Market Commentary

Second Quarter 2015

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The second quarter of 2015 continued the trend from the prior quarter of back and forth movements in many asset classes, ending with modestly positive returns for equities and modestly negative returns for US fixed income. The benchmark S&P 500 index rose 0.27% during the quarter on a total return basis bringing the total return for the first half of 2015 to 1.2%. Interest rates rose sharply during the quarter as anticipation of a Federal Reserve interest rate hike and signs of a stronger economy in the second half of 2015 led to declining bond prices and higher rates. The yield on the benchmark 10-year US Treasury Note rose to 2.34% on June 30, up meaningfully from the 1.93% yield on March 31, after getting as high as 2.50% during early June. The US dollar gave back some of its gains versus the Euro, declining by approximately 4% during the quarter, following a sharp rise that began during the latter half of 2014.

Economic and Market Outlook

Last quarter's buzzword was "patient" in regards to how long the Federal Reserve would remain patient before raising interest rates. During the second quarter, Greece was the word. Looking first at the US economy, we believe that after negligible growth in the first half of 2015, numerous signs of improvement are apparent. First quarter GDP growth was held back by severe winter weather in much of the country along with a crippling port strike on the west coast. These two factors caused the majority of the shortfall from trend line growth. Our forecasts are for growth to normalize during the balance of the year and into 2016, leading to modestly better corporate earnings.

While many trees have been killed writing about Greece, few people have spent the time to analyze the overall size of the potential issue. Greece has now been in the headlines for most of the past five years during which its economy has contracted by 25% as measured by GDP. The Greek economy is now approximately the same size as that of Chicago! Based on this, Greece is fairly immaterial in the global perspective. The global economy is stronger and better positioned to withstand a potential Greek default than it was three or five years ago. On the other hand, a Greek default could cause a contagion effect where other European countries with weaker economies default on their debt and/or exit the Eurozone. We fall somewhere in the middle, believing that the Eurozone powers will do whatever is needed to protect its overall financial system and keep its members from leaving. This means we do not see Greece exiting the Eurozone, although this has become the minority view recently. The laser focus on Greece however, meant that markets traded more on macro perspectives rather than individual company or sector fundamentals. With the "risk on" mentality pervasive during the quarter, smaller-cap and lower-quality companies tended to outperform larger, more stable companies.

In our previous market commentary we wrote about the large amount of foreign government bonds with negative or extremely low yields. Like clockwork, many of these bonds saw their prices sell off dramatically in the past several weeks with a subsequent rise in yields. For example, the German 10-year note (mentioned specifically in our last commentary) saw its yield rise from 0.08% to 0.98% in

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only six weeks. This resulted in a principal loss of 8% to investors who held the bond through that chaotic period. We have often mentioned our belief that fixed income is not an area of the portfolio to take large risks. The German bond experience is a classic example of a crowded trade that caused pain for many investors, validating this core belief regarding fixed income.

Portfolio Positioning

Since earnings growth will be challenging in the near-term for many companies and in light of an expected rise in interest rates, we believe the prudent course is to reduce overall portfolio risk. In equities we favor large-cap companies with proven track records, strong management teams and solid balance sheets. In fixed income, we hold relatively short-term maturities that will better withstand a rising interest rate environment. While we don't know when rates will move higher, we know they WILL move higher and thus we wish to protect against the risk of meaningful downside potential. We are not calling for lower equity prices, but believe the overall risk levels have increased in the past year and the odds of a short-term decline have increased. Despite the modest first-half returns for US equities, there have been several stocks and industries that have seen price declines of 10-20% or greater. This internal churning in the market has limited overall stock market returns as speculative investors shift from one industry to another in search of higher returns.

Conclusion

While macro events will always be part of the overall investment landscape, the past several months have seen an outsized focus on these macro drivers. As these begin to be settled, we look for a more normalized investing climate where relative strength in company balance sheets, management teams, and business models will matter more than attention grabbing headlines. Although six month returns in both US equity and fixed income markets are quite small, daily volatility has increased and will likely stay higher until a number of macro issues (Greece, interest rate hikes) are settled. It currently looks like the second half of 2015 will see continued volatility and shifting economic winds, with a trend towards better economic performance. The political rhetoric will also increase as we move towards the 2016 elections. Our early look into 2016 is cautiously optimistic based on our belief that some of the current uncertainties facing investors may be resolved. Yields on fixed income securities should drift upwards in anticipation of Federal Reserve moves and improving GDP data. Equities remain fairly valued based on earnings multiples, cash flow yields and compared to almost every other asset class.

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