ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT INSIGHT
2nd Quarter Review

Markets Take a Breather in the Second Quarter

Market Update

After spending the majority of the second quarter firmly in positive territory, stocks declined in the final few days of June, leaving broad equity indices near the unchanged mark. The S&P 500 Index declined by 0.2% in the second quarter. After significantly outperforming U.S. equity markets in the first quarter, developed international market returns were in-line with domestic equity returns. The MSCI EAFE Index (developed international equity benchmark) finished the quarter with a decline of 0.4%. After a strong start to the year, widely followed fixed income indices posted negative returns in the second quarter with the Barclays U.S. Aggregate Bond Index declining 1.7%. Interest rates climbed as economic data improved marginally and investors grappled with the increasing prospects of interest rate hikes on the horizon.

Range bound is a very accurate description of domestic equity market performance in the second quarter and also for the first half of the year. The S&P 500 has not advanced by more than 3.75% at any point so far this year while the index has not experienced a decline of more than 3.75% at any point in the first half of 2015. According to Bespoke Investment Group (BIG), there has never been a year when the S&P has traded in such a tight range.

While the domestic equity market has made little progress so far this year, we are reminded of a few important points. First, stocks (as measured by the S&P 500) have produced average annualized returns of almost 15% over the past five years. The economy has improved over this period, financial markets have become more stable and corporate profit growth has been impressive. However, the case could certainly be made that stock market returns have run ahead of the improvement in fundamentals to some degree. A pause in the upward trajectory of the stock market helps to better align returns with underlying fundamentals. Also, while year-to-date returns have been muted, we are encouraged by the resiliency of the equity markets. The market has faced numerous and significant challenges – including – weaker economic data in the beginning of the year, looming interest rate hikes, valuation concerns, flat lining of corporate earnings growth driven by the collapse in energy sector earnings and the impacts from a surging U.S. Dollar, as well as the continuation of the tiresome drama in Greece. Given these challenges, it is not at all surprising to see the market take a “breather”.

Economic Update

Heading into the second quarter, our expectation was for a rebound in economic activity after the slow start to the year. We do see solid evidence that the economy is perking up and our conclusion remains that the economy is on solid footing. Monthly employment gains averaged 240,000 in the quarter, while continuing jobless claims are at near historic lows. In addition to adding more workers to the payrolls, workers are now benefiting from acceleration in wage growth. More jobs and higher wages are solid underpinning for the U.S. consumer. Outside of the employment picture, housing and auto sales have also been bright spots. Both new and existing home sales advanced to the highest levels in seven years. This spring marked the best season for U.S. auto sales in a decade. We wouldn’t classify the second quarter as a barn burner, but we are encouraged by the improvement in economic activity.

Greece Commentary

After hanging around in the background for most of the quarter, Greece’s debt standoff moved to the center stage during the final week of June. Greece became the first advanced economy to miss a debt payment due to the IMF (International Monetary Fund), joining the ranks of delinquents that has included Cuba and Zimbabwe. Greece’s economy has been in various stages of disarray for a very long time. Greece recently went through a massive debt restructuring in 2012. To put this situation in a longer term context, Greece has spent 46% of the time in default since its independence from the Ottoman Empire in 1829. We do not believe that investors should draw conclusions about the health of the overall European economy from the events in Greece’s uncompetitive economy.

Reiterating a few points from our email last week – the Greek economy is roughly the size of 2/3rds of the Boston Metro area. The combined value of the Greek stock market represents a small fraction of the European equity market. Also, U.S. and European banks have dramatically pared back their exposures to Greek debt. The risks of a broader “contagion” caused by an outright Greek default are significantly less than several years ago. However, the new developments in Greece have increased the level of uncertainty in financial markets. Stock markets can handle good news and bad news but they do not like uncertainty. We are monitoring the situation closely and will make portfolio adjustments as needed.

Portfolio Positioning

After moving one step below maximum equity exposure towards the end of the first quarter, we maintained this slight bias towards equities throughout the second quarter. While our overall equity allocation was unchanged, we did make a number of portfolio shifts. The most significant of these shifts was an increase to our international equity allocation. Our international equity allocation is now roughly 12-14% of clients' overall stock exposure. We continue to have a favorable view on the developed international markets given improving economic growth, attractive relative valuations, respectable corporate earnings growth and supportive monetary policy. The U.S. economy is moving towards the full employment level and corporate profits at American corporations are at record levels. These same metrics have improved to some degree in Europe. However, there is certainly room for additional upside in these metrics in European economies. On the fixed income side we continue to maintain a relatively short duration or sensitivity to interest rate movements. In our view longer maturity bonds still offer an unattractive risk to reward tradeoff.

Closing Thoughts

Increased uncertainty has kept the market returns constrained so far in 2015. While investors have enjoyed the smooth ride over the past five years, we recognize that the tailwinds that drove those returns have abated to a large degree. We expect returns to be more driven by the fundamentals going forward. Elevated levels of volatility are likely to remain in the near future.

We outlined a number of risks/challenges above. These issues are widely discussed by market commentators and pundits. However, we are also very focused on what could go right. We think this list is just as long as the list of challenges but has received significantly less attention. We agree that the level of uncertainty has increased. However, our view is that the overall environment looks strong enough to maintain a reasonable allocation to risk assets. We remain well diversified across asset classes and strategies.

Second Quarter Performance Attribution

As outlined above, broad bond market benchmarks posted decisively negative returns in the second quarter as interest rates advanced. The Barclays U.S. Aggregate Bond Index posted a decline of 1.7%. However, our fixed income allocation protected capital well and performance was generally flat for the quarter. We are pleased with the performance results of our fixed income managers/mutual funds. Our tilt towards shorter maturity and higher yielding fixed income investments has been the right stance so far this year.

Our equity performance was generally in-line with domestic equity market index returns for the quarter. Overweight positions within the financial and healthcare sectors translated into positive performance attribution. Our allocation to small-cap stocks has also been beneficial as small company stocks continued their run of outperformance versus large-cap equities. In a reversal of the first quarter results, our international equity allocation slightly underperformed U.S. stocks in the second quarter. Not surprisingly European stocks bore the brunt of the late June selloff driven by the uncertainty in Greece. Despite the near-term volatility and risks surrounding Greece, our positive view on developed international markets has not changed. Energy sector exposure was another detractor in the quarter. While energy prices have rebounded from the lows set earlier in the year, concerns about oversupply remain unresolved. Our energy sector exposure is focused on high-quality companies that have adjusted their costs and capital expenditures to deal with the lower energy price environment. Dividend yields in this sector are attractive given the ultra-low interest rate environment.

On a year-to-date basis, performance results are in positive territory and look strong compared to passive indices which are flat (for stocks) or slightly negative (for bonds).