Economic & Market Commentary

The International Monetary Fund (IMF) recently reported that, for the first time since 2007, every advanced economy in the world is expected to expand this year. Rich world growth should exceed 2% for the first time since 2010. For developed economies, including ours, this should have been a cause for celebration, reflected in rising equity prices. For most developed countries this was the case, as equity markets performed well in both local currency and dollar terms for the first half of the year. The U.S. stock markets, however, continued the lackluster pace of the first quarter and turned in a flattish second quarter, concluding the first half in barely positive fashion. Obviously, the rest of the world's equities did better than the U.S., reversing the pattern of the recent past. After outperforming equities in the first quarter, bonds were negative in the past three months, leaving them just in negative territory for the first half. The character of the U.S. stock market continued the pattern of the first period. Small and midcap equities did better than large, growth did better than value, and low quality did better than high quality. The narrowness of stock performance has been a constant theme, which also continued. Only four of the ten S&P groups outpaced the index during the quarter, leaving three outpacers for the half. We have talked about the problems with a narrow focus of stock performance and the compression of valuations in the past. A long period of very narrow performance and multiple compression can mask good business performance in many companies, and prevent superior performance from being rewarded.

Despite what was a tepid first half for financial assets and the trouble in Europe and China, we think the U.S. economy is progressing on course. We came through a rocky and negative first quarter, but it looks like the second quarter could produce a real GDP gain of around 2.5 – 3.0%. Job growth and employment are doing well, as are most other measures of economic health. As a result, we see no reason to alter our broad economic framework for the year from what we have had for some time. As we wrote last time, our expectations are as follows:

- 2 – 3% real GDP growth
- Continued adequate job growth
- Contained inflation
- Modest corporate profit growth
- The beginning of Fed normalization of interest rates leading to higher rates – probably not starting until Q4
- Europe, Japan and China showing improved economic results
- Modest positive returns from stocks

Interestingly, the IMF recently lowered their April forecast of global growth for the year from 3.5% to 3.3%, largely due to the problems recently surfaced in Greece and China. Greece and China are clearly the wild cards in today's picture. Greece is not new to this position. In his epic poem *Odyssey*, Homer wrote of the 10 year wanderings of Odysseus (Ulysses), the Greek leader, after the Trojan War.

The Greek's current odyssey began after the world wide recession in 2010. In fact, we wrote about this in our 2011 year end Commentary: "The most pressing problem, as it has been for some time, is the resolution of the European debt crisis… A structured or managed Greek default is probably already discounted in financial markets, and that event can probably be absorbed without great difficulty. Of course this circumstance is not new to Greece, which according to economists Carmen Reinhart & Kenneth Rogoff has been in default or restructuring 50% of the time since 1800. An unstructured or chaotic default would cause risks to increase exponentially. A cascading of the debt crisis to the point where it engulfs other of the peripheral states is not in the financial markets". While much has changed over the last five years (most of it for the better) the risks remain high. In the years since the recession, Greece has had four governments, two financial bailouts, and two write-downs of debt, yet today debt stands at an unsustainable 177% of GDP. Over this period, Greek GDP shrank by 25% and unemployment is over 25%, with youth unemployment over 50%. Clearly, Greece is in a deeply depressed state.

The current ruling party, Syriza, led by Prime Minister Alexis Tsipras was not even on anyone's radar screen 5 years ago. They appear to be a "ragbag of leftists" and anarchists who are largely unpredictable. As a member of the European Union and the Monetary Union, Greece is in a position to create problems. They have already defaulted on an IMF loan earlier in June, and have a $3.9 billion bond payment to the European Central Bank on July 20th. The creditors proposed a bailout that included significant austerity provisions, which the Greeks rejected last week. Tsipras subsequently submitted a new economic policy proposal, which appears to be a carbon copy of what the creditors originally offered, with some tweaks. The Greek parliament has approved the initial plan, they must now approve the "adjusted" plan, after which the creditors must respond, then the members of the EU, and finally some national parliaments (Germany & Finland most notably) must give their blessing. So we still have long way to go, and there could well be bumps in the road. Approval would result in a 3 year loan to cover debt due, and an extension of some maturities, and perhaps haircuts to some interest dates. Should all of this happen, the Greeks' problem would be "postponed" for 3 years, and in all probability resurface in 2018. If an agreement is not ratified it would, in all likelihood, result in Greece's exit from the monetary union (Euro), which could present a whole range of added risks. However, the monetary issues are not the root cause of Greece's or the European Union's problems. As we wrote in 2012, "Differences in labor costs, productivity and competitiveness are more reflective of the issues that need focus and reform. This is a problem that is cultural in nature and can't be solved in a short period of time. As the Bank Credit Analyst wrote, a monetary union without a fiscal union is always a strange animal". Should the Greeks exit the Euro, they would issue their own currency (Drachma) which would be deeply devalued versus the Euro, ensuring that austere conditions would continue and create greater pain and suffering for a long time.

While the risks surrounding the situation are clearly high, it is important to put them in some perspective. Five years ago, most of Greek debt was in the hands of investors, and banks throughout Euroland. Today, most of the debt is held by the ECB and other sovereign entities. In effect, the risk of default has been shifted from the private to the public sector – from private investors to public taxpayers. In addition, the Greek economy is only about 2% of EU GDP (about the size of Oregon), with tourism representing about 15% of the total. So, while the risks are great and the unknowns many, in general, they appear manageable.

China, of course, is a much larger economy and therefore of greater consequence. Its impact on the whole of the emerging market group is large, and emerging markets now represent more than half of global GDP. China's previously heady growth has slowed, and its future growth has been questioned, taking a toll on virtually all commodity prices, many of which are back near the lows after the 2008 financial crisis. On top of that, we recently had the dramatic crash in China's stock markets. From mid-June to recent lows, the Chinese markets suffered a 27% decline in market value. Citicorp research calculates that loss to be some $4 trillion, twice the size of the Indian economy. This staggering loss has to have some impact on China's future economic growth. In sum, these global risks are many and the derivative effects of them are unknown. We may be able to manage our way through them with some luck; however, the one thing that seems likely is that those circumstances will probably ensure subpar global growth for several more years.

The U.S. stock market ended the first half with a meager gain, earnings grew slightly in the first quarter and consensus estimates are for a slightly down second quarter. This leaves the market (using the S&P 500 as a proxy) at close to 18X current year estimated earnings. In our opinion, that is not cheap and, in fact, by most commonly used measures of valuation the conclusion is the same. The only measure of valuation that indicates a "cheap" market is a comparison with interest rates. The problem with this metric is that interest rates are extraordinarily low. If the Fed were to "normalize" rates they would be significantly higher. The Bank Credit Analyst points out that never before (post WWII) have Treasuries and stocks been so overvalued at the same time. We all know that valuation metrics are a poor indicator of short term stock market performance. Stocks can remain undervalued or overvalued for long periods. However, valuations are a good indicator of subsequent 5-10 year returns, and current metrics indicate longer term stock returns in the mid single digit area. As is always the case when we write our quarterly outlook, we are in the midst of corporate earnings reporting season. Expectations for the quarter have moderated and range from down slightly to up slightly. This bias is mostly driven by the energy sector, which will be reporting negative results, given the decline in oil prices. For the full year, estimates have been coming down since late last year. Operating margins are at record levels. Wage growth has been subdued for a long period, and low interest rates are estimated to have contributed one percentage point to margins over the last 5 years. Those inputs are likely to change (reverse) at some point soon. Likewise, corporate share repurchase (corporate cash, as a percentage of cash flow spent on dividends and share repurchase has doubled over the past decade) has significantly added to per share earnings for many companies. It is expected that many of these earnings drivers will diminish over time. As we have written previously, this environment has made finding attractive candidates to add to the portfolio more difficult. Combine this with the heightened geopolitical risks mentioned earlier and we conclude that the landscape is not as fruitful as it has been. This means it is likely that more residual cash could appear in client portfolios, as we reduce holdings that we think have reached our estimate of fair value and search for more compelling investments.

Fixed Income Review and Outlook

The U.S. bond market had a disappointing quarter as it gave back the gains of the first. The increase in Treasury yields that started in the first three months of the year, continued in the second. Since bond prices move down as yields go up, when we closed the books on June 30, the Barclays U.S. Aggregate Bond Index had generated a -1.68% return for the quarter and a -0.10% return Year-to-Date (YTD).

The market continues to focus on when the Federal Reserve will start to raise the Fed Funds rate target. Most Fed Governors have been vocal in their support of a rate hike in 2015. The Fed wants to raise rates if only to be able to lower them again in the event of an economic slowdown. In the statement following the June meeting, the Federal Open Market Committee (FOMC) noted the improvement in the economy since the first quarter but remained concerned about slack in the labor market and that inflation remains below their 2 percent target. Interestingly enough, following the June meeting, the Fed released the summary of the Fed Governor's economic projections which included GDP and Personal Consumption Expenditures (PCE) inflation guesses that were lower in June than they were after the March meeting. Similarly telling was the projection of where the Governors think the Fed Funds target will be at the end of the year. The median estimate in June was 0.625%, unchanged from March. However, in March, one member suggested that only one tightening would be sufficient by the end of this year. In June that number had climbed to five. Also in the earlier report, four members had the target at 1.00% or greater by December. The number in June? Zero. We think the Fed's first tightening will be in December, and the pace of normalization of interest rates will be a slow.

Treasury Inflation Protected Securities or TIPS (which did slightly better than the overall market in the first half) remain an attractive alternative to nominal Treasuries. The breakeven rate, the point at which investors are indifferent to owning a TIPS whose principal resets with the CPI or a nominal that is completely exposed to inflationary pressures, remains low by historic standards across the yield curve. With some deflationary pressures abating, breakeven rates should trend higher and offer better value than nominal Treasuries. We are hesitant to commit to a large position in TIPS, as forces such as European and Japanese Quantitative Easing and assumed Fed tightening tend to strengthen the dollar and push inflation expectations down. We are holding our allocation to TIPS in the low single digits with an eye on exiting if breakevens move back toward their historic norms or deflationary pressures return.

We are continuing to maintain a defensive strategy with durations of about 90% of our target. We are positioned with most of our interest rate exposure using the seven to ten year part of the curve. We have started to move to a more pronounced barbell strategy in portfolios. A barbell strategy involves holding a mix of securities some with short maturities and others with longer maturities that are less affected by changes in the Fed Funds target.

Agencies, which outperformed for both the quarter and year to date are instrumental in this barbell strategy. We prefer to add bullet Agencies with less than one year to maturity as a highly liquid cash equivalent in order to generate a small yield advantage over that available in short Treasuries. We continue to add callable Agencies opportunistically as volatility moves higher. We look for those bonds with short call dates and two to four year maturities to minimize extension risk.

Investment grade corporate bonds underperformed the market for both periods. Given this poor showing of credit this year, it makes sense to ask, why? After all, the economy recovered from the slowdown in the first quarter and began growing slowly again, and the yield curve began to steepen. Normally credit tends to do well in those circumstances. There are two explanations for the underperformance: supply and uncertainty about the Fed. Last year was a record setting year with respect to corporate issuance, and during the first six months of the year, supply was running 15% ahead of last year. Supply is overwhelming the market. With new issuance occupying the market, secondary issues, held by portfolios whose managers need to sell to make room for new issues, tend to get marked down. Regarding the Fed, we note that historically credit underperforms in the months leading up to, and a few months following, the first tightening. After those few months, credit's greater income return characteristics reassert themselves and credit becomes a better investment vehicle. Given the increased uncertainty about the exact timing of the beginning of the tightening cycle, it's understandable that credit had a poor showing.

In spite of all this, we maintained our earlier allocation to corporates. We like the seven to ten year part of the curve as we see it representing the best value. We continue to prefer issuers with the ability to raise prices or those engaged in ongoing balance sheet repair. And as always, we tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

Mortgages delivered a better than index return for both the quarter and YTD in large part because of the short duration or interest rate sensitivity of the product. Bond volatility, which can drive the prices of Mortgages lower, fell early in the quarter but rose quickly in June, as uncertainty about the timing of the Fed's first tightening moved higher. We held our mortgages position constant as volatility fell and look for further increases in volatility as an opportunity to add to mortgages. We expect to use Collateralized Mortgage Obligations (CMOs) carved from high quality Fannie Mae and Ginnie Mae mortgages with yields comparable to corporate debt. We like structured paper priced below par ($100) designed to be less interest rate sensitive in the face of rising interest rates.