NYSE, PUERTO RICO, CHINA, GREECE, & NOT FIGHTING THE FED

After hearing a groan from the audience in response to another cringe-worthy pun, Johnny Carson as Carnac the Magnificent would sometimes curse his audience by saying "may you all live in interesting times." With the debt woes of Puerto Rico and Greece, volatility in Chinese equities, our recent stock exchange outage, nuclear tensions with Iran, and the fretting over future Fed policy (not to mention the various social wars whirring around marriage, race, religion, cops, and flags), it seems like Carnac's curse may still have some traction.

NYSE GLITCH

Although it's concerning any time a major exchange halts operations unexpectedly and especially concerning when a major airline and newspaper (United Airlines and *The Wall Street Journal*) experience similar outages at roughly the same time, the NYSE has characterized the problem as a "configuration issue." The Department of Homeland Security has found no sign of malicious activity and the FBI reached a similar conclusion, so I'm willing to trust that this event was neither the result of a cyber attack nor was it another "flash crash." Because trades are now handled electronically rather than manually, trades that would ordinarily have been handled by the NYSE were simply re-routed to other exchanges. The NYSE is left with a little egg on its face, but for the rest of us, this was mostly a non-issue.

PUERTO RICO

Despite the fact that we hold a number of bonds issued by the Commonwealth of Puerto Rico and its Transportation Authority, Puerto Rico's debt woes impact me about the same way "lost cat" notices do. It's not that I lack empathy for cats, it's just harder for me to care about one that abandons someone other than me.

With respect to the Puerto Rican bonds we hold, they're all insured and/or pre-refunded. On the chance my comfort does not automatically translate into your comfort, the notion of an insured bond simply means that in exchange for a one-time insurance premium paid by the bond issuer at the time the bonds are issued, an insurer

guarantees the timely repayment of principal and interest to whoever ends up owning any of those bonds, thereafter. In exchange for the insurer's guarantee, bondholders receive a little less interest than they otherwise would. Often, the cost of that insurance is a waste of money, but in this case, I'm glad to have it.

The solvency of the insurer then becomes a concern. When an insurer is publicly held, one can gauge how well investors think the insurer could absorb the expected loss by looking at the value of its stock once a major default is feared. In this case, the insurer's shares traded down by about 30%. Since stock represents a residual claim on a company's assets, investors apparently think the insurer has the financial wherewithal to make good on its Puerto Rican debt guarantees while leaving shareholders with 70% of what they would have had in the absence of such a default. That's not the best thing for shareholders, but it's a very good thing for us.

Some of our Puerto Rican debt is also "pre-refunded." This odd term simply means that even though our bonds are still outstanding, the issuer has already set aside enough U.S. Treasury securities as collateral to support the full and timely repayment of these bonds when they mature. In essence, Puerto Rico has already retired these bonds even though they still exist in the marketplace. So unless something changes here, I'm more inclined to worry about stray cats than our exposure to Puerto Rico.

CHINA

The recent 30% plunge in the value of Chinese equities is a little like an teenaged kid who's just learning to cope with testosterone. You figure the kid will eventually work through it, but the drywall might get dinged up in the meantime.

To be sure, an overly volatile stock market can play havoc with whatever economy happens to be hosting it. Since China's economy is a major one, any shocks felt within China are likely to reverberate elsewhere. For the moment, however, my read is that Chinese stocks are in the midst of a bursting bubble that has been caused by China's growing wealth, the fact that Chinese investors are fairly well confined to Chinese equities markets, and a host of aggressive policies designed to support stock values (which is not usually the government's job).

Compare the red and green lines, below.

Shares that trade in Shanghai are generally restricted to domestic investors within China. However, many of the shares that trade in Shanghai also trade in Hong Kong on the Hang Seng exchange, an exchange that *is* open to foreign investors. For a given company whose shares trade on both exchanges, shares trading in Shanghai are said to be "A" shares while the Hong Kong versions are known as "H" shares. Since many companies are listed on both exchanges, it's possible to compare how Chinese investors value their shares to how the rest of the world values parallel versions of those same shares. Apparently, I'm not the first guy to wonder about this because an index already exists to address this very issue. (You can't know everything, but I still like to think my doctor does.)

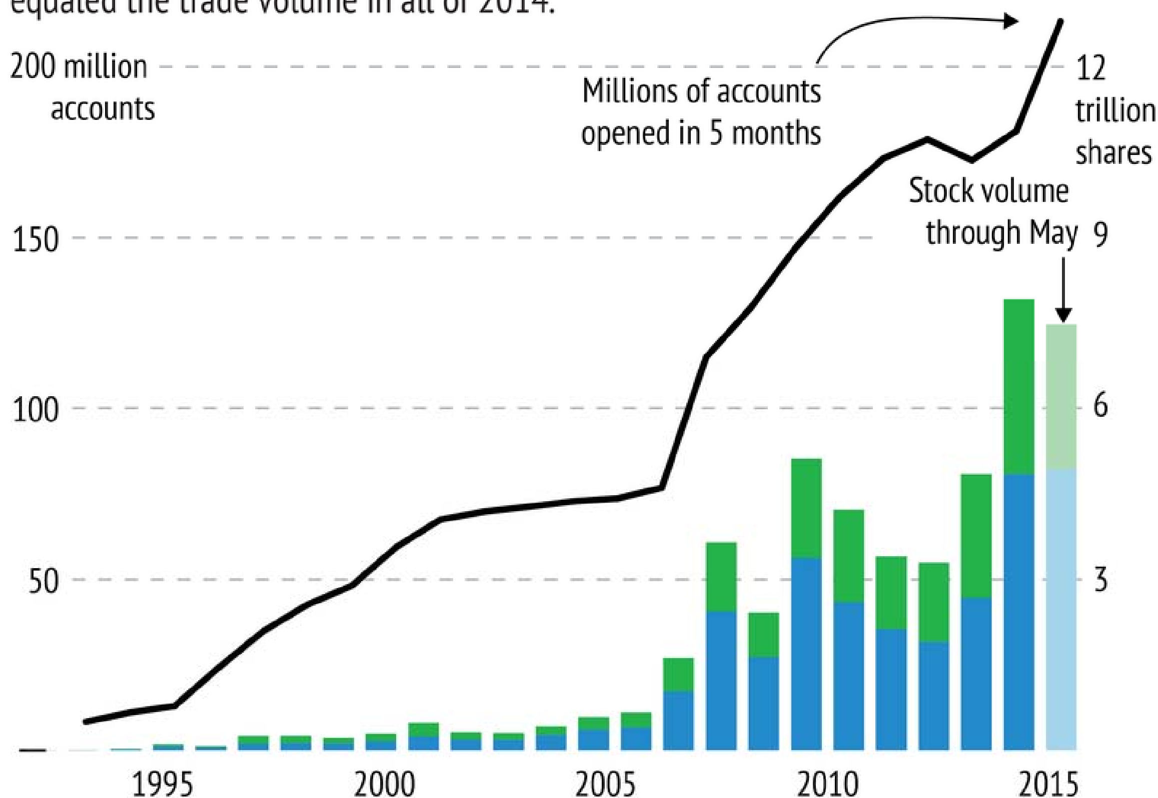
The graph on the next page captures that index. From 2010 to late 2014, "A" shares have tended to command about twice the price of "H" shares (premium of around 100%). That ridiculously high premium, which would not persist in an open market, has recently soared to around 150%. Normally, arbitrageurs would buy the less expensive

"H" shares in Hong Kong and simultaneously sell the more expensive "A" shares in Shanghai. But again, the Shanghai market is mostly not available to outside investors, so this valuation discrepancy persists.

In fact, it not only persists, it has been exacerbated by Chinese regulators who have made a strong effort to support stock valuations within the country by implementing a host of initiatives which include making it easier to buy stock with borrowed money and limiting the ability of certain shareholders to sell their shares. In an effort to support prices, Chinese regulators have even pledged to use government funds to buy stock directly (a far more aggressive role than simply regulating its stock market).

CNBC ran a story on this very issue recently. In that piece, it noted that over 85% of China's stock transactions are initiated by individual investors, two-thirds of whom have not graduated high school. In this country and, I assume, in most other developed countries, much of the trading volume is driven by large institutional investors who know a thing or two about valuation metrics … and who mostly *have* made it all the way through high school.

The following graph provides a little more visual weight to the severity of China's stock market craze. To the extent China's stock market volatility negatively impacts economic activity within the country, the rest of the world's drywall is likely to suffer a little.



GREECE — IN GENERAL

Having lost around half of its deposits over the past few years, the current rate of bleeding is around 1.5% of total deposits per day. In short, Greece's banking system is in a death spiral whether it fully reopens to the public again, or not. To be sure, the capital controls that are now in place will surely strangle the very thing they are intended to save if a deal is not reached soon.

Despite the fact that the Greek "no" vote appeared to signal Greece's increased willingness to exit the Eurozone, Standard & Poor's has concluded that a Greek exit would be extraordinarily messy. "Greece's payment system would shut down and its banks would not be able to operate." This would complicate trade and make it hard for Greek exporters to take advantage of the cheaper currency. Nonetheless, it places the odds of an eventual Greek exit at 50% … much higher than I would have thought.

The bottom line is that Greece has far more debt than it can be expected to repay and the International Monetary Fund said as much a few days ago. As such, the IMF thinks that Greece needs a new $67 billion bailout package, be allowed to ignore $59 billion in existing debt, and be given much more time to repay whatever debt does remain.

Since 2007, Greece's economy has shrunk by a quarter and its debt-to-GDP ratio (a measure of debt burden) has remained far higher than what many economists believe to be sustainable. So, the IMF is probably correct in concluding that austerity alone will not solve the problem. The stakes are high enough that I assume a deal will be reached.

GREECE MIGHT NOT IMPACT US TOO MUCH IF A DEAL IS REACHED

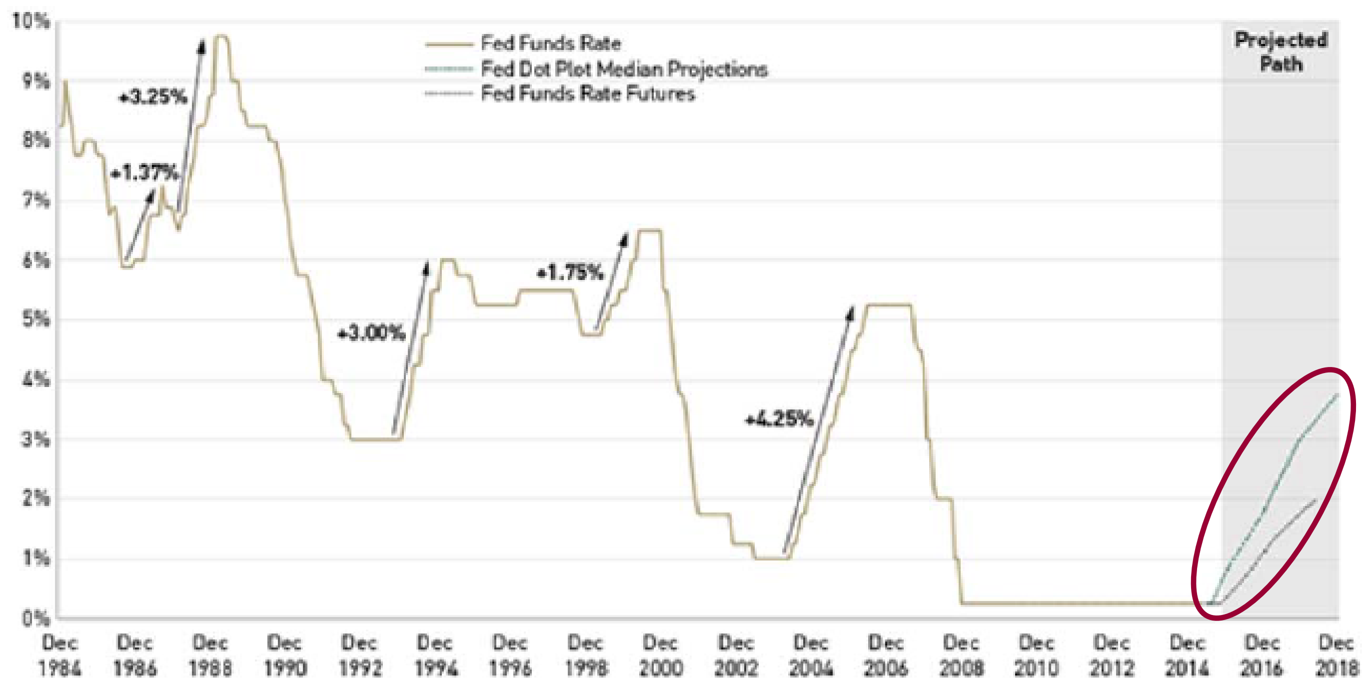
Greece's outstanding debt amounts to barely 1.0% of Europe's banking assets, so the financial impact of Greece defaulting on all of its debt would be relatively small. Plus, the European Central Bank is already in the midst of a large stimulus measure which would further reduce the impact of a Greek default. (It's also why we continue to favor European equities.) The primary threat Greece poses to the rest of the world is the possibility that Greece's bank run will spread to other debt-laden countries in the Eurozone. However, my temporary conclusion is that even if Greece is allowed to ignore a substantial portion of its debt, the investment impact could be minimal as long as Greece remains in the Eurozone. For now, I assume it will.

RISING RATES

I've mentioned in previous notes that rising interest rates present something of a headwind to economic activity and investment returns, but that the Federal Reserve is unlikely to raise rates unless it believes the economy can withstand the insult.

At this point it seems likely that we'll face our first rate hike later this year.

Fed funds target rate (December 31, 1984–June 19, 2015) and indicated projections of future rates



Source: Federal Reserve and Bloomberg. Percentage figures accompanying arrows refer to the size of the total increase in the fed funds rate during the indicated period. Market forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

The grid on the next page depicts the performance of a number of asset classes during previous, rising-rate periods. There's no assurance the asset classes I've circled will outperform during the next rising-rate cycle, but I would expect the forces and factors that were in force then will remain in pretty much in place. Consequently, our portfolios are heavily tilted toward short-term corporate bonds, floating-rate instruments, and high-yield debt (especially shorter-term high-yield debt). We don't specifically favor the S&P 500 as depicted in this grid, but we are remaining committed to equities in this country as well as in Europe and Japan because their central banks are on our side.

PORTFOLIO ANALYSIS

We've inserted a couple pages worth of portfolio analysis for each portfolio we oversee for you. Each analysis is labeled in the upper left-hand corner in a way that ought to

Table 1. How Have Key Asset Classes Performed during Past Periods of Fed Rate Hikes?

Total return by index during indicated periods of Federal Reserve rate hikes

Date	2-Year Treasury	10-Year Treasury	Barclays Aggregate	Short Corporate Bonds	Floating Rate Loans	High-Yield Bonds	S&P 500
06/29/2004-06/29/2006	1.51%	1.87%	3.09%	2.41%	5.79%	7.40%	7.81%
06/29/1999-05/16/2000	2.81%	-0.25%	2.17%	3.46%	3.00%	-1.78%	9.65%
02/03/1994-02/01/1995	1.16%	-7.11%	-2.23%	1.84%	9.33%	-1.77%	0.67%
03/28/1988-02/24/1989	4.13%	2.47%	3.41%	5.65%	—	8.95%	15.09%
12/15/1986-09/04/1987	2.45%	-6.32%	0.40%	3.09%	—	6.38%	35.35%
Average	2.1641	-1.87%	1.21%	3.29%	4.04%	3.84%	13.71%

help you understand which accounts are included in the analysis. In the upper right-hand corner of each analysis, you'll see "Morningstar Fixed-Income Style Box %." Unless your portfolio holds a lot of individual fixed-income (bonds), you are likely to see relatively heavy percentages in the "Ltd" (stands for limited-term or short-term) column. In contrast, you are likely to see relatively minor percentages in the "Mod" (stands for moderate-term or intermediate-term) column, and maybe nothing at all in the "Ext" (stands for extended-term or long-term) column. This is because we've already positioned our portfolios for rising rates.

INVESTING WITH THE FED

Next time, I'm going to discuss a powerful, 48–year study that found a number of interesting relationships between Federal Reserve policy and the performance of various types of assets. I was aware of some of these relationships, but certainly not all. I was also surprised to learn how strong and persistent some of these relationships have been. They could provide a useful investment edge, unless too many people read that same study.

— Glenn Wessel