INVESTMENT OUTLOOK

Dixon, Hubard, Feinour & Brown, Inc. investment counsel

- U.S. stock market flat for the second quarter.
- Questions on Greece, Federal Reserve stymy market.
- Chinese stock market plunges.
- Global trends favorable for economy.

Second Quarter 2015 Review & Outlook

by Whitney Brown

Also in This Issue

Equity markets both at home and abroad accomplished little in the second quarter. What limited gains there are for the year in the growth-stock heavy NASDAQ Composite, the small cap Russell 2000, and the international MSCI EAFE came mostly in the first quarter. The large cap S&P 500 is just a hair above flat through six months, and the venerable Dow Jones Industrial Average has slipped 1%.

Many of the issues that have stymied the market this year are longstanding ones with no clear path to resolution. The fact that some of these problems have been fully acknowledged by investors for quite some time may be why the market has not reacted more negatively. For example, the fiscal crisis in Greece has been building for years, but somehow the players have always found a way to avert disaster. Please see the article on page 2 for more about Greece. The uncertainty surrounding timing of the Federal Reserve's long-awaited rate increase has been a source of anxiety since last year, at least, and at many other times during the halting recovery from the financial crisis of 2008. The market has factored in the certainty of an eventual increase, but the timing keeps getting muddled with the ups and downs of the global economy.

Investors have known for several years that China's export-fueled high growth era is ending, but a recent rout in Chinese stocks has added a fresher topic to the list of market concerns. While U.S. equities stalled earlier this year, many investors sought out emerging market equities for better value and upside potential. That shift coincided with changes to the Chinese stock market that opened it to more investors. Those stocks shot up way too fast, far ahead of the economic fundamentals; and as evidence of extended weakness in the Chinese economy mounted, investors headed for the exits. Excessive margin borrowing has exacerbated the correction, and the fear is that the stock crash could damage the Chinese economy and cause a spill-over effect for the U.S. and global economies. The good news is that in China the stock market is a much smaller part of the economy than in the U.S. and most other developed countries. In fact, only 15% of Chinese households own stocks compared to 50% in the U.S. Also, economic indicators in China are showing signs of stabilization.

On a global scale, most of the broader trends are positive and improving with regard to economic growth, employment, and consumer spending. Yet, investor sentiment has avoided extreme optimism. Add low inflation and a stabilizing U.S. dollar to the mix, and stocks should be able to end the year higher. Clarity on interest rates would help, and the Federal Reserve will most likely oblige with a small bump to interest rates before the end of the year, if not in September.

Market Measures	2nd Qtr.	YTD
S & P 500 (price)	-0.2%	+0.2%
Dow Jones Industrial Average	-0.9%	-1.1%
NASDAQ Composite	+1.7%	+5.3%
Russell 2000	+0.1%	+4.1%
MSCI EAFE	-0.3%	+3.8%
Barclays Capital Inter Gov't/Credit Bond Index	-0.6%	+0.8%
	6/30/15	6/30/14
10-Year Treasury Bond Yield	2.36%	2.53%
Three-month Treasury Bill Yield	0.03%	0.04%

Greece — Don't Expect a Quick Solution by Jim Hall

As we've all seen, Greece has been dominating the financial news this year. It seems almost every rally or pullback in our equities market has been tied to positive or negative news surrounding Greece and its financial condition. Gathering definitive info on the exact situation is quite difficult. It is obvious there is some sort of major liquidity crunch occurring where expenses are exceeding revenues; however, determining the cause and any possible solution will prove to have many variables and will be quite elusive.

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After much research and reading from many sources ranging from "The Economist," "The New York Times," and "The Wall Street Journal" to "the guardian," "Stratfor," and "Eurobank Global Market Research," the problem can be overly simplified to the fact Greece has amassed a debt of roughly $240 Billion euros ($270 Billion dollars). This debt is owed to the European Union (EU), the European Central Bank, and the International Monetary Fund (IMF).

Of course, as with any debt, interest and principal must be paid. In this case, it appears the monthly debt service is roughly $1B. Add to that another $1.7B to cover pensions and salaries. Note, this does not count the "overhead" expense of operating the everyday infrastructure of the country.

To cover this monthly expense figure, Greece must rely on the collection of income taxes and fees. Unfortunately, the unemployment rate in Greece is 26.6% and their economy remains primarily agricultural in nature which doesn't lend itself to providing a steady and predictable stream of income. Their recently-elected Prime Minister (Tsipras) campaigned with promises of taxing corporations and the rich more heavily to help fund the government's income needs. Obviously, with a background of these threats, corporations either moved away or didn't relocate to Greece if they had been contemplating a move into the country. Likewise, the more wealthy citizens utilize any means available to minimize the taxes they might be required to pay. Thus, Greece appears to have limited options available to increase its income stream enough to make its required payments.

Because increasing their income seems to be difficult at best, their alternative is to try to decrease the amount of money required to be paid each month. These options are equally difficult—make further cuts to pensions, lay off more workers, or strike a deal with the EU to reduce the amount due each month.

When looking at the EU side, there is no independent centralized monetary authority that can act and decide for the good of all (like our Federal Reserve here). Instead, each country must approve or ratify any sort of deal through its own governmental process. The Germans seem to have been leading most of the negotiating and want Greece to make all sorts of structural changes before they agree to any "next steps" to keep Greece afloat. The EU would definitely like to keep Greece as a member as the alternative would drive the country more towards Russia and any assistance offered by Vladimir Putin.

If a compromise can be struck, it will require give and take on both parts; however, politically, many parties (Greece and all of the EU members) will have to be in agreement on the approach. All of these negotiations are colored by a missed payment deadline of June 30 and a July 5th Greek "no" vote rejecting EU-proposed austerity measures. It will be interesting to see whether the eventual outcome will have Greece leaving the EU and defaulting on their debt or whether the EU members will allow some sort of debt reduction or payment suspension in order to keep Greece in the EU and still obligated on their debt.

A final factor the EU must consider is if Greece exits, there may be other countries who would do the same (Portugal, Spain, Italy, Ireland and England have all been mentioned as countries who might like to exit). Due to the fact these options are quite unpopular on both sides, it remains likely we will be discussing Greece for a long time.

Portfolio Diversification by Stebbins Hubard

In a nutshell, diversification means not putting all of your eggs in one basket. Diversification is an essential tool available to investors. It enables them to capture broad market forces while reducing the risk associated with individual securities. It is a risk management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique contends that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio. Diversification strives to smooth out risk events in a portfolio so that the positive performance of some investments will neutralize the negative performance of others. Therefore, the benefits of diversification will hold only if the securities in the portfolio are not perfectly correlated. Studies and mathematical models have shown that maintaining a well-diversified portfolio of 25 to 30 stocks will yield the most cost-effective level of risk reduction. Investing in more securities will still yield further diversification benefits, albeit at a much smaller rate.

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Once you choose to target a level of risk based on your goals, time horizon, and tolerance for volatility, diversification provides the potential to improve returns for that level of risk. To build a diversified portfolio, you should look for assets—stocks, bonds, cash, or others—whose returns haven't historically moved in the same direction, and ideally, assets whose returns typically move in opposite directions (negative correlation). This way, even if a portion of your portfolio is declining, the rest of your portfolio, hopefully, is growing. Thus, you can offset some of the impact of poor performance on your overall portfolio.

Another important aspect of building a well-diversified portfolio is that you try to stay diversified within each type of investment. Within your individual stock holdings, beware of overconcentration in a single stock. For example, you may not want one stock to make up more than 5% of your stock portfolio. Also, it's smart to diversify across stocks by market capitalization (small, mid, and large caps) and sectors. Again, not all caps and sectors have prospered at the same time, or to the same degree, so you can reduce portfolio risk by spreading your assets across different parts of the stock market. Further diversification benefits can be gained by investing in foreign securities because they tend be less closely correlated with domestic investments. For example, an economic downturn in the U.S. economy may not affect Japan's economy in the same way; therefore, having Japanese investments would allow an investor to have a small cushion of protection against losses due to an American economic downturn. Similarly, when it comes to your bond investments, consider varying maturities, credit qualities and durations, which measure sensitivity to interest-rate changes.

Setting and maintaining a diversified strategic asset allocation is the most important ingredient in long-term investment success. Once you have set your asset allocation target mix, you need to keep it on track with monitoring and rebalancing. If you don't rebalance, a good run in stocks could leave your portfolio with a risk level that is inconsistent with your goals and strategy. There are different ways to rebalance your portfolio. One is to sell those asset classes you currently have too much of and reinvest the proceeds in those that fall short of your target. But selling securities in taxable accounts generally has tax consequences in the year of a sale, so be sure to consider taxes when making any decisions to sell. Another way to rebalance without immediate tax consequences is to invest any new money (savings contributions, inheritances, bonus, etc.), in investments in asset classes that currently fall below your target. Regardless of how you rebalance, it is important that you do it in a way that also keeps your portfolio diversified within each type of investment.

Successful investing means not only capturing reliable sources of expected return but managing diversifiable risks and other risks that do not increase expected returns. Avoidable risks include holding too few securities, betting on countries or industries, following market predictions, speculating in areas like interest rate movements, and relying solely on information from third-party analysts or rating services. To all these, diversification is an essential tool available to investors. While it does not eliminate the risk of market loss, diversification does help eliminate the random fortunes of individual securities and positions your portfolio to capture the returns of broad economic forces.

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Using Relative Strength in Technical Analysis by Watt Dixon

In previous editions of Investment Outlook, I have written about different analysis methods we use at DHF&B in managing client portfolios. In addition to fundamental analysis (e.g. company financials, dividend yields, and stock ratings), we employ technical analysis methods when making our investment decisions.

Relative Strength (RS) is one such technical analysis tool that measures the relationship between two securities. Regarding individual securities, RS can be used to compare one asset to another to decide which one to buy. As a result, it is an excellent screening tool. However, the most common and important use of RS is to compare a stock to a market average. The S&P 500 is the most common market average used in relative strength analysis.

To simplify, we can describe the RS of a particular stock as the extent to which its percentage change in price either outperformed or underperformed the change in the S&P 500 index over a certain duration of time. Like the price of a stock, the RS of a stock can be plotted on a chart in the form of a line.

It is important to remember that a RS line is exactly what the name implies: relative. A rising RS line does not necessarily mean that a stock is advancing in price, but merely outperforming the underlying index. For example the S&P 500 could have fallen by 20% while the stock may be down only 5%, thus the RS line of the stock would be rising because the stock retreated less than the market. So, a stock can be outperforming the S&P and still losing market value.

When both the price and relative strength are rising, they are said to be "in gear." Important trends usually begin with a stock's RS and price both moving upward. Eventually, the RS line fails to confirm new highs being set by the price itself. This situation indicates that the odds favor the stock beginning a period of underperformance against the market. When an advancing stock's RS begins to deviate from the price trend and move sideways or downward this does not necessarily mean that the stock price is about to turn downward. It is, however, a warning sign that uptrend could be ending.

In addition to using RS in individual stock analysis, RS can be helpful in identifying longer term asset class rotation strategies. For example, one might use RS to determine if commodities are outperforming stocks or whether international stocks are favored over domestic issues.