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In-The-Know Monthly eNewsletter

Market Commentary, Second Quarter 2015
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The second quarter investment returns were mixed across the broad asset classes. Diversified portfolios, such as the "L Funds", were up slightly thanks to strong returns in the international stock markets offsetting some of the losses in bonds and US small stocks. Of course, the international markets have given some of those returns back in the first week of July due to the fall out of the Greek financial crisis. For the year, the best description of the diversified investment markets is "stuck in neutral". Let's look at the topics of discussion occurring in most of my current client conversations.

The U.S. Stock Market: The economy continues to show signs of strength and weakness simultaneously.

Areas of strength include:

- Low interest rates for loansLow inflation
- Unemployment rate at 5.3% (50-year average is 6.1%)
- Car sales above long term averages
- Housing starts growing and nearing long term averages
- Manufacturing output increasing
- Real capital goods orders above long term averages
- Household debt decreasing (as percentage of disposable income)
- Household net worth increasing

Areas of weakness include:

- Low interest rates for savers and investors
- Modest average wages and lackluster wage growth
- Smaller percentage of population is working
- Labor force participation rate is 62.6%, lowest since 1977 (This means 93.6 million Americans age 16 or older are not working)
- Lower corporate earnings
- Federal Reserve poised to raise interest rates
- Stock market valuations slightly above long term averages
- Investor worries about other global economies (China, Greece, etc.)

Such diversity of economic news creates an investment climate that can shift widely from day to day, based upon the set of factors that are most prominent at the time. As can be observed from year-to-date results, the wide swings tend to offset each other, leaving investors with very modest gains or losses. There is no dominant trend pointing to "irrational exuberance" or to "the sky is falling". We appear to be stuck in neutral! In light of this slow plodding of the markets, we are committed to staying the course and NOT trying to predict or outwit the market.

The International Stock Market: This topic is almost literally "hot off the press" as Greece and the European Union try to come to grips with the Greek debt crisis.

I have read all that I can on this topic as it relates to the returns in the international markets and any contagion that will cause to the US stock market. Just about every article ends with a version of the phrase, "…in the end, it is hard to predict what the Greek situation will mean to the world's investment markets." Given the difficulty, some say impossibility, of knowing the fall out, we are maintaining our investment strategy across the broad international stock markets. Greece's economic impact worldwide is minor, but the fear that it might be the first domino to fall with Italy, Portugal and Spain nearby, is the real concern. What precedence is being set if the world continues to bail out countries who have spent far more than they can possibly pay back? This is the major concern. If you have a long-term time horizon for your portfolio, I would not abandon the international stock markets in the short term.

Interest rates and The Federal Reserve: We have been told for several years now that interest rates are going to rise.

At the beginning of this year, most economists felt confident that The Fed would raise rates by June. Once the first quarter economic data was released, the focus shifted to September. Given the topics we've covered above, there is serious doubt that rates will rise this year.

There are two burning questions in the minds of investors: "What will happen to my portfolio if interest rates rise?" and "Should I change my fixed-income allocation because of the potential change in interest rates?" Clearly, each investor's individual circumstances are unique and no single answer to these questions can universally apply to all. However, for long-term investors there are a few points that should be considered.

- Keeping part of your total assets in fixed income has a specific purpose in a diversified portfolio. Fixed income has lower volatility than equity asset classes so it is less vulnerable to large drops in value. Additionally, as part of a diversified portfolio, it serves to lower the total portfolio volatility. Finally, the allocation to fixed income provides a source of liquidity during periods when equities are in decline

- If the Fed raises interest rates slowly, then fixed-income prices will likely drop slowly as well. For example, with a one-time 0.25 percent rise, a one-year bond may fall in price about 0.25 percent. If the yield is at least 0.25 percent, then no overall loss is incurred. It is anticipated, but certainly not guaranteed, that rates will rise slowly.

- If the Fed raises interest rates higher or at a faster pace, then fixed-income prices will likely incur larger drops. The faster rate of change may also make it more difficult for a bond portfolio manager to exchange the lower interest rate bonds for higher interest rate bonds. In this case, the regular interest dividend payments may take longer to offset the drop in share prices.

Given the doubt and indecision that is collective in the markets; US stocks, international stocks, real estate, bonds, etc. I stand by the investment philosophy that advocates participation in the markets with a globally diversified portfolio. This has been a prudent strategy for those with a long term time horizon. Stay safe and enjoy the rest of your summer!

Mr. Jackson has been a presenter with NITP for over 13 years addressing both retirement and mid-career level groups. His areas of specialization are financial planning, investment management, tax and retirement planning.