

## **The Financial Navigator – July 2015 Newsletter**

Greece and China have been in the news a lot recently due to the financial crisis in Greece and the bear market impacting the Chinese stock market. The US stock market has reacted in kind by rocketing down, and up, by 200 points or more during the past couple of weeks. The articles below, *Brink of Grexit* and *The Bears Invade Shanghai* might help to put some of the market headlines in perspective for those of you that are long-term investors. In addition, the third article *Life Satisfaction and Economic Growth* looks at the “life satisfaction” of the average person in different countries since 2007—which roughly marks the beginning of the financial crisis around the world. The strong correlation between the growth of GDP per capita and perceived life satisfaction among the countries studied provides some interesting food for thought in the context of the relatively slow growth in the US, and an election coming in a little more than a year.

Enjoy your summer, and as always feel free to forward this email to anyone that may share your interest, and let me know if you have questions about a specific situation.

Sincerely,

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### ***Brink of Grexit***

Well, the Greek voters were asked, once again, whether they would accept additional austerity measures that were demanded by their creditors, including the European Central Bank, the International Monetary Fund and the European Commission. And once again they voted—this time overwhelmingly (61.31% to 38.69%)—to hunker down and move the country to the brink of a Grexit from the euro currency.

Their choice may not have been hard to make. Virtually all of the \$264 billion that has been loaned to the Greek government have actually been paid to the European banks who unwisely loaded up on Greek debt before 2009—and the loans and extensions, to them through Greece, has kept the European banking system solvent during the crisis. Virtually none of that money has gone back into the ailing Greek economy.

Over the past three years, the Greek government, following many of the demanded

austerity measures, has actually reached the point of budget surplus, aside, of course, from the debt repayments. The cost: a skyrocketing unemployment rate that has reached 25.6%, including 60% of the nation's young workers, and a steep recession which economists seem to agree would only get steeper if the country accepts the austerity demands. The Greek economy has shrunk by 25% over the last five years.

But the hardship continues. Anticipating a shift from euros to drachma, Greek citizens have staged the mother of all bank runs, trying to get as many euros out of the system as they could before they were exchanged for lesser-value drachmas. The government limited the amount of their own money that citizens could withdraw to approximately \$67 a day, and has now shut down the Greek banking system at least through end of day Tuesday. Reopening the banks could be problematic, since they don't hold nearly as many euros as depositors have put into them.

Some are betting that the European Central Bank will provide guarantees and financial support to keep the banks from collapsing and taking the Greek economy down with them. But you can expect Germany to push back hard on this idea.

Will Greece leave the Eurozone? Nobody knows, but the vote suggests that the citizens of Greece have had enough of European (read: German) control over their economy and political decisions; indeed, some observers saw the extremely hard line at the negotiating table as a ploy to destroy Greek's ruling Syriza party by forcing Greek voters to abandon it. There are sizable numbers of people in other European countries who feel the same way about losing control over their own affairs, who are closely watching how the European Union responds.

The discussions will be tricky. If the European Union offers further concessions, then you can expect Spain (unemployment rate: 23.1%) to ask for less stringent austerity and some space to get its own economy moving again. Portugal could be next.

And, of course, if Greece leaves, and begins to experience economic growth again, then those citizens in other countries could demand that their leaders also cast off the layer of oversight and control coming from Brussels.

What should you watch for? Greece is already technically in default as of Tuesday, on \$1.7 billion in payments. At the end of July, it will owe the next payment, in the amount of just under \$4 billion. One compromise possibility is that the European Union, led by Germany, will reluctantly allow Greece to extend its payments, and also put together some kind of an aid package for the Greek economy that would help it become more able to make payments in the future.

How does this affect you? Once again, you're going to see turmoil in the markets, and a temporary decline in the value of the euro on international markets. You'll hear pundits and economists speculate about the "fate of the Eurozone," and eventually, one way or another, everything will settle down again without affecting in any way the underlying value of the stocks you own. We've all seen this crisis a few times before, and each time the predictions of some form of doom haven't come true. This "crisis" is very real to the Greek people, but the world will go on no matter how it's resolved.

### ***The Bears Invade Shanghai***

With all eyes on Greece, a bigger and potentially more disturbing market disruption is taking place—in a much larger economy. As you read this, the Chinese stock market is experiencing the kind of free-fall not seen since the 2008 drop in global markets. Some are comparing it to the 1929 crash in U.S. stocks.

The fall has been fairly dramatic, even if it has not yet taken share prices on the Shanghai Composite Index below where they were previous to a perilous bull run that began in February. The fall has apparently alarmed the Chinese government, which has authorized extraordinary interventions. Among them: twenty one Chinese brokerage firms have agreed to invest the equivalent of \$19 billion in stocks, in an effort to create more demand. The stock exchanges suspended initial public offerings so as not to put any more shares on the market. The Chinese central bank has cut its benchmark lending and interest rates. And the government itself, through its pension system, has now been authorized to play the market.

Perhaps the most ominous intervention, however, came when China's market regulator decided that brokers should not force people who have bought stocks on margin to engaged in forced selling in order to cover their debts. Instead, the brokers were told to extend additional margin loans that would be collateralized by investors' homes. If the market continues to plunge, observers wonder, how will investors (or banks) liquidate those houses? Is it wise to spread the risk from the stock sector to real estate valuations?

The brokerage pledge to buy shares is reminiscent of 1929 Wall Street, when the great banking houses of J.P. Morgan and Guarantee Trust Company committed their resources to propping up the U.S. stock market. That experiment was not a notable success; the Dow Jones Industrial Average fell 13% the following Monday and dropped another 34% over the next three weeks. The Chinese intervention fund, led by Citic Securities Co. and Guotai Junan Securities Co., faces a similar uphill battle; the war chest represents only one-fifth of the Chinese market's daily trading volume.

So far, Chinese investors have lost \$2.7 trillion of stock value—the equivalent of six times Greece’s entire foreign debt. Much of the pain has been borne by individuals, who own four-fifths of China’s stocks, far more than in Western markets where institutional investors are the dominant owners. Many of these common folk borrowed money to buy their shares, contributing to a nine-fold increase in margin lending by brokerage firms over the past two years. This dramatic rise in speculative investing has echoes both in the run-up to 1929 and 2008, two periods when reckless betters (individuals in the earlier era, Wall Street in the latter) were able to borrow 90% of the money they “invested.”

Moreover, the margin loans carry annual interest rates as high as 20%. Total margin debt, when you add up the brokerage firms, banks and informal loans, could amount to as much as \$1 trillion. As share prices fall, investors would be left with far less in stock value than the high-interest loans they owe—making repayment problematic, potentially putting \$1 trillion worth of stress on the Chinese banking system.

It gets worse. Many smaller Chinese companies have financed their expansion by taking out loans against the value of their shares. The companies have had to post additional collateral as the share value dropped down to the outstanding balance on the loan. Additional market losses could put these companies in real danger of default, adding to the stress.

Nobody knows if the free-fall will continue to feed on itself, or if the government will somehow manage to slow the descent. But highly-leveraged investing on a mass scale seldom ends well, as most of us remember from the subprime crisis when we had to reach into our pockets to make Wall Street whole again on its disastrous speculations.

Fortunately, none of this is likely to directly affect the portfolios of American investors, since foreigners account for only about 4% of the Chinese stock market. But as the crisis deepens, and especially if the defaults start to mount, companies go under and the banks stop lending into the economy, you could see commodity prices fall on weaker demand, and there could be a hit to large American companies that do a lot of business in the Asian markets. And it could be a long time before individual Chinese investors trust the stock market again.

### **Life Satisfaction and Economic Growth**

You’re probably tired of hearing about the Greek debt crisis, but sometimes it helps to connect the abstract with the concrete—that is, the huge numbers involved with the actual lives of the people living in the country.

The Greeks today live in a vacuum of uncertainty, with their banks closed at least another day, limited access to their funds, and the knowledge that the banks don't actually have much of the money they've deposited there unless a somewhat uncaring European Central Bank decides to provide a backstop package of guarantees.

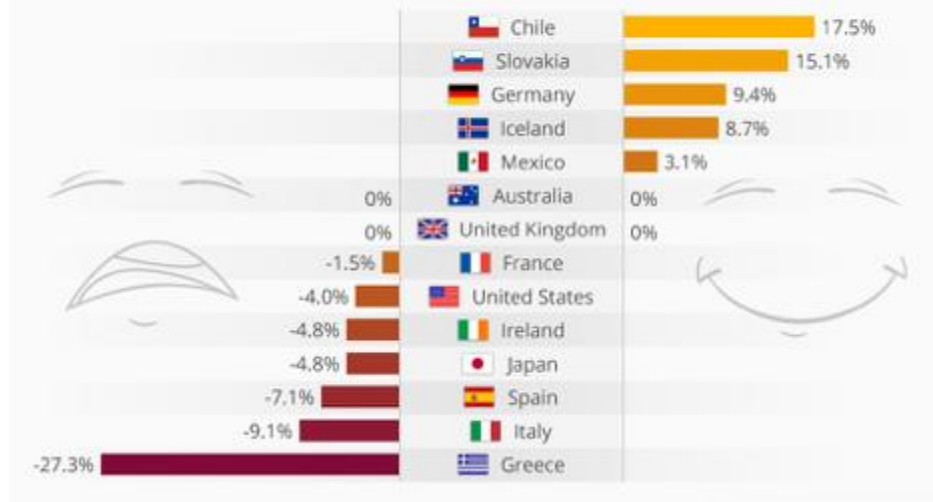
And they're not alone. The chart, with statistics compiled by the Organization for Economic Cooperation, shows the percentage change in the "life satisfaction" of the average person in different countries since 2007—which roughly marks the beginning of the financial crisis around the world. As you can see, there has been a small decline in the U.S., probably reflecting wage stagnation and a slow recovery in jobs and economic activity. But look at the bottom and you see that the Greeks have experienced a 27.3 percent decline in their life satisfaction. According to the report, only 47.8% of Greek citizens agree with the statement: "I generally feel that what I do in life is worthwhile." In Denmark and the Netherlands, 91.4% agree with that statement.

Other countries that are experiencing a debt crisis and high unemployment—Italy, Spain and Ireland—have gone through lesser (but still significant) declines. Meanwhile, at the other end, the German people, who hold all the cards in the various debt crises, have been experiencing a mild euphoria, matched only by Slovakia and Chile, which have been among the fastest-growing economies over the past seven years.

Overall, there was a strong correlation between the growth of GDP per capita and perceived life satisfaction among the countries studied—with a few exceptions. The people of Denmark and the Netherlands seem to have been consistently satisfied with their lives before, during and after the crisis. The people of Poland and Turkey seem to be unmoved by the rapid economic growth their countries have experienced recently. And the U.S. and Canada, which are better off than most of the world economically, have experienced a decline in their general life satisfaction. Maybe we should realize how lucky we are in our situation compared to the Greeks'.

## Life Satisfaction In Greece Has Plummeted

% change in life satisfaction in selected countries from 2007 to 2014



### Sources:

1. [http://www.forbes.com/sites/niallmccarthy/2015/07/06/life-satisfaction-in-greece-has-plummeted-infographic/?utm\\_campaign=Forbes&utm\\_source=TWITTER&utm\\_medium=social&utm\\_channel=Business&linkId=15339276](http://www.forbes.com/sites/niallmccarthy/2015/07/06/life-satisfaction-in-greece-has-plummeted-infographic/?utm_campaign=Forbes&utm_source=TWITTER&utm_medium=social&utm_channel=Business&linkId=15339276)
2. <http://www.ons.gov.uk/ons/rel/wellbeing/measuring-national-well-being/measuring-national-well-being--international-comparisons--2015/art-mnwb-international-comparisons--2015.html#tab=Personal-well-being>