Insights: August 2015

Market Overview and Performance

As Greece faded into the collective sunset of investor attention during July it was far cry from just one month prior. In the month of June, the market was held captive to the unfolding drama between Greece and its creditors. The fact that we committed last month's Insights entirely to the topic is a testament to its influence. However, the ordeal came to somewhat of conclusion as Greece, backed into a corner and out of options, had no choice but to accept the ECB and IMF's terms.

While there is still a long road ahead for Greece and the European Union, the progress made during the month allowed investors to devote some of their mindshare to other matters as well, most notably the volatility in the Chinese equity market, the timing of the first U.S. interest rate hike and corporate earnings results from the second quarter. This is a good thing since it denotes a shift away from markets being driven solely by macro events and a return to a focus on economic and company fundamentals. Hopefully this trend will continue throughout the coming months and provide a pathway beyond the sideways and "boring" market we have been experiencing for much of the first seven months of 2015. While there was plenty to occupy investors in July, once again, we saw muted returns for the period.

Thank you for taking the time to read our thoughts and insights on the markets. We hope you enjoy the last few weeks of summer.

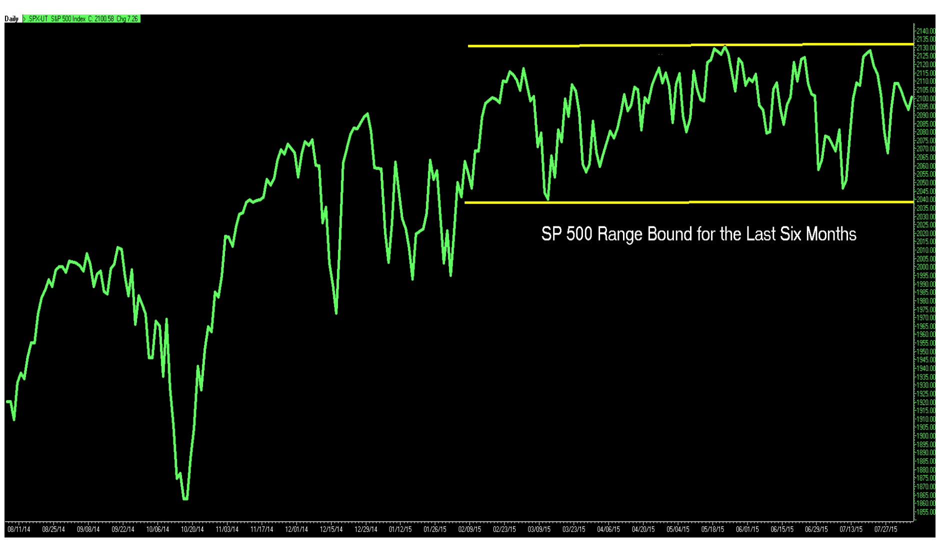
	Month to Date	***Year to Date***
Equity	***Percentage Change (USD$)***	***Percentage Change***
S&P 500 Index	1.97	2.18
Russell 2000 Index	-1.16	3.54
MSCI EAFE Index	2.08	7.72
MSCI Emerging Markets Index	**-6.93**	**-4.19**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.70	0.59
Barclay's U.S. Credit Index	0.63	-0.16
Barclay's Corporate High Yield Index	-0.58	1.93
Barclay's Municipal Bond Index	0.72	0.84
Macro Measures		
Gold	-6.55	-7.52
Crude Oil	**-20.50**	-11.54
CBOE Volatility Index	**-33.52**	-36.88
USD Dollar Index	1.74	**7.65**

July Themes – Back to Fundamentals; Sideways Market Persists; Earnings Resilient; Timing of Fed Rate Hike Debated; China and Puerto Rico Remain Concerns

Sideways Equity Trend Still in Place

The S&P 500 closed out the month of July with a gain of roughly two percent which largely offset the two percent decline of the prior month. In fact, the index's July return of 1.97 percent accounts for most of the year-to-date return of 2.18 percent. And so it goes. As we have been saying since late spring, the "treadmill" market where there is lots of activity but little forward progress continues to prevail. To put some numbers around it, consider this: since February, the S&P 500 Index has not fallen more than three percent below 2100 or climbed more than two percent above that level.

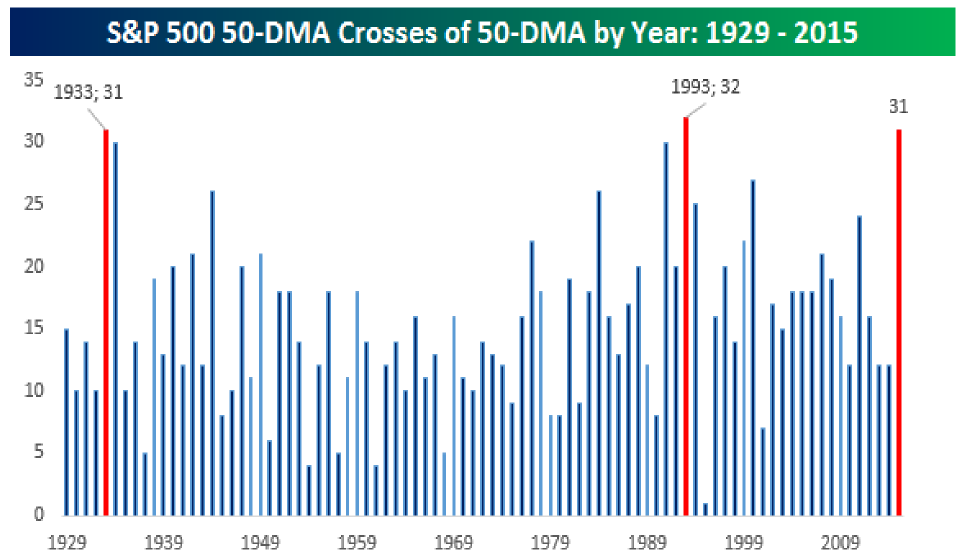
S&P 500 Index Range Bound Since February



Source: Thomson One; S&P Dow Jones

What's more, from a technical perspective, one of the indicators utilized by traders to assess short term market direction is the 50 day moving average. When the Index trades above that level, the trend is bullish and when it dips below, the opposite is true. As Bespoke Investment Group highlighted, through the first trading day of August, the S&P 500 has crossed its 50 day moving average 31 times this year. There have only been two other years where more than 31 instances have occurred and we are only seven month into the year. That is the definition of a sideways market.

S&P Has Crossed Trendline over 30 Times in 2015

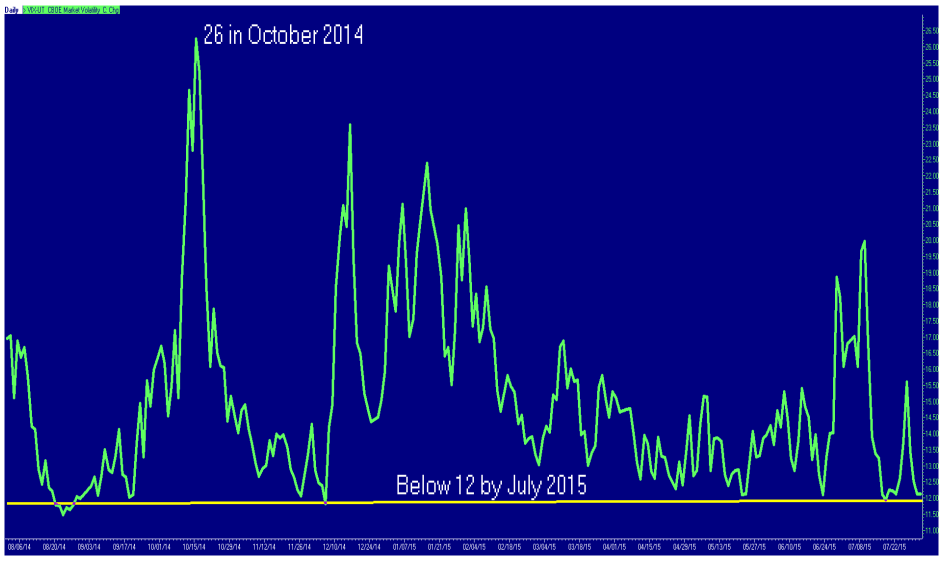


Source: Bespoke Investment Group.

All of this lack of progress may seem unimpressive and perhaps even unappealing to some, but consider what equity markets have weathered over the last six months – the potential break-up of the Eurozone, a bursting Chinese equity bubble, Fed interest rate uncertainty and various increasing tension points in the Middle East. That's a pretty serious list of issues to contend with and yet, equity markets have held up. We are referring just to the U.S. here, but developed international markets have fared even better in terms of returns this year, climbing over seven percent as a group, despite the macro headwinds.

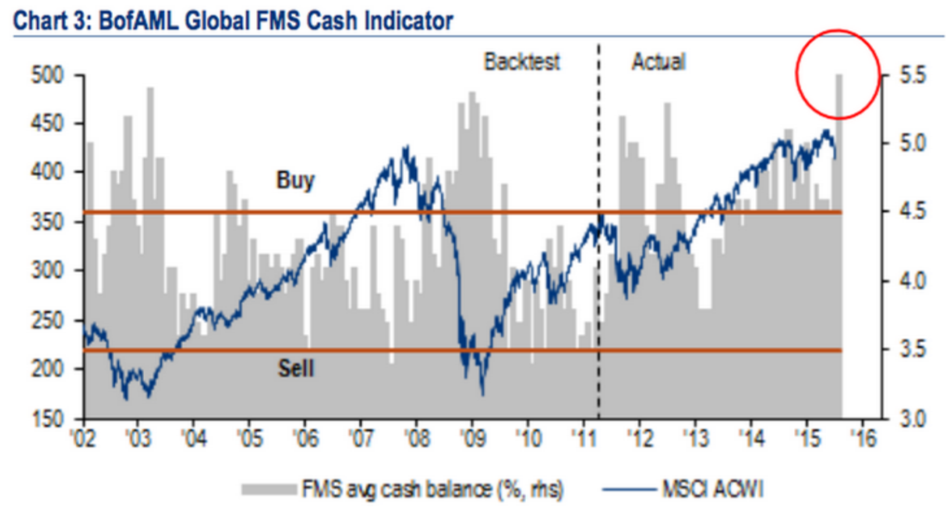
Given the environment, one might expect that volatility would be elevated this year and particularly during this summer given the events in Greece. However, we find that the opposite has occurred. In fact, the CBOE Volatility Index (VIX) has fallen significantly for the year and even just since June as seen in the chart below, touching multi-year lows during the period. Perhaps sideways is not such a negative thing in the eyes of investors then.

CBOE Volatility Index (VIX) at Multi-Year Lows



Source: Thomson One; CBOE

Fund Level Cash Balances Highest in Years



Source: BofA Merrill Lynch; Reformed Broker

A reasonable question at this point might be that if the market is not reacting dramatically either positively or negatively to developments and volatility is low, does that mean that the market is too complacent? We can't rule out that possibility however, there are several factors present which would suggest that this is not the case.

Sentiment, Earnings, and the Economy

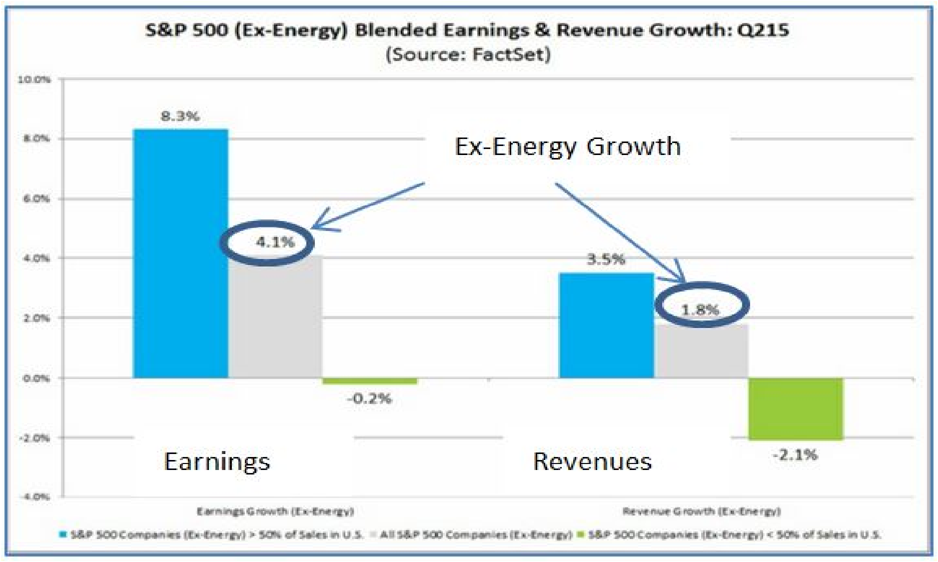
One of the indicators we monitor and have talked about in past Insights is investor sentiment, or how investors perceive the outlook for the future investment environment. There are several surveys that track this type of data. BofA Merrill Lynch looks at Wall Street strategists' consensus views which is now well below average in terms of bullishness (51% versus average of 59%). And with regards to individual investors, the American Association of Individual Investors records weekly readings and states that bullish outlook for the next 6 months is just 21 percent versus a long-term average of close to 40 percent. Those data points suggest a fairly high level of caution rather than complacency on the part of a broad range of investors. Perhaps more notably this month, BofA Merrill Lynch in their Global Fund Manager Survey found that portfolio managers are holding cash in their funds at the highest level in many years (5.5%).

In reading this, you might be tempted to think that this all beginning to sound like sentiment is in opposition to a sideways market and low volatility, however, these are contrarian indicators. By that we mean when cash levels are high and investors are cautious on the near-term outlook, it has historically been a good time *buy* equities.

The question then becomes what to do next? The market is directionless but resilient and managers are sitting on cash. Additionally, with Greece seemingly in the rearview mirror, the macro picture looks a bit more benign now as well. As we indicated in our opening comments, it is going to be left to fundamentals to drive the market forward, which again, is a beneficial transition for the market.

The most immediate signpost in the month of July was the deluge of second quarter corporate earnings being reported. As usual, this quarter's earnings season has generally been viewed skeptically by investors as CEOs' list of culprits for what appear to be mediocre results included softness in Europe and China, the strong U.S. dollar, and a thriftier U.S. consumer. However, as we suggested in our May Insights piece which discussed first quarter earnings, if you simply look beyond some of the headline numbers, you will find that corporate America is faring quite well.

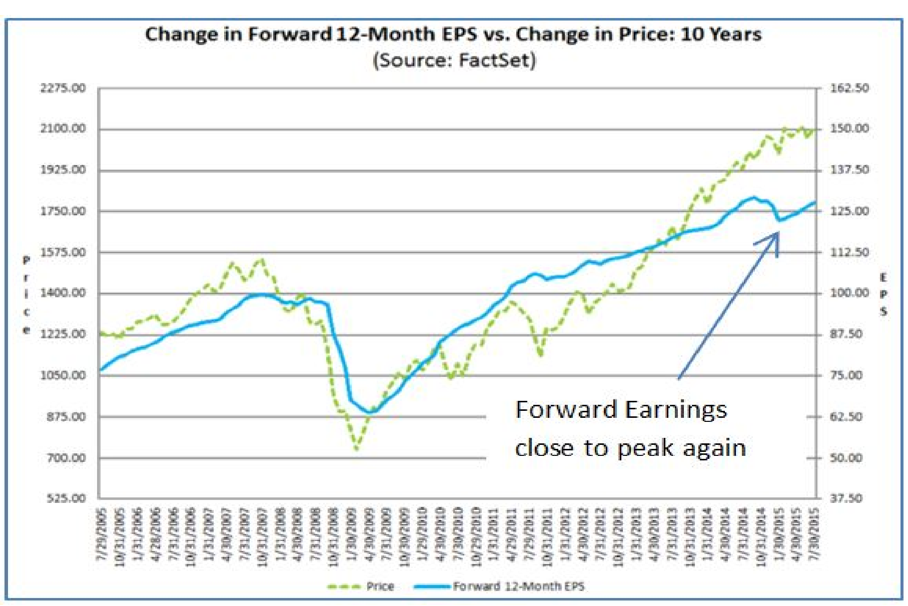
Earnings and Revenue Ex-Energy Surprisingly Strong



Source: Factset

The aggregate numbers for S&P 500 companies through the end of July showed basically flat earnings growth and a two percent decline in revenues (sales). However, if you look at the other sectors outside of the hard hit energy sector, earnings growth of over four percent is being produced by the broader market this quarter. Similarly, revenue growth excluding energy would be almost two percent. While those numbers may not be astoundingly high, they are a far cry away from a contracting economic environment and help to demonstrate the strength in the economy across a wide segment of industries. Certainly, areas like Healthcare continue to lead, but other areas like consumer discretionary and financials are posting solid growth rates as well.

Forward Earnings Once Again Being Revised Higher



Source: Factset

Importantly, as the previous chart highlights, not only are current results better than some would suggest, but the forward outlook is improving as well. As the chart from Factset illustrates, after some retrenchment during the first quarter when estimates for full year growth were being reduced, the second quarter has brought a return to an anticipated path higher to record earnings levels.

This is certainly a positive and fits well with the economic data that has been steadily improving over the last few months and reinforced by figures reported in July. In fact, there were a number of notably strong economic indications released during the month pointing to a very robust growth and activity levels from a number of areas. For example, business activity in the service sector, the largest component of the economy, reached a ten year high. Housing permits, starts and sales were all notably higher in July as well. Construction spending, especially in areas like manufacturing and lodging, were especially strong. And of course the labor market continues to be the driving force of the recovery with jobless claims now sitting at a 42 year low. All of that is to say there is ample evidence for a re-accelerating economy in the second half of 2015. The chart below from Citigroup showing their economic surprise index illustrates the inflection since June very clearly.

Citi Economic Surprise Index Showing Acceleration

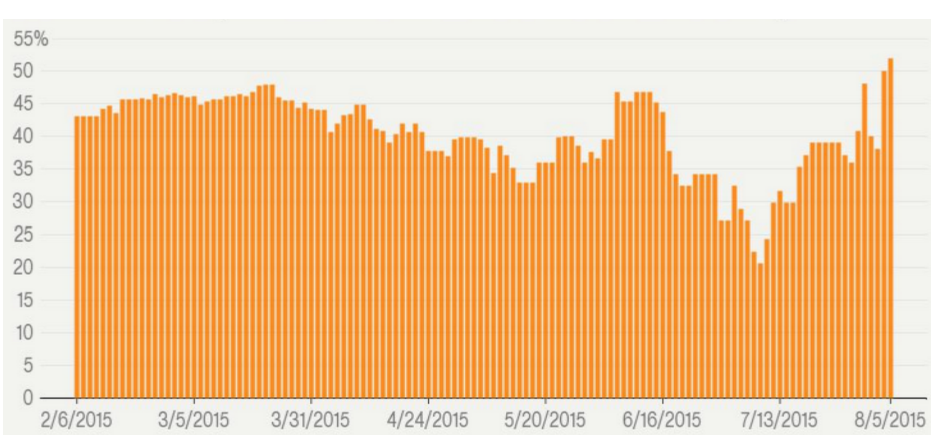
Source: Citigroup; Wells Capital

This would all seem to point to a green light for the Fed to raise rates in September, no? One would think, however a number on contradicting items arose during the last few days of the month which muddied the waters a bit.

First, on the 28th, the Consumer Confidence Index plunged from 99.8 in June to 90.9 in July, a massive surprise. Concerning, but merely a one-off perhaps. Second, on the 30th, Q2 GDP came in at a disappointing 2.3 percent. Even though growth in the first quarter was revised from a negative number to a slightly positive one, the market was still unimpressed. Finally, on the 31st, the Employment Cost Index, key measure of inflation for the Fed, was reported to be virtually flat in the second quarter. As a result, the likelihood of a September rate increase seemed to be diminishing rapidly.

However, to the surprise of almost everyone, Atlanta Fed President Dennis Lockhart gave a speech on August 4th stating that the Fed, "Is close to being ready to raise rates" and that "significant deterioration in data" would be needed to put off a rate increase. The market reaction was immediate, and within a short time frame, the probability of a September rate hike had gone from 20 percent to 50 percent as seen in the chart below. As of now, that is what the market believes is going to happen – a 25 basis point rate increase in September. We shall see.

Odds of September Rate Hike Now Over 50%



Source: Bloomberg; CME

A Few Thoughts on China and Puerto Rico

With the risks surrounding the situation in Greece seemingly addressed for the time being, market participants' risk radar honed in on China and Puerto Rico in July.

With regard to China, the building equity bubble and subsequent bursting in July has been discussed by many, ourselves included. For the most part, the securities involved in that reversal are mainly contained within mainland China. What is more concerning to investors is the state of the overall Chinese economy and the government's capacity to successfully address problems. In the face of a slowing economy, the Chinese government has publicly supported inflating equity markets to spur activity, however when the market got overheated, they were forced to step in to try and slow the pace. This led to several conflicting measures from the central bank and the Chinese securities regulator. The concern is that they do not have control over the situation. More broadly if the stock market decline drags down the country's overall economic activity, the effects will be felt elsewhere around the world since China is both a large producer and consumer of goods at this point.

For Puerto Rico, the situation is simply one of overwhelming debt. Their economy has never recovered from the late 2000's and they attempted to paper over shortfalls with more debt until the situation become untenable. While they defaulted on a small payment this week, they have sizable general obligation payments (viewed as backed by full faith and credit) due in the coming months. There is a bill being reviewed in Congress to grant them debt relief, and the current consensus is that a solution will be reached at some point soon.
Both issues are legitimate concerns but are in the early stages of development. We will be closely monitoring for signs of deterioration as things progress.

Going Forward

As we mentioned last month, in anticipation of increased volatility, we took profits in selected areas of the fixed income and equity markets earlier in the summer. Once we received more clarity in Europe and experienced a reduction in volatility in July, we reduced cash exposure and added to U.S. and developed international equities. We are still constructive on equities both in the U.S and in developed markets abroad for the remainder of the calendar year.

Within equities we continue to favor the large cap segment of the U.S. market. We would prefer to achieve our exposure through cyclical areas of the market such as the technology, health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy and a strong dollar. These sectors have performed well so far this year. However, we continue to look for areas of future opportunities in areas such as the financial sector. We think this group is well positioned to benefit from a weaker dollar, higher bond yields and improving global growth and we will be looking to add to our exposure.

Our non-U.S. developed markets exposure has served us well this year. While we are still believers in the strong U.S. growth story, we think that international diversification through allocations to Europe and Japan in particular will allow us to participate in improving economic conditions globally. Both of these global regions continue to provide confirming data points on the progress of their respective recoveries and each remain in a very accommodative policy environment. We are encouraged by the progress in the European Union regarding the periphery nations and believe that Europe represents a good long-term investment opportunities.

Additionally, Japan continues to make progress on its structural reforms which has helped propel that market consistently higher throughout the year.

We remain underweight traditional fixed income. With an anticipated increase in the Fed fund rate most likely coming in September, we continue to advocate an emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. Whether the first hike comes in September or December, the narrative is the same.

Commodities remain structurally challenged in our view. With oil moving sharply down from the mid $60 range back to the mid-$40 range in July, we are carefully looking at entry points for long-term investments, however we continue to cautiously monitor this sector before increasing exposure given the global developments such as a potential deal with Iran which are influencing the market beyond just simple demand and supply dynamics.

Thank you for taking the time to read some of our thoughts this month. With August typically being a quiet time in the markets, we hope you get to enjoy some rest and relaxation as summer comes to a close.