STRATEGY

As we expected, U.S. economic activity seems to be recovering from a very weak first quarter. The primary news moving the market during the quarter concerned Greece. Against the backdrop of accommodative European Central Bank (ECB) policy, and continuing discussions in the European Union on the Greek debt issue, April and early May returns were generally positive. After mid-May, concerns about Greek debt began to escalate, and the S&P 500, the MSCI Europe, Asia, and Far East (EAFE) Index, and the MSCI All Country Worldwide Index began to move down in concert, trimming 2.75% from the S&P 500 and 4.56% from the EAFE index by quarter end, as Greek Prime Minister Tsipras called for a referendum on the proposed austerity terms. On July 5, Greek voters overwhelmingly voted against accepting the European Union's offered austerity terms. As of July 8, Greece's finance minister has resigned, and Greece has re-entered talks with the European Union, but the eventual outcome, whether Greece remains in or exits the European Union, and whether Greece remains in or exits the Eurozone, is uncertain. In contrast to previous bouts of Greek solvency concerns, global market reaction to this latest twist has been quite muted, both because markets have largely priced in the uncertainty about Greece's membership in both the Eurozone and the European Union, and because non-Greek banks and governments have significantly reduced their holdings of Greek debt, which would limit the cascading effects from a widespread failure of Greek banks and a Greek default. European markets are off between 4% and 6%, with U.S. reaction extremely limited.

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At this point, we are more concerned with the effect of a gathering economic slowdown in China. For comparison, China has a 15.4% share of world GDP, while Greece's share is just 0.3%; China's exports are $2,049 Billion per year while Greece's are $35 billion; China's imports are $1,818 Billion per year while Greece's are $62 Billion. In recent years, Chinese economic policy has attempted to change the composition of economic growth from investment-led to consumption-led. Although the Chinese consumer sector is expanding, it is much smaller than the investment sector, causing a significant slowdown in Chinese economic growth. The International Monetary Fund forecasts China's 2015 growth to be 6.8%, but other estimates based on electricity use, railroad cargo loadings, and bank loan growth all indicate underlying economic growth of about 2%. This significant change in both the composition and the rate of Chinese economic growth has driven down commodity prices, including oil, copper, nickel, and aluminum. Slowing Chinese economic growth will also decrease China's imports, leading to a growth slowdown in the primary exporters to China: Japan, South Korea, other Asian countries, the United States, and Germany. While we do not expect the direct effect on U.S. economic growth to be significant, it is likely to dramatically affect the earnings of some companies, and will definitely not be helpful for the overall level of world economic growth.

In addition, the Chinese stock markets have been experiencing bubble conditions. These have started to unwind, with greater than 30% declines in the Shanghai and Shenzhen market indices in the past month. Even more troubling than these declines are the policy actions taken by the government in an attempt to stem the decline, such as halting all initial public offerings and freezing for six months the sale of equities by executives, directors, or holders of more than 5% positions. These actions, focused on keeping equity prices from coming down, reverse recent attempts to liberalize and open Chinese financial markets. Brokers and bankers have also been forced to buy shares and prohibited from shorting. Since this limits financial firms' ability to manage risk, it may well reduce their ability or willingness to access capital markets for funding, further reducing economic growth prospects.

SECOND QUARTER 2015 RETURNS

During the second quarter, we maintained maximum equity exposure for clients where we have the ability to allocate between stocks and bonds. While returns for stocks for the quarter were tepid at best, stock returns slightly outpaced U.S. bond market returns. Indeed, equity market returns have been better than bond market returns thus far in 2015 and for the past twelve months. During the quarter, large capitalization stocks, measured by the S&P 500, returned just 0.28% for the quarter, and 7.42% for the past twelve months. Small and Midsized Capitalization stocks, measured by the S&P 1000, lost ground during the quarter, with a total return of 0.68%, and a total return of 6.49% for the past twelve months, with small companies slightly stronger than midsize ones. The MSCI Europe, Asia, and Far East Index (EAFE) returns reflected the tension over Greece, returning 0.80% for the quarter and -3.59% for the past twelve months. The MSCI All Country World Index (ACWI), which has an approximately 50% exposure to the U.S., and 10% allocation to emerging markets, returned 0.50% for the quarter and just 1.30% for the twelve months, measured in US Dollars.

Oil prices increased during the quarter, with West Texas Intermediate oil ending the quarter at $59.47 per barrel. Concern over the Shanghai stock market and Chinese economic growth pushed oil down to $51.77 by July 7, 2015. U.S. stock returns varied significantly by sector, with healthcare stocks increasing by 2.4% and utility stocks falling by 6.7% during the quarter.

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US ECONOMIC GROWTH CONTINUES

We continue to be positive on domestic US economic conditions, but we have slightly lowered our expected economic growth in 2015 to 2.5% from 3%. Employment growth has strengthened, and new entrants are either coming into or returning to the labor force; in the most recent job report, 60% of new jobs were filled by new entrants to the labor force. Consumer confidence continues to be strong, and more importantly, the breadth of U.S. consumer confidence is increasing, with confidence improving for both high and low income brackets. Average hourly earnings are showing very modest increases, currently 0.5% higher than the year before.

As we wrote last quarter, the Federal Reserve has indicated that it will begin raising short term interest rates in the near future; this has been widely forecast, and should not be a surprise when it happens. However, recent events in China and Greece could generate sufficient financial market volatility to induce the Federal Reserve to delay the first increase in short term rates until after September. A flight to quality, i.e., a movement of funds into assets perceived to be safer, has pushed U.S. Treasury rates down, with the 10 Year dropping from 2.35% at quarter end to 2.19% on July 8. Additional volatility in European and Asian markets would decrease the probability of a Federal Reserve rate increase in September.

VALUATION

Current valuations for U.S., European (except Greek), and Japanese stocks do not look excessive. U.S. economic growth continues to be solid and moderately slow. Job creation has been strong, inflation is well contained, and our positive view on the U.S. economy should support current stock levels. However, as a result of the increase in the value of the US dollar, corporate earnings for the S&P 500 are expected to be essentially flat for 2015, and companies with greater foreign sales exposure significantly reduced their earnings forecasts after the first quarter of 2015. Dollar appreciation relative to other currencies decelerated in the second quarter, which leads us to anticipate that corporate profits will begin rising again in the fourth quarter of 2015, and we expect corporate earnings to grow by about 10% in 2016 in comparison to 2015. Currently, the S&P 500 index is at 16.4 times expected earnings for the next twelve months, a bit above the 25 year average of 15.7 times earnings. Yale Professor Robert Shiller's cyclically adjusted P/E ratio, or CAPE ratio, which looks at the average of ten years trailing earnings, is at 26.7 times earnings, 1.5 standard deviations above the average since 1881, but just slightly above the 25 year average of 25.4 times earnings. Compared to the current S&P 500 earnings yield of 6.1%, the yield on the 10 Year Treasury Inflation Protected Security is just 0.33%, indicating that stocks should return about 5.8% more than bonds over the next twelve months.

While the economic and valuation underpinnings of the U.S. stock market are reasonable, several areas of increased risk are likely to increase day to day volatility, and may affect the timing of the Federal Reserve's expected change in direction from an extraordinarily expansionary monetary policy to a merely extremely expansionary policy. The ECB and the Bank of Japan (BOJ) are now pursuing extraordinarily expansionary policies intended to prod their economies out of prolonged stagnation. While The ECB and the BOJ will do everything they can to prevent the spread of financial contagion from the Greek debt crisis and the slowdown in Chinese growth, we still expect additional market volatility as markets react to daily news flows. Second, economic slowdowns in China, much of Europe, and countries with significant energy and commodity exports, such as Brazil, Canada, and Russia, provide multiple opportunities for additional volatility in currency flows and interest rate adjustments. That said, we continue to emphasize stocks over bonds, believing that the balance of risk and return for the remainder of 2015 favors high quality stocks. As we watch developments in the Eurozone, we will be alert to the opportunity to increase exposure to European markets and companies with significant Europe-based revenues when we see that economic conditions are beginning to stabilize.