Second Quarter 2015 Investment Environment

- Bond market volatility continued to be the dominant investment theme during the second quarter. The debt negotiations between Greece and its European creditors whipsawed investor sentiment. European bond yields moved rapidly higher, which pushed U.S. bond yields higher. The 10-year U.S. Treasury bond yield rose from 1.87% to 2.34% during the quarter.
- Bonds underperformed stocks as the plunge in bond yields earlier in the year dramatically reversed course. Global investors sold European bonds as the Greek debt default drama intensified and investors worried that other peripheral bond markets in Europe could be next. Rising bond yields created negative returns for bonds.
- Returns for global stocks were barely positive during the quarter. International stocks slightly outperformed U.S. stocks and emerging markets slightly outperformed developed markets.
- Within the U.S. stock market, small cap stocks slightly outperformed large cap stocks and now lead large caps by 3.5% year to date. Small companies benefited from having less exposure to foreign markets as the strong U.S. dollar creates more earnings headwinds for large cap, U.S. multinationals.
- Small cap growth stocks outperformed, lead by the Healthcare and Technology sectors while large cap, dividend yield biased stocks were laggards during the quarter, hurt by rising bond yields.
- According to Goldman Sachs research, 10 stocks, or less than 5 percent, accounted for 63 percent of the 2015 year to date returns for the S&P 500 Index. That's the definition of a narrow market and suggests weak performance for most large cap stocks.
- Oil prices rose 23% during the quarter, with WTI (West Texas Intermediate - the U.S. oil benchmark) trading near $58 per barrel, up from $47 per barrel at the end of March. Gasoline prices followed suit.
- Gold was slightly negative during the quarter, a reflection of continued weak inflation data and the U.S. dollar maintaining its recent strength.
- The table below shows the returns for major asset classes during the quarter and year to date through 6/30/15.

	QTR	YTD
S&P 500 Index (large cap U.S.)	**+0.3%**	**+1.2%**
Russell 2000 Index (small cap U.S.)	**+0.4%**	**+4.7%**
MSCI EAFE Index (large cap int'l)	**+0.6%**	**+5.5%**
MSCI EM Index (emerging mkts.)	**+0.7%**	**+2.9%**
Barclays Aggregate (invt. grade bonds)	**-1.7%**	**-0.1%**
Barclays High Yield (non-invt. grade)	**+0.0%**	**+2.5%**
Barclays Short-term Treasury bills (cash)	**+0.0%**	**+0.1%**
Gold	**-0.9%**	**-0.9%**
WTI Oil	**+23.0%**	**+9.0%**
Lipper Balanced Funds Average	**-0.5%**	**+1.3%**

- The second revision for first quarter 2015 U.S. real GDP growth came in at -0.2%, an improvement from the prior -0.7% estimate. The Federal Reserve Bank of Atlanta is forecasting second quarter real GDP to be +2.2%. The dramatic decline in oil prices and the resulting cuts to capital spending budgets by energy firms plus the strong U.S. dollar (which hurts exports) have been headwinds to the manufacturing sector. The U.S. consumer is spending but very deliberately as wage growth remains poor. New home sales are starting to improve (rental rates are at 80-year highs) and the continued strength of U.S. auto sales are the two major positives for the U.S. economy at this time.

Third Quarter 2015 Investment Outlook

Deal? Or No Deal?

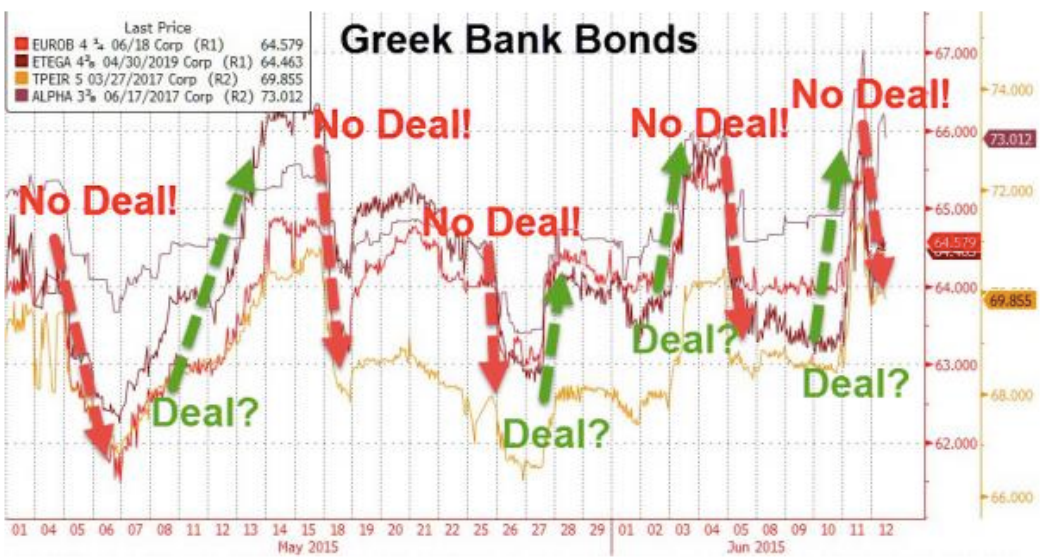
America has been fascinated with game shows ever since TV was invented. Game shows are popular because they offer drama, competition, and people win money. By the late 1950's, game shows were some of the highest rated shows on television. In the early days of TV game shows, there used to be a higher level of intellectual content. The $64,000 Question, Twenty-One, and Password were some of the most popular and intellectually stimulating shows on TV. Today, Jeopardy is the king of intellectual game shows and gives America's intellectual elitists an opportunity to get paid for being smart (since real, good paying jobs remain scarce). Over the past 50 years, Jeopardy has probably done as much for improving the knowledge base of Americans as public schools. My brother Dave tried out for Jeopardy. Dave is very smart but he couldn't get the hang of that dang clicker fast enough to make it out of the Pittsburgh tryouts. Jeopardy requires intellectual ability and quick thumbs.

As TV and America have aged, the game show genre has been watered down, as many game shows today are more about generic entertainment/dumb luck and less about intelligence. Deal or No Deal is one such game show that was based on dumb luck. One lucky contestant gets to randomly select 1 of 26 briefcases that represent dollar amounts ranging from one cent to one million dollars. So, from the get go, the lucky contestant has a 1 in 26 shot or 3.8% chance of becoming a millionaire. The first briefcase selected is set aside and then the contestant picks 10 brief cases initially and the dollar content of each brief case is revealed. If the contestant selects the briefcases with lower amounts, the odds increase that the briefcase initially selected by the contestant contains one of the higher value dollar prizes in it. A veiled man up in the booth, known as The Banker, assesses which amounts have been uncovered and then offers the contestant a prize amount to walk away and not continue. The contestant can take the Banker's deal offer at any time or he/she can continue in the hopes of uncovering more low prize amounts. Each time a new briefcase is opened, the odds change and the banker raises or lowers their Deal or No Deal prize offer.

Not only is each contestant's selection to be on the show an amazing stroke of good luck, but also there was no intellectual skill associated with the selection of any of the 26 briefcases as the game played out. Frequently, dumb (luck) contestants turn down very large prize amounts (often well in excess of what a truly smart person can earn on Jeopardy) under the mistaken belief they somehow have a special skill to keep picking the briefcases with low prize amounts that will force The Banker to keep raising the

Deal/No Deal offer. They quickly get smug and think they are in control until the next briefcase reveals the $1 million prize and The Banker's next offer plummets and their potential prize money evaporates in front of their eyes.

Alex Tsipras, the Prime Minister of Greece, looks like one of those smug contestants on Deal or No Deal. The Deal or No Deal drama between Mr. Tsipras and the Bankers (European Union, European Central Bank, the International Monetary Fund) has all of the compelling attributes of a U.S. TV game show but the stakes are MUCH bigger. The Bankers keep offering Mr. Tsipras a Deal, to which the Prime Minister has replied No Deal every time and keeps playing on, hoping his lucky briefcase contains the most valuable prize in the game: billions of debt forgiveness. Greece, which owes about $350 billion to its creditors, has literally no means to pay it all back. It's all a big game (show) being played between Mr. Tsipras and The Bankers with global investors caught in the cross fire. Global financial market volatility has increased as the game plays on (and on and on and on). Even Howie Mandel is fed up. The chart below shows how the price of Greek bank bonds has popped and dropped depending on how each new Deal/No Deal-Greece episode has played out.



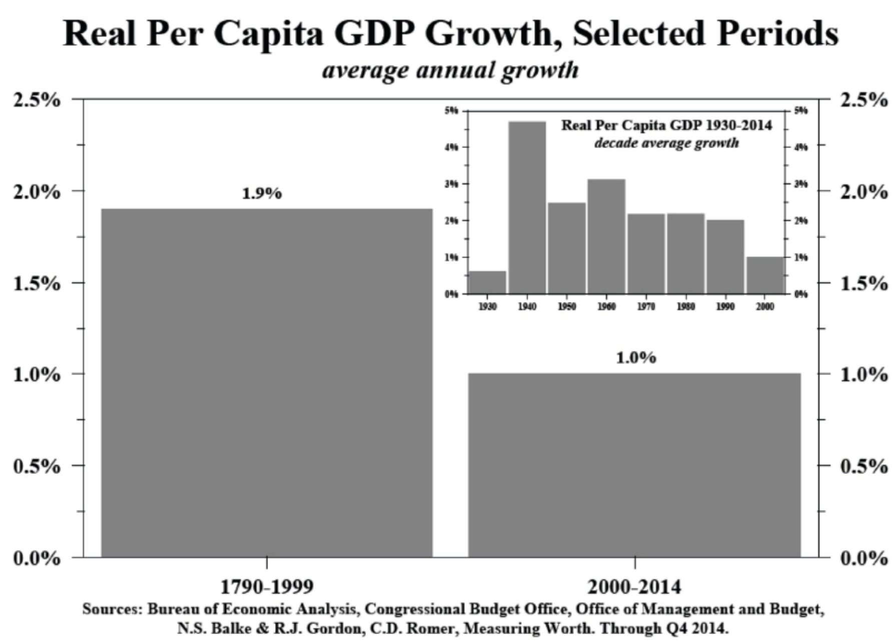
Source: ZeroHedge.com

At the end of June, Tsipras raised the stakes further by turning down the Bankers last offer and calling a referendum vote on July 5th to let the Greek people vote on a Deal/No Deal. The Greeks, whose banks are now shuttered, whose economy is collapsing, and whose ATM withdrawals are limited to a mere €50 per day, voted a resounding 61% for No Deal. This situation remains fluid day to day but as of this writing it is not clear what the final outcome will be of this Deal/No Deal drama. Just keep in mind that markets hate uncertainty so the longer this situation plays out the worse it will get for Greeks and possibly global financial markets too.

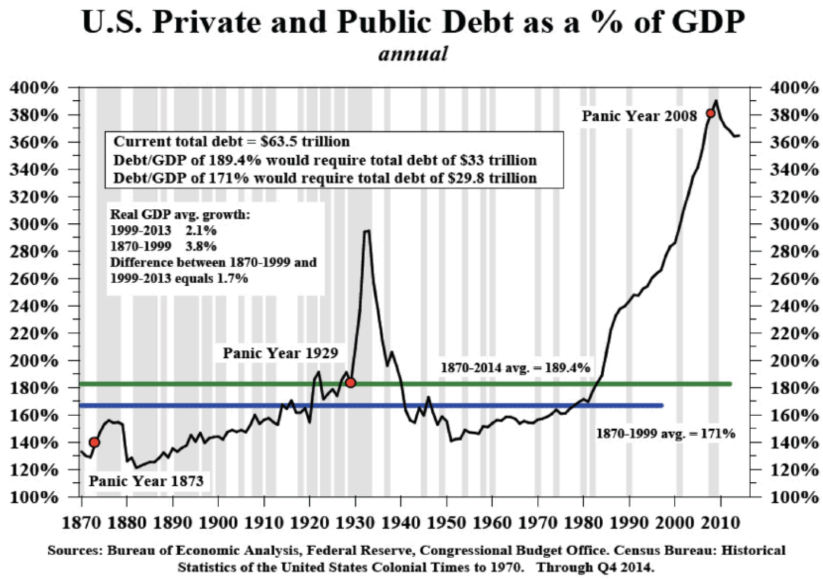
Where's The Beef?

Since the 2008 Great Recession, the U.S. economy has experienced below trend real GDP growth. Despite the Fed and other global central banks providing massive amounts of liquidity to the global financial system, it has not had any meaningful impact on GDP growth rates. The Fed just lowered its expectations for 2015 real GDP growth to just under 2% and its current 2016 real GDP forecast (the Fed's forecasts have consistently overestimated GDP growth since the Great Recession) is 2.5%. The American people keep waiting for this pall to lift yet there never seems to be any traction to get the U.S. economic growth profile consistently above 3%.

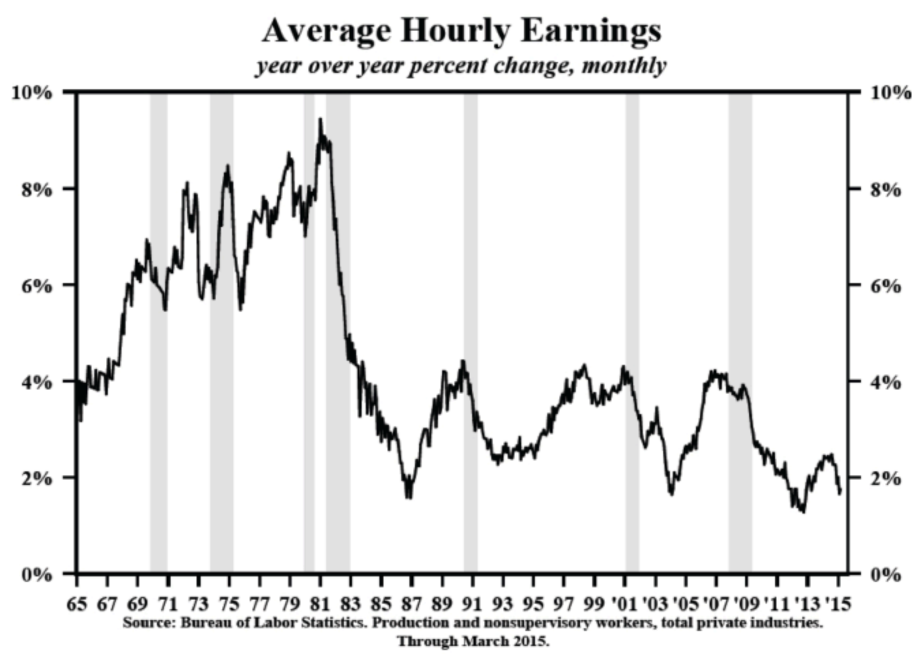
The next chart shows just how woeful the economic growth profile of the U.S. has been in recent years compared to U.S. history. As shown on the left, for the 109 years up to 1999, the real per capita annual growth rate of the U.S. economy was nearly 2%. The mini chart in the upper right breaks down growth rates by decade. The decade starting in 2000 (far right bar) saw the U.S. economic growth profile take a major step lower. From 2000-2014, the 1% real per capita growth rate of the economy has been almost 50% less than the long-term average up to that point in time. Why?



The main reason behind America's (and the rest of the world too) declining and disappointing economic growth rate is that public and private debt has become excessive relative to the size of the economy. Remember that debt represents the pulling forward of future demand. If you borrow today for current consumption, you have to pay off the debt in the future, which directs your cash to repayment of the debt instead of to future consumption, unless your income profile happens to go higher over time as well.

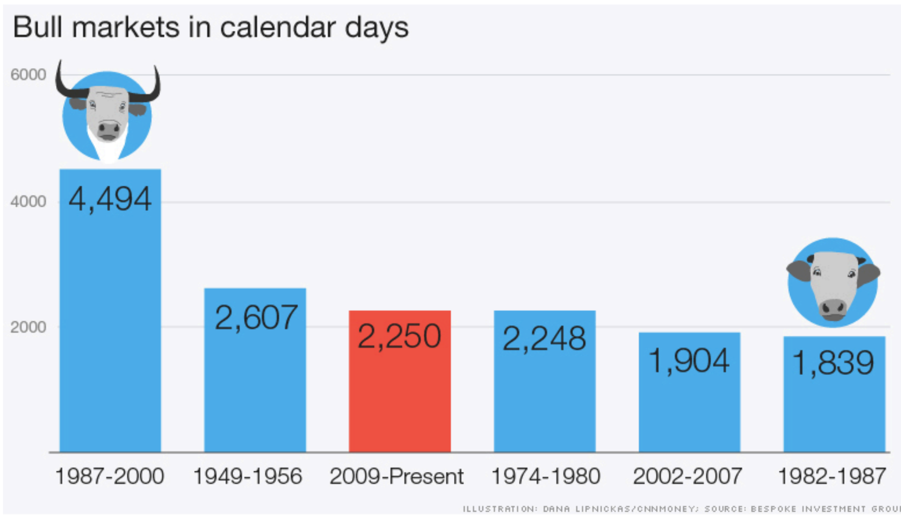


The chart above shows the U.S. debt to GDP ratio peaked in 2010 and has since declined but that the size of existing debt relative to the size of the U.S. economy remains extremely high. Another major problem impacting economic growth is that the average American is experiencing weak wage growth. The next chart shows the average hourly earnings of U.S. workers and indicates wage growth is barely at 2% per year, near the lowest growth rate since 1965. During a time when debt is at very high levels, income growth has also been stagnant. In the U.S., consumption is the largest component of GDP growth. The combination of excessive debt and low wage growth goes a long way towards explaining why the economy cannot get out of its sustained rut. The bottom line is there is too much debt in the global financial system and it needs to be reduced in order for the economic growth rates to move above the current paltry levels in place. After 7 years, it is also clear the Fed's zero interest rate policy is having little effect on driving GDP growth higher.



Fed Inflating Bubbles

Even if the Fed's policies since 2008 have not been successful in driving GDP growth rates higher, its policies have produced other consequences, whether intended or not. One key beneficiary of extreme Fed policies is the U.S. stock market. The current bull market in U.S. stocks is now the 3rd longest in history. The chart below shows the length of the current rally (in days) compared to other major bull market rallies.



Source: Bespoke Investments/CNN Money

Since the U.S. stock market bottomed in March 2009, it has steadily moved higher and without any major or extended periods of pullbacks, which are typical (and healthy) during normal investment cycles. However, this is not a normal investment cycle. In fact, we are in one of the most abnormal investment cycles on record due to the aggressive monetary policy actions undertaken by global central banks, lead by the Fed beginning in late 2008. Only time will tell if this time is truly different but history suggests some degree of payback is coming and overdue from this extended period of easy money. The only question is what could the catalyst be for a market correction.

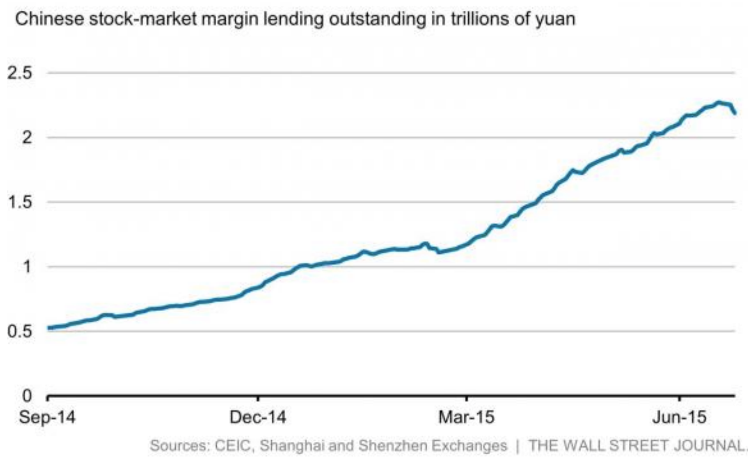
One potential catalyst could be a reversal of cheap credit brought about by the Fed's Zero Interest Rate Policy. Given that interest rates have been maintained at abnormally low levels for such a long time, many investors have adopted a mentality that cheap financing is a given. When investors can use cheap financing to invest in risk assets like stocks, it is not surprising that stock markets will rise from the extra demand created by the access to cheap money. However, at some point (TBD), there is the inevitable correction that comes when the situation gets overextended and begins to reverse course.

The next chart shows the growth of NYSE margin debt (lower section) compared to the growth of the S&P 500 Index (black line). NYSE margin debt is now at all-time highs. Unsurprisingly, so is the S&P 500 Index. The Fed is responsible for the growth of margin debt that has occurred since the 2008 due to its zero interest rate policy. Keep in mind that when the Fed eventually raises short-term rates, the cost of borrowing for margin loans will rise. At this time, it does not appear the Fed will raise short-term interest rates quickly but will most likely take a very deliberate approach. However, on the margin, the Fed raising rates will take away some of the fuel that margins loans have provided to the stock market advance since the March 2009 low. As shown in the chart, in the two previous periods when margin loans peaked (two circles in lower section) and began to decline, the stock market also peaked and followed the decline in margin debt lower (two circles on black line).

The availability of cheap credit is not just a U.S. phenomenon. The Chinese stock market has seen a similar explosion of stock margin debt that fueled a parabolic rise in stocks. Margin loans in China have doubled over the past six months, up $320 billion. The Chinese are notorious gamblers, and the rapid rise in the stock market has pulled in millions of neophyte and uneducated Chinese “investors”. There was a viral video going around recently of an interview with a Chinese pig farmer who said he could make more money trading stocks than raising pigs. As the old saying goes, bulls make money, bears make money, but pigs get slaughtered. Retail investors comprise 90% of the Chinese stock market trading volumes.

Stock prices on the Shanghai stock exchange, which rose 110% over the past year, have recently fallen nearly 30% over three weeks and now frequently rise or fall +/-5% on any given day as the parabolic move over the past year begins to break down. The Chinese stock market (called A Shares) is mostly closed to foreign investors but many Chinese stocks trade in Hong Kong (called H Shares) and are owned by foreign investors. There are also many Chinese stocks trading in the U.S. in the form of American Depositary Receipts (ADRs). A stock market crash in China will have some degree of negative sentiment rub off on other global stock markets although the much of the pain will be isolated to the “pigs” in China that got into the stock market within the past few months. Things appear to be unraveling in the China stock market as 50% of its publicly traded companies asked authorities for a trading halt on their shares given the massive daily upheaval in the stock markets. Of course, only in centrally planned economy would authorities consider such actions. In the West, caveat emptor rules financial markets. The trading of the Chinese ADRs in the U.S. stock markets continues even if trading is halted in China. Some Chinese ADRs experienced 10-20% declines on news of the trading halts in China.

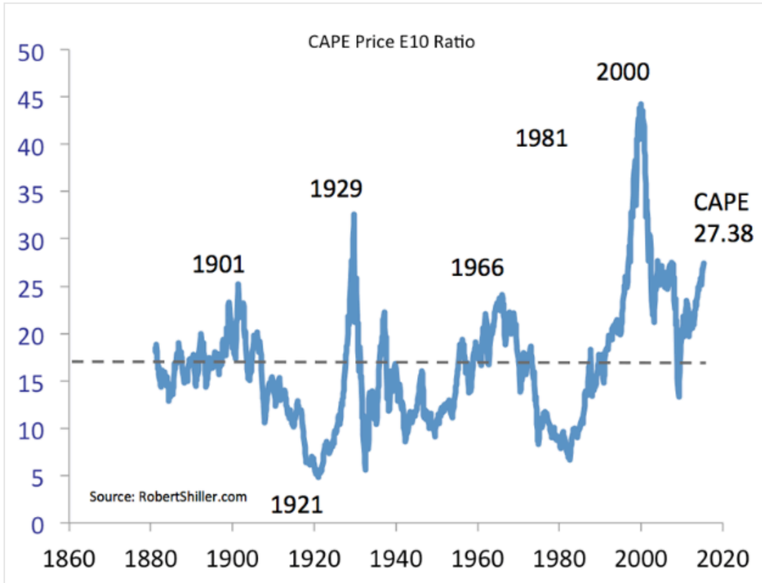
The lesson here is that cheap and easy access to credit creates market distortions that can easily turn on a dime and bite one in the gluteus maximus. We may have reached the inflection point on zero interest rate policies.



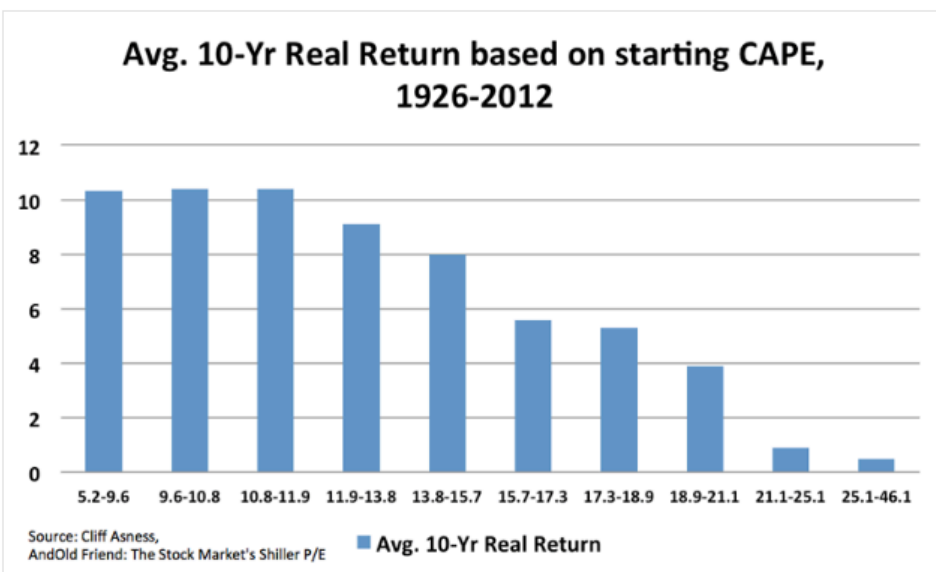
Good Times, These Are The Good Times, Leave All Your Cares Behind

For Chic investors that have had money in the stock market over the past five years, it has been an exceptional good run of performance along with subdued levels of price volatility, thanks to central bank policies. The payback from the current good times is that the future returns from stocks are likely to be below average over the next 5-10 years. The reason is that ultra low interest rates have driven the stock market multiple to expand to a level that suggests future stock returns have a high probability of being lower as a result.

The next two charts show how current valuations have an impact on future returns. The CAPE is the Cyclically Adjusted Price Earnings ratio, a concept developed by Nobel Prize winning economist Robert Shiller. The first chart below shows the 10-year moving average value of the CAPE going back to the beginning of the U.S. stock market in the late 1800's. The dotted line shows that the long-term average CAPE is around 17X. The two greatest stock market bubbles of all time, in 1929 and 2000, show the CAPE reached 32X and 45X, respectively. Today, the CAPE is just over 27X, or the third highest CAPE on record, now exceeding the 1901 and 1966 peaks.



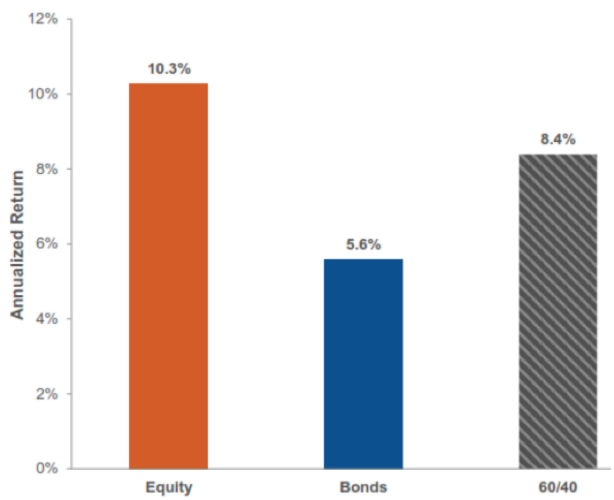
No red-blooded capitalist will ever complain about the strong stock market returns. But, it's important for investors to understand the returns one could potentially earn over the next 10-year forward period based on the current value of the CAPE. This data is shown in the next chart. For example, today the current CAPE is 27. Based on past periods when the stock market traded around this CAPE level, the forward 10-year average return from stocks ended up being in the low single digits. Here's the basic message for investors to take away from this data: be happy to have earned some excellent returns from stocks in recent years but be prepared to earn much less from stocks over the next 10 years.



Resetting Expectations

The previous section discussed why current valuation levels for stocks suggest that future return expectations should be lowered. What is a realistic assumption for returns from a typical balanced portfolio that includes stocks and bonds? The chart below shows the 100-year annualized return through 2014 for U.S. stocks, bonds, and a balanced portfolio comprised of 60% stocks/40% bonds.

Chart 3: Annualized returns over the last 100 years (U.S. only)



Source: Research Affiliates, Bloomberg, Robert Shiller

Let's compare the 100-year return history in the graph above with the more recent returns generated from the primary asset classes that are typically found in most investor portfolios. The table below shows the average returns for U.S. stock, international stock, taxable U.S. bond, and balanced mutual funds as of 6/30/15. This return data is collected and reported by Morningstar.

	1 yr.	3 yr.	5 yr.	10 yr.
U.S. Stock Funds	**+6.1%**	**+17.1%**	**+16.3%**	**+7.9%**
International Stock Funds	**-2.2%**	**+10.8%**	**+9.2%**	**+6.2%**
Taxable Bond Funds	**-0.6%**	**+2.4%**	**+4.0%**	**+4.5%**
Balanced Funds	**+1.0%**	**+9.2%**	**+9.6%**	**+5.6%**

The 3 and 5-year average return from U.S. stock funds are significantly above the long-term 10.3% return while the 10-year returns are below. Keep in mind the 10-year return includes a -35% year during 2008 when the stock market collapsed but the 3 and 5-year returns do not. International stock mutual funds have underperformed U.S. stock funds across all time periods but especially over the past 3 and 5-year time periods. Bond fund returns for all periods are below the long-term 5.6% return. With the 10-year U.S. Treasury bond yield now around 2.5%, and the bull market in bonds now over 30 years old, investors need to significantly reduce return expectations from bond portfolios and should earn well below the long-term 5.6% return for a very long time.

The recent outsized returns for U.S. stocks and the current extremely low bond yield environment leads to a big conundrum for investors with balanced portfolios. For the past 3 and 5 years, balanced portfolios have generated returns above the 8.4% 100-year return profile of a 60/40 balanced portfolio but exclusively due to the outsized returns earned from U.S. stocks. With the current stock market PE level above the long-term average, U.S. stocks are most likely to return less than recent results and below the long-term average. Additionally, bond yields are at historical lows, which means the bond portion of balanced funds are unlikely to deliver anything close to the long-term bond market returns, especially as interest rates rise over time. Therefore, there is a high probability today that balanced portfolios will earn considerably less than the 8.4% long-term average return and below the results of the last 3 and 5-year returns as well. Let's also not forget that any cash holdings in the present zero interest rate policy environment contribute nothing to portfolio returns.

Summary

After years of being suppressed by aggressive and unprecedented central bank monetary policy actions, volatility appears poised to head higher in the years ahead. The Greece Deal/No Deal debt drama and the China stock market bubble are the two primary global events that will dictate short-term market volatility. However, the Federal Reserve Bank's decision on when to finally end its zero interest rate policy and the pace in which it raises interest rates in the future will dictate volatility over the medium term. The Fed's decision to keep interest rates artificially low for nearly 7 years has not only suppressed market volatility but it has also juiced U.S stock returns well above the long-term return experience. As a result, investors need to reduce their expectations for how much return they can expect their portfolios to return over the next 5+ years. Lower returns from investments means that more cash contributions to retirement portfolios may be required in order to meet retirement savings goals. As Monty Python sang in Life of Brian, always look on the bright side of life. You could be living in Greece.

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