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BCA Q2 2015 Review

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Second Quarter in Review

As the second quarter began, investors worried about an apparent slowdown in the U.S. economy. However, it turns out the soft growth data was the result of bad weather, a port strike and a negative seasonal adjustment which was later reversed.

Despite the continuation of higher volatility that was experienced in 2013 and 2014, stocks have managed to stay in positive territory for the year. Equities have been aided by mildly improving economic data, continued easy monetary policy from global central banks, and high levels of merger and acquisition (M&A) activity. The S&P 500 has gone 914 days without a 10% correction, its third-longest run on record. European stocks have been able to push past renewed worries over Greece on the back of low valuations, improving data, and belief that the worst case scenario of a "Grexit" wouldn't result in financial contagion.

Bond investors fared worse, with the Barclays Capital Long-Term Treasury Index dropping 4.7%. 2015 represents the first year in almost a hundred in which both the Dow Jones Industrials and long-term Treasuries fell during the first six months of a pre-election year (typically they are quite strong).

Benchmark Index (USD)	2Q 2015 %	YTD %
S&P 500 Index	0.28	1.23
MSCI EAFE Equity	0.62	5.88
MSCI Emerging Markets Equity	0.69	3.12
U.S. Aggregate Bond	-1.68	-0.10
Long-Dated Treasury Bonds	-8.30	-4.67
High Yield Bonds	0.00	2.53
U.S. Dollar Index	-2.92	5.82
Crude Oil	17.76	10.42
Gold	-0.92	-1.03

Source: Bloomberg, MSCI

Investment Summary

- The current slow growth, easy money environment remains positive for financial markets.
- Full valuation and historically high profit margins mean returns from broad U.S. stock indexes will likely be lower in the coming cycle.
- We see activism as a fruitful investment strategy for skilled managers in the current environment.
- International stocks are less highly valued but also are generally less profitable. We see tactical opportunities in Europe and Japan on the back of anticipated cyclical recoveries and continued easy monetary policies.
- Given the imminent Fed rising rate cycle, we favor credit investments different from the major benchmarks. The pullback of traditional lenders has resulted in yield opportunities in middle market and mortgage lending.

A Note on Valuation

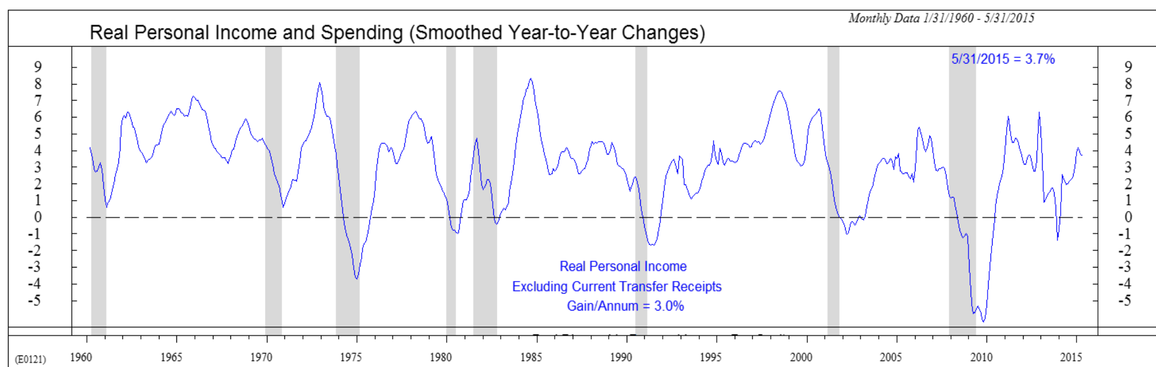
Investors need to remember that valuation measures have little predictive power over the short run. However, they are important indicators of expected returns over longer time horizons. At above average valuation levels, investors should expect lower broad market returns for both stocks and bonds as broad categories. The good news is investors don't have to own just the broad market, rather they can hold more attractively valued subsets of it. Depending on the opportunity, we will use either passive ETFs and funds or active managers to access these returns.

Outlook

Despite negative headlines from China and Greece, evidence indicates the global economy, while slow, is stable and likely to improve. The U.S. in particular should enjoy continued acceleration. Even with the recent rebound, energy prices are substantially lower than they were last summer, helping consumers. Unemployment is down, interest rates remain low, and wages are gradually starting to rise.

Housing is also starting to pick up steam: the National Association of Homebuilders (NAHB) Index, along with building permits, has begun to rebound. Last month existing home sales rose over 5% while new home sales gained 2.2%. The home ownership rate is currently 63.7%, the lowest rate since 1989. This may set the stage for household formations to strengthen, as adults aged 24-35 have begun finding employment at higher rates.

Consumer Incomes are Recovering



*Shaded areas represent National Bureau of Economic Research recessions

Source: Ned Davis Research, NBER

Accordingly, we see the risk of recession as low. As noted, the economy is doing better and the market is well-prepared for the Fed to slowly begin raising interest rates. Monetary easing in the rest of the world also continues unabated. Inflation remains quiescent. Barring a negative economic or geopolitical shock, the weight of the evidence supports a moderately favorable economic backdrop.

International Opportunities

After years of U.S. stock market outperformance, international markets surprised investors by outpacing domestic stocks so far this year. There are several factors contributing to this recent outperformance over domestic stocks. First, enthusiasm for continuing recovery in Europe and Japan, coupled with easy monetary policy, has provided support for markets. Although it may seem surprising, the data highlights improvement in both Japan and Europe, although from an admittedly low base.

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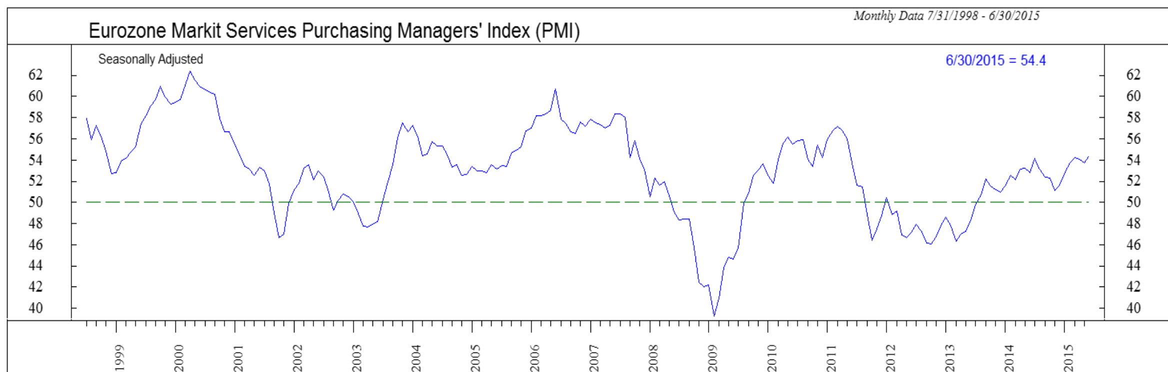
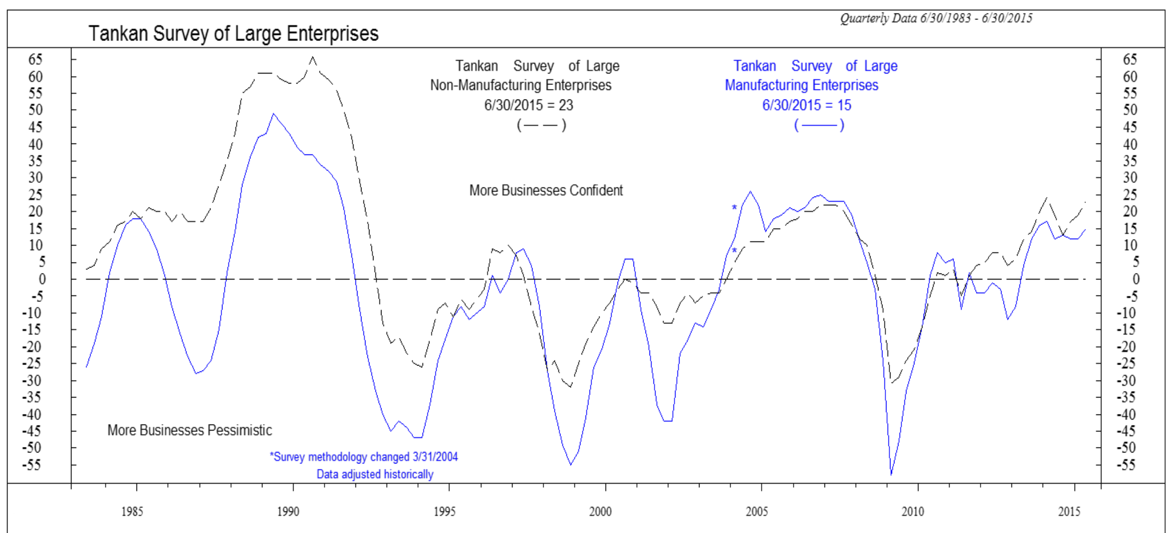
European Business Conditions Improving



Source: Ned Davis Research, Markit LLC

On a relative basis, European earnings appear set to improve. In the U.S., a weaker earnings picture on the back of strong U.S. dollar gains and lower energy profits contrasts to strengthening earnings in Europe. While progress has been slow, there have been some notable structural reforms in a number of key countries in peripheral Europe.

Japanese Business Conditions Improving



Source: Ned Davis Research, Markit LLC

Similarly, while the pace of regulatory reforms has disappointed in Japan, the government's massive stimulus measures and efforts to combat deflation continue to assist the export-led economy. **For all of these reasons, we are seeing stronger opportunities in international equities, especially on a currency-hedged basis, as we see the U.S. dollar's strength likely to continue.**

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The backdrop of a better international economy should help emerging markets in the coming quarters, as well. At present, the economic news has been generally poor in emerging markets. Growth has slowed in China, hurting its suppliers, especially commodity producing countries. Outright recessions have gripped both Brazil and Russia. Yet in the long run, emerging market growth should reaccelerate as these economies improve. **At present, we see good opportunities in India, where growth is stronger and a pro-business government is in power for the first time in a generation.**

Fixed Income Outlook

Despite volatility from China and the Eurozone, U.S. Fed Chief Janet Yellen continues to signal a rate rise is likely at the Fed's September meeting. The Fed seems eager to end the experiment of extremely low rates for a very long time. Based on inflation alone, one might not raise rates, but the Fed's decision is understandable and seems accepted by the market.

Given this backdrop, barring recession or a geopolitical crisis, it's hard to see being sufficiently rewarded by owning longer maturity Treasury bonds, as they have significant interest rate risk. Ultra-low rates in Europe and Japan are still driving their investors to relatively higher yielding U.S. debt, keeping a lid on rates.

As we noted last quarter, we think off-the beaten path credits represent the best opportunity in fixed income. The economy is stable, credit is easier to come by, and companies have generally cut costs and increased cash flow. Increased regulation has also restricted the lending activities of large and regional banks, creating opportunities for more nimble and less-regulated investment vehicles to fill the gap. This point is key to our thesis for exploiting niche credit opportunities to capture higher yields. Expressing our desire to sharply limit interest rate risk, many of these investments have floating rate structures in case rates do rise. We would avoid what we see as crowded investments such as high-yield bonds widely held by mutual funds and ETFs.

Final Thoughts

Recent events have again shown that investors are best off not acting on market gyrations. Despite Greece and China, world stock markets are taking things well in stride. By historical standards, volatility is not that notable. If markets do get worse, it may create the opportunity for investors to take advantage. Diversification of risks and patience remain our mantra. Thank you for the trust you place in us as your investment advisor, and we wish you a wonderful summer.

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