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Recent Market Turmoil

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Markets have been volatile the past couple of weeks as worries regarding Greece's potential exit from the Eurozone and a bursting bubble in China's stock market have come to the fore. After starting the second quarter in positive territory, the major indexes have all turned lower. The U.S., partly due to its status as a safer haven without an immediate negative catalyst, is only down 0.75% as of July 8th. Europe is lower by almost 3% (in USD), and the more volatile emerging markets are lower by almost 7%. These worries have been worsened by the trading halt the NYSE endured Wednesday. Let's take each of these events in turn.

NYSE Trading Halt

Problems at the New York Stock Exchange (now owned by Atlanta-based Intercontinental Exchange) emerged soon after the open on Wednesday morning, as orders for a group of small capitalization stocks failed to go through.

Following additional sporadic failures, at 11:30 a.m. NYSE announced that it was shutting down all trading, without warning. This initial lack of information allowed for rumors to spread, which gained more traction given investors' already-heightened anxiety in recent days.

Perhaps fortunately, the shutdown proved to be the result of a software error that required a significant reboot of the exchange's systems. **There was no cyberattack or other external issue that caused the problem.** Trading resumed just after 3:00 p.m.

On one hand, the problems highlight the vulnerability of today's highly automated, complex markets. Investigations will follow, and greater efforts to improve redundancy and robustness are needed. On the other hand, the fragmentation of the equity market exchanges proved to be an asset. Investors were able to trade on NASDAQ and a number of other exchanges, and the overall equity market was largely uninterrupted.

A large amount of trading also occurs on private platforms ("dark pools") that let investors buy and sell shares without public transparency. Some have criticized fragmented markets that have created opportunities for high-frequency trading firms. However, this system proved better able to deal with failures at a major exchange in this case.

China's Wild Market

China's stock market went on an enormous tear from July of last year until June, rising 150%. Since peaking on June 12th, the Shanghai Composite fell nearly 32% as of July 8th. In China, companies have the discretion to suspend their own shares from trading. The selling pressure has been so severe that about 1,300 companies have halted trading in their stocks, freezing 40% of the stock market capitalization. In response, the Chinese government has tried to stem the damage, loosening margin requirements and banning company insiders from selling shares for six months.

The optics of this boom and bust are terrible, and go to show how immature China's regulatory regime and equity markets truly are. The government's role as cheerleader during the run up and its panicky response to the downturn has hurt its credibility with global investors. **These events should give pause to any investor in China's A-share market, in which we do not participate.**

With that said, it should be remembered that China's markets are still up nearly 70% from last year. The move has been wild and arguably fueled by excessive margin loans and government intervention, but **we believe the crunch is likely to remain a Chinese issue.**

The recent volatility in Chinese equities has largely been limited to mainland stock exchanges, not the far more mature and regulated Hong Kong exchange. This is an important distinction as they attract different types of companies and a different shareholder base. The rout has been most pronounced in the retail driven, smaller cap weighted Shanghai and Shenzhen indices, not the blue chips on Hong Kong's market.

The issue of China's slowing growth (and rising debt) is not new, but these real problems are well known. The bursting of a stock market bubble does not change the fundamentals, which still have significant growth potential. In addition, the mainland stock markets are not the same thing as the Chinese economy. Recently, the People's Bank of China cut its benchmark interest rate and the amount of reserves certain banks are required to hold. This should help bolster growth.

Greece's Ongoing Endgame

Perhaps out of desperation as much as defiance, Greeks voted "No" to the ECB's financing package this past weekend, which required additional austerity. Frustrated European leaders have set Sunday as a final (and without major progress it likely will be final) deadline for the Greek government to propose a way forward. Greece truly is in crisis, with banks shuttered and the economy grinding to a halt.

Compared to last week, the situation is dire and Greece is undoubtedly much closer to an exit from the Euro. The current situation is untenable, and there is a last ditch effort underway to find a deal. As terrible as this situation is for the Greeks and the European project, we still feel that a systemic crisis is very unlikely regardless of a "Grexit" or not. If we are right, further declines in international markets are a buying opportunity.

In the grand scheme of things, there is little evidence of contagion, even in emerging markets. While they have declined significantly, one needs to remember how volatile emerging markets can be. One reason for limited contagion could be that lots of bad news has already been priced into markets, especially in the emerging world. As long as China avoids a hard landing (which we expect) and Greece does not trigger stress in peripheral Europe, neither pose a systemic threat to the world equity markets.