Quarterly Economic Update 2Q 2015

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The quarter in brief. Oil prices and foreign currencies reversed, earnings growth rebounded, and economic data slowly improved in Q2. A late inning shock from the Greek debt crisis and the Chinese stock market left asset class returns mixed for the quarter.

Economic news. Real GDP surprised on the downside, declining 0.2 percent in the first quarter. This is after growing at a 2.2 percent in Q4 and a 5.0 percent rate in Q3 of 2014. Lower net exports and business fixed investment were primarily to blame, as plunging oil prices and a rising U.S. dollar hurt the nation's output.

The weakness has been in the industrial side of the economy and can be seen in ISM Purchasing Managers Index (PMI) levels. The PMI reading hit a 22 month low in March (51.5) after peaking at 58.1 in August of last year. The economy has been feeling the effects of a 50 percent decline in the price of oil, where energy related projects got pulled, capital expenditure budgets were slashed, and suppliers and service providers saw their backlog disappear. The contagion has been swift and severe. Recent estimates put the negative impact of falling crude at nearly 1 percent of U.S. GDP. At the same time a stronger dollar weighed on GDP growth by reducing US exports, clearly a weak spot in the Q1 GDP report. The consumer benefits from lower energy prices and a strong currency are well documented. The industrial sector however, tends to feel pain first, and that appeared to be the case in Q1.

Consumer sentiment has finally picked up and is back near the highs before the great recession. Growth in nonfarm payrolls rebounded with increases of 254,000 and 223,000 jobs in May and June after a couple of soft months in March and April. The labor market continues to tighten as job openings are actually at the highest level since the end of the '90s and wage growth, which averaged 2.2 percent in Q2, is on the rise. As a result, U.S. consumer spending recorded its largest increase (+.9 percent month over month) since 2009 while the savings rate declined to 5.1 percent.

Greece was in the news again as it missed the deadline for the 1.5 billion payment to the International Monetary Fund (IMF) at the end of June. Eurozone officials refused to extend the bailout package, the ECB cut liquidity, and Greek banks were forced to close. During negotiations, Greek Prime Minister Alexis Tsipras called for a referendum to vote on whether to accept austerity measures. A "no" vote from Greek voters (61 percent majority) led to another round of negotiations, which eventually led to a new agreement that included a new bailout of 86 billion over the next three years. The fanfare was similar the second time around, however, market reaction was far different. Though Greece represents only 2 percent of Europe's GDP, the risk of contagion to the rest of the Eurozone was always the risk. Now, the IMF and ECB own most of the debt, not the banks, lessening the systematic risk across the region. The fact that bond spreads in the periphery remained fairly stable would support this theory.

Markets. Stocks rallied early in the quarter as stronger economic data and better than expected Q1 earnings helped push the market 3 percent higher through mid-June, only to have the Chinese stock market correction and the Greek debt crisis take much of it away by quarter end. The S&P 500 was still able to eke out a positive return (+.28 percent), marking the 10th consecutive quarter of positive returns for the popular index.

Mid cap stocks (-1.54 percent) were the worst performing domestic equity group in the quarter. Large cap and small cap stocks performed similarly in Q2, however, small cap (4.32 percent) has outperformed large cap (.95 percent) by a large margin year to date.

After peaking in March, the U.S. dollar weakened in Q2, helping returns on assets held outside of the U.S. Developed international markets ended the second quarter with small gains as measured by the MSCI EAFE Index. The local-currency return for the EAFE index was -1.61 percent, but because of currency translation, it managed to earn a .62 percent return in U.S. dollar terms.

Index Performance	Q2 2015	Q1 2015	YTD
Domestic Equity			
S&P 500	0.28%	0.95%	1.23%
Russell Mid Cap	-1.54%	3.95%	2.35%
Russell 2000	0.42%	4.32%	4.75%
International Equity			
MSCI EAFE	0.62%	4.88%	5.52%
MSCI Emerging Markets	0.82%	2.28%	3.12%
Fixed Income			
Barclays Aggregate	-1.68%	1.61%	-0.10%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

China's main stock index, the Shanghai Composite, dropped more than 30 percent from mid June to early July. Due to the wild swings, the Chinese government intervened and cut rates more aggressively in an effort to support the market. Even with the dramatic sell-off, Chinese equities were not only positive for the quarter—they were amongst the leaders—helping emerging market equities post a positive return in Q2. The MSCI EM Index finished up .82 percent despite all of the volatility.

The 10-year Treasury yield rose .35 percent in Q2. Most fixed-income categories suffered losses during Q2 as rising rates and wider spreads caused negative returns during the quarter. Long duration bonds had the largest decline, while lower credit quality categories outperformed. Overall, the Barclays Aggregate Bond Index suffered a 1.68 percent decline in the quarter.

S&P 500 Sector Performance	Q2 2015	Q1 2015	YTD
Consumer Discretionary	1.92%	4.80%	6.81%
Consumer Staples	-1.74%	0.99%	-0.77%
Energy	-1.88%	-2.85%	-4.68%
Financials	1.72%	-2.05%	-0.37%
Healthcare	2.84%	6.53%	9.56%
Industrials	-2.23%	-0.86%	-3.06%
Information Technology	0.18%	0.57%	0.76%
Materials	-0.48%	0.99%	0.50%
Telecommunications	1.59%	1.54%	3.15%
Utilities	-5.80%	-5.17%	-10.67%

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Healthcare continued to be the top-performing sector for the second straight quarter, driven by ongoing merger activity and the overall defensive nature of the group. Financial stocks outperformed in the second quarter as a shift to higher interest rates would be of great benefit banks. Industrials, energy, and material stocks were all lower as commodity pressure and dollar strength in Q1 hurt both reported and forecasted earnings growth. Utilities sold off as the rise in long-term interest rates made their dividend yields relatively less attractive.

Outlook. The uninspiring performance of U.S. stocks so far is understandable given the circumstances. Economic data has not met expectations, the strong dollar is hurting company earnings, and the oil shock is working through the economy. While understandable, it is likely temporary.

Low energy prices, strong job growth, and moderate wage gains could finally lift personal incomes—leading to increased consumption—and extend the economic recovery. The Federal Reserve is still expected to raise rates in Q4, and when it does, it will do so at a time the rest of the world is raising theirs. This has the potential to further strengthen the U.S. dollar. While this would continue to crimp the industrial side of the economy, it could make it easier for the Fed to be more methodical with monetary policy, as dollar strength could offset inflationary pressures from rising wages.

S&P 500 Index earnings growth outside the energy sector continued to be healthy, surprising on the upside again with "ex-energy" earnings up 8 percent in Q1. Decent earnings growth and continued merger and acquisition activity remain positive for stocks. In fact, M&A activity is 30 percent higher than this time last year.

So far this year, we are reminded why international stocks make sense in a diversified portfolio. Through June, stocks in Europe and Japan had gained 12 percent and 17 percent, respectively, while the U.S. was up just 1.2 percent (all in local currency terms). Aggressive stimulus in two of the world's largest regions is proving effective. Japan's economic growth is accelerating with real wages turning positive for the first time in two decades and capital expenditures rising. Lower energy costs, aggressive quantitative easing, and a weaker euro have helped elevate the Eurozone's growth outlook. Calendar year earnings expectations are positive for the first time in 5 years.

The positive commentary is not meant to imply that everything is great, just that it is much better than Q1 would indicate. Global growth remains sluggish and much of the world is battling structural issues—issues that are being dealt with by aggressive monetary policy. The Chinese stock market meltdown has many wondering about its broader impact given the fact that China imports roughly $1.5 trillion in goods from the rest of the world each year. On top of all that, the one area that has been a pillar of strength, the U.S., is on the cusp of removing monetary support.

Nonetheless, our stance remains the same: there appears to be more good than bad and we maintain our positive bias. Major bets, positive or negative, however, seem unwarranted given the recent turmoil and volatility.