July, 2015

It’s hard to believe that we are already half way through the year; how the time flies. In this commentary we will revisit our end of the year themes as highlighted in our February commentary, but this is how the 2nd quarter played out. The 2nd quarter of 2015 saw stocks mostly flat as investors digested soft 1st quarter GDP growth in the U.S. and the continued standoff between the Greek government and the Eurozone. During the quarter, large cap equities as measured by the S&P 500 returned 0.3% while mid-cap and small cap equities returned -1.5% and .4% respectively. Abroad, the story was much the same with developed international stocks increasing by 0.8% while emerging markets declined -0.2%. Fixed income declined -1.7% in the quarter as interest rates began to creep higher. Turning to alternatives, commodities reversed their decline gaining 4.7% in the quarter, while MLP’s and real estate declined -7.5% and -10.8%.

The Economy

For the second year in a row, the U.S. experienced negative 1st quarter GDP growth, contracting 0.2%. This was largely due to weather-related factors along with the west coast port closure which ended in February. This economic recovery has been one of the weakest after a recession with U.S. GDP averaging just 2.2% over the last 5 years versus almost 3% after the attacks on 9/11. While weak, it does appear to be sustainable and has had the effect of lowering the unemployment rate from above 10% to 5.3% today, all while inflation has remained in check. Moving forward the focus will be on the Fed and when and how they exit their zero interest rate policy. We believe reasonable scenarios for rate increases are 25 basis points in September and then another 25 basis points in December. We also believe the Fed will not look to move quickly from there, with many economists calling for a 25 basis point increase each quarter in 2016. That would put the fed funds rate near 1.5% at year-end 2016, still well below historic averages. As we have said in previous commentaries, our economy doesn’t feel like it warrants a zero interest rate Fed policy, with unemployment below 5.5% and growth appearing modest yet stable. We feel it’s important for the Fed to get off zero in order to “restock its quiver with arrows” should the economy begin to falter and need additional stimulus. Last quarter we spoke a bit about the dollar’s strength and our concern that that could be detrimental to U.S. profits, and its negative implications for U.S. GDP growth. We have seen the dollar weaken recently which has eased our concerns a bit. However, it’s not what has happened but what may happen that we focus on and moving forward we do feel there is potential for the stronger dollar to act as a headwind to economic growth. We will be watching these developments closely.

Equities

Much like the 1st quarter, equities were led in the 2nd quarter by developed international, albeit very slightly. The Greek debate continues as the Greek government attempts to thwart any additional austerity efforts placed on it by the European governing bodies. (Although I expect that by the time you read this there will be much more clarity on the issue.) Because of this, financial support in the form of Greek bank lending has been cutoff. The reality is they must accept austerity measures to remain part of the Eurozone and avoid the disastrous impact to their economy should that come to fruition. While this is tragic for the Greek people, who have suffered through a deep and protracted recession culminating in > 25% unemployment, we believe that much of this debate is simply headline risk and will not have any lasting effects on the overall recovery of European economies. It is worth noting that International equities have underperformed US equities 4 of the last 5 years (including emerging market equities), which has resulted in portfolios that diversify equity exposure globally to significantly underperform the US equity benchmark S&P 500. We have written previously of the tendency for some to begin to question the merits of a diversified approach and look to chase performance by allocating a greater amount of capital toward the S&P 500, an approach that we feel is ill-timed and short-sighted. We are optimistic that we are now seeing the benefits of maintaining a diversified approach. Over the last 5 years, developed international stocks have underperformed the S&P 500 by 9.65% annualized over that time period. The last time we observed this type of 5-year underperformance, international stocks outperformed the S&P 500 by over 9% annually over the next 5 years. We hope this reinforces the need to maintain a diversified approach and resist the temptation to chase performance. Domestic equities were essentially flat in the quarter with the strong dollar and energy sector weighing heavily on corporate profits and investor sentiment. We expect corporate profits to pick up in the 2nd quarter and the last half of the year and look for markets to continue to move higher but at more modest pace than years past. We wanted to briefly touch on China, as it has been in the news of late. There is no doubt you have read of the wild ride in Chinese equities. The Shanghai index began the year at 1500 and touched 3287 in mid-June before retreating back 2500 by the end of the quarter (even further as of the time of this writing). It's worth noting that U.S. investors cannot purchase or participate in the Shanghai equity market. This market is for Chinese citizens only and outside investors cannot invest directly in these stocks. We have spoken here many times about our outlook for emerging market equities of which China is an important factor of that thesis. Because of this, we do own Chinese stocks but through the Hong Kong market not the Chinese market-an important distinction given the recent volatility.

Fixed Income

We hope you will take the time to go back and read our end of the year 2014 commentary where we predicted rates would rise this year. Forecasting the movement of interest rates is extremely difficult, so we are proud that our research led to such an accurate and astute prediction. Obviously we say this in jest since we had the same prediction in 2013 which was off by a regrettable margin. Rates have finally started to rise, with the 10-year moving from 2.25% at the beginning of the year to 2.35% at the end of the quarter. With the fed signaling that they are ready to lift off the zero fed funds target, the broad fixed income benchmark may experience a negative return this year. While the outlook for fixed income looks challenging, we want to remind you that bad years in fixed income are not like bad years in equity. For those who cannot tolerate the risk inherent in equity markets, we still believe that holding fixed income assets is a safe alternative. We continue to favor non-constrained and alternative fixed income strategies over traditional fixed income exposures.

Alternatives

With the recent volatility in energy prices, it was surprising to see commodities actually up in the quarter. Oil price volatility has and will continue to be the key driver for commodities moving forward. While domestic oil production continues to come off line, the total U.S. production for 2015 is estimated to be greater than 2014. Demand does seem to be picking up slightly, however, with the possibility of increased global production via the Iran negotiations, we feel there is likely further room for oil to move lower near term. Real Estate declined fairly significantly in the quarter. The macro backdrop for real estate continues to be positive, but investors have moved into real estate over the years chasing yield and that trade is beginning to unwind given increasing interest rates. MLP's were negative in the quarter due to rising rates and a similar unwinding of a yield-chasing trade.

Halftime Report

As you may recall, in our February commentary we outlined 6 themes that we felt might play out throughout 2015. We will revisit each below and update you on their progress.

1. ***"We see continued strength in the U.S. economy and further upside to U.S. equity prices……The stronger dollar should make small caps slightly more attractive …… we also expect increased volatility"***

   Our first theme seems to be playing out much like we expected. The U.S. economy has continued to grow, although arguably slower than we would like. Equities are positive on the year with small caps outperforming and volatility has certainly increased. We feel this will likely continue to be the case for the 2nd half of the year as corporate profits accelerate slightly and economic growth continues.

2. **"Interest rates will rise"**

   We knew we would eventually be right on this call, as it was simply a matter of when, not if. Barring any unforeseen geopolitical issues, we do think rates will continue to move higher but our revised thesis is that rates will stay lower for longer and don't see rates moving back to historical averages for quite some time.

3. ***" We feel that the risk in these developed markets is to the upside, especially with the Eurozone"***

   Developed international equities have been a bright spot this year. Looking through the Greek noise, the Eurozone continues to benefit from an easing Central Bank and low oil prices. As headline risks abate, we see continued upside here. The same can be said for Japan.

4. ***"Emerging markets will be a story much like 2014 which is to say there will be winners and losers."***

   Looking back, this statement was not very audacious, as there are bound to be winners and losers in any given asset class. However, we will stick by this theme (another bold call) as many emerging markets are struggling to maintain growth while others are accelerating. We will likely speak more about emerging markets in the coming commentaries, but I still feel the investment thesis remains appropriate for this asset class, namely, the growing middle class.

5. ***"While we don't have strong convictions on the direction of commodities……. increase in domestic supply should have the effect of lowering the top end of the oil market, meaning we may move higher but the years of $100 per barrel may be behind us."***

We did a good job of hedging ourselves here by admitting upfront that we don't have a strong conviction one way or the other, but we do feel that it will be sometime before we are back at the $100 per barrel level, if ever. While we have seen a fairly significant reduction in supply, we haven't seen a commensurate increase in demand. However, with the summer travel season upon us, we may see the demand side of that equation change.

6. ***"We feel that real estate should continue to be a good place to allocate capital."***

   As we mentioned above, the macro environment continues to be strong for real estate, however, it was not a "good place to allocate capital" thus far in 2015. We do feel that much of the underperformance is due to a rotation out of real estate as many investors moved into the space seeking yield in this low rate environment. Over time we would expect the fundamentals to be the primary driver of performance and feel that real estate warrants a place in a well-diversified portfolio.

Overall it appears things are moving much like we expected, however, we will not let this trend move us to complacency. We continue to look for opportunities to add value within portfolios by identifying macro trends or underlining investments that meet your specific investment needs. Toward this end, we recently made a few changes to our allocation. We have increased our developed international equity exposure as low oil prices, easing Central Banks, and strong export environment act as a tailwind to that asset class. In addition, we have reduced our real estate and commodity exposures. The near term pressures both from declining oil prices and investor sentiment warrant reduced exposures in those asset classes.

We are dedicated to the diversified approach and to providing you the exceptional service you expect. Hopefully you are finding the new reports useful and informative and we continue to look for ways to enhance these reports and provide you even greater color and transparency.

As always, we would like to thank you for the trust and confidence you have placed in us and look forward to speaking with you in the coming weeks.