

Newsletter – August 2015

Greek Tragedy and Fed Drama Dominate Headlines!!

MARKET TRENDS 6/30/2015

<u>US Stock Markets</u>	<u>Q2</u>	<u>YTD</u>
S&P 500 Index	0.28%	1.23%
S&P MidCap 400 Index	-1.06%	4.20%
Russell 2000 Index	0.42%	4.76%

<u>Int'l Stock Markets</u>		
EAFE Index	0.62%	5.52%
Emerging Mkts Index	0.69%	2.95%

<u>Fixed Income</u>		
Barclays Intermediate Gov't/Credit Bond Index	-0.62%	0.81%
Barclays Capital Muni Bond 3 Year Index	-0.02%	0.39%

<u>Commodities</u>		
SPDR Gold Shares (NAV)	-1.45%	-2.55%
Goldman Sachs Commodities	8.73%	-0.21%

<u>Real Estate</u>		
Dow Jones US REIT Index	-9.07%	-5.19%

<u>Yields</u>	<u>6/30/2015</u>	<u>12/31/2014</u>
6 Mo. US T-Bill	0.11%	0.12%
10 Yr UST	2.35%	2.17%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

Tim Vanech
Tvanech@shorepointpartners.com

Luis M. Raposo, CFA
Lraposo@shorepointpartners.com

Main 781 341 7250
Fax 781 341 7246

14 Page Terrace
Suite 2 C/D
Stoughton, MA 02072

shorepointpartners.com

This past quarter would appear to have been a bit of a yawner if judged solely on price change in the equity markets. While bonds experienced an uptick in yields, the results were negative total returns across the different bond sectors with long dated bonds down -7.6%. Other areas hit hard by higher rates were: REITs (-9.1%) and utility stocks (-10.7%). Strangely enough major domestic large cap, mid cap and small cap indices as well as international developed and emerging market indices all ended within a fairly tight range, with the best performance coming from the growth stock laden NASDAQ Composite +1.75%. The S&P 400 Index (mid-cap stocks) was the weakest, losing -1.06% in the period. Given the cacophony of handwringing and noise, an alien looking down on Earthlings from 265,000 feet would be justified in saying, "These humans need to relax!"

At Shorepoint, we have come to believe that this is the most hated rally in history. For the last year, fair valuations for equity markets and the barrage of headline risk has resulted in a market pause. The main investor concerns are as follows:

- 1.) The fear of the Federal Reserve ("Fed") increasing rates this fall has investors nervous. However, the Fed is only likely to raise 0.25% to 0.50% in the next six months, hardly amounts to cause the angst that we have seen so far. Also, hasn't the recent weakness in the equity and bond markets priced in the long, anticipated interest rate increase? We think the answer is YES. The key will be the timing and magnitude of the increase compared to expectations. As the following chart indicates, stocks tend to be weak before the first rate increase but perform above average both 12 and 24 months after the tightening begins.



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- 2.) The price of oil firmed quickly and started rising more than expected causing anxiety even as it turned lower again by quarter end. Lower oil prices have reduced capital spending by the major oil companies which is a negative for the economy. However, with over two-thirds of the U.S. economy driven by consumers, aren't we missing the "big" benefit of lower energy prices to the economy? Also, the supply of oil continues to increase due to increased production and weaker demand from the global economic weakness. The impending addition of Iranian oil on the market will only further help keep oil prices low. It generally takes about six to nine months for this benefit to manifest itself to the economy so we should start seeing the positive impact in the second half of 2015. Cheap gas will act as a major tax cut for consumers and has a disproportionately positive impact to lower income families.
- 3.) U.S. dollar strength continued to weigh primarily on revenues, especially for U.S. export-rich global companies. In spite of this near-term negative effect, corporate earnings results have been mixed although generally inline or slightly better than analyst expectations. As of this writing, second quarter earnings for the S&P 500 are up 3.2% on flat revenue with over 70% of the companies beating expectations. This isn't great, but it's not awful either! Global growth did slow in the quarter, so the weakness is not simply due to a strong dollar. Besides the negative impact to sales of the strong dollar, U.S. multinationals are benefiting from lower international operating costs which helps offset the sales hit. The strength of the U.S. dollar has both negative and positive effects and is just another factor to monitor. Being diversified with exposure to domestic and international equities mitigates some of this risk.
- 4.) The index of transportation stocks turned lower, which historically has been a harbinger of weaker economic activity. However, this hasn't always been predictive. The global economic weakness in the first quarter may be the main reason for the pull back in transportation stocks/index. We will be keeping a close eye on these stocks.
- 5.) Greece's economic system began to implode at quarter end as a compromise with the European Union ("EU") and International Monetary Fund proved elusive. The Greek situation spooked global markets as the probability of Greece leaving the EU became all too real of a potential outcome. Since this would be a first for the EU, concerns were widespread of the impact to the EU and whether others would follow – Portugal, Spain, Italy...

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“...the solid domestic economy could provide a constructive back drop for long term investors if their expected returns are reasonable...”

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- 6.) The recent bear market in China stocks along with its economic slowdown is significantly contributing to volatility in global markets. The negative impact is especially being felt by any commodity related stocks as investors worry about lower demand and excess capacity. The Chinese government is attempting to prop up their stock market but government intervention doesn't usually work. China also may be a deflation risk to the global economy, if they cannot stabilize economic growth.

While the U.S. stock market is not cheap yet, the solid domestic economy could provide a constructive back drop for long term investors if their expected returns are reasonable:

- *Strong employment with payroll numbers improving*
- *Refinancing up and new home starts improving and record car sales*
- *Household net worth high and debt decreasing - best in years*
- *Low interest rates with a spike in rates unlikely and scant signs of deflation or inflation*
- *Consumer sentiment better while stock sentiment worse - a good combination for investors*
- *Tax cut for consumers due to lower oil prices - helpful to a consumption driven economy.*

Conclusion

All we hear from the naysayers is that the bull equity market won't end well because of the Fed's "easy money" monetary policy. They are probably right. It usually doesn't. But when? In five months or five years? And how do we manage to earn investment returns in the meantime if we are paralyzed by fear and stuck in low yielding investments? And when it ends, when the music stops, as it always does, the story just closes that chapter and then it begins another - hence the cautious risk taking process of careful investing. We are working with the averages and probabilities, not making big calls with timing decisions that are hard to make correctly, let alone duplicate. The trick is to find a plan and an approach that you can repeat, that can endure, that relies on the opposite of ego - humility, and the opposite of fear - not greed but bravery, to endure some pain for the opportunity to build assets that gain competitive returns over time.

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“We view the S&P 500 Index as fairly valued...”

“We expect continued volatility in the markets and view pullbacks as a buying opportunity while still being selective, disciplined and patient.”

Characteristics of past bear markets

◆	Market Corrections	Cycle Peak	Bull Market Duration (Months)	Decline from All-time High	Recession	Commodity Spike	Aggressive Fed Tightening	Extreme Valuations	Commentary
1	Crash of 1929	Aug 1929	37	-84%	◆			◆	Excessive leverage, irrational exuberance
2	1937 Fed Tightening	Feb 1937	22	-74%	◆		◆		Premature monetary tightening
3	Post WWII Crash	May 1946	48	-54%	◆			◆	Post-war demobilization, recession fears
4	Flash Crash of 1962	Dec 1961	14	-22%				◆	Flash crash, Cuban Missile Crisis
5	Tech Crash of 1970	Dec 1968	73	-29%	◆	◆	◆		Economic overheating, civil unrest
6	Stagflation	Dec 1972	29	-43%	◆	◆			OPEC oil embargo
7	Volcker Tightening	Nov 1980	31	-19%	◆	◆	◆		Extremely high rates to rein in inflation
8	1987 Crash	Aug 1987	59	-27%					Program trading, overheated market
9	Tech Bubble	Aug 2000	118	-42%	◆			◆	Extreme valuations, mostly in tech stocks
10	Global Financial Crisis	Oct 2007	55	-51%	◆	◆	◆		Leverage, housing, Lehman collapse

The above chart contains the characteristics of the ten bear markets (20% price decline from the high) of the last 85 years. The four main reasons are as follows: 1. recessions; 2. commodity spikes; 3. aggressive Fed tightening; and/or 4. extreme valuations. Most of the past bear markets actually exhibited more than one of these characteristics. At this point, we feel that these conditions do not exist in the current market and are unlikely to manifest in the near term.

We view the S&P 500 Index as fairly valued based on current interest and inflation rates. However, relative to bonds, the equity market is still significantly undervalued! We expect continued volatility in the markets and view pullbacks as a buying opportunity while still being selective, disciplined and patient. As we have stated previously, Shorepoint favors higher quality companies that are attractively valued, with solid balance sheets, that are strong cash flow generators.

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