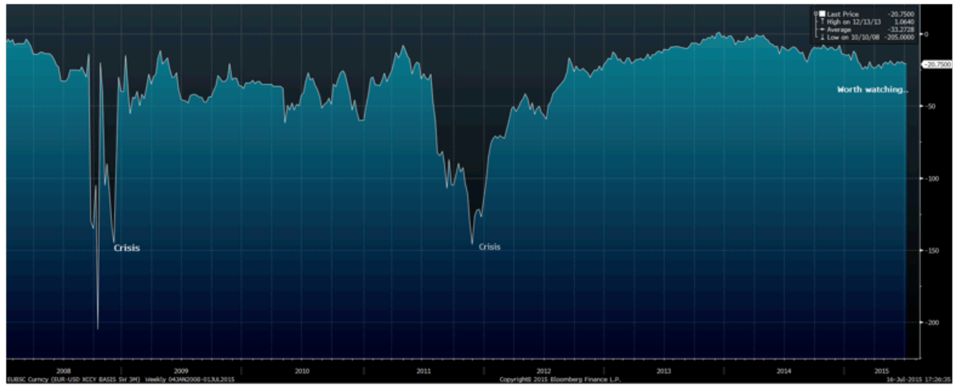
Source: FactSet, Driehaus Capital Management

In addition to being indicative of the level of global growth, many economies aren't receiving needed dollar liquidity from their export revenues. Several countries around the world have high levels of corporate dollar borrowing. In general the emerging markets are most sensitive, while European and Japanese companies are less so. This results in muted global growth due to rising dollar interest rates and declining dollar loan supply, in addition to exacerbating the well-known non-US dollar currency weakness. The supply of dollar liquidity has already been tightening even with the fed funds rate at zero. Capital inflows to these markets have slowed and trade receipts have also now contracted sharply.

Of course, they should tighten further once the Fed begins interest rate hikes. In the past, the Fed has tightened when growth was good and international markets were seeing strong trade, lessening the effect. A supply-side driven tightening is obviously a different situation altogether, and one that is more negative for the many dollar borrower nations. At this point, the liquidity picture is not suggestive of crisis at all, but will worsen if trade doesn't recover, so a trade recovery is key for the second half of the year (Exhibit 6).

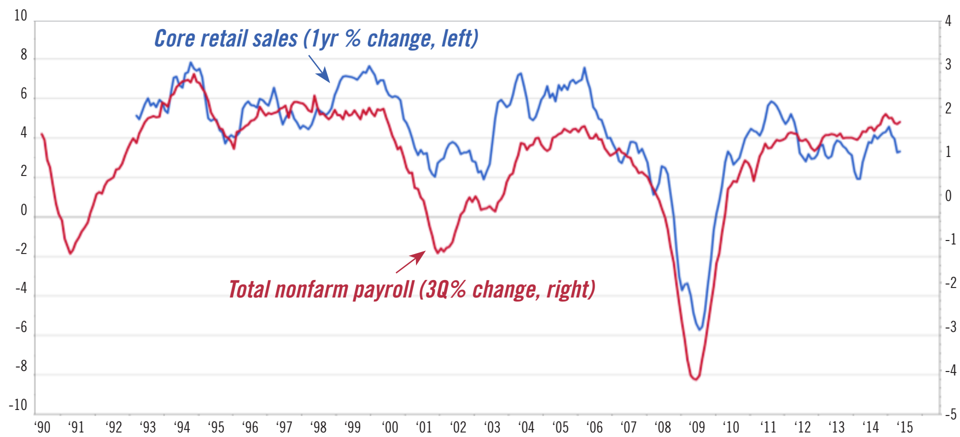
One contributing factor to the weak global trade volumes has been the recent poor performance of the US consumer. We never have been believers in the gas "tax-cut" argument, but we were not expecting consumption to worsen this year alongside lower gas prices. We believe that consumption has underperformed its fundamental relationships and will revert to trend in the second half (Exhibit 7).

Exhibit 6: The pricing of EUR/USD basis swaps is indicative of a tightening dollar liquidity environment globally, but not one near crisis levels at this point



Source: Bloomberg

Exhibit 7: On several levels, US consumption has underperformed underlying relationships. The break in the correlation between payrolls growth and consumer spending will likely not be permanent



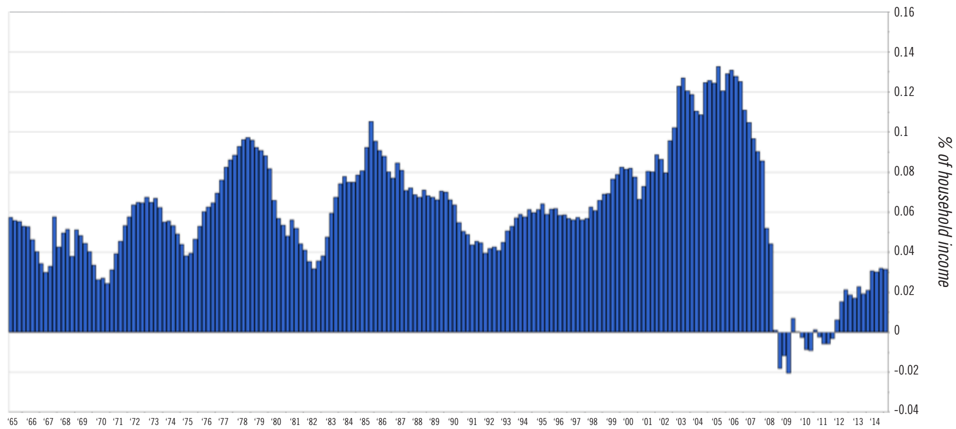
Source: FactSet, Driehaus Capital Management

The unwillingness of the US consumer to spend the gas savings has led many commenters to suggest that a new era of cautious consumer behavior is upon us. We do not think there's been a complete about-face in the past year on how Americans spend money, but the volatility of the past decade has overshadowed what has been a major change in demographic trends in the US. With household balance sheets largely healed, consumer confidence high and retail sales still constrained, we clearly see that the thing missing from the consumer recovery has been leverage, period (Exhibit 8). Unfortunately, we see a strong relationship between the age and growth of the labor force with the propensity to take on leverage, and as such are not sanguine about the possibility of rising household leverage (Exhibit 9).

The final thing we see as superseding the Greek drama in importance is the market volatility and economic slowdown in China. The margin-fueled ascent of local Chinese equities and subsequent collapse should have limited effect on global markets given the exchange's very insular nature with very low foreign participation. The fall only roiled markets globally when the selling ban enacted in China forced local investors to sell everything they could that was still trading, specifically commodities, futures and their Hong Kong-listed stocks.

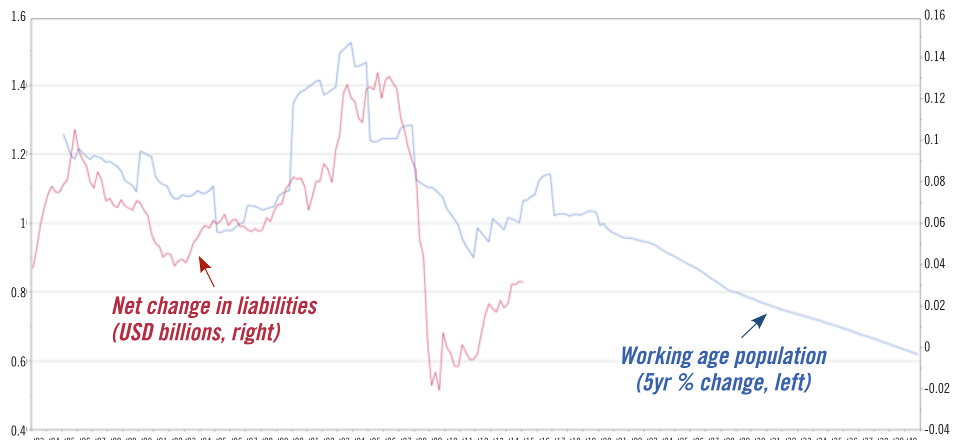
We are not particularly concerned with the economic fallout given very low levels of household participation in the market, the high levels of household savings and the relatively short-term nature of the rally, which makes the prospect that it caused severe capital misallocation unlikely. Similarly, despite embarking on what is a blatantly obvious structural growth slowdown, we feel more optimistic about Chinese growth in the second half than consensus expectations and believe that the ongoing recovery in property sales, combined with a thawing in fiscal spending, has the potential to surprise the markets. Any such recovery, occurring alongside an improved European backdrop and US consumption returning to trend would be positive for global cyclical forces.

Exhibit 8: US households' propensity to take on leverage has greatly changed post-crisis, shown here as net new liabilities as a percent of household income



Source: FactSet, Driehaus Capital Management

Exhibit 9: Unfortunately, the relationship of rising consumer leverage is closely tied to the age of the labor force, suggesting it is not something that will change dramatically with higher consumer confidence



Source: FactSet, Driehaus Capital Management