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INSIGHTS

A QUARTERLY NEWSLETTER BRINGING YOU FINANCIAL INSIGHTS

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2015 Q2 Insights: "Puerto Greco"

	NOTABLE SECTORS	Q2	TTM
STOCKS	***GLOBAL EQUITY***	***0.35***	***0.71***
	U.S. Large Cap (S&P 500)	*0.28*	*7.42*
	U.S. Small Cap (Russell 2000)	*0.42*	*6.49*
	International Developed Markets	*0.62*	*-4.22*
	International Emerging Markets	*0.69*	*-5.12*
BONDS	***GLOBAL BONDS***	***-1.18***	***-7.09***
	U.S. Aggregate (High Quality)	*-1.68*	*1.89*
	U.S. High Yield (Low Quality)	*0.00*	*-0.40*
	International Aggregate	*-0.83*	*-13.19*
	Emerging Market Debt (USD)	*0.45*	*0.20*
ALTS	*Gold*	*-0.96*	*-11.36*
	Commodities	*4.66*	*-23.71*
	Master Limited Partnerships	*-6.09*	*-19.81*
	Real Estate	*-10.44*	*3.93*
CASH	*Inflation*	*0.46*	*-0.48*
	Cash (3-month T-bills)	*0.01*	*0.02*
	U.S. Dollar Index	*-3.37*	*18.37*

RECAP: Like most quarters, Q2 certainly saw an abundance of newsworthy stories. But unlike most quarters, the news seemed to come from all corners of the globe. China, in the midst of a new wave of investor frenzy, saw massive price movements on their mainland stock exchange. The Shanghai Index rose 38% *within the quarter* only to subsequently drop 22% from its highs in the final weeks of June. Greece, only 4 years removed from their first default within the PIIGS European debt crisis, threatened a 're-default' as their new fringe political leadership balked at the existing austerity-tied loan bailout packages from the European Central Bank and the International Monetary Fund. Closer to home, Puerto Rico was also near default with the island's economy unable to support its $72 billion debt load (if it were a state, Puerto Rico would rank 29th in terms of population and 37th in terms of GDP, but astonishingly would rank 3rd in terms of debt size!). Finally, investors continued to focus on Washington D.C. and the Federal Reserve, trying to determine when the Fed would move interest rates off of zero, signalling an end to the emergency monetary policy first put in place nearly 7 years ago.

Yet despite this all, Global Equity returns remained virtually unchanged, finishing the quarter with modest gains. Likewise, U.S. stocks also ended the quarter relatively flat, with dividends driving them into marginally positive territory. If one looks at price only, the S&P 500 closed the quarter down four points at 2063, marking the first negative quarter since 2012q4 (breaking a streak of nine winning quarters). But although the S&P 500 price action was negative, it should be noted that the index was negative on only four of the 64 trading days in the quarter—the first two days serving as bookends to the last two. Intra-quarter, stocks rose to all-time highs. The S&P 500 climbed to 2130 on May 21st followed by the NASDAQ pushing to 5160 on June 23rd and finally surpassing the index's all-time high of 5048 set over 15 years ago.

After tepid gains in the first quarter, the meager Q2 gains for the S&P 500 brings the index's total year-to-date return to a mere 1.23% with little volatility. In fact, the first half of 2015 marks the first time in history that the index's year-to-date gains were neither up nor down more than 3.50%!

Whereas last quarter all U.S. asset classes (stocks, bonds and cash) had record quarters, this quarter witnessed losses in both bonds and the U.S. Dollar. Domestic bonds broke their own streak, suffering their first quarterly decline since 2013q4 as the yield on the 10-year Treasury Bond rose 40 basis points (from 1.93% to 2.33%). The Global Bond Aggregate also lost ground, as yields rose

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around the globe including Germany where interest rates rose in the face of QE from the absurdly low 0.16% to the still low 0.77%. Finally, the U.S. Dollar similarly lost ground this quarter, retreating nearly 3% from its record run set earlier in the year.

EQUITY: As posited here last quarter, the headwinds of the cold east coast weather and the west coast port shutdown did indeed prove temporary and the U.S. economy regained momentum throughout the quarter, allowing stocks to march to new highs. But new headwinds (rising interest rates and default fears in Greece and Puerto Rico aka "Puerto Greco") dampened investor enthusiasm and kept a lid on gains—especially over the last days of the quarter. While *Puerto Greco* will likely prove temporary, it would be wise to caution that investors are in somewhat unchartered waters—a U.S. Territory (Puerto Rico) currently does not have a legal method to file bankruptcy, and a Developed Market (Greece) has never been in arrears (the official and more civilized way to say 'default') with the IMF. Nevertheless, there were pockets of equity strength in the quarter as International Small Caps posted a 4.53% gain.

On the other hand, the major headwind of rising rates looks more sustainable given recent improvements in the economy and ongoing strength in the jobs market. This headwind took a toll on interest-rate sensitive securities, as high yielding Utilities lost -5.80% in Q2. But with the significant rise in interest rates, investors should be content that most equity indices eked out small gains—unlike the "Taper Tantrum" of 2013. Strange, however, was the similarity of returns and the tight spreads between varying investment styles. For example, the spread between the gains in U.S. and International stocks was only 25 basis points (bps), Growth and Value saw only a 27 bps spread, and the spread between Large and Small Cap was a miniscule 14 bps. We doubt this trend will continue.

FIXED INCOME: The U.S. Aggregate index lost -1.68% in Q2 (the third worst quarterly loss dating back to 1996, trailing only the losses in 2013 and 2004). Lower quality bonds, however, fared better as Credit outperformed Government with High Yield posting a flat quarter. Why the discrepancy in performance? While high quality Government bonds are sensitive to changes in interest rates, lower quality Credit bonds are sensitive to changes in the economy as well as interest rates. As the economy rebounded from a weak Q1, economically sensitive bonds fared better than interest rate-only sensitive Government bonds. Moving forward, we expect this trend to continue.

ALTERNATIVE ASSETS: Commodities bounced back during Q2, rising over 4% as Crude Oil rebounded nearly 25% (from $47 to $59 by the end of the quarter). However, similar to Utilities, interest-rate sensitive assets such as Master Limited Partnerships (MLPs) and Real Estate Investment Trusts (REITs) both suffered sizeable losses (falling 6.09% and 10.44% respectively). While interest rates look poised to rise further, the path of rate increases by the Fed should be gradual. If so, income investors might benefit from locking in current MLP yields approaching 9%.

OUTLOOK: One of the few certainties is that markets hate uncertainty. At the time of this writing, the relationship between Greece and the European Union is still very much in question. And while vitally important to the citizens of Greece, the political posturing in its present state should not pose too much of a risk to the economic fundamentals of global stocks. Nor should the problems of Puerto Rico. While the warm beaches of *Puerto Greco* may entice you to spend your vacation dollars there this summer, we urge your investment dollars to seek out refuge elsewhere—namely the Far East. A shift and reallocation to Japanese equities may prove profitable as the region is still benefitting from an accommodative central bank, low valuations, high projected rates of growth, and a weak currency tailwind—not to mention a multigenerational shift in local investor attitudes. The drink of summer? It's not Rum or Ouzo—its Sake.

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