Observations and Outlook

July/August 2015

Despite several significant issues coming to the forefront of global financial markets, US equity markets remain subdued and have vacillated +/-4% for the first half of 2015. Oil price collapse, another near death experience in Greece and the rise and fall of the Shanghai Composite have done little to shake investors' belief in an ever increasing stock market.

Selected Index Returns 2015 Recent Quarter and Year to Date

Dow Jones Industrials -.29%/ +.03% S&P 500 +.28%/+1.23% MSCI Europe +.36%/+3.82%

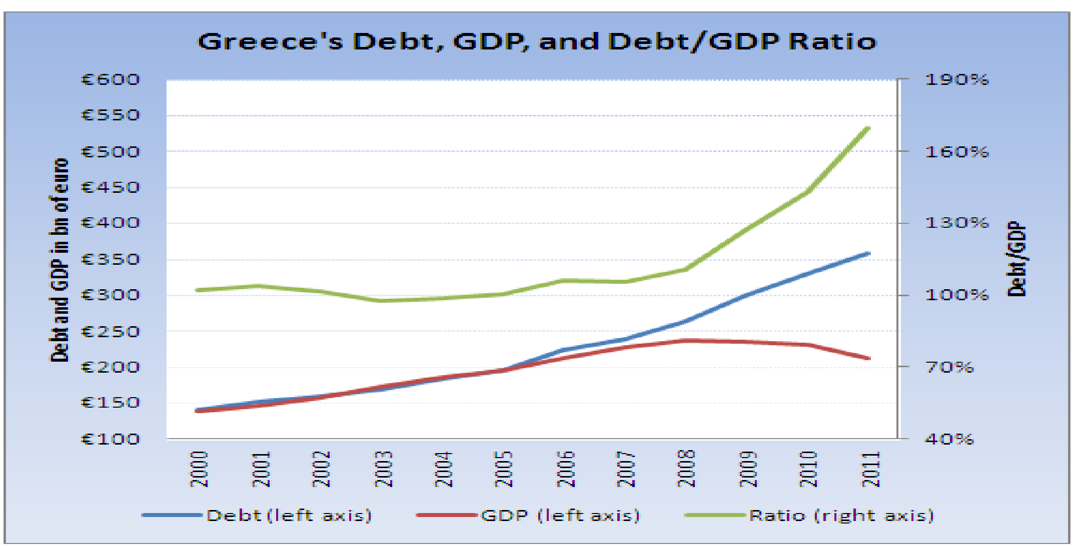
Small Cap US (Russell 2000) +.42%/4.75% Emerging Mkts +.69%/2.95% High Yield Bonds -.65%/1.61%

US Aggregate Bond -1.68%/-.10% US Treasury 20+Yr -9.05%/-5.25% Dow Jones/UBS Commodity 4.66%/-1.56%

Looking at the returns from the recent quarter and year to date there is very little of note except for the decline in prices for long dated Treasury bonds. Indeed the rise interest rates the past two months has been dramatic. Stock prices, junk bond prices and commodities; all "risk" assets, have put up mixed results. At one point this year, the DJIA had moved in the smallest range over a multi-month period of time, in over 100 years. This can be viewed either as a consolidation that will turn into another bull rally; or as a decrease in momentum, presaging a decline in prices. Commodities are showing positive year to date due to oils price increase since its January low. Many equity market bulls are citing the rise in interest rates as an underpin to the 'bonds are risky, better own safe stocks' mantra. Given we've seen a 'dramatic' rise, while the Aggregate Bond Index has declined only .10% year to date; one might consider what a 'dramatic' move in stocks would look like and then decide which asset is more or less 'risky'.

Near(er to) Death in Greece

On July 5 the Greek parliament voted "oxi", or no, to further austerity measures in exchange for more loans from the European Central Bank. Banks had been closed for several days and ATM cash withdrawals were limited to only 60 euros per day. On July 15th, the same parliament voted to accept even more restrictive austerity measures along with putting up 50billion in collateral for more loans and extensions. Airports, islands, power grids, and railroads were amongst these items. While the 'no' vote on July 5 provided a glimmer of longer term hope for the Greek people (while more difficult in the near term), the 'yes' vote yesterday guarantees a much longer agony for the Greek people. This is due to the fact that borrowing more money and pledging assets that will surely be lost, is no way to balance cash flows and get out from under an oppressive debt burden. The end game remains the same: massive debt reductions must be instituted in Greece. This new extension only prolongs the inevitable, as it is mathematically impossible for Greece to come up with the ongoing cash flow to service these debts and provide government services to its citizens.



When debt is increasing faster than gdp or income it's a death spiral to bankruptcy. This simply means Greece needs to default, restructure fiscally and move on. While all appears calm, Greek banks will reopen Monday, probably with massive withdrawals to begin again.

The Rise and Fall in Shanghai

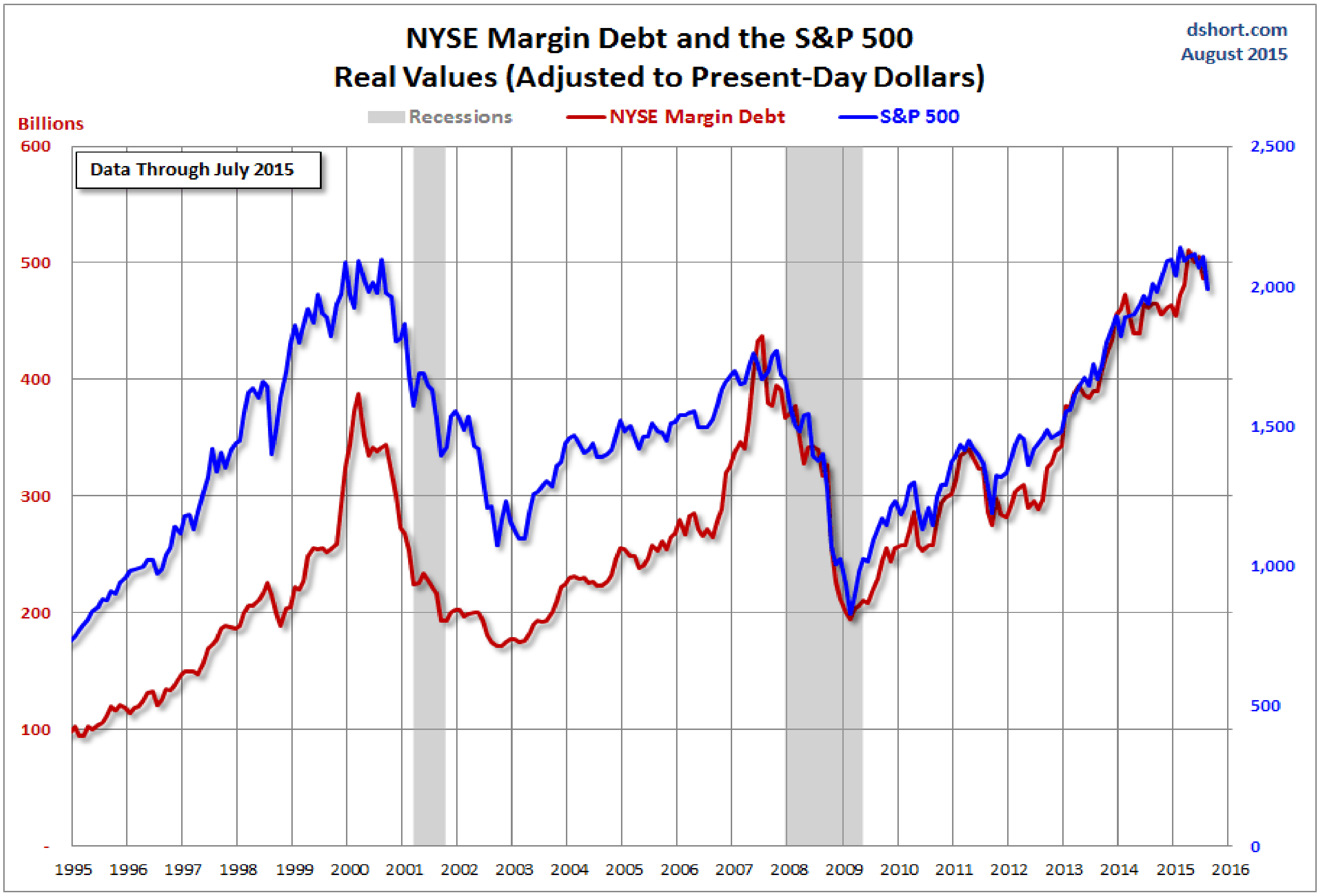
China, and all its attendant problems is by far the biggest issue facing the global economy and financial markets. As the chart above shows, the level of margin debt outstanding is concurrent with its stock index levels. As stock prices have increased so has margin debt. Often the rise in prices is due to borrowing more to by rising stocks and it appears to be a virtuous cycle. Unfortunately the more debt a person, company, nation or any system takes on the more fragile it value becomes. The amount of equity isn't really growing but the debt is. And once prices begin to move down the selling is faster than the ride up.

China's debt fueled 'investment' binge appears at its end. Post 2008 China began its own stimulus, that as compared on a % of GDP basis was more the 3 times that of the United States. Investment in infrastructure and real estate caused China to consume massive amounts of commodities, driving price up from 2009 lows. Real estate topped out and has been rolling over for several months, while the Shanghai stock market has been the new source of 'wealth creation' for the Chinese people. But since mid-June (one month after US indices topped out), there has been a massive decline in equity values. Reflecting upon other great stock market bubbles and crashes, -50% to -80% from the high seems like an appropriate multi-year target.

Oil and other commodity prices have crashed to multi-year lows given the slowdown in China. In light of these prices, it is completely absurd for China to report continued GDP growth in excess of 7%. Government statistics are always to be questioned. Chinese government statistics have only one proper place: at the bottom of a bird cage.

A Final Note

Here we see US margin debt and US stock prices. The more debt a system has the more fragile, and the faster the decline once the first domino falls. That first domino may well be falling corporate earnings and ebbing of historically high profit margins.



What lies ahead for 2015 and 2016 for global investors should be fairly obvious. Don't look to any TV shows or salespeople from broker/dealers of mutual fund companies to indicate poor returns on the horizon—as they have never ever indicated as such in the past. Controlling risk in an investment portfolio is dependent upon how one is invested ***prior*** to any market declines.

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