# Quarterly Investment Report

July 2015

***SUMMARY:*** ***The second quarter was a difficult period for investors, both in equities and fixed-income in-struments, both in the U.S. and abroad. The major U.S. stock indexes closed mixed, with the S&P 500 gaining 0.3%, including dividends, while the Dow Jones Industrial Average fell by that much. NASDAQ did better, returning 2.0%. Overseas, European markets were roiled by Greece's debt default following the breakdown of bailout talks and the correction in Chinese stocks accelerated. Bonds recorded their first negative quarter since the end of 2013. The Federal Reserve has indicated that it may begin raising interest rates later this year, possibly as early as September, as the U.S. economy shows modest improvement following negative first quarter growth. But events abroad may force it to forestall that action until 2016.***

**U.S. stocks closed mixed for the second quarter after mostly losing ground in June.** Equities were mostly weaker last month, as the Federal Reserve signaled that it may begin its first interest-rate increases since the global financial crisis later this year. More recently, the failure of Greece to secure a new bailout package and avoid a June 30 debt default unsettled investors. Both the Dow and S&P 500 fell about 2% in June, with the S&P returning 0.3%, including dividends, for the quarter, and the Dow losing 0.3. For the year to date, the S&P is up 1.2% while the Dow is largely unchanged.


**But NASDAQ and the Russell 2000 both recorded gains for the quarter and are firmly in the green for the year.** NASDAQ lost 1.6% in June but managed a 2.0% return for Q2, closing the quarter at 4987, just 3.3% below its all-time high of 5160, reached just a week earlier. The index has returned 5.9% so far this year. The small-cap Russell index was one of the few major indexes to record a gain in June, rising 0.6% to bring it slightly into the green for the quarter. YTD, the index is up 4.1%.


**Consumer discretionary stocks were the only sector in the S&P 500 to record a gain in June, rising 0.6%, but health care stocks remained the best performers year to date, as they outperformed the nine other sectors in the second quarter.** Health care stocks got a boost from several big mergers announced during the quarter as well as the Supreme Court's decision last month upholding the Obamacare law. Despite losing 0.3% in June, health care stocks rose 2.8% in Q2, bringing their market leading gains to 9.6% in the first half. Interest-rate-sensitive utilities fell along with bonds and were the worst performers in June (down 6.0%), Q2 (-5.8%) and YTD (-10.7%).

**European stocks were down sharply in June and negative for second quarter as the bailout talks with Athens failed to**

## Global Investment Returns
### In U.S. Dollars

| | Q2 2015 | | Trailing 12 Months | |
|---|---|---|---|---|
| | Stocks | Bonds | Stocks | Bonds |
| **U.S.** | **0.2%** | **-1.7%** | **7.0%** | **1.9%** |
| Canada | -0.9% | -0.1% | -15.3% | -10.0% |
| Mexico | 0.3% | -2.8% | -11.9% | 0.3% |
| **Japan** | **3.1%** | **-2.2%** | **8.3%** | **-15.4%** |
| Pacific ex Japan | -2.5% | -3.0% | -6.8% | -12.9% |
| Australia | -6.2% | -2.2% | -14.2% | -13.4% |
| China | 6.0% | 2.0% | 24.6% | 7.7% |
| Hong Kong | 5.6% | N/A | 12.4% | N/A |
| **Europe** | **0.4%** | **-0.8%** | **-7.7%** | **-15.8%** |
| France | 0.3% | 0.4% | -9.6% | -15.8% |
| Germany | -5.6% | -1.0% | -9.5% | -15.3% |
| Italy | 2.5% | -3.6% | -13.4% | -15.3% |
| Netherlands | 2.8% | -1.3% | 2.5% | -15.1% |
| Spain | -2.0% | -3.4% | -17.3% | N/A |
| Switzerland | 1.0% | 3.0% | -1.1% | -1.3% |
| U.K. | 3.0% | 2.0% | -8.2% | -0.3% |
| **World** | **0.3%** | **-1.2%** | **1.4%** | **-7.1%** |
| World ex U.S. | 0.5% | -0.8% | -5.3% | -13.2% |

Sources: MSCI Stock & Barclays Bond Indexes as of 6/30/2015

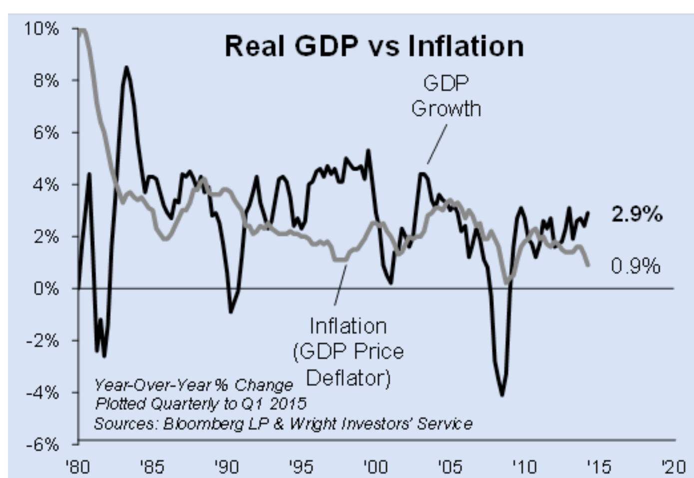
**avoid a Greek default at the end of the month.** Negotiations between Greece and its international creditors in late June ended in acrimony, leading to Athens' defaulting on a $1.7 billion debt payment to the International Monetary Fund. Another $7.6 billion is due to the European Central Bank this month and next. The ECB's refusal to grant Greek banks yet more emergency funding led to Athens declaring a bank holiday and controls on withdrawals. The broad-based Stoxx Europe 600 fell 4.6% in local currency in June, leading to a 4% decline for the quarter. Other major national indexes were also down on the order of 4% for the month. Germany's DAX index fell 4.1% in June and was down 8.5% for Q2, both on the problems with Greece as well as profit-taking following a 22% run-up in Q1. Nevertheless, both indexes are up more than 11% year to date in local currency. The Athens Stock General Index fell a relatively modest 3.4% in June and was actually 2% higher for Q2, but that masked the volatility in the index, which gyrated up and down as hopes for a deal failed to materialize. Greece's stock exchange was closed on June 29 along with the nation's banks.

**The Shanghai composite index was one of the worst performing major indexes in June but the losses it sustained weren't nearly enough to knock it off its perch as the best performer for the second quarter and year to date.** The index lost 7.3% in June, dropping more than 17% after hitting a post-financial-crisis high on June 12. But despite that profit-taking, the index held onto a 14% gain for the quarter and 32% YTD. The index, which more than tripled in the 52 weeks ended June 12, has been climbing not because of growth in the Chinese economy – which has fallen to a more mundane level of about 7% – but because of what is driving most other stock markets, namely central bank stimulus and investor speculation on more to come. On June 26, China's central bank cut interest rates for the fourth time since last November after the market plunged the previous two weeks, perhaps justifying that speculation, even as other government agencies and private stock-trading companies have taken steps – fairly limited so far – to rein in margin lending, which is feeding the rise.

**Elsewhere in Asia, the major indexes were lower for the month but held onto strong gains for the quarter and year to date.** Japan's Nikkei 225 retained a 5.4% quarterly gain and 16% YTD rise despite a 1.6% decline last month. Hong Kong's Hang Seng index fell 4.3% in June but was up 5.4% in the quarter and 11.2% for the first six months of the year. Indian markets have been relatively subdued, as the Sensex index had a modest loss for the month and the quarter but is up 1% so far this year.

**Bonds recorded their first negative quarter since the fourth quarter of 2013.** While skittish investors sought the safety of U.S. Treasury bonds at the end of June as the Greek talks ended in failure, it wasn't enough to reduce the losses sustained earlier in the month and quarter as investors sold bonds in the face of improving economic news and expectations of higher interest rates. The Barclays U.S. Bond Market Aggregate fell 1.1% in June, dragging its quarterly return down to a negative 1.7% and pushing it into the red for the year to date. The yield on the benchmark 10-year Treasury note ended the quarter at 2.35%, up 23 basis points for the month and 43 bps for the second quarter. The yield on the 30-year Treasury bond closed June at 3.12%, up 24 bps for the month and 43 bps for the quarter. While those yields are off slightly from their highs of the year, reached about a week before the end of June, they are up sharply from their late January lows of 1.64% and 2.22%, respectively.

**Euro zone sovereign bonds fared even worse.** Those bonds lost 5.7% in the second quarter, according to Bank of America Merrill Lynch's Euro Government Index, their worst performance since the firm began tracking data in 1985. The decline was led by a 16% drop in Greek securities, but German bunds fell 4.7%. German bunds were the best performers at the



end of June as investors sought safety from the Greek bailout crisis, but bonds of all types ended the quarter with lower prices and higher yields. The yield on the benchmark 10-year bund ended June at 0.77%, up 28 basis points for the month and 61 bps for the quarter, rising sharply after reaching an all-time low yield of 0.08% on April 20. But yields on so-called peripheral country bonds – debt of those potentially most likely to follow Greece out of the euro zone – climbed nearly twice as much, sharply widening their yield differential with their German counterparts. For example, yields on comparable Italian and Spanish bonds rose nearly 50 bps in June and more than 100 bps for the quarter on investor concerns, with both closing June 30 at about 2.30%.

## The U.S. Economy

Recent reports on the U.S. economy have been fairly positive, indicating a rebound from a weak first quarter, but growth remains uneven and inconsistent. The final revision for Q1 GDP showed the economy declining by 0.2%, up from the previous estimate of a 0.7% decline. Moving into Q2, however, many economic reports have shown improvement. Leading indicators rose 0.7% in both April and May. The ISM's manufacturing purchasing managers' index rose to 53.5 in June, matching its highest level of 2015, after rising a full point to 52.8 in May. Construction spending rose a better-than-expected 0.8% in May after jumping 2.2% in April, while March was revised sharply upward to a 0.5% increase versus a 0.6% decline originally reported.

**Much of that rebound in construction has been due to the housing sector, which has been the brightest spot in the economy in the second quarter.** Home sales for May, both for newly built structures as well as existing ones, both came in much higher than expected. New-home sales rose 2.2% to an annual rate of 546,000, the best monthly sales rate since February 2008, while sales of existing homes rose 5.1% to 5.35 million, the fastest pace since November 2009. The median existing-home price in May was $228,700, nearly 8% higher than a year earlier. Housing starts fell 11% in May to an annualized rate of 1.04 million, but that was more than offset by an upwardly revised 22% jump in April to 1.17 million, the strongest one-month increase since 1990. That made the April-May numbers the best back-to-back readings since late 2007, just before the housing market collapsed. Building permits, a forward indicator, rose nearly 12% in May to an annualized rate of 1.28 million units, the most since pre-recession August 2007. Not surprisingly, confidence among homebuilders hit a nine-month high in June, as the National Association of Home Builders' housing market index rose an unexpected five points to 59, the highest since last September.

**On the negative side, durable goods orders fell a greater-than-expected 1.8% in May, the third decline in four months.** April was revised downward to a 1.5% decrease from the 0.5% originally reported. Excluding the volatile transportation sector, May orders rose 0.5%, but that was offset by April's downwardly revised 0.3% drop. The Chicago Fed's national activity index remained in negative territory in May. Industrial production fell 0.2% in May after falling a downwardly revised 0.5% in April. Factory orders fell 1% in May after falling a downwardly revised 0.7% in April.

**On the consumer front, retail sales and spending have snapped back sharply.** May retail sales jumped 1.2% while April was revised to a 0.2% gain compared to no change reported previously, while March was revised to a 1.5% increase, the biggest monthly gain in five years. Likewise, consumer spending – a broader category than retail sales – climbed 0.9% in May, the biggest increase since August 2009 and up sharply from April's 0.1% rise. A big part of that boost was fueled by a 0.5% increase in personal incomes in both April and May, the best two-month increase in over a year. Not surprisingly, consumer confidence is rising. The Conference Board's consumer confidence index jumped nearly seven points in June to 101.4, well above expectations. Likewise, the University of Michigan's consumer sentiment index ended June at a better-than-expected 96.1. The expectations component reached 97.8, up more than 13 points in the month to hit a 12-year high.

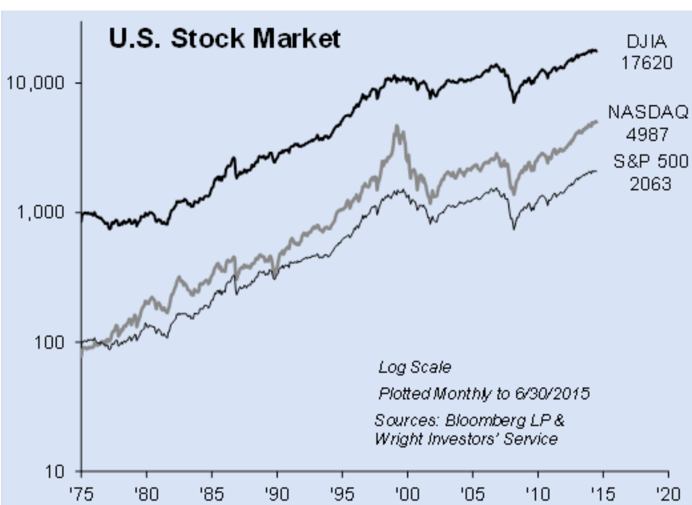
**Yet, while the trend line certainly points upward, growth in the jobs economy remains uneven.** Witness the June Labor Department report, which showed nonfarm payrolls rising by 223,000 jobs, slightly weaker than expected. The report also included sharp downward revisions in May, to 254,000 from the originally reported 280,000, and April, to 187,000 from 221,000. The June unemployment rate did drop to a seven-year low of 5.3%, but that was due to fewer people looking for work. The labor force participation rate fell to 62.6%, the lowest level since 1977. On the bright side, unemployment claims have been the model of consistency, holding below 300,000 for 17 straight weeks.

## Investment Outlook

**The specter of the Federal Reserve raising rates clearly held down the performance of financial assets in the second quarter, particularly bonds.** Although it's too early to say with complete confidence, as the above paragraphs show, the economy appears to be starting to get in good enough shape to justify an interest rate increase before the end of the year. As expected, the Fed left rates at near zero at its June monetary policy meeting. While it didn't provide any overt indication of when it might begin rate lift-off, data in the report seemed to suggest that a 25 basis-point increase, and possibly two, might happen before the end of the year. At the same time, though, the Fed lowered significantly its forecast for U.S. economic growth this year. The Fed now expects U.S. GDP to grow by 1.8% to 2% this year, down from a range of 2.3% to 2.7% in its projection of just three months earlier. Next year, it expects the economy to grow by 2.4% to 2.7% and 2.1% to 2.5% in 2017. It also lowered its interest-rate forecasts for next year and 2017.

**According to the report, 15 of the 17 Fed officials expect to start raising rates before the end of this year, with five expecting a rate hike of 25 basis points by December and another five anticipating an increase of 50 bps.** Two aren't ready to make any move at all this year. Notably, in her press conference following the June meeting, Fed Chair Janet Yellen didn't offer any further insight into when the Fed would start raising rates. By contrast, in a speech in May Yellen said "it will be appropriate at some point this year to take the initial step to raise the federal funds rate, assuming the economy continues to improve as I expect." That scenario, of course, is still up in the air, and no one knows that better than the Fed, judging by its lowered 2015 economic forecast.

**Indeed, a Fed that has less faith in the economy now than it did six months ago is arguably less inclined to start raising rates this year.** The ratcheting down of expected economic growth hardly justifies a rate rise this year, at least not yet. At the same time, events abroad, particularly in Greece and China, may persuade the Fed to wait. The International Monetary Fund, for one, is urging the Fed to delay liftoff until next year. Looking further out, the Fed's median estimate for rates in 2016 moved down to 1.625% from 1.875% last March, while the median estimate for 2017 fell to 2.875% from 3.125% six months ago. As a result, whether the Fed raises rates this year or next, any rate increases are likely to be small and deliberate, as the Fed itself has said. A Fed that has taken this long to raise rates is not likely to start increasing them rapidly. It's more likely to wait at least a couple of quarters to measure how a small increase affects the economy before it risks doing so again.




**The U.S. Economy 2013–2016**

| | | % Change In | | | End of Period Rates | |
|---|---|---|---|---|---|---|
| | | Real GDP* | PCE Core Deflator* | Profits from Operations# | 90-Day T-Bills | 10-Tear T-Notes |
| 2013 | Q1 | 2.7% | 1.4% | 2.3% | 0.1% | 1.8% |
| | Q2 | 1.8% | 1.0% | 3.3% | 0.0% | 2.5% |
| | Q3 | 4.5% | 1.4% | 4.6% | 0.0% | 2.6% |
| | Q4 | 3.5% | 1.3% | 6.1% | 0.1% | 3.0% |
| 2014 | Q1 | -2.1% | 1.2% | 7.5% | 0.0% | 2.7% |
| | Q2 | 4.6% | 2.0% | 9.0% | 0.0% | 2.5% |
| | Q3 | 5.0% | 1.4% | 9.0% | 0.0% | 2.5% |
| | Q4 | 2.2% | 1.1% | 6.1% | 0.0% | 2.2% |
| 2015 | Q1 | -0.2% | 0.8% | 4.6% | 0.0% | 1.9% |
| | Q2 e | 2.5% | 1.2% | 1.6% | 0.3% | 2.3% |
| | Q3 e | 3.0% | 1.3% | 0.3% | 0.6% | 2.5% |
| | Q4 e | 3.0% | 1.4% | 3.4% | 0.8% | 2.5% |
| 2016 | Q1 e | 2.7% | 1.6% | 6.5% | 1.1% | 2.7% |
| | Q2 e | 2.8% | 1.7% | 10.3% | 1.3% | 2.9% |
| | Q3 e | 2.7% | 1.8% | 13.1% | 1.7% | 3.1% |
| | Q4 e | 2.7% | 1.8% | 13.1% | N/A | N/A |

e: Bloomberg Consensus Estimates; *: Annual Rates; #: Year-Over-Year Change in S&P500 EPS
Sources Bloomberg LP, Wright Investors' Service

**We should also keep in mind how remarkably resilient the global financial markets have proven to be over the past several years.** Most recently, for example, after an initial selloff following the breakdown of Greek bailout talks and its eventual default, stocks quickly rebounded. Of course, a great deal of that resilience is based on well-founded investor confidence that central banks will continue to provide the necessary liquidity and accommodation in the event of a crisis. Consequently, Wright continues to recommend a well-diversified portfolio of financial assets, including both foreign and domestic securities.

July 2015