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Financial Market Commentary: 2nd Quarter 2015

A Greek Debt Resolution and Favorable 2nd Quarter Earnings Could Promote a Stronger Second Half of the Year

A general lack of conviction marked the first half of 2015 as the Greek debt crisis and the timing of the Fed's pending interest rate increase seemed to preoccupy investors. Following a lackluster 1st Quarter, markets began to improve as encouraging U.S. economic data and continued signs of a recovery in Europe sparked hopes of a rally. Momentum stalled, however, as Greek bailout negotiations dominated headlines. For the first half of 2015, the S&P 500® Index eked out a 1.2% gain while the Dow Jones Industrial Average is essentially flat. Global markets continued to be pushed and pulled by politics and policy throughout the Quarter rather than real economic improvement. Economic indicators and geopolitical outbursts prompted rallies and corrections, but factors, such as a stronger Dollar, lower oil prices, and divergences of monetary policy made the greatest impact.

Despite a disappointing domestic market performance, fundamentals improved which could serve as the foundation for the next few years. The rest of the developed world markets outperformed so far based on favorable Dollar exchange rates and ultra-loose monetary policies.

U.S. Equities May Have Room to Rise Even If Fed Tightening Begins

The U.S. economy continues to gain strength which may increase the likelihood that the Federal Reserve will begin to raise short-term interest rates later this year or in 2016. History suggests that tighter monetary policy is not necessarily bad for equities. During the 13 Fed-tightening cycles since 1954, the stock market recorded an average gain of 9.3% 12 months after an initial rate hike. The increases didn't stop there; 24 months following an initial rate hike, equities had registered an average gain of 15.3%.

Since the financial crisis supply has contracted to meet demand. If demand struggles to return to a level commensurate with the economy's productive capacity, then something needs to be done to induce consumers to spend and companies to invest in projects. That "something" may be continued low interest rates. Real rates averaged only 1 percent during the last full business cycle that stretched from 2001 to 2007, a period when inflation was stable and wage pressures were largely dormant. This is an incredibly low number considering the economy was buoyed by a massive debt-fueled housing bubble, fiscal stimulus in the form of the Bush tax cuts and the wars in Iraq and Afghanistan, and a weakening dollar. None of these conditions exists today. The dollar has strengthened, there is no fiscal stimulus in the pipeline, the external backdrop is more challenging, and there is no housing bubble on the horizon. Therefore, if a 1-percent real rate was consistent with stable inflation during the last business cycle, a neutral rate of zero, if not negative, is entirely conceivable today.

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Consumers, Start Your Engines. Although Spending Has Disappointed, U.S. Consumers Appear Poised to Open Their Wallets

Assuming that the economy accelerates through the remainder of 2015, the U.S. unemployment rate will likely continue falling. If the Federal Reserve remains on the sidelines, or tightens monetary policy gradually, the unemployment rate could keep falling for perhaps another year or two. This should have positive implications for consumer spending.

While sentiment has been fairly positive, the "tax cut" consumers received in the form of a decline in gasoline prices has not yet translated into increased consumer spending. Instead of spending, consumers appear to be saving and paying down debt. Research suggests that the steady decline in monthly spending on gasoline that began in late 2014 was accompanied by a similar increase in personal saving. Research also indicates that in prior non-recessionary periods, large declines in gasoline prices have initially been offset by increases in consumer savings. However, following these short-term upticks in savings, consumer spending does begin to accelerate. Given this, anticipate consumers to trade trips to the bank for outings to the mall in the second half of the year.

There are additional reasons to think consumer spending will accelerate, including a healthy job market. Initial claims for unemployment insurance are near a record low as a share of the labor force and the job openings rate is approaching a level not seen in nearly 15 years, when the unemployment rate dipped below 4%. Importantly, there is upward pressure on labor costs, with the Employment Cost Index (ECI) for wages and salaries' accelerating as unemployment continues to fall.

The Greek Crisis Shifted Into High Gear

European stocks declined as the sovereign debt crisis in Greece flared up again. Despite signs of improving economic activity in the 19-member euro zone, investor worries that Greece would default on its debt and exit the currency bloc sent European stocks and bonds plunging at times, including the last few days of the quarter. Contentious negotiations between Greece and its international lenders continued, but the outcome remained uncertain at quarter-end.

In June, the deadline approached for Greece to make a €1.55 billion loan payment to the International Monetary Fund. Greek leaders failed to make the payment and proposed a modified bailout package that would restructure the nation's debt and extend repayment by two years. Greek leaders also called for a referendum in July to allow voters to decide whether to accept austerity measures demanded by creditors. Yields on short-term Greek debt soared well above 30%, reflecting the high level of uncertainty.

Emerging Market Equities Rose amid More Accommodative Policies in China

Broad confidence in emerging markets has taken some knocks, fueled by somewhat slower growth in China. During times like these, it's important to look at the bigger picture. The "emerging markets" category includes a diverse set of countries, markets and companies. Certain nations (notably, Russia and Brazil) are confronted with significant near-term economic imbalances. Other economies such as India, Mexico and Indonesia are in better shape with positive structural reforms underway.

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China may have left the days of double-digit returns in the rear view mirror, but that doesn't mean the road ahead can't be profitable. The Chinese economy registered the lowest annualized GDP growth rate since the international recession in 2009 at 7% for the 1st Quarter. That result continued their multi-year slide due largely to overexpansion and a loss of competitiveness to other emerging markets. The decline is also symptomatic of growing pains nations face as they transform from a manufacturing to service economy. Chinese stock markets posted the largest downward correction since the crisis as prices slid over 20%. The Chinese central bank cut interest rates immediately after the correction. China may offer more opportunities down the road, but care should be taken as it is not the same economy as it was before.

Concern is Appropriate, But the Big Picture Remains Positive

It is quite possible that we may see further turbulence, particularly in international markets, but at this point it appears that it would be more of a normal adjustment to changing conditions. Even a larger correction would be normal in the grand scheme of things and nothing to worry about in the medium to longer term. There is confidence in the U.S. economy, and the strength of our financial markets. As always, a well-diversified portfolio with regular rebalancing is still the best way to meet financial goals over the long run and should be maintained through good times and bad.

Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moodys, Fitch, and S&P is Ba1/BB+/BB+ or below.

Equity Performance

Equity Index	Style	YTD Return As of 6/30/2015	1 Year Return As of 6/30/2015	3 Year Return As of 6/30/2015	5 Year Return As of 6/30/2015	10 Year Return As of 6/30/2015
Russell 1000 TR	U.S. Large Cap Stocks	1.71%	7.37%	17.73%	17.58%	8.13%
Russell MidCap TR	U.S. Mid Cap Stocks	2.35%	6.63%	19.26%	18.23%	9.40%
Russell 2000 TR	U.S. Small Cap Stocks	4.75%	6.49%	17.81%	17.08%	8.40%
MSCI EAFE NR	Foreign Develop Stocks	5.52%	-4.22%	11.97%	9.54%	5.12%
MSCI EM NR	Foreign Emerging Stocks	2.95%	-5.12%	3.71%	3.68%	8.11%
DJ US Real Estate TR	Real Estate	-5.19%	3.62%	8.28%	13.42%	5.90%
Bloomberg Commodity TR	Commodities	-1.56%	-23.71%	-8.76%	-3.91%	-2.62%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 6/30/2015	1 Year Return As of 6/30/2015	3 Year Return As of 6/30/2015	5 Year Return As of 6/30/2015	10 Year Return As of 6/30/2015
BarClays US Aggregate Bond TR	U.S. Core Bonds	-0.1%	1.86%	1.83%	3.35%	4.44%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	2.53%	-0.40%	6.81%	8.61%	7.89%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	-3.08%	-7.09%	-0.81%	2.07%	3.54%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	3.39%	0.10%	3.97%	5.55%	6.89%
CitiGroup 3-Month T-Bill	Cash	0.01%	0.02%	0.05%	0.06%	1.34%

Source: Morningstar®

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