Review & Outlook

SECOND QUARTER 2015

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Review

Given the news regarding unrest in the Middle East, the price of oil, and growing questions about Greece, the financial markets were remarkably quiet for most of the second quarter of 2015. The Federal Reserve remains on track to raise interest rates later this year, due in large part to the stability of the U.S. economy. After outperforming the large-cap indices during the first quarter, mid-cap stocks trailed during the second quarter. Yields on 10-year U.S. Treasuries climbed back above 2%, in part due to continued uncertainty about when the Federal Reserve will start to raise interest rates. Year-to-date, the two best performing sectors have been Consumer Discretionary (up 8.4%) and Health Care (up 12.2%). The worst performing sectors have been Energy (down 3.5%) and Utilities (down 10.6%). Utilities, in particular, have been negatively impacted by expectations of a rising interest rate environment going forward.

The following table summarizes market performance for the most recent quarter and trailing 12 months.

Figure 1: Market Index Performance Data: Total Return (%)[1]

	As of 6/30/2015	
Index	Q2 2015	Trailing 12 Months
S&P 500[2]	0.28	7.42
Barclay's Capital Intermediate-Term U.S. Government/Credit[3]	-0.63	1.68
Barclay's Capital U.S. Treasury 1-3 Years[4]	0.15	0.90

Outlook

The consensus forecast of 3% GDP growth finally appears to be taking shape[5]. In recent years, the forecast has been revised downward during the year, but this year things are different. Rather than forecasts being adjusted down based on weaker than expected performance in the housing and labor markets, we are seeing stronger fundamentals, and a forecast that remains at 3%. The outlook for inflation also remains steady, and has been close to zero for the first part of 2015, which is well below the Fed's target of 2%. One positive aspect of low inflation is the increased real return for fixed income, meaning that the return for bond holdings has effectively increased in terms of purchasing power. However, the relatively strong performance of the U.S. economy will continue to put pressure on the Fed to raise interest rates. It also suggests a strong, and perhaps strengthening, U.S. dollar. This, in turn, puts pressure on U.S. firms that export and/or earn revenue outside the U.S. in foreign currency.

In Focus

As we approach the end of the 2nd quarter, we believe that the last weeks of June may be turbulent for the equity markets, largely due to the uncertainty surrounding the Greece situation, with the probability of a bad outcome rising. One potential outcome is a "Grexit," or Greece leaving the Eurozone (e.g. giving up the Euro and reverting to the Drachma), and possibly even leaving the European Union altogether.

The short version of the drama is that Greece has a mountain of debt, mostly financed one way or another by other EU countries; Germany, in particular. Under the current terms, there is no plausible way that Greece can repay its debt, and they will be forced to default on their loans. The Greeks want a restructuring of the debt, including a write-down of principal and lowered interest payment over a longer amortization period. The German solution appears to be that the Greeks should all start behaving like Germans (paying their taxes, retiring sometime after age 60, etc.) which seems unlikely. Meanwhile, other Eurozone countries that have amassed large piles of debt (Portugal, Ireland, Spain, Italy) will be highly responsive to any outcome, and must therefore be considered in the resolution. It is generally regarded that any leniency toward Greek bad behavior will lead to a line-up for similar

debt write-down and/or restructuring by these other countries. This would be very costly, to Germany, in particular.

Our concern at Waycross is the increasingly plausible outcome of a disorderly Greek default. In the short term, this means that any financial institution owning Greek debt will likely have to write it down, affecting its balance sheet, and potentially triggering breaches of regulatory or contractual requirements for levels of reserves, required collateral etc. One of the easiest ways to raise capital quickly is to sell equities, driving stock prices down. The most recent traumatic version of this was the collapse of Lehman Brothers in September of 2008. While we do not view the current situation in Europe to be anywhere near as dire as Lehman Brothers, the Greece-Eurozone situation is potentially significant. The outcome is linked to you, through the value of your equity portfolios, and this has our attention.

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From a wealth management perspective, the Greece situation presents much uncertainty. Here we distinguish "uncertainty" from "risk." In general, risk can be managed around, as it refers to the idea that there are a certain definable number of outcomes with well know probabilities. For example, when rolling a six-sided die, you have a one-sixth chance of turning up any number one through six. The world experts in managing risk are casinos, who can predict with great precision how much they will make in any given night, even though they may not be able to predict which table will be up or down at a particular point in time.

With uncertainty, identifying potential outcomes and their probabilities is difficult. In Rumsfeldian-speak, it is dealing with the "unknowns", which, with respect to investing, can be a low probability event, or events, with a bad outcome. Diversification mitigates this possibility on a stock-specific basis. However, some outcomes are systemic in nature, affecting all equities, and often multiple asset classes. The way to protect against systemic risk is to move funds into the most secure asset class available, for example, U.S. Treasuries or U.S. dollars.

At Waycross, we are observing the situation with caution, and have built up a significant cash position in the equity portion of our clients' accounts over the past few weeks. The increased cash position achieves two things in the short term: it helps protect against a significant short-term drop in the markets; and allows us to easily move into new equity positions when opportunities for investment present themselves.

The potential risk in using this strategy is that we may miss some upside in equity prices if the Greek situation is resolved. However, as equity prices are close to record highs, measured by indexes such as the S&P 500 and NASDAQ, or by metrics such as price-to-earnings ratios, which are at the high end of historical ranges, we feel our conservative approach is most prudent. The relatively high cash position is tactically transitory, and we do not anticipate needing to employ this strategy for long.

By the time you receive this publication, much of that chapter in the Greek drama may have already unfolded. Regardless of how the story develops, we feel that our short-term management strategy strikes a prudent balance in the face of transient uncertainty.

1. Figure 1: Our equity holdings tend to be a mix of large and mid-cap stocks. Our traditional equity mutual funds also tend to include a mix of large, mid, and small-cap funds.
2. The S&P 500 index is composed of primarily large-cap stocks: https://us.spindices.com/indices.equity/sp-500.
3. The BarCap U.S. Government/Credit index includes U.S. fixed-rate Treasuries, and government-related and corporate securities. https://index.barcap.com/Benchmark_Indices/Aggregate/Bond_Indices.
4. The BarCap U.S. Treasury 1-3 Years index measures the performance of short-term government bonds issued by the U.S. Treasury. https://index.barcap.com/Benchmark_Indices/Aggregate/Bond_Indices
5. Sources: NABE March 2015 Outlook: http//:nabe.com/NABE_Outlook_March_2015. CBO Budget and Economic Outlook: 2015-2025: https//:www.cbo.gov/publication/49892.

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