Summer 2015

Listening to the earnest concern of a CNBC reporter asking how investors planned to "position themselves" over the long Independence Day holiday weekend with the "jobs number" on Thursday and the Greek referendum on Sunday, a quick response of "on the deck in a comfortable chair" seemed innocently flip. That is not to say that current economic data and the international financial situation are not important but that trying to react to the daily parade of seemingly crucial events and reports is fruitless for the vast majority of investors.

The crisis in Greece is just one of many in the realm of sovereign, state and municipal debt. Closer to home, Puerto Rico, the state of Illinois and city of Chicago all face the same kind of reckoning day for overly generous public pensions, early retirements and other unrestrained spending. These entities aren't the first to confront these issues and more will follow as the bills come due in other states and cities. We face difficult choices as a nation as we need to balance the Social Security and Medicare systems in a political environment of rancor and inaction. The Greeks need to make some tough choices soon and while our situation in the U.S. isn't comparable, some hard measures will be needed here as well and the sooner the better.

Debt concerns added to the ongoing debate over the timing of Fed rate hikes and the strength of the economic recovery continue to impact markets. Analysts who called for the initial rate hike in June have had to revise their projections and now September is questionable as the pace of our recovery amidst the international concerns may give pause to the Fed. We would like the Fed to take action sooner rather than later as we do not believe the process will permanently derail the stock market or the economy. Goldman Sachs estimates that, as the Fed increases rates over the next two years, the yield on the 10 year Treasury Notes will rise from 2.4% to 3.0% by 12/31/2015 and 3.5% by year end 2016. This gradual rise could certainly be tolerated by the stock market in our opinion.

Many are concerned that the stock market has advanced for over 6 years without a meaningful decline and that at current valuations a severe pullback is inevitable. Certainly the performance of stocks over the first half of 2015 has not been encouraging as the S&P 500 is up only 0.2% and the Dow Jones Industrial Average is down 1.1% measured by price change only. In terms of total return, the S&P advanced 1.2% and the DJIA was basically unchanged. This uninspiring performance would have been welcomed by many individual stocks which are actually down meaningfully from year to date highs. An S&P Capital IQ report in USA Today on June 10, 2015 stated that 100 stocks in the S&P 500 were down at least 20% from their 2015 highs. These stocks are not necessarily down 20% for the year but have experienced a significant correction from their 2015 peak prices. This rolling correction has hit some industries particularly hard including the airlines, railroads and energy sectors. There are also many stocks down 10-15% from yearly highs but so far we have avoided a significant market decline across all sectors.

In addition to concerns about Greece, other international worries include the tepid Chinese economy and its volatile stock market and the ever present crisis in the Middle East. In spite of these problems, many foreign stock markets actually performed better than U.S. markets in the first half of 2015. The total returns of the Vanguard Foreign Developed Markets Index Fund and the Vanguard Emerging Markets Index Fund were 6.5% and 3.3% respectively versus the 1.2% return of the S&P 500. Small cap foreign stocks also outperformed as the Vanguard All World ex-US small company index fund provided a total return of 7.7%. We have tried to increase our client's exposure to foreign stocks over the past 18 months or so as we believed the generally lower valuation measures of foreign companies offered better long term return potential than U.S. stocks.

What does all of this mean for the second half of 2015? According to a recent report from Argus, since 1980, in years when the S&P 500 advanced less than 5.0% in the first half of the year, the average return for the full year was 9.3%, which was less than the 35 year average of 10.1%. Given the events riling the world of finances these days and our weak performance so far, a return close to 9 or 10% for the year would be a very pleasant surprise. We caution that this is not our projection but it is interesting to see that a flat first half of a year does not preclude decent annual returns or presage a disaster. Each year is different and the key to stocks remains valuation.

At the beginning of the year the consensus estimate for the 2015 earnings of the S&P 500 companies was $125. After a weak first quarter impacted by the strong dollar, bad winter weather and lower oil prices impacting the earnings of energy companies, it looked like $125 for 2015 would be revised downward. Conditions improved through the second quarter and many analysts are optimistic about the second half of 2015 so perhaps $125 is a reasonable estimate. At current levels that would put the S&P 500 at roughly 17X earnings which, while slightly on the expensive side, does not seem excessive.

In spite of the international turmoil the economy continues to improve in the U.S. as housing recovers and the positive effects of lower energy costs are fully realized. Many analysts and financial reporters were surprised in the first quarter when retailers and other consumer sectors did not immediately benefit from lower energy costs. However, in a recent interview, Tobias Levkovich, Chief U.S. Equity Strategist for Citigroup said: "There is about an 18 month lag between changes in energy prices and changes in economic activity."

Given these positive factors and the ongoing gains in employment, it appears the economy will grow in the second half of 2015. There will be volatility in markets due to international developments and any modest increase in interest rates by the Federal Reserve but we believe stocks can withstand and overcome these challenges. As to "positioning" ourselves for the summer, we will be ready to take advantage of any opportunities born of increased volatility and remain committed to a sound, long term strategy.

We appreciate your confidence in Knox & Downing Advisors and we wish you a very enjoyable and relaxed summer.

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