2015 Second Quarter ReView of the Markets

Index	2nd Qtr Return	YTD Return
S&P 500	0.3%	1.2%
MSCI ACWI Ex USA	0.5%	4.0%
Barclay's Bond Index	-1.7%	-0.1%
Consumer Price Index	0.87%	0.64%

Investment Commentary

The second quarter of 2015 saw continued choppiness in financial markets. The S&P advanced just 0.3% during the quarter bringing the year-to-date return to 1.2%. Markets watched Federal Reserve policy closely and reacted favorably to the Fed's decision to hold interest rates near zero after their June meeting. However, the Fed continues to signal that given continued positive economic data, interest rate hikes will begin in 2015.

The world focused a great deal of its energy on Greece during the second quarter. June ended with Greece missing a scheduled payment to the International Monetary Fund. Seemingly, each day came with a news report of, "Stocks (rose, fell, were unchanged) on (optimism, pessimism) surrounding a deal between Greece and its creditors." International stocks continued to outpace their U.S. counterparts, albeit at a slower pace. MSCI ACWI Ex USA, a benchmark for foreign equities, was up 0.5% during the quarter, bringing the year-to-date return to 4%.

Despite the Fed leaving rates unchanged, interest rates on U.S. bonds increased during the quarter, primarily due to expectations that the Fed rate hike will be coming in the short term, sending bond prices lower. The Barclays Aggregate Bond Index was lower by 1.7% during the quarter, pulling the index down slightly for the year.

Economic Outlook

The U.S. economic story, as told by net new jobs, continues to be a positive one characterized by slow but sustainable expansion. Based on the job market and inflation expectations, we continue to believe that the Fed will begin to increase interest rates over the next few quarters in the gradual and deliberate manner that they have previously signaled. Interestingly, given that the last Fed rate hike was in June 2006, this is the longest period between Fed tightening cycles since at least the 1940's.

Outside of the U.S., we think that whatever happens with Greece is likely to have minimal impact on global markets over time. Greece has an economy roughly the size of the Dallas-Fort Worth metro area. While this is reasonably large, it is almost inconsequential on a global scale. Furthermore, 40% of Greek GDP comes from the public sector and another 18% comes from tourism. These sectors are unlikely to cause any sort of contagion throughout Europe. One key difference between 2011 and 2015 in terms of Greece is that Greek sovereign debt has largely shifted from the balance sheets of private sector banks and institutions to government related entities. The fact that the vast majority of Greek debt (~80%) is held by the European Central Bank (ECB), International Monetary Fund (IMF), and other bailout mechanisms limits the risk of contagion.

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Investment Strategy

We believe valuations for U.S. equities continue to be reasonable relative to historical levels given the current interest rate environment. That being said, these stocks are certainly not “cheap” relative to history. Where we have rotated from U.S. equity to international equity, we have generally sold passive investments (that are intended to provide the market return) rather than active investments. We believe that there is less room for error at these valuations and active management in equities will likely be rewarded. Given our expectation that valuations are unlikely to provide a significant source of return from these levels (and could in fact have a negative contribution to total return), and that earnings growth is unlikely to be pushed higher by further margin expansion (profit margins for S&P 500 companies are near their historic peak), our outlook for U.S. equities, while still positive, is certainly characterized by lower expected future returns.

Our thesis behind meaningfully increasing our clients’ exposure to international equities during the first quarter remains intact. We continue to see accommodative central bank policies in Europe and Japan. Energy prices, although higher than they were at the end of the first quarter, are still supportive of the majority of European economies which are net importers of oil and gas. Finally, major currencies remain depressed relative to the U.S. dollar helping exporters in those economies. Similar to our stance on U.S. equities, we still believe that valuations are broadly reasonable in foreign equities (with the exception of Russia and Japan which are cheap on a historical basis but facing unique economic challenges in terms of their reliance on oil and demographic issues respectively and have had wildly volatile currencies). On the earnings side of things, however, we do see a compelling opportunity for earnings growth in foreign equities relative to their U.S. counterparts. Our positive outlook on foreign earnings growth is a function of both improved economic growth as a result of the ECB’s Quantative Easing (QE) program as well as the potential for profit margin expansion.

In the fixed income market, much has been reported recently about constrained liquidity. This is something we have observed for quite some time since the Dodd-Frank legislation dramatically impaired banks’ ability to “inventory” bonds. Imagine having to wait for the produce truck to show up every time you go to the grocery store and then having to take whatever price the truck driver decides to set for your vegetables. This is essentially the landscape for many bond investors today. Occasionally, this makes bond trading difficult. The greater concern is that if some event occurs that causes widespread selling, the only people providing liquidity to sellers (i.e. have the ability and willingness to buy bonds being sold) will demand such a discount that bond prices could be hurt meaningfully. We have discussed these possibilities with the bond managers we use and are comfortable with their experience and ability to prepare for and react to these conditions. Furthermore, we believe the relatively short maturity profile of our fixed income allocation gives our clients a level of protection against both rising interest rates as well as a possible liquidity event. Unfortunately, the same cannot be said for “passive” bond funds, which many investors use, but we do not allocate to on behalf of our clients. We continue to have a core of high quality bonds for our more conservative investors which we anticipate will be held to maturity and will be largely unaffected by volatility unless we are forced to sell at some point prior to maturity.

As always, with the wide variety of market and economic issues presented in the media, we remain available to answer any questions our clients may have and discuss the ultimate impact any of these could have on your financial independence.

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