Independent Wealth Management

Market & Economic Review

IWM

A Quarterly Publication | Historical Perspectives | 2nd Quarter 2015

2Q15 Benchmark Returns

	2Q	YTD
Equities		
S&P 500 Total Return Index	0.3%	1.2%
Russell Index 1000 w/Dividend	0.1%	1.7%
Russell Index 2000 w/Dividend	0.4%	4.8%
Russell Index 3000 w/Dividend	0.1%	1.9%
MSCI Developed EAFE (USD)	-0.4%	3.8%
MSCI Emerging Markets (USD)	-0.2%	1.7%
Alternatives		
Credit Suisse Hedge Fund Index	0.9%	3.4%
DJ Wilshire Global REIT Index	-8.6%	-5.6%
Credit Suisse Hedge Mgd Fut Index	-5.1%	1.8%
S&P GSSI Natural Resources Index	-2.7%	-4.1%
Barclays High Yield Bond Index	0.0%	2.5%
Fixed Income		
90 Day Treasury Bill	0.0%	0.0%
Barclays Muni Bond Index	-0.9%	0.1%
Barclays Aggregate Bond Index	-1.7%	-0.1%
Barclays Global Bond Index	-1.5%	-5.1%

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Second Quarter / Key Takeaways

As the quarter ended, Greece was making headlines for its June 30 default on a debt payment to the International Monetary Fund amidst increasingly fraught negotiations with its Eurozone creditors, China was in the news for its very sharp short-term stock market decline and surprise interest rate cut, and Puerto Rico announced it would be unable to fully repay its municipal debts.

While U.S. stocks were barely positive for the quarter, overall they are broadly positive for the first six months of the year with larger caps rising 1.2% and smaller caps increasing 4.7%.

On the economic front, first quarter U.S. GDP growth was revised higher in June though it remained in slightly negative territory after a harsh winter depressed economic activity. Job growth remained strong and the housing market appeared in decent shape as average home prices hit levels not seen since 2006.

Developed international stocks were roughly even with U.S. stocks in the second quarter and maintain a lead for the year so far.

Emerging-markets stocks rose during the quarter and are also outpacing U.S. stocks for the year despite a mixed bag of economic outlooks as well as concerns that higher U.S. interest rates could be harmful to countries with heavier amounts of U.S.-dollar-denominated debt. Among larger emerging markets, China was a strong positive contributor for the quarter, despite its June decline.

After five consecutive quarters of gains, core bonds declined 1.8% over the last three months as yields on 10-year Treasury bonds rose 40 basis points. Below-investment-grade bonds (a market segment that includes high-yield bonds and floating-rate loans, among others) performed well relative to core bonds in the second quarter, and floating-rate loans outperformed core bonds by nearly three percentage points.

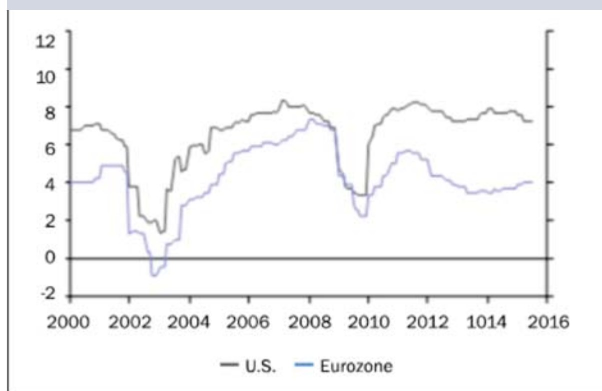
Second Quarter 2015 Investment Commentary:

Important to Keep Greece's Economic Impact in Perspective

As we write this, Greece is in the headlines as the deadline ticks closer for a broader debt default, if not outright exit from Europe's Economic and Monetary Union, and the parties appear far apart in reaching a compromise. It's possible that significant uncertainty will remain at least until July 20, the date Greece owes the European Central Bank a €3.5 billion bond payment. And even if there is a default at that point, the full implications (political as well as economic) will remain unclear for a long time to come.

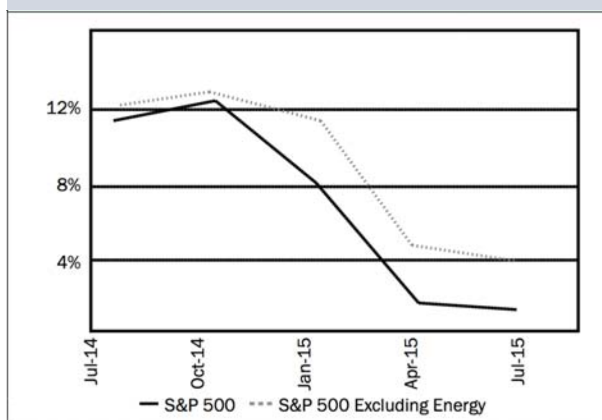
This latest Greek crisis provides us with an opportunity to highlight how we think about these types of overarching, large-scale, and often complex events in the context of our investment process and portfolio management approach. (Other examples include the potential impacts and outcomes from national elections, central bank actions, and geopolitical conflicts). These situations fall into the category of important but unknowable. It's important to keep Greece's economic impact in perspective and to note that the risk of a Greek default in terms of its broader economic impact is reduced today relative to prior flare-ups of this question (though not eliminated, of course). As economist David Rosenberg wrote in his June 16, 2015, "Breakfast with Dave" column, "Remember that we are talking about a $240 billion economy here or 2% of the Eurozone GDP [0.3% of global GDP]." Moreover, more than 80% of the total €315 billion Greek debt is held by government-related/taxpayer-supported entities, such as the ECB, IMF, and the European Financial Stability Facility, according to data from Capital Economics. From a financial standpoint, these entities could handle a default although there would be political ramifications (just as there will be ramifications if Greece is bailed out again). Only 18% of Greek debt is held by the private sector and private banks, which is where the potential for financial contagion was a big concern just a few years ago.

Wide Profit Margin Gap Between the Eurozone and U.S.



Source: Capital Economics.

Earnings Growth Expectations Steadliy Declining



Source: Thomson Reuters. ©2015 BCA Research.

So for now we agree with the assessment that even if Greece exits the Eurozone the risk of a financial contagion (e.g., "another Lehman" or a repeat of the subprime mortgage crisis) is low. However, markets may overreact if Greece looks increasingly likely to exit, and European stock prices could take a short-term hit. Indeed, the blue-chip EURO STOXX 50 Index has already dropped around 9.1% in local currency (euro) terms (as of 6/30/15) from its April high as concerns about the Greece negotiations have amplified.

Asset Class Views

U.S. Stocks: Another source of uncertainty and potential market volatility is Fed monetary policy. While we acknowledge that central bank actions (as well as Fed governors' speeches) obviously do impact financial markets on a day-to-day basis, we also firmly believe it's foolhardy for long-term investors to base investment decisions or portfolio allocations on short-term predictions of central bank behavior.

As we've discussed in prior newsletters, with corporate profit margins at historically high levels and stock market valuations expensive, the potential for earnings to disappoint the market's expectations (as reflected in those high valuations) is meaningful and it could happen sooner than later. Counterintuitively, it might even be improved economic growth that is a negative catalyst for stocks to the extent that a strengthening labor market leads to accelerating wage growth, which in turn puts downward pressure on profit margins and earnings. Looking back at what we've seen so far this year, S&P 500 profit margins, while still high, have turned down over the past two quarters. Further, S&P 500 earnings growth expectations have been steadily coming down since last year.

European Stocks: European stocks appear to be very attractive relative to U.S. stocks looking out over the next five years. Despite a rebound earlier this year, European stock market valuations and corporate earnings (which are well below their long-term trend) still have room to improve, both on absolute terms and relative to the United States. For example, the following chart shows the wide gap in net profit margins of non-financial companies in the Eurozone compared to the United States. The Greek situation may clearly lead to more market volatility over the near term, certainly on the downside if events unfold worse than the market currently expects. (Of course there is also potential for the market to be surprised on the upside if there is an unexpected agreement.

Investment-Grade Bonds: Below-investment-grade bonds (a market segment that includes high-yield bonds and floating-rate loans, among others) performed well relative to core bonds in the second quarter, and floating-rate loans outperformed core bonds by nearly three percentage points.

Concluding Comments

Looking ahead, we know there are inevitably going to be shorter-term surprises, including negative ones. This should not be surprising, and yet we know they will still feel uncomfortable for many investors. In those moments, it's useful to remember that volatility is the shorter-term discomfort an investor must often experience in order to earn attractive longer-term returns from owning stocks. For it's exactly those volatile market movements that can create compelling longer-term investment opportunities.

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