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BALANCE IN A CHANGING WORLD
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SECOND QUARTER 2015 INVESTMENT ADVISORY REPORT

"Hurry Up and Wait"

After many fits and starts, an end of quarter sell-off left the major indexes essentially flat for the first half of the year. According to CNBC.com, the S&P 500 ended the first half of 2015 basically unchanged, while the Dow lost -1.14%.[1] The NASDAQ fared better, boosted by gains in biotech, but other sectors saw significant deterioration. The energy sector continued to be under pressure as, for example, stocks like Exxon (XOM) and ConocoPhillips (COP) lost -8.47% and -8.96% respectively.[2] Within energy, industry specific sectors such as coal lost a whopping -18.28%. This weakness spilled over to the transports which dropped -11.46% (and -7.43% in the 2nd quarter alone), paced by an -11.7% decline in trucking and -9.3% in the railroads. In technology, semiconductor memory lost -20.8%; computer systems -14.7% and data storage – 13.7%.[3]

Thus, below the surface, the broader market saw much greater deterioration than conveyed by the popular indexes and, according to James Investment Research, the median stock actually declined by 1% last quarter, with mid cap stocks sliding even more.[4] Of noteworthy significance were the losses in the supposedly stodgy defensive utilities which dropped by almost -11% in the first half (and -6.26% in the quarter)[5]. Utilities have often been called the "canary in the coal mine" for the bond market, due to the capital intensive nature of their business, and their typically stable and generous dividend payouts which give them bond like qualities.

The carnage in the utility sector – and, in fact, all securities with high dividend yields and bond-like attributes, such as REITs, telecoms, and of course all types of bond funds – correlated strongly with the steady increase in interest rates during the first half of the year.

[1] S&P 500 ekes out first half gain amid Greece debt crisis; http://www.cnbc.com/id/102798600
[2] http://performance.morningstar.com/stock/performance-return.action?t=XOM®ion=USA&culture=en_US
[3] Ibid. #2.
[4] Market Commentary; James Investment Research, In.; July 6, 2015; pg. 1
[5] Op. cit. #2

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This can be seen in the chart below of 10 year US Bond yields.[6] According to US Treasury data, yields hit a low (on a closing basis) of 1.68% on January 30, and rose steadily to a recent peak of 2.49% on June 26 - a nearly 50% increase - before retreating as the turmoil in Greece and China caused a temporary “flight to safety” flow into US Treasuries.[7]

The rise in interest rates was unusual because, as noted in last quarter’s commentary, the US economy was exceptionally weak (a weak economy typically sees interest rates fall). According to BEA statistics, the US economy contracted by an annualized rate of -0.2% in Q 1 (after being upwardly revised from even weaker initial estimates).[8] In our last quarterly commentary, we discussed the economic forecasting model developed by The Federal Reserve Bank of Atlanta (GDPNow). It has consistently been delivering superior estimates of actual GDP, vs. a “Blue Chip Consensus” estimate of private forecasters. We also looked at several of the seasonal and specific factors that have been plaguing first quarter growth measurement in general (weather, the West Coast port strike…). As of last April, GDPNow had been forecasting basically 0% growth (well below the overly optimistic consensus call for

[6] http://stockcharts.com/freecharts/gallery.html?s=%24tnx
[7] http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2015
[8] http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm

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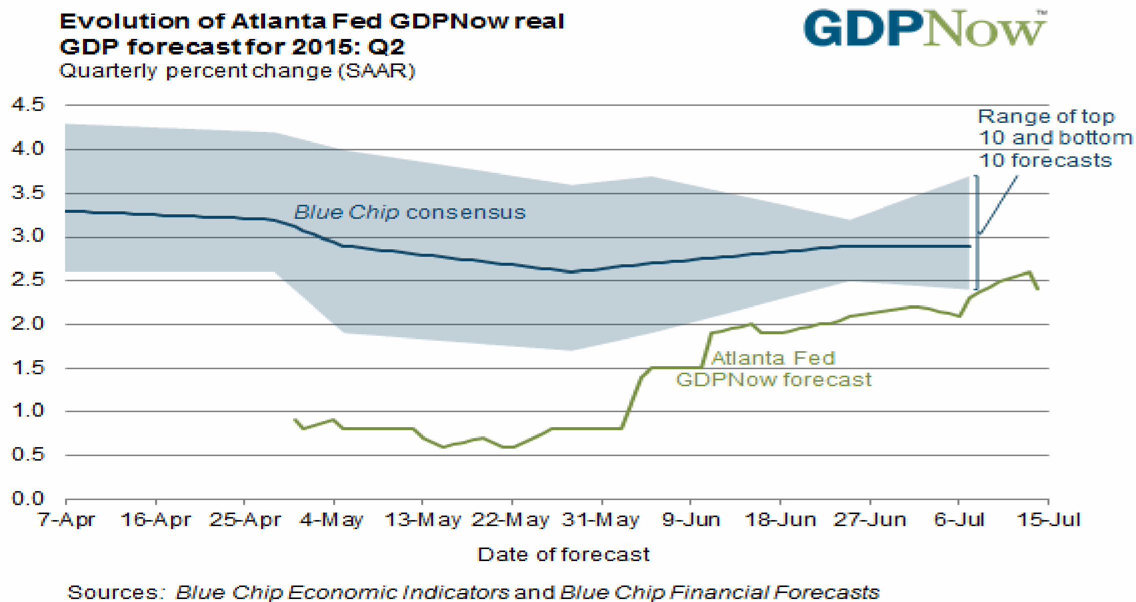
+1.5%). However, the model has been rising steadily since then and is currently forecasting growth of around 2.5%, nearly matching consensus private views (see chart below – green line).[9]



Indeed, recent economic data strongly support the case for growth – albeit modest – in the developed Western economies. A headline in an FT article proclaimed "Greek Crisis Fails to Dim Eurozone Recovery – Figures hit highest level in four years…", as the FT reported "The flash purchasing managers' index (PMI) rose to 54.1, up from 53.6 in May and well above the level of 50 that marks an expansion in activity".[10] Additionally, as IBD noted, the index's rise was broad-based. Both the manufacturing PMI and the service PMI rose. Germany's flash June composite was 54.0% (up from 52.6% in the prior month) and France's output rose to 53.4 from 52.[11]

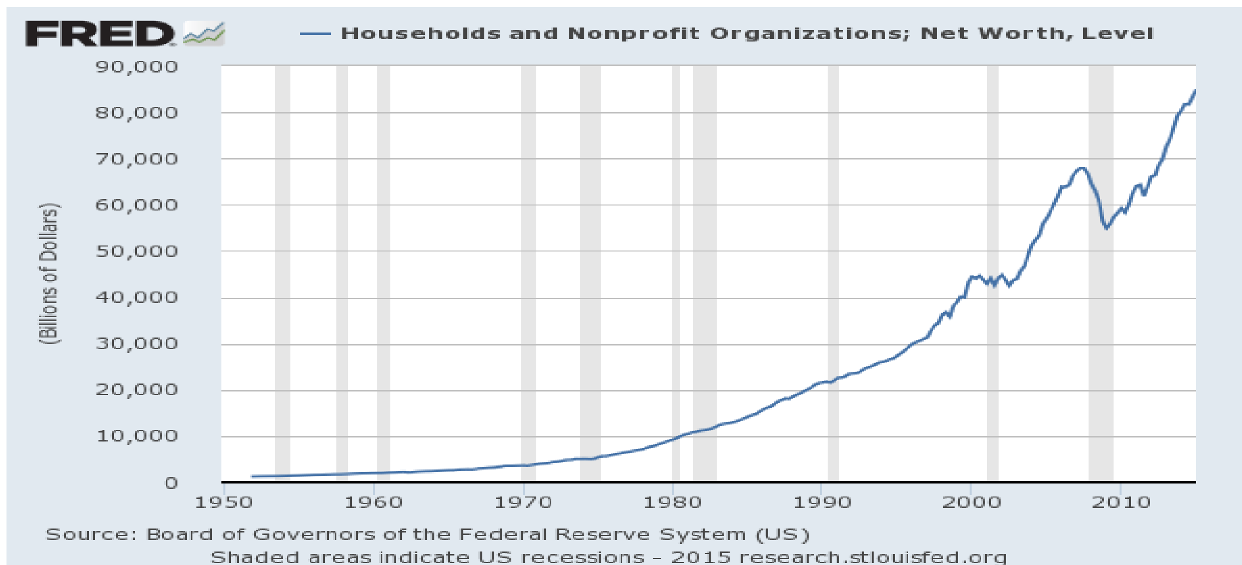
Turning to the US, IBD reported that "(new home) sales ran at an annualized rate of 546,000 in May, the best in more than 7 years. Inventory remains lean, and at the current pace, there's only 4.5 month's (of inventory) available".[12] The flash manufacturing PMI for the US did slow a bit to 53.4% in June, but still remains well over the 50% level connoting expansion.

Reuters reported that "U.S. consumer spending recorded its largest increase in nearly six years in May on strong demand for automobiles and other big-ticket items, further evidence that economic growth was accelerating in the second quarter. While other data … showed a modest increase in first-time

[9] https://www.frbatlanta.org/cqer/research/gdpnow.aspx
[10] "Greek Crisis Fails to Dim Eurozone Recovery"; Financial Times; June 24, 2015; pg.2
[11] Investor's Business Daily; "To the Point column"; June 24, 2015; pg.2
[12] Ibid. # 10

applications for unemployment benefits last week, the underlying trend in jobless claims continued to suggest the labor market was tightening". They add that "The strengthening economy suggests the Federal Reserve could raise interest rates this year even as inflation remains well below the U.S. central bank's 2 percent target. Many economists expect a rate hike in September".[13]

This then explains the rise in interest rates, as the market – ever the discounting mechanism - is clearly anticipating a normalizing economy that will enable the Fed to begin to "normalize" interest rates. Finally, Household Net Worth, as measured by the St. Louis Fed, was recently reported at an all-time record high level of $84.9 trillion.[14]



So, what could possibly go wrong (your skeptical author asks rhetorically)? Well, plenty. First, looking domestically, the IBD/TIPP[15] Financial-Related Stress Index recently spiked by 10% to 59.4, the highest level in 15 months. Their overall Economic Optimism Index fell to 48.1 from 49.7 last month, and 51.3 prior to that. Issues such as higher gasoline prices, racial unrest in Baltimore and Ferguson, continued unrest in the Mideast, California's drought and floods in the South all contributed to general unease, and nearly all of the demographic groups tracked showed higher financial stress. But significantly, some of the largest increaces were expressed by the 18-24 and 25-44 aged cohorts.[16] This opens a whole

[13] Reuters.com; http://www.reuters.com/article/2015/06/25/us-usa-economy-idUSKBN0P51J920150625
[14] Board of Governors of the Federal Reserve System (US), Households and Nonprofit Organizations; Net Worth, Level [TNWBSHNO], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/TNWBSHNO/, July 15, 2015.
[15] Note: IBD/TIPP is collaboration between Investor's Business Daily and TechnoMetrica Market Intelligence.
[16] "Financial Stress Up Most Since Oct. 2008"; Investor's Business Daily; June 3, 2015; pg.1

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range of questions about the overall quality of the recovery, the nature of job creation and employment opportunites for the new generation of job entrants in particular, and emerging household formation in general.

Next, there's merely the entire rest of the world! While Greece has been garnering most of the headline attention, growth in Asia is slowing significantly. This will arguably hold far greater import for global growth, the US dollar, and the ability of the Fed to begin their interest rate normalization. Recent data from India showed industrial output rising by 2.7% y.o.y., below expectations and down from 3.4% in April. Manufacturing grew by only 2.2%, which was half of April's 5.1%.[17] Clearly, however, the main show is China and it's various stock exchanges.

It's difficult to know where even to begin, or which superlatives to use to describe the events unfolding in this market. A good starting point is probably where we left off when we touched upon this issue in last quarters report:

> …while on the topic of credit fueled bubbles, we'd be remiss if we didn't give a shout out to the Chinese stock market, as represented by the Shanghai Composite Index. As Marketfield Asset Management noted, "…the parabolic advance by the local equity market has shocked observers expecting to see a re-run of 2008. Clearly with a record 1.67 million accounts opened in a single week and 33.38 billion active accounts we are witnessing a wave of local speculation rather than a considered allocation of capital."[18] And, Bloomberg cites a strategist at Bocom international Holdings Co., one of the top 5 leading commercial banks in China, who just issued a bullish call on the Chinese market. Despite "…soaring price-to-earnings ratios, the shrinking yield advantage that stocks offer over bonds and the fact that mainland-listed equities now trade at a 34 percent premium over nearly identical shares in Hong Kong…(this analyst states that) '***Our traditional market models may not be able to capture the full picture***' (emphasis added). In this vein of being doomed to repeat history, it's beyond ironic that although the title of the report is "Price-to-Whatever: A Bubble Scenario"[19], the analyst feels that as long as the government supports the rally and keeps rates low, ***the market has nowhere to go but up!***

And, up it did go…until it didn't! (Ed. note: there are actually several various indexes and exchanges associated with the "Chinese stock market". The Shenzen Market is more volatile and tends to represent smaller more speculative stocks, but for purposes of this report, we're using the Shanghai

[17] "To The Point" column; Investor's Business Daily; July 13, 2015; pg., 2
[18] "The Weekly Speculator"; by Marketfield Asset Management; April 2, 2015; pg. 2
[19] http://www.bloomberg.com/news/articles/2015-03-25/china-bulls-adopt-price-to-whatever-ratio-as-market-math-upended

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Composite Index as a proxy for "Mainland" Chinese companies). The magnitude of both the rise, and subsequent crash of the Shanghai Index can be seen in the chart below.[20]

According to the Guardian;

> "With markets rising in straight lines on graphs plotting their progress – the Shanghai exchange had shot up some 135%, and the Shenzhen exchange had gone even higher at 150% in less than a year... At the time of the crash, 9% of Chinese households – some report the figure as high as 200 million people – had bought into the booming market. Steadily rising prices seemed to be delivering on both Deng Xiaoping's promise of "a relatively well-off society" (*xiaokang shehui*) and the current president Xi Jinping's rhetoric of a full-blown "Chinese dream" (*zhongguo meng*) – a fuzzy notion that promises wealth, wellbeing, and power to individuals and the nation as a whole…With the party cheerleading the market's inexorable rise, it became even easier to imagine that the government was, in effect, declaring an informal debt obligation on the stock market's future – essentially covering any bets with its own considerable assets. How could you lose? And so the bubble grew and grew: price-to-earnings ratios for Chinese stocks averaged an

[20] "Watch These Charts To Better Understand China's Stock Market Crash"; Forbes.com; http://www.forbes.com/sites/jessecolombo/2015/07/12/watch-these-charts-to-better-understand-chinas-stock-market-crash/

astounding 70-to-1, against a worldwide average of 18.5 to 1; the value of the A-shares inside China grew to be nearly double the equivalent shares of the same companies on the Hong Kong exchange…

"By this spring, the stock markets in Shanghai, with 831 listed companies, and Shenzhen, with 1,700, boasted a combined market capitalisation of $9.5tn, which made them – along with the much older Hong Kong exchange – the second-largest financial market in the world…Shares of newly listed companies soared thousands of percentage points within months of their initial public offerings."[21]

Of course, no bubble would be complete (or, arguably, even exist) without the requisite overextension, and consequent abuse, of credit. According to the FT;

"Official margin lending totalled Rmb2.2 trillion ($354bn) as of Wednesday's close (June 26th), up from Rmb403 billion a year earlier…yet this officially sanctioned margin lending, tightly regulated and relatively transparent, is only the tip of the iceberg.

For standard margin lending by brokerages, only investors with cash and stock worth Rmb500,000 in their securities accounts may participate. Leverage is capped at 2:1, and only certain stocks are eligible for margin trading.

In the murkey world of grey-market margin lending, however, few rules apply. Leverage can reach 5:1 or higher, and there are no limit(s) on which shares investors can bet on."[22]

The article goes on to quote a securities analyst in China who observed "Money has abandoned the real [economy] and entered the fake [i.e. financial assets]"[23]

The results, if not the timing, were predictable. According to Bloomberg.com, "The rout in equities which erased almost ***$4 trillion of value in less than a month*** (emphasis added) was spurred by margin traders unwinding bullish bets. Holdings of shares purchased with borrowed money on the nation's two bourses plunged by $134 billion to $231 billion through Monday [July 13th] from the June 18 peak…A five-fold surge in leverage had helped propel the Shanghai gauge to a 150 percent advance in the 12 months through June 12."[24]

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[21] "Why China's Stock Market Bubble was always Bound to Burst"; The Guardian.com; July 16. 2015 http://www.theguardian.com/world/2015/jul/16/why-chinas-stock-market-bubble-was-always-bound-burst

[22] "China Shadow Bank Crackdown Looms Over Stocks"; Financial Times; Friday, June 26, 2015; pg. 22

[23] Ibid. #22

[24] "China Stocks Resume Rout as GDP Fails to Lift Investor Sentiment"; http://www.bloomberg.com/news/articles/2015-07-15/china-s-stock-futures-fall-before-economic-growth-data

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To try and put this into some perspective, according to World Bank data as of year end 2014, $4 trillion is larger than the entire GDP of Germany, and almost as large as the $4.6 economy of the world's third largest economy, Japan.[25]

Conventional wisdom holds that most of the speculative growth fueling the bubble was driven by smaller, "less sophisticated" individual retail investors. As the FT relates, "Stories of grandmothers and college graduates eagerly speculating form an easily comprehensible narrative…(however,) a close look at the available data on who invests in Cina's stock market, and how much, tells a different story."[26] By parsing data from the Shanghai Stock Exchange, the FT reveals that more than two-thirds of the investors on the Shanghai Exchange owned less than 5% of the tradeable market (i.e. 69% of investors had accounts worth only Rmb100,000 [roughly $16,000] or less). "At the other end of the spectrum, 71,400 investors – just 0.1 per cent of the total – held between Rmb 10 million and Rmb 100 million, and more than 4,400 accounts held more than Rmb 100 million…Though registered as 'individuals' such investors are hardly the amateur punters of popular imagination."[27]

This leads us to the real potential achilles heel of the current macro picture. As Henny Sender recently observed in several recent FT columns, "The drop in share prices (of the Chinese markets) is especially bad news for the numerous companies that hoped to reduce their debts, either by issuing shares or by making windfall profits through canny investments in the market – often, alas, with borrowed money."[28] Indeed, the recent bursting of the real estate bubble in China revealed many real estate "investments" on the books of operating companies otherwise having nothing to do with real estate development. Now, it appears that phantom real estate values have been replaced by now potentially phantom stock portfolio values. Sender notes that;

> "Private debt in Asia alone amounted to 125% of gross domestic product in the final quarter of 2014, says the BIS, and too much of it was in dollars." She continues, "The macro situation is also sobering. For years, Asia grew on the back of exports to developed markets. It was a formula that worked first for Japan, and then for South Korea and Taiwan, But it does not seem to be working any longer. World trade has been almost flat for the past three years and been slower than (also anemic) global GDP.
>
> "'This is something we have not seen in a generation,' notes David Lubin, an economist with Citibank in London. Trade matters not only because it supports economic growth, but because

[25] http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?order=wbapi_data_value_2014+wbapi_data_value+wbapi_data_value-last&sort=desc
[26] "Data Busts Myth of China's Retail Investors"; Financial Times; Tuesday, July 14, 2015; pg.6
[27] Ibid. # 25
[28] "Don't Look Down if You Think it's Just China's Roadrunner Moment"; Financial Times; Wednesday, July 15, 2015; pg. 28

> it cements relations among countries and should reduce geopolitical tensions. It is therefore of double concern that this year the outlook has worsened.[29]
>
> "In a world where linkages between financial markets are ever closer, and any big lurch quickly travels, the ripple effects of the drop in Chinese shares will probably have lasting consequences across a range of markets, including credit, currencies, commodities and Treasuries, and will influence the fortunes of foreign companies in China.
>
> Moreover China's economy was already slowing, albeit off a much larger base than in the past. That means China will create less foreign exchange reserves, and fewer dollars to circulate back to the rest of the world."[30]

In fact, data as of the end of the first quarter show that since the last half of 2014, Emerging markets in general have experienced larger net capital outflows than during the 2008-2009 financial crisis. The FT reported that "Total net outflows from the 15 largest emerging markets rose to $600.1bn over three quarters to the end of March, higher than the $545.2bn in outflows seen to the end of March 2009." They note that this is admittedly only a partial reversal of the flood of the nearly $2.2 trillion of capital that poured into these markets, as a result of the Fed easing after the 2008 financial crisis. However, they further note that "There has also been an unprecedented plunge in emerging market foreign exchange reserves since December. In March this year, total reserves held by the 15 countries fell $374.4bn – by far the largest contraction since the countries began to build their stashes of hard curency early this century."[31]

As noted in past reports, we have long been concerned about all of the emerging market (EM) space in general, and about China in particular. We've used the US dollar (USD) as our barometer, and it had consistantly been pointing towards tightening global liquidity, as it stregnthened over the past year. During the past quarter, the USD began to weaken, and in several of the models we initiated positions in energy, commodities and basic materials. The USD looks to be regaining it's uptrend, the positions have not been profitable, and we will be exiting them. As Sender noted:

> "…Chinese demand - which fed the coffers of everyone from iron ore miners in Australia to carmakers headquartered in the US - was softening even before the setback. Iron ore prices have fallen 20 per cent in the past week alone, largely on downward revisions of demand from the mainland. The latest data (which do not reflect the turbulence of the past 10 days) show Chinese retail sales weakening, while demand for cars (9 per cent of that) declined sharply, "taking away the final growth engine", says Credit Suisse. In recent months officials fretted

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[29] "Contrasting Concerns Cast Heavy Debt Clouds Over Emerging Asia"; Financial Times; Wednesday, July 1, 2015; pg. 24
[30] Op. cit. # 28
[31] "Emerging Market Capital Outflows hit $600bn as Strong Dollar Takes its Toll"; Financial Times; Friday, May 8, 2015; pg. 13

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> openly that the currency was too strong, as the renminbi rose in tandem with the dollar and capital outflows, a feature of much of last year, dwindled. "[32]

This has also led us to liquidate (reluctantly) a profitable position in Volkwagen. We continue to feel the company is undervalued, but the auto sector has been a strong performer and we have other exposure there. We're re-evaluating all of our exposure to the space.

Finally, we continue to feel that the broader trend in the market is still up, but this is clearly an aging market, and the participation is becoming more and more selective. We've begun adding some downside protection to many of the portfolios, and at some point, we will be looking to increase our defensiveness – possibly going into the seasonally weaker 2016 election cycle.

We hope you are finding that things have slowed down a bit with the arrival of summer (we have not) and are finding time to get to beaches, pools and barbeques.

Sincerely,

Jason Waxler

[32] Op. cit. # 28

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Second Quarter 2015 Market Wrap-Up[33]

U.S. Stocks		
	Total Returns	
Index	Second Quarter 2015	Year-to-Date
DJIA	-0.29%	0.03%
S&P 500	0.28	1.23
Nasdaq Composite	1.75	5.30
S&P MidCap 400	-1.06	4.20
Russell 2000	0.42	4.75
Index	**Second Quarter 2015**	**Year-to-Date**
Barclays U.S. Aggregate Bond Index	-1.68%	-0.10%
Credit Suisse High Yield Index	0.30	2.90
Barclays Municipal Bond Index	-0.89	0.11
Barclays Global Aggregate Ex-U.S. Dollar Government Bond Index	-0.83	-5.43
J.P. Morgan Emerging Markets Bond Index Global Diversified	-0.34	1.67
	Total Return	
MSCI Index	**Second Quarter 2015**	**Year-to-Date**
EAFE (Europe, Australasia, Far East)	0.84%	5.88%
All Country World ex-U.S.A	0.72	4.35
Europe	0.68	4.28
Japan	3.12	13.79
All Country Asia ex-Japan	0.65	5.59
EM (Emerging Markets)	0.82	3.12
	Total Returns	
MSCI Index	**Second Quarter 2015**	**Year-to-Date**
Emerging Markets (EM) Index	0.82%	3.12%
Asia Index	-0.04	5.22
Europe, Middle East, Africa (EMEA) Index	2.05	4.10
Latin American Index	3.61	-6.22

[33] T.Rowe Price; Second Quarter 2015 Market Wrap-Up; http://individual.troweprice.com/public/Retail/Planning-&-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups

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