Quarterly Commentary 2015 | Q2

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Everything is funny as long as it is happening to somebody else. –Will Rogers-*

Throughout much of the second quarter, major equity indices reacted like a roller coaster. Equities rose and fell as investors weighed a potentially changing economic landscape and struggled to determine how various positions would be effected.

As the quarter drew to a close, several indices leveled out any gains. The chart below shows the S & P 500 returning almost to the starting point, where it had begun three months before. Although the index in the end had moved very little, several positions did, creating winners and losers along the way.

Unfortunately, the roller coaster analogy is applicable not only to the second quarter, but to the entire first half. Unlike past years, neither the blue chip Dow nor the broader S & P 500 has succeeded in generating any sustained forward progress in 2015.

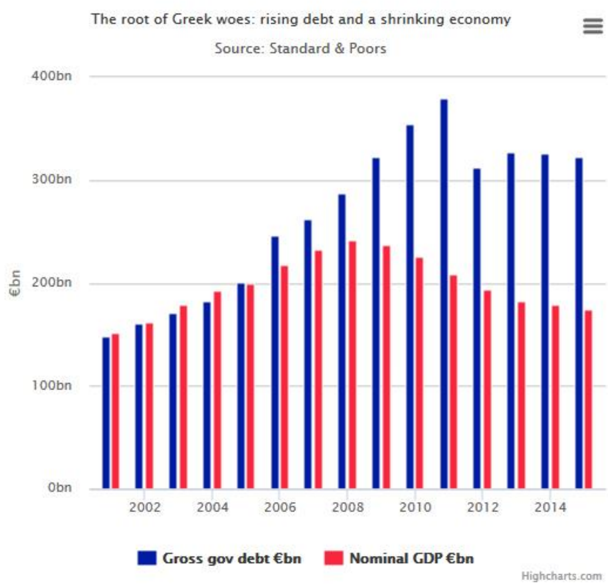
S&P 500 Index – Q2 2015

A recent Bloomberg headline described the markets year to date as the "worst first half since 2010". What an attention grabbing headline! The report then went on to note that stocks in the S & P 500 are up 200 percent since March 2009. Since then corporate earnings have doubled and companies have repurchased approximately $2 trillion of their stock. As Paul Harvey would say, now you know the rest of the story.

Throughout much of the last six months, stocks have traded in a relatively tight range, failing to generate any sustained upward momentum. But perhaps that is to be expected given current valuation levels and the relative uncertainty that they could go higher. In the end, the market broke a string of significant gains, stretching back nine quarters.

To be fair, investors were forced to grapple with several unknowns—how will the situation in Greece affect the global economy? Will China be able to regain its mojo? How will the first rate hike since 2008 impact businesses, consumers and the economy as a whole? Could ISIS disrupt rising confidence, prompting the consumer to retreat and retrench?

These geo-political concerns lingered against a back drop of mixed economic data here at home. While job growth continued and the unemployment rate fell, so did labor force participation.



The much anticipated rebound in U.S. Growth after a disappointing GDP number for the first quarter was also slow to develop. Growth in many developed countries around the world began to outpace economic growth in the United States.

Despite sluggish growth stateside, oil prices began to rebound, after a nine-month decline. Some analysts believe that increasing investor optimism for global economic growth and receding concerns about deflation are the two factors responsible for the turn-around.

Additionally, much to the pleasure of both investors and management of international corporations, the U.S. Dollar began to weaken after three consecutively strong quarters. It is interesting to note that oil prices, interest rates and currency markets have been moving together since the middle of 2014.

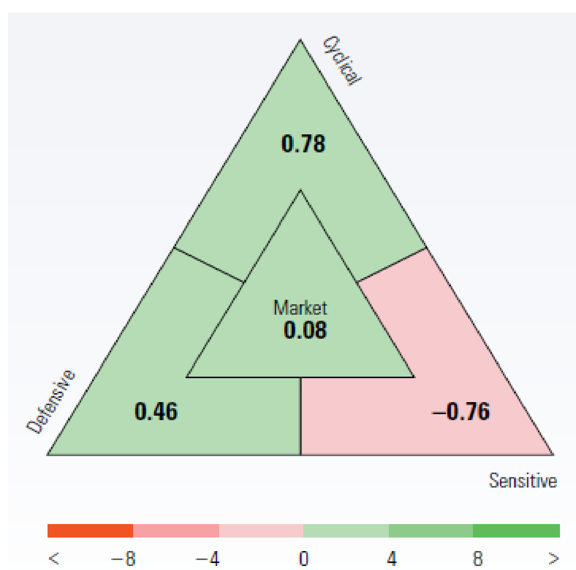
The softer U.S. Dollar, combined with a bump in oil prices, prompted global bond yields to surge. Yields on German Bunds, which we discussed in our commentary last quarter, accelerated from a low of 0.07% in mid-April to 0.72% in less than three weeks, as the flight to safety dissipated.

In sum, the economic headlines were neither as favorable as most investors would have liked nor as unfavorable as some feared. The one aspect that was clear, however, is that no definitive trend line emerged. Lacking any specific direction, markets tended to mirror the news and oscillate between gains and losses.

As many equity positions and sectors became more fully valued, the fluctuations both up and down were at times magnified, creating some winners and losers, even though several well-known indices remained relatively flat.

A Closer Look….

U.S. equities moved largely sideways during the second quarter, in the absence of any real conviction on the part of investors. For the most part, stocks classified as cyclical—those which tend to track the overall economy—fared slightly better than their defensive and sensitive counterparts.



Q2 2015 Morningstar Sector Delta and Return %

Among the biggest winners for the cyclical sector were JPMorgan Chase, Bank of America, Goldman Sachs and AIG, all posting gains in excess of 10%. Amazon and Starbucks also enjoyed significant gains of 16.7% and 13.6% respectively. Tesla Motors, however, delivered an extraordinary performance with a 40% return for investors.

Conversely, several consumer names plummeted. Michael Kors, Kate Spade and Sears all fell more than 35%. Much of the loss was attributed to diminishing brand equity.

Several defensive stocks also did well, thanks in large part to the boom in health care experienced during the second quarter. AbbVie, Eli Lilly, Cigna and Aetna posted gains exceeding 15%.

Consumer defensive stocks, however, lagged significantly. Apollo Education Group, which operates the University of Phoenix and the College for Financial Planning, plunged 31% after management announced its intention to bottom out the business in 2016, before resuming any growth initiatives. The plans include reducing enrollment by 25% over the coming year.

Sector	Quarter	1-Year	3-Year
Cyclical	**0.78**	**9.99**	**19.78**
Basic Materials	–0.93	–3.26	11.51
Consumer Cyclical	0.38	14.24	22.21
Financial Services	4.32	11.61	22.75
Real Estate	–9.40	3.75	8.57
Sensitive	**–0.76**	**–0.22**	**14.32**
Communication Svs	4.91	6.85	16.83
Energy	–1.97	–23.40	6.32
Industrials	–2.37	3.04	18.05
Technology	–0.42	9.43	16.12
Defensive	**0.46**	**16.84**	**20.55**
Consumer Defensive	–1.80	10.21	14.65
Health Care	3.22	26.38	28.45
Utilities	–6.31	–3.65	8.44

Stocks often classified as sensitive—those which reflect economic developments but not with the same intensity as cyclical positions—had mixed results during the quarter. Netflix surged posting a 57% gain, while AT & T and Microsoft enjoyed respectable returns of 10% and 9% respectively.

On the other hand, fears of a downturn in the semiconductor industry lead to equally disappointing results. Qualcomm fell 9%, while Micron tumbled more than 30%.

Growth vs. Value

Growth stocks continued to outpace their Value counterparts in the second quarter, albeit slightly. Walt Disney ended the quarter up 8.8%, due in large part to escalating content valuations. Comcast also posted a notable gain of 6.9% due to success with its X1 Platform of bundled services.

Among Growth or momentum companies, results in health care were mixed. Gilead Science posted a 20% gain, while smaller peers—Dyax and Seattle Genetics—rose over 35%. On the other hand, shares of Puma Biotechnology plunged after the company announced that trials of its breast cancer drug Neratinib produced only marginal results.

Large banks, many of which enjoyed double-digit gains during the quarter, were among the top contributors in the Value arena. Retailing giant, Wal-Mart, however, did not share a similar fortune. While the retailer is synonymous with unmatched scale and a wide moat, investors are becoming increasingly concerned about the firm's long-term revenue stream and future margins. Wage hikes are expected to squeeze margins over the next several quarters. The second quarter saw shares fall more than 13%.

Similar to other content providers, Starz surged 30%, as investors continue to place a premium on high-quality video productions. Conversely, coal producer, Peabody Energy, sank more than 55%, while shares of Caesar's Entertainment dropped more than 40%.

Large Cap vs. Small Cap

Many stocks classified as Large Cap outpaced their Small and Mid Cap counterparts in the second quarter. The Large Cap performance, year to date, is a slightly different story.

Microsoft was one of the largest contributors to the Large Cap category in the second quarter, thanks in part to its success migrating its Office platform to the cloud, marketed under the moniker Office 365. A new version of Windows is also expected to be rolled out in the third quarter.

Keurig Green Mountain, on the other hand, after serving as the S & P's top performer in 2014, fared poorly after delivering lackluster earnings, as sales of its K-Cup brewers plateaued. Twitter suffered a similar fate as user growth and engagement diminished. Shares of the company fell more than 25%.

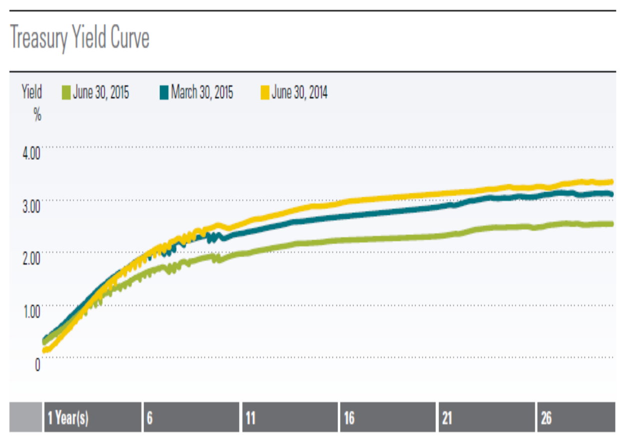
Small Caps offered a tale of highs and lows. While some companies enjoyed significant gains of more than 20%, others foundered. One of the most notable names, Sketchers ended the quarter with a gain of 50%, while fracking firm, Carbo Ceramics, regained some of its losses, rising more than 35% in the second quarter, after falling approximately 80% last year.

Among the Mid Cap disappointments, Whole Foods Market fell 25%, as the grocer sought market share. One analyst summed the company's struggles by saying that the average consumer is simply not willing to pay up significantly for organic food items.

Shares of Groupon also continued their multi-year slide. Extreme competition among competitors has made it increasingly difficult for the company to differentiate itself. Shares slid more than 30% over the course of the second quarter.

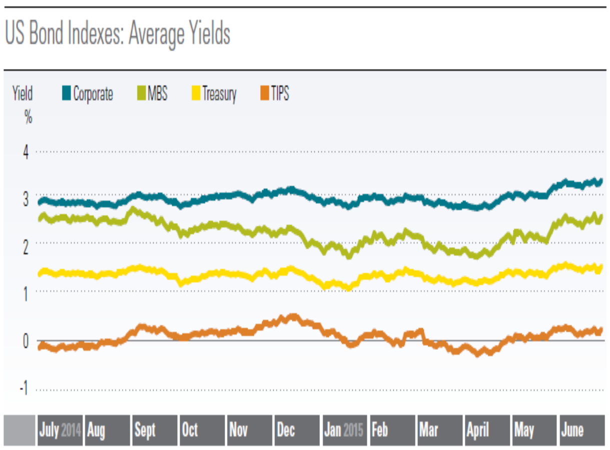
Fixed Income

Rising interest rates in the second quarter wiped out much of the gains in fixed-income positions generated during the first quarter. Long term interest rates rose across the world's developed markets. The increase resulted in depressed valuations of existing bonds positions, eroding the advances of the first quarter rally.



Longer-term bonds fared the worst as the yield curve on U.S. Treasuries steepened. By the end of the quarter, the yield on the five-year Treasury had decline 2 basis points, while the 10 year and the 30 year rose 17 and 35 basis points respectively. Short term issues performed somewhat better.

Corporate bonds followed an over performance in the first quarter with an under performance in the second. Disappointing returns were largely attributable to widening credit spreads and longer durations among corporate positions. As the Greek debt crisis re-emerged, investors became concerned about the risk of contagion across asset classes and investors demanded a more significant risk premium.

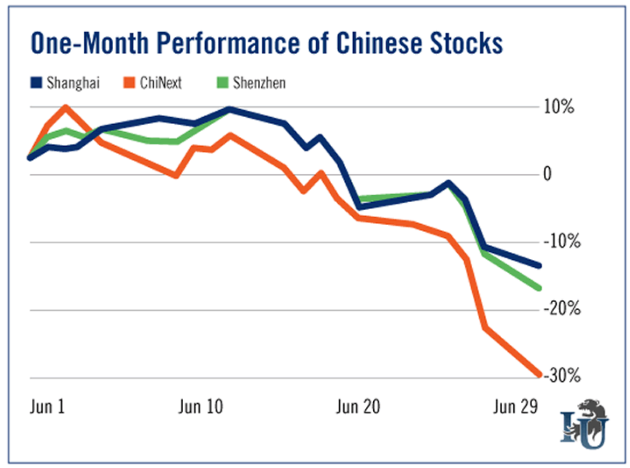


Looking Forward…

Much of the risk to markets today is geo-political. In a diverse world that it increasingly inter-connected, there are always opportunities for issues to arise that could disrupt financial markets.

While we appear to have side stepped one such issue recently with a European consensus on a bailout for Greece, it is important to note that the agreement is in its infancy. Some analysts have noted that it may be difficult if not impossible for the Greek people to abide such rigid conditions. Furthermore, one economist recently noted that the austerity imposed on the Greek economy will curtail any meaningful financial growth.

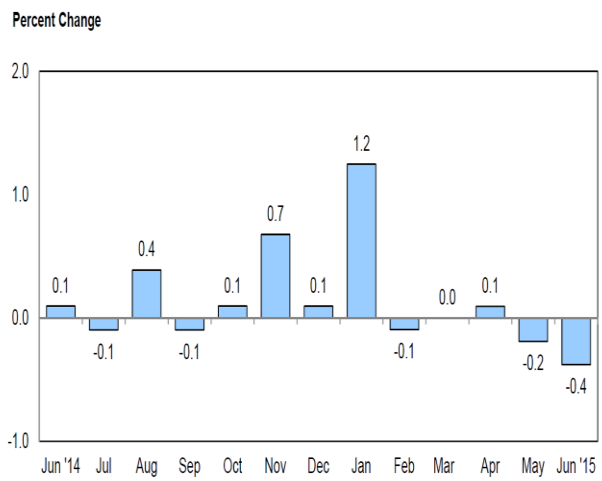
Perhaps the one bright spot should Greece default and ultimately exit the Eurozone is that much of Greek debt is now consolidated with the International Monetary Fund and the European Central Bank. A few years ago, banks across Europe held much of the Greek sovereign debt. A default at that time could have crippled an already fragile financial system. Today, while a Greek default would be highly undesirable, it would likely not prove catastrophic to either the European or global economy.



A much larger concern lurking on the horizon could be China. Although the Chinese government is aggressively intervening to stimulate the economy and curtail outflows from the county's equity markets, these efforts may or may not meet with long term success. Should the world's second largest economy suffer a significant downturn, the effects would most certainly ripple throughout the global economy.

On the upside, job growth should remain relatively stable, however, the recent gains have not translated into meaningful wage growth. Most economists attribute the lack of wage growth to continued slack in the labor markets and somewhat stagnant productivity among those who are employed.

The Bureau Labor Statistics recently reported that the real average hourly earnings fell 0.4% between May and June 2015. While there was no change in average hourly earnings, the Consumer Price Index for All Urban Consumers (CPI-U) rose 0.3%.

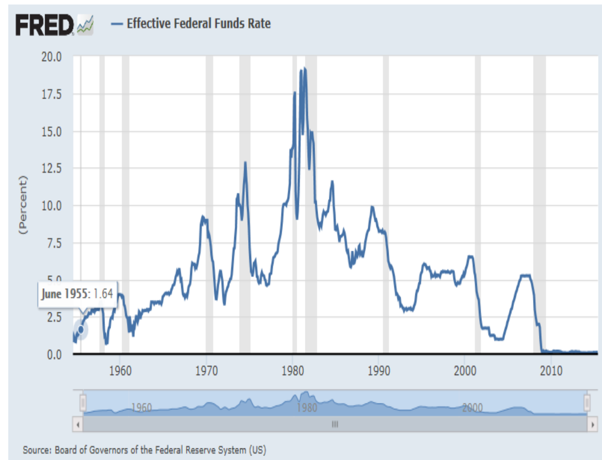


Over-the-month percentage change in real average hourly earnings for all employees, seasonally adjusted, June 2014 – June 2015 Source: Bureau of Labor Statistics

Despite the lack of wage growth, consumer confidence has continued to improve. The health of the consumer remains particularly important to the U.S. economy. None the less, consumer psyche remains fragile. Any shock waves that disturb the consumer's sense of security and well-being could prompt the consumer to retrench.

Perhaps the greatest cloud hanging over both equity and fixed income markets this year has been the specter of the Fed's interest rate lift off. The market has risen and fallen dramatically anytime investors perceive that the Fed may be ready to act sooner or be afforded cover to delay.

While we acknowledge fear of the unknown, we feel that investors can take solace in two important elements. First, an increase in interest rates has now been part of the public dialogue for much of 2014 and 2015. It would seem rational



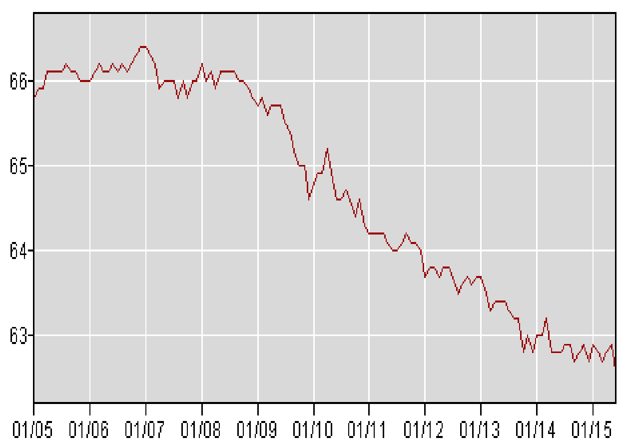
that an increase has been embedded in current valuations. Secondly, Fed Chair Janet Yellen has said repeatedly that markets should not become fixated on the first increase, but consider the pace of future increases. We agree. She and other members of the Fed have indicated that interest rates may be very low for an extended period of time.

With that said, as we move into the second half of the year and a rate increase becomes more likely, we could still see a knee jerk reaction among equity and fixed income markets. Increased investment could flow into rate-driven businesses, such as banks. Additionally, money could flow out of equities and into fixed income (bond) investments. We could also see yet another push for Initial Public Offerings (IPOs), as companies seek to cash in on strong valuations. The water is murky, but several possibilities could prove opportunistic.

It is important to note that investors are operating in the seventh year of one of the most sustained upward moves in U.S. market history. Although many equities are becoming more fully valued, there does not appear to be a significant aura of overvaluation, given the prevailing market environment.

Currently many companies are still able to meet or exceed earnings and revenue expectations, but that trend will need to continue to justify higher valuations. Whether that is possible, given the prospect of rising interest rates, a tighter labor pool, and increased global competition, is a chapter that has yet to be written.

We do think it is reasonable to assume that some companies will simply run out of the steam needed to make sustained forward progress in the near future, without increasing expenses, which may tighten margins. Additionally, in the absence of meaningful wage growth and reduced labor force participation, we question whether demand will be sufficiently high to absorb any realized increase in goods and service.



Labor Force Participation Rate Source: Bureau of Labor Statistics

Until interest rates begin to normalize, we anticipate maintaining relatively short durations on our fixed income positions. As previously noted, this strategy resulted in the forfeiting of some gains during the first quarter, however, any gains that remained unrealized would likely have been erased in the second quarter, as interest rates rose. Any attempt to capture yield on the long end of the curve could likely result in a significant erosion of principal at some point in the near future.

As always, we will continue to monitor the investments we recommend carefully, applying what we believe to be appropriate valuation metrics and objective analytics. We will then evaluate the resulting data against the current economic backdrop, to determine whether each position a client holds remains suitable for his or her investment objectives, risk tolerance and time horizon.

If you have questions or concerns, or if your situation has changed in any material way, we would welcome a call. At a time when increased volatility may well become the norm, effective communication will likely be the key to a favorable outcome.

Sincerely,
Capital Asset Management, Inc.

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