Second Quarter 2015
Market Review

By Donna Gilding

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The month of June was a pretty lousy month across the board. Equities and fixed income posted negative returns. The quarter was lackluster, especially for interest-rate sensitive securities such as REITs and MLPs. On a year-to-date basis, US and emerging markets small cap stocks have been the best performers The Russell Microcap, for example, is up 2.80% and emerging markets small cap is up 8.25%.

Is The Streak Over?

Managers believe that the S&P 500 may see the first year-over-year decline in profits in almost three years. Companies are expected to report a 4.5% drop in second quarter earnings. The anticipated decline would end 10 consecutive quarters of growth, and it accompanies a drop of 0.29% in the value of the S&P 500 during the quarter ending June 30. This is the S&P's first quarterly decline since the end of 2012. The S&P peaked in May.

Falling energy prices, the relative strength of the dollar and the downturn in commodities have all been detrimental to the international business of US corporations. By contrast, companies focused domestically continue to perform well as the US economy has improved.

It's not surprising, then, that the Russell 2000 small cap index is up 4.75% year-to-date, while the S&P 500, weighed down by energy stocks and large exporters, is only up 1.23% for the quarter. The S&P 500 is trading at more than 20% above its historical price-to-sales ratio of 19.7x. While that ratio shouldn't be used as a market-timing tool, it is, as one manager noted, representative of a headwind to further gains in the S&P 500.

The good news is that the US economy has shown healthy growth in 2015. The most recent survey of the US manufacturing shows the fastest growth since January. Subsequently, expectations of a rise in the Federal Reserve rate in September have been diminished. Commodities continue to struggle because of the turmoil in equities markets due the slowdown in demand from China, and the recent hit to energy sector from the sharp drop in oil prices.

The rout in the Chinese equity markets has certainly created a great deal of speculation in the last few weeks. As Andy Rothman of Mathews Asia mentioned recently, this will not last! If the Chinese government wants the brokers to prop up the economy by purchasing securities, that is exactly what the brokers will do. The government still owns the majority of brokerage firms, as well as the banks. It does not mean it will be an easy ride!

The Bottom Line

At the beginning of the year, managers and consultants predicted that 2015 would be a year of continued volatility. We only have to look at the headlines, as outlined below, to realize that volatility will continue for a while. Today, for example, we see the following:

- Beijing push fails to calm China stocks
- Cheap debt spurs Europe cash hoarding
- Record spending race for White House (Oh, that we could have the six-week campaign rule of Britain.)
- "Clean" growth possible, report finds
- Debt crisis boon for Puerto Rico lawyers
- Malaysia graft woes weigh on currency
- , etc., etc. !!

At times like these, managers and consultants like to urge patience. That's smart. While returns may be more muted going forward, portfolio decisions need to be well conceived and executed.

Donna Gilding is an investment consultant with more than 30 years of institutional investment experience.

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