ECONOMIC & MARKET REVIEW

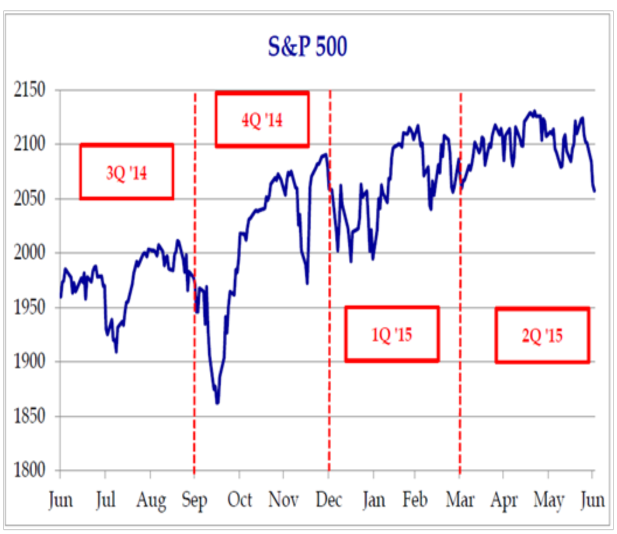
Second Quarter 2015

Returns were subdued this quarter. Collectively, large cap U.S. equities were positive, but barely. Small caps did better, but the best equity market return was found in emerging markets. Interest rates went up, so the return of the taxable fixed income market was modestly negative.

All in all, the first half of 2015 proved to be full of events and topics, but investment returns simply marked time.

Second Quarter and Year-to-Date 2015 Performance:

	2nd Qtr.	YTD
S&P 500	*+0.3%*	*+1.2%*
Russell 2000	*+0.4%*	*+4.8%*
Barclays Agg.	*-1.7%*	*-0.1%*
MSCI EAFE	*+0.6%*	*+5.5%*
MSCI EM	*+0.7%*	*+3.0%*



Source: Strategas Research Partners

This year's increase in volatility has, at a minimum, knocked the incredible run of remarkably high correlations among stocks into the ditch. This year you no longer see good and bad stocks moving up and down in lockstep with each other. The market is finally differentiating. This quarter brought a bag full of crosscurrents: somewhat weaker than expected earnings, higher interest rates, a Greek default and the threat of Puerto Rico doing the same.

But not everything was negative. The U.S. economy shrank by 0.2% in the first quarter, a result of foul winter weather. The second quarter, however, seems to have rebounded nicely, repeating the same pattern from the first half of 2014. Consumer confidence has shown strength aided by better job growth, still low fuel costs, low inflation and modestly higher home prices, which were up 4.2% for the last year. The consumer has by far the most impact on overall growth, so strength in confidence should lead to improved retail sales. Also, there is clear evidence that wages are moving higher. This is another positive for consumers as average hourly earnings seem poised to accelerate further. Job growth, if not spectacular, is at a minimum solid. So far in 2015 we are averaging 215,000 new jobs a month. While that is lower than the monthly average in 2014, the consistency of job creation is impressive. The unemployment rate has dropped to 5.3% and will likely continue to move lower.

The discussion of solid, but not robust economic growth, an improving job market, higher average hourly earnings and improving retail sales leads to the conclusion that the Federal Reserve is on course for a September rate hike. We are no longer in an "emergency" and the need for zero percent short-term rates has passed. While I do believe that rates in general will continue to rise, the pace of the rate increase should be modest.

I think it is a mistake to be distracted by Greece. This is an interesting finance and political story but, in my opinion, not worthy of obsession. I am more concerned about China than Greece. China finds itself as the largest contributor to global growth, (India is second). The Chinese have many issues: real estate valuation, leverage, regulation, pollution, on and on. They are a much more "managed" economy and can manipulate economic activity easier than most countries. However, there is a risk that events could spiral out of control. I really don't believe that is likely, but must acknowledge the risk of that outcome is not 0%. The rest of the world needs China to be successful at managing a soft landing.

Here is a list of what I consider important: U.S. economic growth is fine, interest rates are modestly moving higher, earnings matter…a lot. With PE multiples on the high side, the growth rate of earnings now through 2016 will be important in order to allow equity prices to move up. I think that is likely, but it will not produce any more than a single digit return over the next twelve months. There is nothing wrong with that, considering how far we have come. But, in a relatively low–return environment, I think that is about all you should expect.

I believe the second half of the year will bring better U.S. data. Housing seems to be improving, preceded by an improvement in household formation. Consumer confidence has improved to a level that should lead to improved retail sales and lift growth. Rates will move higher, but shouldn't reach levels that would impede an improving economy.

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