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Issue 92 — ***Summer Quarter, 2015***

Despite a plethora of important economic data points in the second quarter, market volatility remained muted. That all changed as the quarter ended and Greece's troubles, along with a plunge in Chinese stocks, took center stage.

The second quarter posted small losses for large-company U.S. stocks. And while the S&P is slightly positive year-to-date, the Dow Jones Industrial Average is down about 1% for the year. There is certainly some good economic news; however, it is not translating into positive returns for our markets. Both U.S. stocks and bonds are essentially flat for the year.

As usual, there are both positive and negative signposts for future returns in stocks. However, some troubling negative developments at this time (early July) give us additional cause for concern. These events include the following:

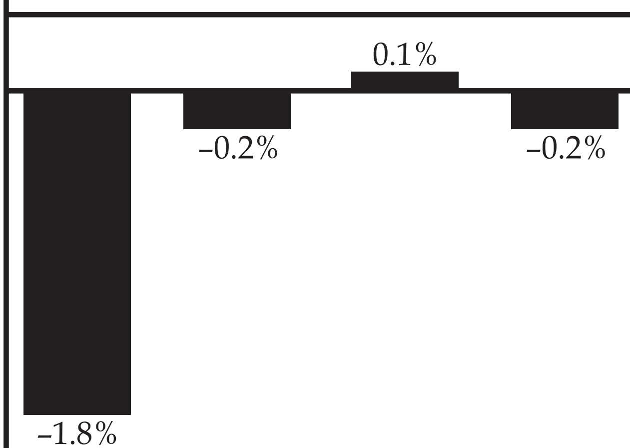
1.) Chinese markets are down over 25%.
2.) Both the Dow Jones Transportation Index and the DJ Utilities Index are off 11%.
3.) Greece is on the verge of insolvency and possible exit from the EU.
4.) Puerto Rico can't pay its debt obligations.
5.) First quarter GDP was revised to the negative column (-0.2%).
6.) Finally, there is the possibility of a September hike in interest rates by the Fed.

The U.S. stock market has been attempting to scale this "wall of worry." But the stock market is overdue for a retreat and we may finally get it in the third quarter. We wouldn't be surprised to see a 5%-10% correction soon. Through quarter end, we have gone 1367 days without a stock market decline of 10% or more, the third longest stretch in the past 50 years. (The longest ever was 2,553 days from 10/11/90 to 10/07/97). The crystal ball is a bit cloudy, but we like the fourth quarter's prospects for good returns. Getting to the fourth quarter, though, could be a bumpy ride. Hang on, we are taking steps to address our concerns and hopefully smooth the ride just a bit.

Market Review and Forecast. Despite plenty of good news about U.S. economic growth, our stock markets were basically flat for the second quarter in a row. The Dow Jones average dropped about 0.8% last quarter, and with its fractional loss the first quarter, is now down 1.1% percent this year. Theoretically, the S&P 500 snapped a nine-quarter winning streak when it lost 0.2% last quarter. However, with dividends reinvested, it actually eked out a small gain. The story was basically the same for U.S. small companies and international stocks. The Russell 2000 gained a miniscule 0.1% last quarter, while the international index (EAFE) declined 0.2%.

The Major Indices
Second Quarter — 2015

Barclays Agg. (Bonds)	**S&P 500**	**Russell 2000**	**EAFE** (Int'l)



The Greek debt crisis and a nearly insolvent Puerto Rico combined Monday, June 29, to send the Dow down 350 points (2%) for the biggest one-day selloff in two years. That one-day plunge exactly matched the 2% loss for U.S. stocks during June.

Besides Puerto Rico and Greece, another worry internationally is the ever-increasing total debt in China — quadrupling since 2007 to $28 trillion if all government, corporate, and household debt is included. Many experts think China has a real-estate bubble, yet its stock market had doubled in a year until a 25% drop since June 12.

Here in the U.S., the economy continues to strengthen as the unemployment rate last month fell to 5.3%, its lowest in seven years. We now have had 64 consecutive months of job growth, an all-time record. The economy added 223,000 new jobs in May — slightly less than forecast — but the total for 12 months is still near 3,000,000. (Incredibly, approximately 60 million people were hired during the past 12 months — 57 million left their previous jobs to find new ones!)

One negative was the lackluster June labor participation rate — the percentage of the population seeking jobs — that tied an all-time low. However, advertisements for job openings are now at their highest level since 2000.

Pending home sales rose 9% in May and are at their highest level in nine years. New car sales are running at a record 17 million annually, the best number ever. Consumer spending jumped 0.9% in May, the largest increase since back-to-school sales last August.

Household wealth is surging, now the highest inflation adjusted amount ever at $84.9 trillion as of March 31. That's nearly $30 trillion above the lowest level during the 2008-09 recession. Household debt (not counting mortgages) is now the lowest ever since record keeping began in 1980. Personal income rose 0.5% in May after another 0.5% increase in April, the best two-month gains in more than a year.

Lower gas prices are also a positive — they are about 90 cents nationally below last year. When the quarter ended Tuesday, June 30, our Triad prices averaged $2.61 cents a gallon compared to $3.52 twelve months ago. Certainly lower gas prices are helping consumer confidence, the best since 2007.

The outlook for corporate profits earned last quarter is slightly negative primarily due to (1) a stronger dollar and (2) energy sector profits that are projected to drop more than 60% since last year's second quarter. (Energy production is about 9% of the economy.) Several forecasters are arguing that the negative profit predictions are setting the bar low so that earnings will be significantly exceeded. Also, estimates for economic growth for last quarter are averaging about 2.5% with some optimistic forecasters expecting 3.5% or better for this quarter and next.

The Fed seems set to raise rates in September or at its December meeting. Given how low interest rates are now, we are fairly confident the pending one-quarter percent increase will not harm the economy. Since 1953, the market has gained a 9.2% average for the 12 months after the Fed raises rates for the first time.

We are still hopeful that U.S. stocks will increase this year by a number in the mid to high single digits. We doubt there will be a 10% correction or more any time this year even though we haven't had one in almost four years. However, a downturn this summer or early fall of 5% or more does seem somewhat likely.

The Greek Debt Crisis. It seems somewhat absurd that events in Greece, a country with a $250 billion GDP that is about the same size as Louisiana's and one-eighth California's GDP, can rock and roll world stock markets.

When the Greek banks closed Monday (June 29) and it became apparent that Greece would default on its $1.7 billion debt payment to the International Monetary Fund (IMF) due June 30, the Dow fell 350 points (2%) while European markets plunged twice as much, about 4%. (U.S. stocks rebounded a little the next three days to end the short July 4 week down 1.2%.)

A solid "no" vote by Greek voters July 5 (61% to 39%) to reject what German Chancellor Angela Merkel called an "extraordinarily generous offer" and Greek Prime Minister Alexis Tsipras termed "blackmail" caused markets worldwide to decline the next day — 2 to 3 percent overseas but less than one percent here.

As we write this, European leaders are telling the Greeks that they must make their last best offer or face expulsion. A so-called "Grexit" could certainly impact global stock markets negatively. (By the time our clients receive this newsletter the current Greek crises may be over. Our best guess is that an agreement will be reached so that the Greeks will keep the Euro. Early July polling data indicated that 74% of Greek citizens want to retain the Euro.)

Greek banks were still closed as of July 10 even though they are still receiving some assistance from the European Central Bank (ECB). Greek citizens, except those on pensions, may only withdraw 60 Euros (about $66) a day from ATM machines; however, some ATM machines are out of cash. Even more discouraging is that Greek bank-issued credit cards are no longer accepted and Greek businesses letters of credit are no longer valid, essentially ending imports, as the Greek economy implodes.

Almost every economist believes there is no way the Greeks can manage their $335 billion debt in loan guarantees without significant debt relief. (Even though $335 billion seems like a large number it is only about one-400th of the world's total debt markets.)

However, three years ago in 2012 during the first Greek debt crisis, the fear of contagion was a much bigger threat as the Spanish, Italian, and Portuguese economies were declining (in recessions). Now, all Euro economies are currently growing except Greece's. Also, back then, the Greek debt was mostly held by banks and other private investors. Today only 20% of Greek debt is privately owned — the other 80% is mostly owed to the IMF, ECB, and the German government. ECB head, Mario Dragi, has indicated that he'll do "whatever it takes" to supply liquidity to any other Euro country if needed.

Greece's problem has two primary causes. The obvious one is that the Greeks lived way beyond their means after (and even before) the Euro became their official currency in 2002. They hired Goldman Sachs in 2001 to move government debt off their books so they could qualify for the Euro, and then various Greek governments issued false numbers for a decade, simply telling continual lies about how much they owed. In essence they were deadbeats who could borrow at low interest rates because of the Euro's backing by Germany and the other 17 countries using the Euro.

Tax collection in Greece is totally inefficient with some estimates of the underground economy there reaching 50 percent of GDP. The current average Greek retirement age is 57! It is estimated that the average Greek's standard of living has dropped 25% in the last five years.

The more worrisome problem for the long run is the very nature of the Euro currency. Normally the value of a country's currency fluctuates based on economic conditions — declining or increasing based on the strength of the country's economy, its debt, and many other factors. If a country's economy is perceived as problematic, the value of its currency will decline. However, that will make its exports cheaper, and cut down on imports. The lower currency value also will boost tourism (especially important to Greece). Soon, the argument goes, the country's economy will improve. Of course, none of the above takes place when there is a common currency. Typically the Euro's value is based on the strongest economies, particularly Germany.

One reason Germany is so committed to the Euro is that its economy is so much stronger than the other Euro countries. If there were no common currency, a return to a German Mark would immediately result in an extremely high-valued currency that would devastate Germany's export-heavy economy because it would significantly increase its production costs. (Germany is the world's number one exporter — depending on export sales for about 45% of its economy.)

Our best guess is that the commitment to keep the Euro is incredibly strong and the Greek problem will abate. Despite the turmoil in Europe, some market experts continue to tout Europe as currently the best place to invest, given the improving Euro economies and lower stock prices there, about 25% cheaper than ours.

Interest Rates. The general consensus is that the Federal Reserve will raise interest rates a small fraction by the end of 2015. The earliest consideration for the rate increase is September. This of course is assuming the U.S. economy continues to grow, as now seems to be the case, and can in fact support an initial rate increase.

However, there are several events and/or situations on the horizon that may require the Fed to delay its rate increase. As previously discussed, the debt problem in Greece is one issue. Meanwhile, the Puerto Rican governor announced June 29 that there was no way that his commonwealth could repay the $72 billion it owes to bondholders.

Unlike Detroit, Puerto Rico is forbidden by law to file for bankruptcy. But Congress does allow Puerto Rico to issue bonds that are not subject to any federal, state or local taxes — triple tax frees. Just as the Greeks could borrow cheaply using strong German-backed Euros, the triple tax-free status has enabled Puerto Rico to live beyond its means because its higher-yielding bonds were eagerly snapped-up by national muni bond funds. Several California tax-free bond fund hold more than $1 billion of Puerto Rican debt.

One Puerto Rican utility owes $9 billion. On July 1, Puerto Rican sales taxes jumped from 7 percent to 11.5%, the nation's highest, with a new 4% tax on professional services. President Obama has made it clear he won't support any federal bailout funds for the Puerto Ricans.

Another concern among many well-known economists such as Mohamed El-Erian and members of the Fed is a growing focus on bond market liquidity. (Liquidity in the bond market is generally thought of as the ability to trade large blocks of bonds, especially during times of stress.) The concern is that with an increase of high frequency electronic trading, bond market liquidity may become less resilient than in the past.

The 10-year Treasury closed the quarter yielding 2.33%. Over the last 52 weeks the yield has seen a high of 2.63% and a low of 1.66%. For second quarter of this year, the 10-year Treasury yield increased by 48 basis points, the result of fixed income selling. (When bond prices decline, rates increase.) The Barclays Aggregate Broad Market Index YTD is negative 0.1%, while intermediate term corporates were positive 0.8% during the second quarter.

Commodities and Currencies. The second quarter of 2015 ended with a rise in virtually every commodity sector with precious metals and base metals being the exception. Palladium led the precious metals slide by losing 8.5% of its index value and tin pulled the base metals index down, dropping by 16.7%. All of this in spite of a slight slide in the value of the dollar over the same period.

Conversely, the best performing commodity sector turned out to be energy, with the composite index closing up by nearly 14%. NYMEX Crude Oil gained 24.9% due to lower prices and increased demand. Brent crude oil and NYMEX gasoline each rose nearly 15% for the quarter. However, the first week of July saw a 15% drop in oil prices on concerns over economic weakness in China.

The US dollar closed out the quarter down 3% from its March 31 value while the majority of commodity indexes closed up approximately 3%. This should not come as a surprise, as the U.S. dollar/commodity relationship is typically inverse. (The weaker the dollar, the more dollars it takes to buy a particular commodity, all else being equal.)

Please let us know if your circumstances, needs, risk tolerance, or objectives shift which may have an impact on the way we manage your assets. We can and will respond to your needs by tailoring the allocation to meet your criteria. We look forward to hearing from you and discussing any issues that would relate to our management of your assets. Please call us at 336-998-7000; we always look forward to talking to you.