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Quarterly Commentary – July 2015
The Big Question…To Grexit or Not?

My Dear Client:

As during the entire first quarter, the debate over when the Fed will begin to raise short-term rates continued to dominate financial markets during the start of second quarter. With U.S. economic growth regaining some momentum after its first quarter slump, the Fed appears set to be the first major central bank to increase interest rates, even if that happens later than analysts initially forecasted. At the same time, the European Central Bank is instigating negative interest rates to try and force banks to lend and citizens to spend in hopes of keeping Europe out of a prolonged recession. Even with the gradual and measured interest rate increases, the Fed's monetary policy will continue to be accommodative and interest rates will remain low relative to historical levels.

Of course the story that will forever be imprinted on June 2015 and thus the second quarter was our new vocabulary word "Grexit" or properly pronounced Greek Exit from the Eurozone. To some Athens and its potential exit from the Eurozone was a short-term distraction from the themes of a broadening economic recovery in developed markets, benign inflation and increasing divergence in global monetary policies during the second quarter. Sentiment shifted swiftly and sharply throughout the quarter as investor angst, uncertainty and hopes about Greek debt developments, prospects for economic growth and the timing of the Federal Reserve's (Fed) first short-term increase swung between optimism and pessimism. The result was global stock markets declining and rebounding over the quarter.

While seeming like a distant memory as the second quarter closed, several major equity indexes reached new record highs earlier in the period, including the S&P 500® Index. Comparing the initial 2,058 level of the S&P 500 on January 1st to the close of the quarter at 2,063 may prompt one to think that the 1st half of 2015 has been uneventful, but the reality could not be more different. In the second quarter, the S&P 500 Index rose 0.28% and the broader Russell 3000® Index rose 0.14%. Style-wise, growth-oriented stocks generally outpaced their value-oriented counterparts across all market capitalizations. Robust merger and acquisition activity continued to provide a tailwind for equity markets during the second quarter, especially in the Health Care sector. The Utilities sector continued to be a notable laggard as long-term interest rates inched up during the period. Many investors had viewed utilities companies as an alternative to bonds because of their yields.

Investor concerns about a contracting Eurozone economy have mostly passed as the economic recovery appears to be broadening. Unlike the temporary factors that led to the U.S. economy's first-quarter slowdown, the drivers of the European economic recovery benign inflation, accommodative financial conditions arising from quantitative easing, a diminished drag from fiscal tightening and improved credit conditions—are likely to be longer lasting. In fact the diminishing fear of Eurozone contraction could be argued as a factor that emboldened the Germans and the French in leading the pushback against Greek demands during negotiations. And remember for all the consternation Greece is not much of a force on the global scene as it has GDP of a mere 0.38% of the world economy. Non-U.S. developed equity markets, as measured by the MSCI EAFE Index (net of taxes), rose 0.62% in the first quarter. Emerging equity markets, as measured by the MSCI Emerging Markets Index (net of taxes), gained 0.69%. This rise in foreign stock markets was tempered by the falling Chinese stock market during the quarter as Beijing sought to assure the world that it could manage an economy that is no longer growing above a 7% GDP rate.

The Treasury Movement

In 2015, much of the movement in Treasury yields reflected what has been happening overseas and investor perception of risk. Dr. Yellen's plans for the Fed to raise interest rates this year injected an additional layer of uncertainty into the mix. During the quarter (and especially after its June meeting), the Fed had been trying to shift investors' focus less on the timing of the first interest rate increase and more on the trajectory of the rate increases. Janet Yellen has emphasized that the Fed will continue to be accommodative while watching data closely, making the delay in interest rate hikes drive speculation over the past three months. This is slower than many investors initially had expected. With the Fed incorporating a broader perspective and dataset that seeks to take into account geopolitical events, global financial stability, global economic growth and the strength of the U.S. dollar, as well as inflationary pressures and the strength of the U.S. labor market. The price of oil surprised by breaking through a widely-accepted $60 per barrel floor as a production glut remains on the horizon thanks to a nuclear deal with Iran (that closed after the quarter), opening the floodgates of one of the world's largest oil producers in an already oversupplied market. U.S GDP growth contracted in the first quarter, with the Fed forecasting annual growth in the 1.8% to 2.0% range for 2015, a slowdown from 2014's 2.4% expansion. Consumer spending, which accounts for nearly two-thirds of GDP growth, remains strong as upward revisions in outlays give promise for further GDP-boosting spending.

The yield on the 10-year Treasury note ended the quarter at 2.35%, up from 1.94% at the end of the first quarter—its biggest one quarter rise since the end of 2013. Even as interest rates rise, they are expected to remain low by historical standards for a while. Unlike the U.S., central banks around the world have been loosening monetary policies and launching or maintaining stimulus measures and bond-buying programs. While I believe there will likely be increased volatility in stocks ahead of the first rate increase, the move to raise rates is a vote of confidence for the U.S. economy because it indicates the Fed believes the economy is on more solid footing. Historically, economic growth has boded well for corporate earnings and led to gains in equity markets. This time we shall see.

There was an earlier time when demand drove various forms of capital formation, a relationship that has changed as the Fed injected approximately $5 trillion newly printed dollars into the US and world economies since 2009. Thus, that money, mainly in the form of debt, both public and private, must earn its keep and thus must be serviced, at least in part, not only with inflation but with interest payments by growing and profitable businesses. Therefore, it can be said that for the first time finance is driving business demand, not the traditional reverse. One result of this phenomenon has been a flurry of recent mega-mergers such as Chubb-Ace, Aetna-Humana, Kraft-Heinz, among many others. The present need is to generate nominal 5% interest on $5 trillion dollars, or about $250 billion annually. That is a hurricane-like force on markets, and only substantial companies willing to merge and use personnel reductions to increase productivity enough to use salaries of discontinued employees to fund interest payments on new debt can contribute and participate in this massive shift in economic emphasis. Thus in theory, many companies with stocks listed are likely to grow fastest in the years ahead, enough to offset the tornado-like forces the Fed has wrought. <u>*However, expect this uncharted territory will likely be very bumpy.*</u>

The Look Ahead

Heading into the second half of the year, on balance, my capital market expectations from the start of the year have remained largely unchanged. Headline risk has driven equity markets for most of 2015, making management of volatility and assessing risk the key to preserving capital and generating positive performance. More specifically, I expect a broadening moderate global economic recovery led by continued divergence in global monetary policies. In addition, I believe there are two primary downside risks and "swing" factors: China's economic slowdown and developments in Greece. China is one downside risk which has often led emerging markets economic growth is downshifting to a slower, more subdued pace of economic growth from its historical double-digit level. While we know that after the end of the quarter speculation and angst of a possible "Grexit" were removed. The real concern about the negotiations had less to do with Athens and more to do with the precedent that would be set for Libson, Rome, and Madrid. Portugal, Italy and Spain have their own internal struggles with debt, austerity, unemployment and citizen discontent with the Spanish having the world's 13th largest economy and the Italians the 9th any liberties given the Greeks would be much more significant when these countries come asking.

The short-term "noise"; sudden, sharp swings in investor sentiment and market direction; and the amplified uncertainty about developments in Greece and its impact on the global economy and financial market stability often made it challenging for investors to remain focused on the long-term, big picture. These events also serve as reminders of the important role active portfolio and risk management can plan in helping you screen out the "noise" and better stick with a disciplined investment plan designed to help you reach your long-term wealth goals and objectives. As Warren Buffet sagely said, "Predicting rain doesn't count. Building arks does." After the rising tide environment of the broad market gains over the last several years, the often abrupt market dips and swoons, as well as the sharp swings in sentiment and capital market conditions, have served as reminders of the importance of building "arks." This for investors could look like trimming long running winning U.S. equity positions back to Investment policy/plan targets, shortening the duration of your bond portfolio as well as underweighting it. Holding "**cash"** this summer while thoughtfully selecting good cheaper assets; global/international investments, illiquid investment opportunities, un-loved energy options, burgeoning distressed options, and the lending void left by Basel III and other financial regulations can have long-term rewards albeit…in the midst of some *short term volatility*.

As we have our mid-year conversations about your long-term strategy, investment plan, and portfolio, I look forward to discussing the challenges and opportunities that are presented today for your specific situation. As always, if you have any concerns, questions, or general thoughts about your portfolio or any other matter, please never hesitate to contact me.

I want you to enjoy a happy, healthy and safe summer.

Appreciatively,

Walid L. Petiri

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Sources: Barclays Capital, MSCI Barra, Russell Investments, Standard & Poors, Reuters, Federal Reserve Board