Market Review and Outlook—July 8, 2015

We seem to have passed a turning point. After about an almost seven-year wait, the Federal Reserve Bank is close to raising overnight rates. While we knew that this time would come, we have known it for years, investors in the past quarter appear to have finally awakened to this fact. Long-term government bonds fell over 4½%, and real estate funds fell 9¼%.

Energy has also been dragging us down. Natural resource stock funds are down over 22% in the past year. The S&P 500 US stock index, without energy, saw earnings grow 8.5% year-over-year in the 1st quarter. However when the energy sector is included, the S&P's earnings fell 5.6%, despite the energy sector making up only 8.4% of the S&P index. For all of 2015, the energy sector is expected to see its earnings fall 67%. Energy has also been dragging down emerging markets, which typically export natural resources including fossil fuels. Emerging markets are up 1.8% year-to-date while foreign large-cap stocks are up 5.9%.

Energy has also been helping. Many countries are net importers of fossil fuels. They have been big beneficiaries of the sharp drop in energy prices. This is one reason why foreign stocks have been outperforming US stocks this year, +5.9% versus +1.1%. This has been particularly beneficial to India, Japan, China, and much of continental Europe.

The US dollar has jumped in the past year, although it has fallen back a little lately. This has produced several investor implications. Initially, in late 2014 it dampened foreign stock returns. In 2015, however, it has helped foreign stock success, for foreign companies have been benefitting from the higher dollar; they have seen their sales rise against their US competitors. Concurrently, US companies have had a tougher time increasing their sales for this exact reason.

One section which has been on a tear lately is **healthcare**. It is up over 15½ % this year, and up over 31% annually over the past three years. Technology has been OK, up 3¾% year-to-date and 17¾% annually for three years. Overall growth has been sharply outperforming value this year, and small companies have been outperforming large ones in the US.

Bond Update Opportunity bonds have outperformed quality bonds. High yield bonds are up over 2¼% year-to-date. Municipal bonds are down for the year, and corporate bonds' results depend on maturity—short term are up ¾% year-to-date, while long-term corporates are down 3¼%. While they have sharply lagged US stocks in the past five years, and while bonds are subject to significant challenges in the coming quarters, they remain important to portfolios due to their drastically lower risk than stocks. To control the risk in your bonds, intentionally set the balance between your quality and your opportunity bonds, and intentionally set the maturity level for your quality bonds. It is getting quite interesting!

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.02%	+1.50%
Intermediate Term Bond	-1.50%	+1.04%	+2.28%	+3.70%	+4.19%
Intermediate Muni Bond	-0.92%	+1.93%	+2.31%	+3.74%	+3.60%
Large-Cap Stock	-0.09%	+5.49%	+16.50%	+15.84%	+7.26%
Mid-Cap Stock	-0.68%	+3.86%	+17.31%	+15.90%	+8.00%
Small-Cap Stock	-0.12%	+3.42%	+16.72%	+15.95%	+7.91%
Foreign Large-Cap Stock	+1.12%	-3.28%	+10.83%	+8.91%	+5.15%
Real Estate	-9.25%	+3.96%	+8.23%	+13.53%	+6.32%
Natural Resources	-1.15%	-22.42%	+0.49%	+3.93%	+4.29%
Technology	+0.80%	+9.03%	+17.79%	+16.25%	+9.54%
Moderate Allocation (60% stocks)	-0.53%	+2.06%	+10.08%	+10.38%	+5.98%

The data in this table comes from Morningstar and is as of June 30, 2015

It is (still) the Economy. The US economy continues to grow, despite repeated lower 1st quarter figures. There remains substantial pent-up-demand in the cyclical industries which took much longer than other industries to re-awaken: housing and autos. Consumer confidence and consumer spending are solid. Some of this is due to more money in consumers' pockets, due to low unemployment, low gasoline prices, and low mortgage rates. All three will rise over time, but each should be gradual. The most worrisome is unemployment—our low unemployment rate and our relative low productivity figures appear to put a ceiling on future economic growth.

In 2008, PIMCO introduced the term the **New Normal**, in which future economic growth would be capped. In the US, this appears to be occurring. Our demographics indicate that there is little expansion likely with our work-force (absent a dramatic immigration program, such as the H1 visa program). Perhaps a new wave of highly effective technology can help step up our labor force productivity, however what it would be is not apparent. Low long-term economic growth rates should accompany lower expected bond yields and returns, and lower expected stock returns.

We are, fortunately, a global economy. While there appear to be worrisome limits to US economic growth, higher average economic growth can be achieved beyond our borders. Demographics in the emerging markets support substantial labor force growth, and with it the potential for substantial economic growth. Technology-led productivity growth is quite possible outside the US, simply by harnessing much of the technology steps adopted years ago in the US, not just in emerging economies, but also in developed foreign economies.

We are comfortable with US stocks, but more comfortable with foreign stocks. It seems most likely that a US economic slowdown is 18 or more months away. Economic growth and stock market returns in the US have moderated, however the risk of policy stumbles, and overall economic stumbling, is at a very comfortable level.

What would foreign investing be without storm clouds? The current ones are China and Greece (and perhaps Iran), however tomorrow it could be North Korea and Portugal. It is far healthier to invest in an area with worries than in one with no areas of concern. Europe continues to appear to be at least two years behind us in its recovery. If you think about it, in hindsight, stock market returns for the US were far stronger two years ago than they are now. This is one reason that we are very comfortable with foreign stock investing, including in the US. There is a long list of concerns with Asian economies and markets, however there is also a long list of potential successes. The list of concerns is the reason that we more commonly use mutual funds, with a manager, to navigate the hazardous waters of Asian investing.

Given these relative factors, we have shifted our US/foreign stock balance from 57/43 to 56/44, shifting 1% from US into foreign stocks. As we have detailed, US upside appears much more limited than foreign stocks.

Bonds are a challenge, now more so than ever. If the past quarter is any indication, the bond day of reckoning is upon us. No longer are we figuring how many quarters until the Fed raises interest rates, but how many weeks. As such, we remain committed to a high level of '**opportunity bonds**' in client portfolios, at 35%. These are spread across several subtypes, sleeves, with high-yield bonds being the largest component, at 13% of bonds. We regularly review the amount we put into each of the sleeves, and recently have directed 2% more into unconstrained bonds which are designed to survive challenging bond times such as these.

We have not changed our **quality bond** balances, as we have been defensive there for many quarters. We continue to maintain this defensive stance, with over half in short-term bonds (33% of the 65% bond money in quality bonds). We are committed to the inflation-focused bonds, which have disappointed up to this point, as we feel that the fairly unique approach of this fund is well positioned to benefit (from rising labor and energy costs) over the next few years.

While inherently value investors, we are currently favoring **growth investing** at this time, due to the very compelling valuations and growth rates from sectors such as technology and healthcare. These sectors can become overvalued, and each has at various times in the past, however the current values do not appear stretched at this time. In time we expect to return to our traditional preference of value over growth stocks/funds.

There is a tide change that has begun. The long-threatened rise in interest rates, and decline in bond prices, is knocking at the door. We prefer to be early to the party, and have prepared our client portfolios for this time for several quarters, and so there are no major changes at this time. Adapting to a sea change is intimidating. Fortunately, we have known that this day would come, and we have been preparing. **It is time to follow the plan.**