Investment Viewpoint

July, 2015

Overview

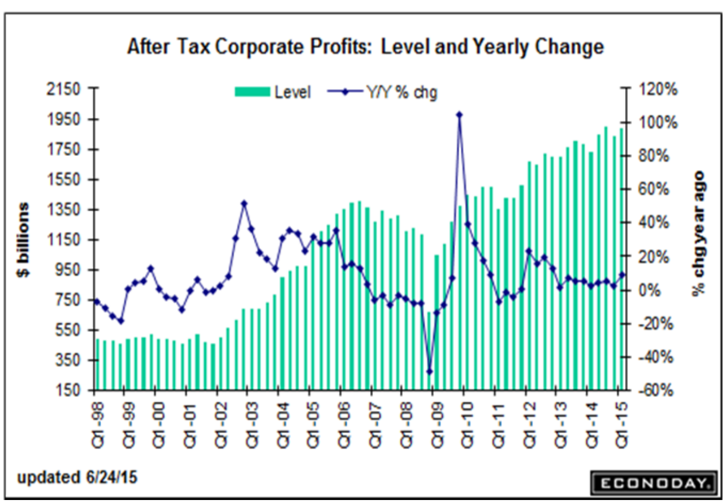
Second quarter Gross Domestic Product (GDP) appears to have expanded at approximately 2.0% on an annualized basis, a rate that was markedly better than the first quarter's decline of 0.2% but well below the 3.0% that was expected. First quarter numbers had been weak, owing to severe winter weather, the West Coast port shutdown, huge reductions in energy capital spending, and the effects of a rising U.S. dollar (versus other currencies, hurting U.S. exports). Although second quarter GDP growth was probably "sub-par", domestic job and housing trends were encouraging. Total corporate profits were strong in the first quarter, expanding 9.0% on a year-over-year basis, and likely grew in the second quarter.

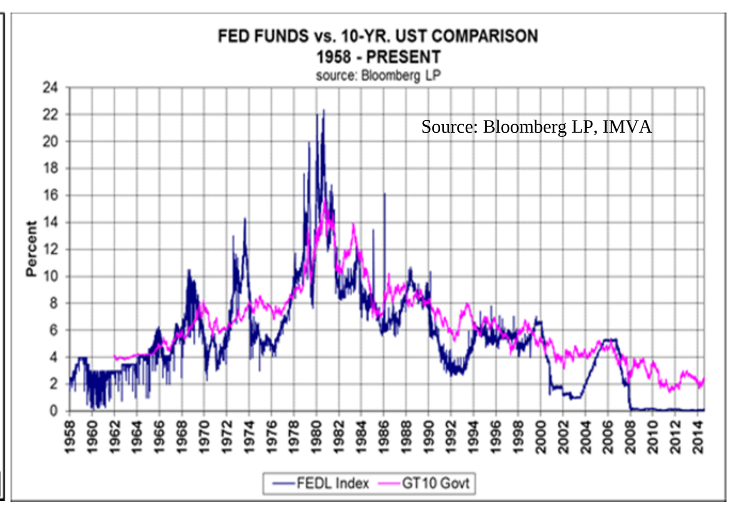
Against this mixed backdrop, the quarterly returns for the S&P 500, the Dow Jones Average, and the Russell 2000 were 0.28%, -0.32%, and 0.42%, respectively. On a year-to-date basis through June 30th, the S&P 500 stood at 1.23%; the Dow Jones Industrial Average was down 0.01%; and the Russell 2000 had gained 4.75%. The latter's exposure to smaller capitalization companies and more U.S.-centric investment themes helped its relative performance. The Health Care, Consumer Discretionary, and Financial Services sectors generally led the way in the second quarter. Industrials, Energy, and Utilities continued to lag.

Although the Federal Reserve remained on hold during the second quarter, the 10-year U.S. Treasury yield rose from 1.9% to 2.4%, reflecting investors' expectations that "normalization" is inevitable. With subdued wage growth, slack in the labor market, inflation still running well below targets here at home, and with weakness and uncertainty abroad, we expect the Fed to move gradually and incrementally either late this year or early in 2016.

At quarter-end, Greece missed its payment to the IMF, "a first" for any developed country borrower. Resolving Greece's debt problems will take time and likely raise market volatility. The Euro, however, showed strength into June 30th, reflecting confidence that Greece's problems will not create broad contagion. Greece represents less than two tenths of global GDP.

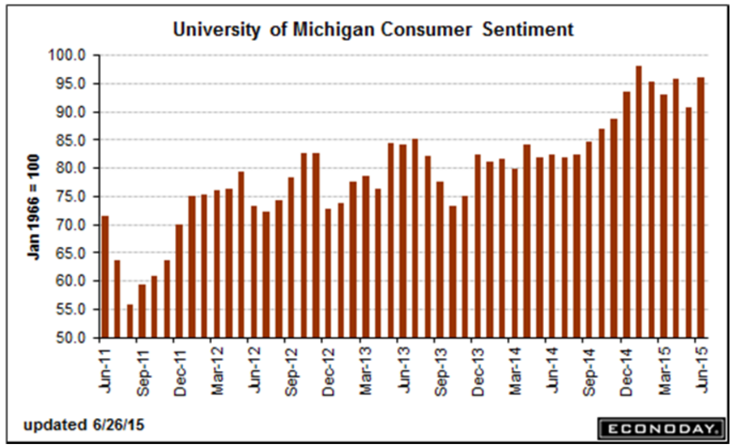
Bull markets typically end with a recession. Even though S&P 500 Index earnings may have declined in the second quarter, we believe that total corporate profits expanded. This conundrum, among other worries, prompted the market to stall. We view this consolidation as healthy. Future earnings growth will tell the tale.

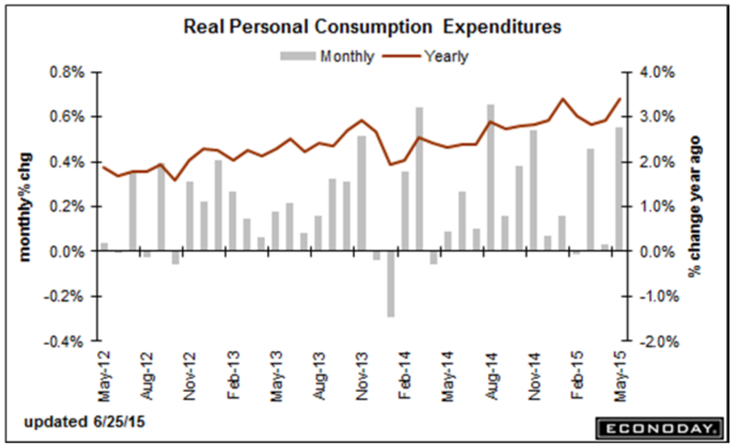


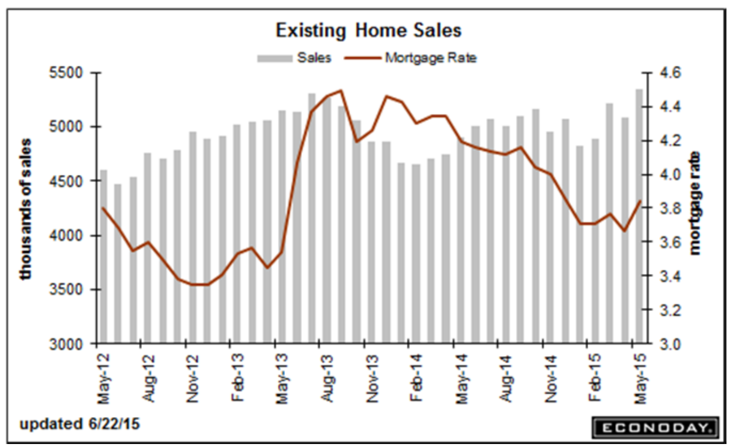


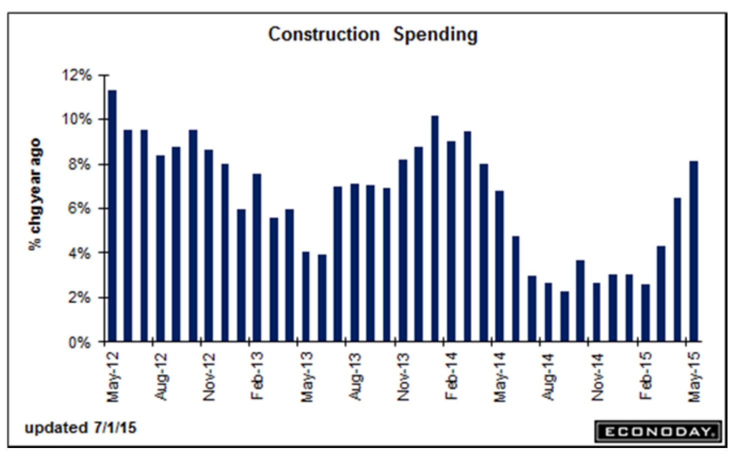
Economic Trends

- The ISM manufacturing index signaled expansion in June for the 30th consecutive month, revealing modest growth in new orders, production, and employment. Exports and pricing contracted, however. Weakness in energy equipment orders continued, and non-defense orders declined.
- Nonfarm payroll growth averaged 221,000 in the second quarter (versus 195,000 in the first quarter), and year-over-year average hourly earnings rose 2.0%. Moreover, personal income rose 0.5% in May (month-ever month). These improvements in employment and income trends raised consumer confidence; the expectations component of that index recently reached a 12-year high.
- Personal outlays, as reflected in auto and retail sales, have shown strength as well. June auto sales were very robust at a 17.2 million unit annual rate.
- May housing trends were encouraging, following an upward revision of the April data to growth of 8.1%; existing home sales rose 5.1% to a 5.35 million annual rate; single-family home sales were up 9.7% year-on-year; and median home prices were up 7.9% year-on-year.
- Stronger home sales, coupled with low inventories, caused residential housing permits and construction spending to spike in May. In a similar vein, construction for manufacturing facilities rose 6.2% in May, the fourth straight monthly gain.









Financial Conditions/Monetary Trends

- Quantitative easing formally ended in October of 2014, and interest rate increases loom on the horizon. Nonetheless, financial and monetary conditions remained highly supportive through June 30th; interest rates vacillated around 50-year lows. Looking ahead, we expect any changes to be gradual and incremental.
- The money supply continued to grow at a healthy clip (MZM over $13 trillion), and banks had abundant excess reserves (chart on next page).
- Growth in bank loans and commercial and industrial loans remained healthy.

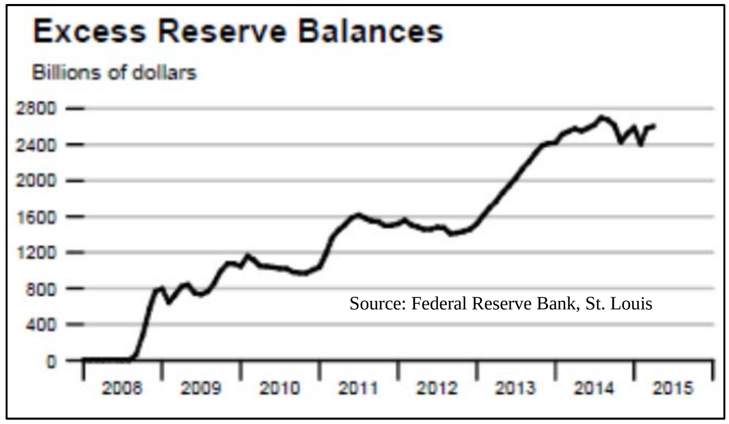
Sentiment Indicators/Market Trends

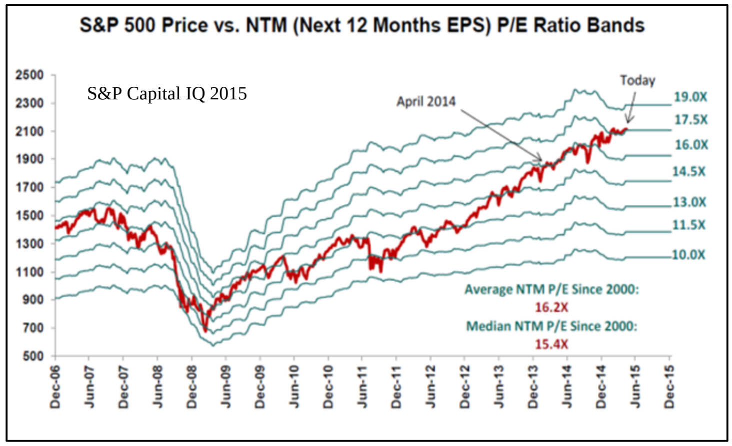
- As of June 30th, Sentiment and Market Trend indicators generally reflected neutral readings, having been extremely bullish and overbought at year-end. Given the litany of concerns among investors (valuations, interest rates, Greece, China, Ukraine, ISIS, etc.), the declines in bullishness were not surprising.

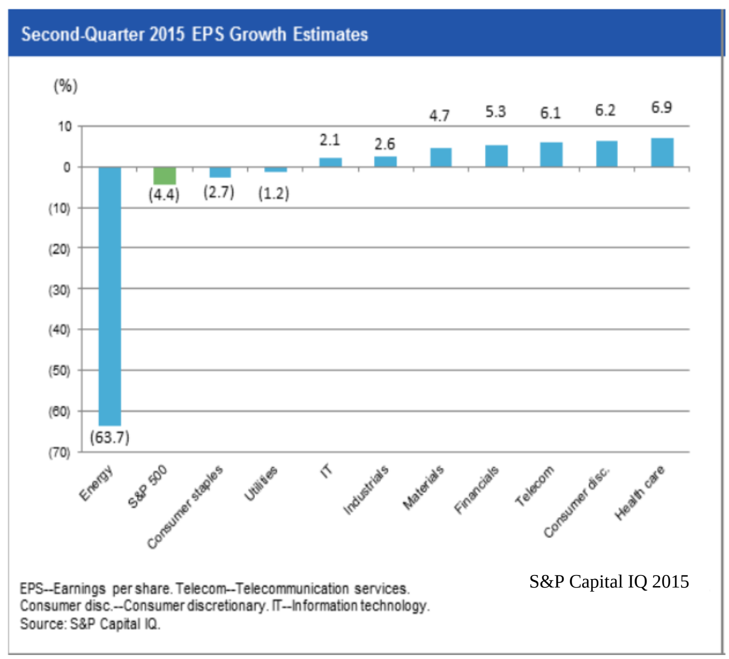
- With respect to sectors, industries, and market capitalizations, many of 2014's leaders trailed in mid-2015. Mid-sized and small capitalization companies, whose revenues are driven primarily by domestic U.S. end-markets, generally outperformed in the second quarter – partially explaining how total corporate profits (those of all companies) can rise while S&P 500 Index profits (those of 500 large companies only) can decline concurrently.

Equity Market Valuations & Earnings

- The difference in the S&P 500 Index price between November 21, 2014, and the close of the second quarter was a mere 0.39 points. Periods of sideways movement/consolidation often set the stage for future advances, assuming that earnings continue to advance.
- With a P/E ratio of 17.5x, the S&P 500 Index valuation appears full. Improvements in revenue and earnings growth will be the critical ingredients for further progress this year.
- S&P 500 Index earnings advanced 2% in the first quarter but likely declined by 4.3% in the second, the first decline since Q3 of 2009 (according to S&P Capital IQ aggregate consensus data). Weak Energy earnings and currency translation adjustments were the major culprits.
- Seven of the ten S&P 500 industry sectors are expected to report positive earnings growth for Q2 of 2015, with negative growth coming from Energy, Consumer Staples, and Utilities. Excluding the energy sector drag of -63.1%, S&P 500 earnings growth would be up approximately 3.8%. Earnings in Health Care, Consumer Discretionary, and Telecommunications are expected to have been strong in the second quarter.







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