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Market Commentary

Summer 2015

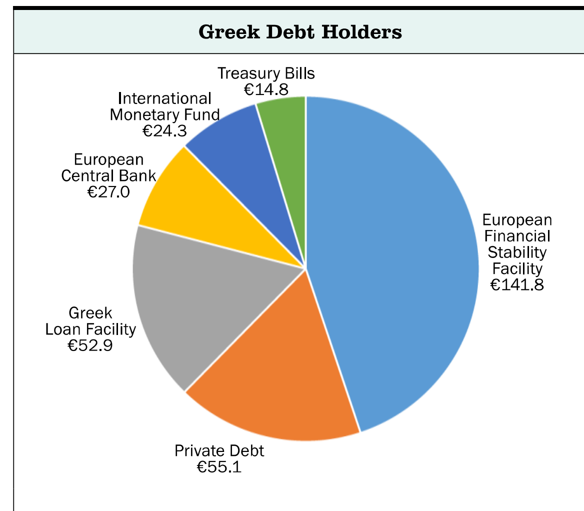
Q1 Key Takeaways

- 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. Notwithstanding a dramatic last couple of days, though, the second quarter was generally positive for global equity markets.
- Contributing to market uncertainty was the timing of when the Federal Reserve will start raising interest rates. Its data-dependent decision has caused Wall Street to put too much weight not only on every economic variable, but also on every word from a Fed governor.
- While U.S. stocks were barely positive for the quarter, overall they are broadly positive for the first six months of the year. 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 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.

Q2 Investment Commentary

Our take on Greece & China

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 (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



Source: Capital Economics.

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. What's more, these private sector-held bond maturities don't start coming due until at least 2017. In his June 18 column, Rosenberg also highlights some other key differences between the risks stemming from a Greek exit now versus a few years ago. "This is not 2010, nor is it 2012, when there was no ECB quantitative easing, when the peripheral euro area economy was far weaker, and the banks were saddled with Greek debt on their balance sheets." 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.

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China was another source of news at quarter-end as the People's Bank of China undertook a surprise rate cut alongside other easing measures. China's economic growth has slowed as policymakers seek to contain overall credit growth and redirect the economy toward a more sustainable path. The most recent rate cut came as Chinese stocks had taken a sharp tumble (with the local "A-shares" market falling more than 20% in the last couple weeks of June) raising concern about the effect of the decline on individual investors, particularly those that borrowed to buy shares. Keep in mind, however, this market has doubled over the past year. (The Hong Kong-based exchange (H-shares) is comprised primarily of blue-chip companies based in China that are open to foreign investors, but can't be bought by the Chinese public. There has been significantly less volatility in H-shares.) China growth concerns are more important than the Greek situation, in our opinion, as demand from China impacts other global markets. The markets appear to be stabilizing, but the economic outlook is more murky. This remains a situation that we will closely monitor.

The Fed's much-discussed rate hike

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. More specifically, as we've noted before, it's pretty clear the central bankers themselves often don't know what they're going to do next or when they're going to do it. And it's often not obvious what the market's reaction will be. Even Fed Board Chair Janet Yellen acknowledged this recently. When she was asked about the potential for market volatility if and when the Fed raises rates, she responded, "I think our experience suggests that it's hard to have great confidence in predicting what the market reaction will be to Fed decisions, and there have been surprises in the past." So while the guessing game over when the Fed will start raising interest rates can be entertaining (at least for economists), it's largely irrelevant to our investment approach.

That is not to say we ignore what the Fed says and does or how the markets react to it. It's possible a short-term market overreaction might create an investment opportunity based on our longer-term analytical horizon, or a market response might amplify a macro risk that we'd want to protect against. But that's not the case presently, where the Federal Open Market Committee's most recent policy statement on June 18 indicated the Fed still expects to hike rates this year. (A historical note: the last Fed rate hike was in June 2006, making this already the longest period between Fed tightening cycles since at least the 1940s.) Yellen also reiterated that the actual decision remains dependent on the Fed's assessment of incoming economic data, particularly with regard to the labor market and inflation. Yellen was also very clear (again) in stating that even once they begin, the Fed expects the pace of rate increases to be very gradual (although that too could change depending on the data). In the grand scheme of things, the path or trajectory of rate increases is much more important than whether the first 25 basis point rate hike happens in September, December, or early next year. So the bottom line is we aren't changing our portfolio allocations in response to the latest Fed statements or the market's reaction to those statements.

US Economy

On the economic front, first quarter GDP growth was revised higher in June though it remained in slightly negative territory after a harsh winter depressed economic activity. Among the positives, job growth remained strong and the housing market appeared in decent shape as average home prices hit levels not seen since 2006. U.S. dollar strength relative to other currencies is viewed as a potential headwind for manufacturers; however, the dollar's pace of gains cooled after a strong first quarter and declined in the second quarter relative to the euro (though it appreciated versus the yen). The dollar is still higher relative to major currencies over the past 12 months. A stronger dollar dampens foreign earnings for U.S. companies and makes U.S. goods potentially less competitive overseas. We feel the U.S. economy remains one of the strongest in the world. Earnings expectations for 2015 call for a 6% earnings increase, despite the fallout in the energy sector, with 2016 looking even better at a 9% growth rate. Should this growth be realized, we believe the markets are headed nicely higher.

Implications for our positions in U.S. Stocks

As with any market response to new developments regarding Greece's debt issues and China's economic outlook, how stocks will respond over the short term if and when the Fed begins raising rates is also an unknown. In fact, history suggests the beginning of a Fed rate-hike

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period is unlikely to trigger a major stock market plunge or mark the beginning of a bear market—particularly if the Fed has convinced the markets it will be unusually gradual in its pace of tightening. That said, this has not been a typical monetary policy cycle (to say the least!) and with the federal funds rate pinned at or near zero for six-and-a-half years, the first moves off that may increase market volatility and could be a catalyst for a market "correction" (i.e., something on the order of a 10% decline). Based on history alone, we are overdue for one. The S&P 500 has now gone almost four years (45 months) without at least a 10% decline, making this the third longest such stretch since World War II. Prior to this recent run, market corrections occurred roughly once a year, on average. We note all of this not as a short-term market prediction, but as a plausible shorter-term scenario to be aware of and prepared for. We would welcome a correction as it would give us opportunities to get into a few names that we believe have gone too far too fast.

Typically it takes a sustained increase in rates by the Fed for a full-on bear market to ensue (i.e., a 20%– 25% or more drop), with such downturns having often occurred only after the Treasury bond yield curve has inverted (i.e., when yields on very short-maturity bonds are higher than yields on long-maturity bonds) and/or the market has started anticipating a recession is in the offing. Right now the yield curve remains relatively steep, with the 10-year Treasury yielding more than two percentage points above 90-day T-bills.

And while there is always the possibility of a severe external shock that causes an abrupt economic contraction and stock market decline, absent something like that, evidence of a potential U.S. recession on the horizon is lacking. We fully acknowledge that most economic models fail to predict recessions, and we don't rely on such models or on any short-term GDP forecast as part of our investment process. We're just noting that the conditions for an imminent recession do seem largely absent.

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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