

Second Quarter Review: Stuck in Second Gear...or Reverse

2Q2015 was not a banner quarter for the majority of core asset classes around the world. The S&P 500 set successive record highs in April and May, each time edging up just a little higher than last time. But the rallies failed to break through key resistance levels, falling back like a mountain climber failing to maintain the new foothold on the cliff in the face of stiff headwinds. One such headwind was an unexpected spike in European interest rates. In late April the yield on the 10-year Bund, Germany's key benchmark interest rate, reached a low point of 0.08% and seemed poised to turn negative. Instead, the yield jumped 775 percent (not a typo) over the next three weeks and would trend higher still before stabilizing in a range of 0.6 - 0.9 percent.

In a reversal of the normal course of things, European bond yields led their US Treasury counterparts by the nose upwards. The US 10-year yield started its upward trajectory shortly after the spike in the Bund, and then fundamentals took over. A stronger than expected May jobs report, buttressed by favorable consumer spending and confidence measures, helped solidify expectations that the Fed will start raising interest rates later this year, perhaps as early as September. While US equities struggled to advance in the face of interest rate fears, events in Europe once again took over center stage. Negotiations between Greece and its European creditors soured as a €1.5 billion IMF loan repayment deadline approached at quarter-end. European and emerging markets took the brunt of renewed concerns that a Greek exit from the Eurozone was imminent.

On the other side of the world another drama was playing out. Domestic share prices in China had been defying gravity all year, as retail investors piled into a buying frenzy encouraged by cheap access to margin credit and outright government support for the bull market. The Shenzhen Composite, one of two major domestic share exchanges, reached a peak year-to-date appreciation of 122 percent on June 12. By that time volatility had spiked up with wild intraday swings. Finally the bottom fell out, and both the Shenzhen and the Shanghai indexes plummeted by more than 40 percent in the space of just several weeks. Down went emerging markets in China's wake, joining Europe and US equity markets in negative territory for the month and a generally flat quarter.

Third Quarter Outlook: Watch the US Growth Story

July continues to be dominated by Greece and China. As of this writing (July 13) the situation in Europe looks to be stabilizing. A high-stakes summit on July 11-12 resulted in a conditional agreement to finance a third Greek bailout in exchange for Greece effectively ceding its economic policy to Brussels and agreeing to the harshest austerity measures yet to be imposed. What this means down the road is less clear, either for Greece or for the Eurozone. The exceedingly acrimonious negotiations opened clear fault lines between Germany, France and other Eurozone members on top of the complete absence of faith in Greece.

We could see our share of bumps in the road for the remainder of the summer – exacerbated by the various crises in play and the usual thinner-than-usual volume of trading characteristic of this time of the year. Looking farther down the road, though, we believe that economic growth in the US will be a more important determinant of share price performance through the remainder of the year and into the first months of 2016. A key data point shaping this narrative is likely to be the 2Q GDP release later this month. If real GDP growth tops 3% – as the current consensus suggests – the case for a September rate hike of 25 basis points increases. That could create some additional market jitters, but could also send a strong signal of confidence that growth is on track.

Other factors are in play. Oil prices appear to be trading in a range of \$50 - \$70, while industrial commodities led by copper are swooning currently, partly in response to the market woes in China. Geopolitics are never far from the headlines. We think the environment remains reasonably healthy for modest (mid-high single digit) gains for US equities and perhaps somewhat less than that for non-US exposures. But there will be some tricky terrain to navigate.