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GOOD TIME
TO GET SOME
GOOD ADVICE

GIMME SHELTER

As the second quarter of 2015 came to a close and the third quarter began, tensions surrounding the Greek debt repayment and a stock market panic in China dominated the headlines. Financial markets exhibited a fearful response as all major asset classes declined. There was no safe haven. The yield on 30-year U.S. government bonds rose from 2.5% to 3.12% negatively impacting bond funds, REITs, utility stocks, dividend producing stocks and gold. Both global and domestic balanced funds fell. Value stocks fell. Leading growth stocks fell. Natural resource stocks fell more than 10% in response to falling commodity prices, continued global economic weakness, a strong US dollar and fears of new oil production from Iran. From a mid-May peak our representative sampling of global asset classes and sectors returned -6.53%. Out of 143 names only biotech, healthcare and homebuilders showed a positive result while the weakest names, mostly international and resource stocks, fell 20% - 30%.

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Portfolio Results and Strategy

Although portfolios also declined during the second quarter, returns remained positive year-to-date. Returns were aided by profit-taking in international equities prior to the drop and an emphasis on US equities, namely, the financial, health care, and technology sectors, where the declines were less severe. We had underweighted REITs (which fell almost 10%) and natural resource stocks earlier in the year thereby avoiding much of those declines. Finally, we emphasized short and intermediate-term bonds, where the backup in rates was not as punishing. Gold has been the one holdout. Normally counter-correlated in times of global instability, we kept our position despite the weakness. This negatively impacted results.

In our last letter, we wrote extensively about the likely impacts of a strong dollar on asset performance. That trend is still exerting an influence on global markets. In response, we have been underweighting natural resource stocks, particularly oil-related issues, where prices continue to fall. We are favoring international equities that are hedged back into the dollar. The weak currencies in Europe and Japan are lifting profits. Greece and China aside, these markets still offer good value and are in the early stages of a long-awaited recovery. The ECB, China and Japan are continuing their quantitative easing, which is both supportive of asset prices and puts pressure on their currencies. A weaker currency (=a stronger dollar), along with persistently weak oil prices, is good news for international manufacturers. We see good investment opportunities in Europe and Japan. This recent sell-off is a buying opportunity.

In the US we have been emphasizing health care, financial services: bank and insurance stocks, housing and select technology. Strong results for healthcare names reflect increased patient participation due to: Obamacare, new drug approvals, new devices and demographics. Financial stocks have shown improving profitability since they benefit from the backup in interest rates. Single family homebuilding is one of the bright spots countering the broad-based decline in manufacturing. Technology, particularly anything internet-related, has shown strong revenue growth in an otherwise slow economy.

Now that long term interest rates have ticked back up to 3%, we see a trading opportunity in long term bonds. Given the relative spread to other countries, the desire for portfolio diversification and a very nervous marketplace, we expect investors will return to US Treasury and corporate bonds, even if just for a trade. Similarly, REITs and utility stocks could also benefit if long rates fall again. Gold is now in a secular bear market, but Ned Davis Research reminds investors that gold “has historically been a good diversifier when: 1.) stock markets have been expensive 2.) the Fed has started a rate cycle, and 3.) bonds have entered a bear market.”

What about Greece and China?

It is likely that Greece will remain in the Eurozone, but the underlying problems remain. In 1997 Milton Friedman wrote that the euro would convert shocks that could have been accommodated by exchange rate changes, into divisive political issues. And while the Euro is a positive for the German economy, it has become a negative for other countries.

Based on history, major debt overhangs are only solved after a deep write-down of the debt's face value. The International Monetary Fund has already recommended debt relief for Greece. But for now, the debt and currency cans have been kicked down the road for a few months. More importantly, the markets have already discounted the developments in Greece. Bottom line, Greece per se is not impacting our investment strategy at this time, but the fears surrounding Greece have created opportunities in other European stocks and we will look to add to our holdings.

Chinese equity prices are experiencing a classic stock market correction following an exponential rise. The Chinese government has responded with an array of measures, including interest rate cuts, trading restrictions and government supported buying, as well as blaming foreigners and short sellers.

China is facing the stock market decline at a difficult time. The economy has weakened considerably; the country is growing at its slowest pace in more than a decade, and debt levels have skyrocketed. The most immediate threats from the market decline would be a spillover into weaker economic growth. In 2015, approximately 40% of world economic growth came from China. As the world's second largest economy, we want to be buyers when price stability returns.

What keeps us up at night?

Global market manipulation remains a troubling concern either from overt restrictive trading policies in China, unbridled quantitative easing in Japan and Europe, and/or a continuation of zero interest rates in the US. This has not been and is still not a time for complacency. The stock and bond markets are heavily influenced by a combination of governmental interference combined with unprecedented debt and liquidity. Normal valuation metrics are hard to use in this zero interest rate environment. There is little precedent for this kind of monetary policy, so the path to normalization could still produce unintended shocks. A deepening of global deflationary forces as evidenced by falling commodity prices or an unexpected rise in rates could lead to a significant market decline. Since 1930, there have only been three other times when U.S. stocks have risen this long and this far without a significant correction. There is a significant narrowing in participation of winners. Investors, seeing few alternatives, are paying up for growth while disregarding value; traits seen at prior cycle peaks. We maintain a vigilant approach to portfolios fully aware that the usual normal safe havens may not provide the same protection that investors have come to expect.

Thank you for your ongoing confidence!

Dave Clara Bill

Dave Rahn **Clara Basile** **Bill Oberman**

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