Quarterly Update & Economic Commentary—June 30, 2015

Quarter in Review

The S&P 500 index level was little changed through the first six months of the year, with a total return (TR) (includes reinvestment of dividends) of 1.23 percent. The quarter started off well with positive gains in both April and May, only to see the gains wiped out at the end of June. Small cap stocks and international equities outperformed the S&P 500 through the first half of the year. The S&P SmallCap 600 TR is positive by 4.16 percent, the MSCI EAFE NR is positive by 5.52 percent and the MSCI Emerging Market Index is positive by 2.95 percent. Other areas of the equity markets that had strong returns include the S&P MidCap 400 Growth TR, 6.53 percent, the S&P SmallCap 600 Growth, 7.51 percent, and the MSCI EAFE Small Cap NR, 10.15 percent.

Interest rates rose during the quarter which caused bond prices to fall. Interest rates were influenced by a dramatic increase in the yield of the German Bund which benefited from better than expected European economic data. In addition, signs of wage growth in the U.S. showed modest increases and other inflation readings ticked higher. The Barclays U.S. Aggregate Index fell 1.68 percent during the quarter and is now negative by 0.10 percent year-to-date. Lower quality bonds were flat during the quarter but remain positive by 2.53 percent year-to-date. Other interest sensitive investments also suffered during the quarter. The FTSE NAREIT All Equity TR index, a proxy for REITs (real estate investment trusts) lost 9.06 percent during the quarter and is down 5.44 percent year-to-date and the Alerian MLP, a proxy for Master Limited Partnerships, lost 6.09 percent during the quarter and is down 11 percent year-to-date.

Oil prices rebounded during the second quarter after significant declines over the last nine months. Oil prices were supported by a decrease in global supplies of non-OPEC output coupled with an increase in the estimate of global demand growth. Gold traded slightly lower during the quarter; it is now down around one percent year-to-date and over 11 percent over the trailing 12-months. After a difficult start to the year, agricultural based commodities bounced back in the second quarter: wheat gained over 20 percent, corn was up over 12 percent, and cotton and soybeans returned over 7 and 6 percent, respectively.

The U.S. Federal Reserve maintained its low interest rate policy but continued to leave the door open for a rate increase later this year if economic data supports the increase. After a sluggish start to the year, some economic readings began to improve during the quarter. As was expected, the U.S. economy contracted during the first quarter. However, this is believed to be an exception, rather than a trend, driven by a colder winter, a West Coast port shut-down and other seasonal effects that are not taken into account. The employment picture continued to improve. The growth trend in nonfarm payrolls is strong, with trailing 12-month job creation reaching almost 3 million new jobs, a level not seen since the late 1990's.

Housing data released near the end of the quarter began to show signs of improvement. Contracts to buy previously owned U.S. homes rose to their highest levels in over nine years. Other housing data, such as building permits, housing starts and new home sales also indicate that the housing market is picking up steam. The average home price also increased by more than expected.

The U.S. auto industry is yet another bright spot for the economy. U.S. auto sales remain steady with the seasonally adjusted sales pace remaining over 17 million, a level not seen since 2006. The first half of the year represented the best six months in a decade for the auto industry.

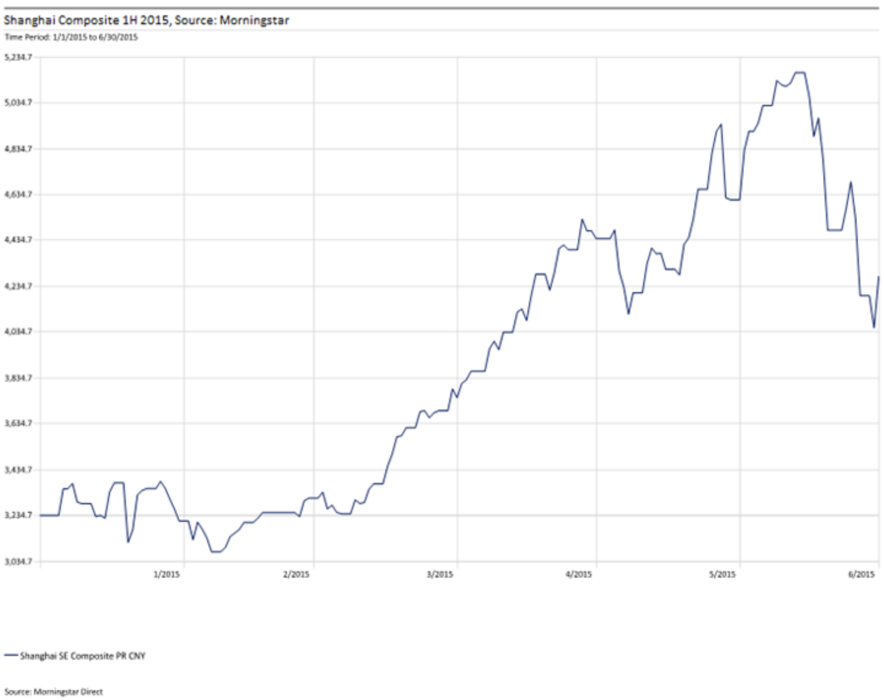
Consistent with the recent economic readings, U.S. consumers appear to be more optimistic. The U.S. consumer sentiment reading for June (Thomson Reuters/University of Michigan) beat expectations. The report also indicated that consumer spending has increased by three percent in 2015. Additionally, the gauge of current economic conditions rose to 108.9 from 100.8 the previous month, while the consumer expectations index increased in June from its May reading.

As has happened numerous times over the past five years, Greece's future stole headlines during the past quarter. As the quarter ended, fears resurfaced that Greece would default on a loan payment to the IMF unless they received additional bailout funds. In order to approve additional bailout funds, European leaders are requiring further austerity. However, the recently elected (January 2015) Greek Prime Minister Alexis Tsipras is refusing to concede to the demands. Prime Minister Tsipras called for a referendum to be held on July 5 to either accept or reject the demands. Many observers believe a "no" vote would precipitate an exit of Greece from the euro zone, though Tsipras believed a "no" vote would only improve his country's bargaining power to receive a bailout with less austerity measures. As of the time of this writing, the referendum has occurred. The referendum resulted in more than sixty percent of voters declining the bailout measures, a development that disappointed negotiators representing the Eurozone.

Puerto Rico's economic troubles have been well documented, but comments made in a New York Post article by Governor Padilla implied that Puerto Rico would miss a July 1 interest payment. In the article, Governor Padilla said the Puerto Rican economy was in a "death spiral" and that the interest payments were "unpayable." The news that Puerto Rico's economy was struggling was nothing new, but the prospect of a missed debt payment caught many investors off guard. As it turned out, Puerto Pico made its payments as scheduled. The article was a significant change in sentiment from the government; in the past the government has expressed its desires to pay its obligations but this recent rhetoric seemed to take a different view. As a result of these comments, many Puerto Rican issued bonds fell by ten percent and re-insurance providers fell by even more.

Geopolitical affairs continue to flare up and cause concern, but little if any of it has significant near-term implications for the conditions of the global economy or global investment portfolios. Renewed clashes in Ukraine, multiple victories by ISIS and the looming Iranian nuclear deal make the headlines often, but, barring any unforeseen events, these developments are not likely to influence the direction of global economic growth. Meanwhile, presidential primary season in the U.S. is getting under way. While the outcome of the general election has important implications for future economic growth, it is too early to forecast future fiscal policy based on statements made by candidates.

China's Shanghai stock market fell into bear market territory during the last three weeks of June after reaching an all-time high on June 12. Despite the 20 percent correction, the Shanghai Composite is still positive by more than 30 percent year-to-date and over 100 percent over the trailing 12 months. The upward surge has been a speculative rally driven by outside investors gaining access to certain exchanges that were previously limited. The Chinese stock market is consumed mostly by retail investors, many of whom are new to investing and have never experienced market losses – this makes them more prone to inflating asset bubbles. Additionally, the average holding period is also very short; some reports indicate it could be as low as 18 days. Margin trading was a big component of the Chinese market until the beginning of June when regulators cut margin lending in an effort to slow down the significant market gains – this policy change is being blamed for the recent pullback. The Chinese stock market has generally not been correlated to indicators on the Chinese economy. The economy was getting worse as the stock market rose, though now the market has begun to fall as the economy shows signs of stabilization.



There remains a strong demand for stocks despite some of the global risks that highlight cable news. June represented the best month for Initial Public Offerings (IPOs) since the dotcom bubble. There were 35 IPOs in June, a number not seen since there were 66 in August of 2000. As a sign of more demand on the horizon, there were 39 initial filings in June, more than any month since June 2014, and seven of these offerings could raise over $500 million.

A Look at the Numbers

Name	2nd Quarter 2015 (%)	Year-to-Date (%)
DJ Industrial Average TR USD	-0.29	0.03
S&P 500 TR USD	0.28	1.23
S&P MidCap 400 TR	-1.17	3.96
S&P SmallCap 600 TR USD	0.19	4.16
NASDAQ Composite TR USD	2.03	5.90
MSCI EAFE NR USD	0.62	5.52
Barclays US Agg Bond TR USD	-1.68	-0.10
Wilshire US REIT TR USD	-9.06	-5.44
IA SBBI US 30 Day TBill TR USD	0.00	0.01

Forecast In Brief

At the time of this writing, the Greek referendum has resulted in a landslide "no" vote. Both Eurozone officials and the ruling Syriza party have begun to position themselves for difficult negotiations over the next few weeks. The key question remains whether both sides will agree on a bailout package. If such an agreement is not reached soon, Greece will have little choice but to begin printing its former currency, the drachma, to reinject liquidity into its now-barren banking system. Such a move would represent a de facto exit from the Eurozone and a strong likelihood of permanent default on Greek debt. Market volatility will almost certainly follow this referendum and will likely continue until a new bailout agreement is reached. Should the "Grexit" actually occur, we expect short-term volatility but are less concerned about the long-term impact. Most of Greece's debt is now owned by the IMF and ECB, meaning that a default would not hurt individual investors as much as it would have a few years ago. Concerns about Greece setting a precedent for other heavily indebted Eurozone countries (primarily Italy, Spain and Portugal) to leave the currency are legitimate but likely overstated. Economic depression is all but certain for Greece in the event of a "Grexit," and its severity will likely deter other countries from following suit. At the same time, though, most observers are hoping for a new bailout agreement for the sake of market tranquility. History suggests that Greece's structural issues and unsustainable debt will continue to cause crises in the future. The least discussed, but probably the most significant risk to a Greek exit is the threat of other countries, like Russia or China, coming to Greece's aid with capital in exchange for access and control of Greece's prime location in the Mediterranean Sea. Not only would military troops of these countries be ominous, it would also be possible that the U.S. could lose access to a prime Air Force base in the region.

Earnings of U.S. companies are perhaps the one aspect of the economy that lend to a more cautious outlook. According to Factset, analysts are predicting a decline in average S&P 500 earnings of 4.5 percent for the second quarter compared with the same time period in 2014. This would mark the first year over year decrease since the third quarter of 2012. The two primary factors driving this decline are the currency headwinds U.S. companies are facing due to the stronger dollar and the steep decline of revenue in the energy sector brought on by lower oil prices. Several U.S. companies have been providing commentary and guidance about the negative impact of the stronger dollar for the second quarter and in the near-term going forward. The energy sector will continue to drag on earnings due to the steep drop of the price in oil beginning in the second half of last year. However, analyst forecasts have improved since the beginning of the second quarter as oil prices have rallied somewhat from $47.60 to $59.47. While these forecasts are negative, it is worth remembering that companies often lower expectations as their earnings release approaches. This is done for the sake of the positive press generated when a company "beats earnings estimates." We expect this tendency to continue as second quarter earnings are released.

China's economy should continue to tread water as they move to a consumption-led economy from an export-driven economy. A shift of this magnitude will take years, if not decades. China remains committed to this shift; in the meantime, China will continue to face headwinds as long as uncertainty and slow growth remain in Europe, one of China's biggest importers. The precipitous fall of the stock market will add to the angst over the slowing economy. We expect the Chinese government to step in and take bold action to prevent further stock market losses and stimulate the slowing economy. China continues to take steps to be more transparent in an effort to gain credibility globally, however, some of the market manipulation they orchestrate reduces their reliability and increases the concerns of many analysts globally.

The U.S. Federal Reserve will continue to evaluate economic data to determine if a rate hike is warranted. The Fed has continued to push off raising rates, but as inflation continues to move closer to its two percent target, it will become more difficult to delay the rate hike. Given the uncertainty around Greece and China, the Fed may have an excuse to further delay a rate hike until later this year or maybe even into next year. We continue to believe the first few small rate hikes will have very little impact on slowing down the U.S. economy. Raising rates just a little will provide the Fed with tools to fight future economic slowdowns. The way it stands today, the Fed has limited room to reduce rates and would therefore need to take extraordinary measures to help stimulate the economy should the U.S. economy fall into a recession.

We expect to see U.S. economic news continue to be positive, led by a strengthening housing sector and improving labor market. Although home ownership is down, household formation is increasing, which should provide a continued demand for both houses and apartments. In addition to the increase in household formation, the effect of "boomerang" home buyers should also add demand to the housing sector. The "boomerang" home buyers are previous home owners who lost their house due to foreclosures and now have a clean credit report allowing them to re-enter the housing market. More than five million American families lost their home to foreclosure between 2007 and the end of last year. As the foreclosure blemish falls off their credit score, usually after seven years, they regain the ability to become home buyers again. A strong housing sector is not only good for home builders and construction companies but it is a positive for the overall economy.

If anything in your financial situation has changed, please let us know so we can determine whether a change in your portfolio is necessary.

— Robert Moyer, CFA, CFP®, CAIA
Director of Research

The views and opinions expressed are for informational purposes only and should not be construed as investment advice. The data provided is as of the writing and is subject to change without notice. All material presented is compiled from sources believed to be reliable and current, but the accuracy of third party sources cannot be guaranteed. The material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities, and is not specific legal, investment or tax advice. The information provided does not take into account the specific objectives, financial situation, or particular needs of any specific person or entity and should not be relied upon as the sole factor in an investment making decision. Past performance is no guarantee of future results. Investing involves risk and could result in loss of principal.

ACG Advisory Services is a registered investment adviser.

1640 Huguenot Place
Midlothian, Virginia 23113
Phone: 804.323.1886
Fax: 804.323.1889
www.acgworldwide.com