2015 SUMMER INVESTMENT OUTLOOK

While the major U.S. equity indices have experienced relative calm thus far in 2015, other parts of the capital markets have seen increasing volatility particularly throughout the second quarter of the year. Global bond markets faced a sharp sell-off that commenced in mid-April with the extreme movement of the German Bund as one prime example.

Yields on the 10-year German Bund were driven as low as 0.05% on April 17th due to a flight to safety around concerns of a potential Greek default as well as investors front-running the European Central Bank's (ECB) quantitative easing (QE) program. However, Bunds underwent a sharp selloff to 0.99% over the ensuing eight weeks before finding some near term price support. The inflation data out of Europe, while still historically low, has surprised to the upside recently due to the weaker euro and the snap-back in the price of oil. ECB Chairman Mario Draghi also stressed the necessity to drive an aggressive QE campaign through at least September 2016 despite the recent bond market volatility, thus investors found some reasons to sell bonds and adjust portfolios after the extreme market moves. European equities fell nearly 9% from their recent peak, echoing the decline in the bond market, before rebounding more than 4.5% in anticipation of a break in the Greek impasse.

The U.S. 10-year Treasury began its ascent higher in yield in early February from a 1.67% trough and picked up some steam alongside the global bond rout. It moved higher by some 80 bps to nearly 2.5% prior to re-tracing some of that loss. [We continue to emphasize short maturity and high quality securities in client fixed income portfolios due to the price sensitivity of long bonds when yields move higher.] The Bloomberg 10+ Year U.S. Treasury Bond Index is down 13.4% since early February, a decline in excess of 10% that even stock investors would deem as the definition of a correction.

Emerging market equities have also gotten the jitters lately, falling more than 7% from their late April peak as investors begin to contemplate the feedback effects of a potential Fed rate hike later in the year. According to EPFR Global, investors pulled $9.3 billion from emerging market stocks last week, the most since late 2008. While the Great Recession dampened private sector credit growth in developed geographies, emerging economies benefitted from huge capital inflows (due to the chase for yield) and piled on debt. Since 2009, emerging market corporate bonds denominated in dollars and other hard currencies have more than doubled to $1.5 trillion according to the Wall Street Journal. However, rising U.S. interest rates usually mean weaker local currencies relative to the U.S. dollar, making it more expensive to repay debt; a rising dollar tends to draw capital away from emerging markets, sometimes in violent fashion as past episodes in Asia and Latin America demonstrate.

Upside volatility is best demonstrated by the China A-share market, which is dominated by Chinese retail investors (less than 5% of the A-share market is accessible to foreigners). The Shanghai market has gained 126% over the past year and Shenzhen A-shares are up 162%, this despite substantial cracks in the

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underlying Chinese economic fundamentals. Both markets have corrected sharply over the past seven trading days, however, down 11-12%. The People's Bank of China (PBOC) has pumped liquidity into the economy in response to slowing growth, leading to massive speculation by investors. During a single week in April, Chinese retail investors opened more than 4 million new brokerage accounts. According to Bloomberg, at 84x projected earnings the average stock on mainland exchanges is now almost twice as expensive as it was when the U.S. market peaked in October '07. Moreover, Deutsche Bank data shows Chinese technology shares to be twice as expensive as U.S. tech stocks were during the dot.com peak. Broad Chinese equities have seen their forecasted earnings revised lower by analysts—not higher—but during bubbles profits become irrelevant to most investors.

Meanwhile, the S&P 500 Index is trading in the smallest price range since at least 1995, according to Bloomberg, with the 2015 low only 6.5% below its year-to-date high. The same can be said for individual stocks in the index, which have an average year-to-date range of just 18%, the narrowest in two decades. Despite the market a touch below its May 20th peak, breadth has waned recently. At the end of May just 59% of stocks closed above their 200-day moving averages vs. 85-90% a year ago. U.S. economic growth forecasts have been lowered for the year following a slow start and S&P 500 earnings grew just 1% in Q1.

2015 YTD Equity Market Returns (excluding income)

	6/23/15 Price	% Change
Dow 30 Industrials	18,144	+1.8%
S&P 500	2,124	+3.2%
NASDAQ Composite	5,160	+9.0%
MSCI All Country World Index ex-USA	280	+6.2%

Outlook

The U.S. economy got off to a slow start during the first quarter, contracting 0.7%. Some of the underperformance can be attributed to the poor winter weather while the spike in the dollar over the past year was another cause, making U.S. exports more expensive and slowing industrial production. West coast ports also experienced delays due to a labor dispute early in the year. Other headwinds such as weak capital investment are less transitory. Thus, several bodies have lowered their U.S. GDP forecasts for 2015; the Federal Reserve is projecting just 1.9% growth while the IMF and World Bank expect growth of 2.5% and 2.7%, respectively. Various sources forecast global GDP growth of just 3% or less.

One positive sign is that household formation has picked up recently in the U.S., which has driven an acceleration in spending on various services throughout the economy. Over the past year the number of new households formed increased by 1.5 million compared to an average of just 580k per year for the prior five years. This has led to an uptick in household service spending, which grew more than 3% in Q1 and has expanded at an annualized rate of 3.3% since the middle of last year. This broad category of consumption includes financial services, insurance, utilities, transportation, healthcare, recreation, foodservice, and accommodations.

There has also been a resurgence in spending on goods in March through May. Auto sales reached a cycle high of 17.8 million in May on an annualized basis and retail sales are up 8.0% at an annualized rate the past three months following the winter doldrums. Thus, the U.S. economy has some solid underpinnings and growth could bounce back into the 2.5%+ range in the ensuing quarters.

One drawback of the uptick in household formation is that all of these new households are renters, on a net basis; the number of households renting rose 1.9 million while the number of home-owning households fell 0.4 million. Therefore, residential construction has lagged during the current recovery cycle. While housing starts have bounced from the depressed levels of 2011 to a current 1.04 million, this level of activity remains near the lows of previous cycles, especially for single family units. First-time home buyers accounting for just 32% of sales transactions is also well below the 40-45% levels that most economists deem necessary for a robust market. On the flip-side, permits to build new multi-family units have spiked to levels not seen since the mid-1980's due to the huge rental demand.

Looking ahead, consumer spending could be further anchored by the strong labor market, which seems to be tightening, and a boost in real hourly earnings. Job openings of 5.38 million have spiked to all-time highs indicating strong demand for labor while even the broadest measures of unemployment continue to shrink. The full impact of the drop in the price of oil and gasoline has also yet to be felt as consumers have increased savings in response to this benefit instead of spending it.

Eurozone GDP grew 1.5% at an annualized rate in the first quarter, a pickup vs. the 1.0% trend that has prevailed since its double-dip recession ended two years ago. More European equities saw their earnings estimates revised upward than downward in April and May for the first time since early 2011, leading to 13-14% gains for broad Eurozone stocks YTD. The area is benefitting from a weaker euro and the decline in oil prices. Lending standards are also easing and loans to the private sector are growing again since troughing in November. Thus, the ECB's QE program seems to be helping the region on the margin. Growth prospects remain anemic, however, and are made even more precarious by the uncertain status of Greece, and the recent trends of the economic data are a shallow rise rather than a sharp, V-shaped ascent. The unemployment rate in the Eurozone at 11.1% is more than twice the U.S. rate. Economic growth is likely to be capped near 1.5% making improvement in the employment situation quite challenging.

The situation in Greece seems to teeter back-and-forth by the hour as the Greek government seeks the remaining funds from the second bailout to repay maturing debt. Regardless of the very short term outcome with its creditors, Greece will not survive as part of the Eurozone without a future third bailout and substantial debt restructuring. While most of its sovereign debt liability is now on the balance sheets of the so-called "troika" of Eurozone governments, the ECB, and the IMF (rather than private creditors), the debt load is still too onerous in terms of long run sustainability at more than 180% of GDP. The deficit in Greece has been cut to less than 1% but to the detriment of GDP, which has shrunk more than 25% in just six years. Greek banks are experiencing deposit flight and are tapping the ECB for emergency liquidity to contain bank runs. They will need additional capital infusions in spite of a potential short term deal with creditors since loans continue to sour.

The contagion risk from a potential Greek exit from the Eurozone has been greatly reduced compared to five years ago with the private sector and global banking system transferring exposure to the troika. Lending by foreign banks to Greek banks fell to just $14.6 billion as of this April, according to the Wall Street Journal. Nonetheless, the greatest risk from a default would be that credit conditions tighten again in the region as banks and depositors in other peripheral countries re-assess the risks that government decisions and the body politic pose to the financial system. Such a reversal in credit could derail the precarious Eurozone recovery.

China could fall short of its 7% GDP growth goal this year and is prone to an even slower pace over the medium term. Many economists question the reliability of the macro data from the state with its statistical irregularities. A handful of respectable research firms believe the Chinese economy is only growing 5% or so after incorporating a broader set of data alongside the country's official statistics. The country's

power output was practically flat and imports from Australia and Asian nations contracted on a y/y basis during the first quarter. Components of GDP such as manufacturing output, fixed asset investment, and retail sales are all slowing. The property sector continues its correction with sales volumes and activity declining. State authorities have reacted to the slowdown by loosening monetary policy on the margin but the credit excesses of the recent past will limit the magnitude of future stimulus. Even if it escapes a hard landing China has entered a period of difficult adjustment.

With just one week remaining in the second quarter of 2015, Q2 earnings reports are right around the corner. Expectations are for earnings per share growth of just 2-5% for S&P 500 companies excluding the energy sector (which will experience a large y/y drop in profits due to the decline in oil prices). Overall earnings are expected to be down about 4.5% in Q2 and up just 1.5% for the full year. More companies are still seeing their forecasts by Wall Street revised lower rather than higher due to the impact of the strong dollar on both the top and bottom lines as well as weak underlying business trends.

Stock prices, in the meantime, continue to be supported by strong corporate share repurchase activity. Since the first quarter of 2009 U.S. companies have repurchased $2.9 trillion in stock according to Trim Tabs data. Corporate M&A activity is up more than 50% so far this year, just behind the peak levels of '07, as organic growth prospects have waned. Overall net buying (i.e., share repurchases + announced cash acquisitions) for S&P 500 companies currently sits at 6.6% of the market cap, more than 3.8 times its norm. Such level of activity tends to occur near equity market peaks so we view it with a little more skepticism at this point in the cycle considering high stock valuations and the tendency of management to be poor market timers. In the meantime the bull market continues to avoid the 10% correction level since October 2011 and enters its 75th month.

One of the greatest uncertainties for the capital markets for the remainder of the year is the timing of the first fed funds rate hike by the Federal Reserve. Data from the latest central bank meeting show 15 of 17 FOMC members expect the first rate hike to occur before the end of the year. The Fed will likely err on the side of caution and it is debatable as to how far and how fast the policy of the past eight years can be reversed without causing unintended disruptions in the capital markets that could feed back into the real economy and impact the recovery. Post-crisis financial regulation has also drained liquidity from the fixed income market. Primary dealer inventories in the $4.5 trillion corporate bond market are down to $50 billion compared to $300 billion before the crisis despite a more than doubling of the market, according to Deutsche Bank, and the average daily trading volume of the U.S. Treasury market has fallen to just 4% of the total market from approximately 13% pre-crisis. Thus, price moves could be magnified during a sharp selloff. A rate hike could also impact the $4.5 trillion market for dollar-based corporate credit in emerging economies. Our expectation is for volatility to increase as markets adjust to the potential shift in U.S. monetary policy.

Investment Conclusion

Our strategy of managing portfolio risk and protecting capital considering the advanced stages of both the equity market and economic cycles has not changed. High stock valuations remain a hindrance to new investment at the moment thus we are comfortable letting cash balances rise for future deployment instead of chasing returns. Should capital market volatility arrive in concert with a Fed rate hike it should present new opportunities to both extend bond maturities and realize better returns in fixed income as well as position the stock portfolios for sustainable long run growth.

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