2nd Quarter Markets Update and Outlook
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As 2015 is halfway over, investors now have a better sense of how the markets are reacting to news, as well as a more solid idea of what the members of the Fed are thinking.

In particular, three themes that influenced markets this past quarter were interest rates, economic growth and market activity. Let's take a look at what happened during the second quarter in those areas, as well as how they may have an affect on the rest of 2015.

Interest Rates
Interest rates dropped, recovered and are currently rising globally. The 10-Year Treasury was under 2 percent for a time due to fear and a flight to safety when things were choppy. One of the reasons we're seeing rates go back up is to correct for the drop that occurred earlier in the year.

European rates have been extremely low, despite the relatively positive economic news that has been released from the Eurozone, aside from the news in Greece. The odds that Europe could dip back into a recession are receding, causing rates to rise across the world.

Domestically, the Fed had intended to raise rates at some point this year, but weak growth has postponed the rate hike. During the June 17 Federal Open Markets Committee (FOMC) announcement, the members signaled a September rate hike is on the table.

It's important to note that ultimately the market controls rates, not the Fed. Regardless of what the Fed does, we would expect interest rates to rise, with our base case having this occur slowly over several years.

Economic Growth
Though we have had growth in the U.S. – GDP is around 2 percent – and growth prospects in developed countries are looking brighter, it has not been enough to cause wage and commodity price increases.

Although companies' bottom lines are healthy, top line sales growth has been slow. First quarter earnings have come in weak, largely due to the performance of the energy sector.

Still, the risk of recession remains low in our opinion, and rates are rising. That's a good thing because it indicates economic growth is likely to stay positive, though the growth we saw in 2009-2011 earnings will likely not be seen again in the near future.

Market Activity

U.S. stocks have continued to move upward, and we still believe they are fairly valued with average upside while international equities are undervalued with larger than average future expected returns.
Over the last several years markets have been very quiet, but now that stocks are priced closer to their fair value we should expect volatility to increase to a range closer to its historical norm. We are also seeing increased volatility across other asset classes (currency, bonds and commodities).

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If we look at the S&P 500 since 2010, stocks' standard deviation has been 12.8 (DFA Returns). If we look at the time period leading up to that, from 1926 to the end of 2009, the average standard deviation was just under 20. Simply put, the last five years have seen two-thirds of the volatility we saw between 1926 and 2009.

There are still few attractive alternatives to stocks and we continue to think stocks will provide attractive returns over the next several years. Inflation has remained under 2 percent and very well may stay low as commodity production remains relatively high and labor markets continue to slowly heal. However, low inflation coupled with slowly rising rates may hurt real estate values. Last year we began underweighting U.S. REITS in our portfolios. Commodities also tend to struggle in low inflation environments, and for that reason we continue to exclude these from our model portfolios.

Greece Debt Situation

Finally, the negotiations over Greek debt have caused headaches for global markets and this week saw daily changes to the situation. Markets and institutions are no longer lending to Greece and the European Central Bank has removed the Bank of Greece's ability to print more Euros. As a result, capital controls have been implemented and news of the resulting bank runs and panic is updated hourly.

We think it is important to put this into perspective. Greece's annual GDP is roughly $280 billion, slightly larger than Connecticut's GDP and slightly smaller than Missouri's. In all, Greece owes about $271 billion to creditors. A primary fear of some is that a default would cause major problems for banks that hold the debt as they would become less healthy and would then transmit the contagion throughout the EU via less lending and less liquidity.

However, privately held Greek debt is relatively small, at roughly $40 billion. In comparison, the estimated size of the non-agency mortgage backed securities market in 2007 (which ended up kicking off the 2007-2008 market fall) was $3.6 trillion. The vast majority of Greek debt is held by monetary institutions such as the International Monetary Fund and the ECB which no doubt will have to write down the debt and absorb the loss. However, they will be in a much better position to do this than the thousands of private owners of MBS were in 2008.

Ultimately Greece will have to rework its budget until the numbers finally work again, as will Puerto Rico, which this week announced that it could not pay back $70 billion in debt. And while we should expect market disruptions like the one that occurred this week, it is best for the longer-term health of markets that citizens deal with the reality of debt that cannot be paid back.

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