Executive Summary

The latest quarter came to be defined by events in the dying days of June – Greece’s decision to shut banks and implement capital controls leading up to a voter referendum on aid and reform proposals. Along with Puerto Rico’s effective bankruptcy and China’s equity “bear” market (after an equally stunning more-than-doubling), Greece’s potential exit from the euro raised the risk of turmoil for the entire euro project, and for markets everywhere.

Too bad, as otherwise we’ve witnessed a resumption of U.S. growth from some temporary factors, strong central bank injections of liquidity in Europe, and, more broadly, a sense that, amidst all the challenges, growth would hold up. As it’s likely to do, and as it has solidly for over six years.

But even as an agreement of sorts may have been reached in Greece, there is material uncertainty arising from the multiple potential paths that Athens’ economic version of running with scissors may trigger. Our base case remains one of “moderate +” U.S. growth, but with heightened global risk, particularly from the recent Hellenic and Chinese events.

The Greece “issue” has been there for years, but felt like a bolt out of the blue. Is it different or more serious this time?

Greece has emerged as a nearly annual crisis in this cycle, and we’re seeing the 2015 act of this drama, or rather, tragedy, with dollops of farce. Athens fudged its fiscal deficits numbers to qualify for entry into the eurozone, and again subsequently to reduce pressure from its European partners on necessary-but-difficult reform actions on pensions, taxes, wages, selling of government assets and opening of labor markets. Finally it began to implement some of these difficult steps, which were beginning to prove successful in 2014, make its economy more competitive, and help the nation live within its means. But earlier this year voters, overwhelmed by the painful adjustments needed, turned to a leftist party that irresponsibly promised relief both on its debt obligations and living conditions.

The play could have ended one chapter only to begin another. Leading up to a bizarre referendum, Greece shut its banks and implemented capital controls to prevent a collapse in its banking system. Although anything is possible, Europe has drawn a line, stressing that Greece must accept primary responsibility for, 

Continued on back
**Equity Portfolios**

**U.S. Monetary Stimulus Easing To Merely Strong**

**Executive Summary**

Impacted by events at the end of the quarter, through June the S&P 500 marked time, which, after nine quarters of gains, is not exactly chopped liver.

That said, the resiliency that investors display in the face of many and varied crises is nothing if not remarkable. The Ukraine/Russia armed conflict, Greece near default, Iran nuclear efforts, Middle East carnage, Scotland/Catalonia/put-your-favorite-region-here threats to secede, U.S. political fighting over guns, immigration, gay marriage, defense and social programs – nothing has materially altered the market’s trajectory and below-average volatility.

But what comes next? Our most significant causal factors remain monetary policy and earnings.

The former is rather supportive globally but is slowly shifting toward reduced stimulus in the U.S. Earnings, in turn, are showing little growth. Although this can change up or down, in a setting of very high profit margins (which may be turning down), strong new hiring and emerging wage pressures, and a context of market global risk, we are marginally more inclined to protect capital.

**Tell us about market action in recent months.**

The broad U.S. equity market, captured by the S&P 500 index, has been fairly quiet this year. In fact, in the first half of 2015, most equity markets generated a fairly narrow set of outcomes, ranging from near 1% on the low side to 6% on the high side. The key exception was Japan, which returned a tad over 14% in U.S.-dollars terms (and nearly 17% if one hedged the yen, as our positions did).

This is an inadequately short period in which to assess growth. Since the end of 2008, which roughly marks the end of the last and deep crisis, stocks have turned in phenomenal performance and managed to beat many asset classes in which numerous investors had sought refuge because they promised high yields and/or returns, like REITs, private equity, hedge funds and, by huge margins, gold and other commodities.

**Do you think this is the pause that refreshes, or the quiet before the storm?**

We’ve had several years and many consecutive quarters of positive returns and below-average volatility, so a nearly flat quarter or six-month outcome is nothing out of the ordinary.

Having said that, these returns occurred in an environment of change and turbulence.

Change arises both from price shifts as well as evolving macro-economic dynamics. Turbulence arises from…well, just about every corner of the world. It’s not exactly new and extraordinary, but the combination makes for interesting times.

**It sounds like there’s another shoe to drop, and I just fastened my seatbelt…!**

Well we’re not trying to be dramatic, but it was the start to a thought.

Look, after 2008 we spent many years in a setting where stock prices and investors seemed to disbelieve strong earnings growth, and everybody was fearful of stock markets and pleased with the large cash positions in their portfolios. Meanwhile, we were fully invested. As we fast-forward to today, the price for large-cap stocks has now “arrived” and is, broadly speaking, in fair range, and, in our view, small-cap and mid-cap stocks have “moved on up” to expensive zip codes.

At the same time, earnings growth has dropped from double digits to effectively zero. Further, this is happening in a setting of continued stresses from past over-indulgence in leverage across many economies, where many borrowers (including governments) are shifting their business model from one of taking on lots of credit and mis-spending a good portion of it, to one where lenders are more stingy, commodities have collapsed in value and everyone must learn to live within their means.

This is raising blood pressures and triggering heightened risks of dislocations – not necessarily for economies but potentially for markets. The Puerto Rico near default is a symptom of this. So are the Greece tug-of-war, the Chinese stock market manipulation, the Brazilian investigations of colossal corruption and so many other examples. Some of these are a necessary component of flushing out the bad and shining the light in places never before out of the shadows. We even see the Arab spring in this light – a painful but necessary transition from a bottled-up, pressure cooker environment of corruption, central control, and arrested evolution to one that ultimately is better and freer. But, in the interim, it stinks.

We are not interrupting your stream of consciousness and will just sit here quietly and wait for the punch line….

Thanks…we think!

Seriously, although we look at many, many causal and leading factors for both equity and bond markets, we continue to view two of them as more-equal-among-equals: monetary policy and earnings.

The former remains broadly stimulative across the world, with over 25 rate cuts this year alone, even as the U.S. moves slowly from ludicrous stimulus (to paraphrase the Tesla folks’ latest auto launch software mode) to something less positive. That started in 2014, as they began “tapering” Quantitative Easing, and will proceed over the next many quarters with outright increases in short-term rates.

As for earnings, nough said earlier. In an environment of full valuations, flat earnings (for now, in any case) and heightened global risks at the margin, we’re somewhat more inclined to a posture that every Missourian would understand: “Show me.” As a result we’re a little more cautious in the U.S., as we continue to balance our clients’ dual goals of growth and capital protection, even if we have to yield some basis points in relative performance. This explains our latest portfolio shifts of recent months, including a modest allocation to cash for the time being.

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**Fixed Income Portfolios**

**Executive Summary**

The “Grexit” drama, trouble in Puerto Rico and Chinese stock market turmoil do not materially change our view on U.S. interest rates. The Fed remains data-dependent. U.S. interest rates will continue to be driven by domestic factors: U.S. growth, labor and housing costs, and other inflation, including commodity prices. These factors have not been materially altered by the above-mentioned events. Therefore, our perspective on fixed-income markets remains similar to that of recent writings.

**Do the Greek crisis, challenges in Puerto Rico and Chinese stock market turmoil change your perspective on global growth and interest rates?**

At the height of the Greek drama, China stock market turmoil and default in Puerto Rican obligations, U.S. treasury yields fell sharply. The U.S. 30-year treasury dropped from 3.25% on June 26 to about 2.91% on July 8. However, as the climax subsided, Greece went back to the negotiation table, China used state power to stop the stock market bleeding and Puerto Rican bond weakness appeared contained. As a result, U.S. treasury yields are again rising.

As discussed earlier in our Economic Outlook, Greece accounts for just 1.8% of euro-area output and 0.4% of global GDP. A faltering Greece is only a small ripple in a vast ocean. But the headline drama is likely to continue, causing market volatility. China’s roller-coaster stock market is a self-inflicted wound caused by the Chinese government micro-managing financial markets. The effect does not appear to have yet spilled over to the real economy, as participants in the stock market are mainly China’s wealthy — a small percentage of its citizens. However, the story of slower growth and challenges in transforming China’s economic structure remain in place.

Therefore, our view on the global economy and interest rates has not changed significantly as a result of these events: world growth is still moderate; inflation remains low thanks to low oil and commodities prices (though underlying inflation pressures may not be fully understood); and the dollar remains strong.

**What should we pay more attention to in the bond market?**

In the fixed-income market, our eyes are focusing more on U.S. domestic developments, especially in the labor market. Employers have been adding well over 200,000 new jobs per month from Q1 2014 through 2015. Wage gains and broader employment compensation measures are trending higher, and employment cost growth has risen steadily from below 2% before 2014 to 2.6% in Q1 2015. We feel that, sooner or later, inflation measures will likely follow higher. In addition, rising labor costs have put pressure on U.S. profit margins and created considerable caution when it comes to the outlook for corporate profits. We believe this will be an important factor in the Fed’s decision-making process.

**Any new developments from Yellen and Co.?**

From the Federal Open Market Committee’s June meeting statement and the Fed minutes released later, we don’t see any signs of large changes in the Fed’s course. Fed policy remains data-dependent, and current U.S. economic data continues to show a “moderate +” pace of growth. The Fed Funds Rate forward guidance has not changed hugely. Longer-term estimates by the Fed were left unchanged at 3.75%. We continue to foresee a risk of moderately higher interest rates and a flatter yield curve going forward. However, we feel that rate hikes by the Fed will be incremental and gradual.

So your fixed-income positioning remains the same I guess?

Broadly, yes. We continue to position fixed-income portfolios on the shorter end of the duration spectrum to protect principal loss should interest rates rise. And we still like high-yield bonds and dollar-denominated EM sovereign debt because of their higher income cushion and reasonable fundamentals.

**In Other Words**

“The major problem (in China’s stock market) is that government intervention is clearly doing more negative than good.”

— Tony Chu, Money Manager, RS Investment Management Co.

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Space is limited, so contact Laura Hamilton at lah@hamiltoncapital.com or (614) 545-4013 to RSVP.
Economic Outlook
(Continued)

and show evidence of concrete steps toward, bringing its spending more in line with its revenue and reforming its entire “business model”, even as its EU partners stand ready to help. But the outcome agreement, although a glidepath to implement long-resisted reforms, may also be viewed as the ultimate humiliation, positioning Germany, in many eyes, as the bully of Europe and leaving many questions unanswered.

Shifting to the homeland, I read that U.S. growth again weakened earlier this year. Is the Greek event going to ensure that it gets even worse?

Growth did indeed pause in the first quarter. However, there were a slew of temporary factors impacting it – from a harsh winter and west coast port closures (which have largely dissipated) to a pull-back in investment by the energy sector and the more lasting impact of a stronger U.S. dollar and lower energy prices.

We feel that the latter may actually become positives in the future, as the U.S. dollar buttresses consumer purchasing power, and lower energy prices, while initially hurting investment in that one sector, function as a special dividend for energy users.

As far as Greece is concerned, it may be noisy, but it’s a very small economy (near 0.4% of global GDP), and we feel that, under most scenarios, it’s not likely to materially alter the path of the U.S. Thus we would continue to label our expectations for U.S. growth as “moderate +”.

So how concerned are you about European events?

Our process leads us to consider a broad range of scenarios and emphasize the most probable. But we also spend a great deal of time on risk management. We feel that Greece’s recent actions do create a new, heightened risk which, although not of significant likelihood, when combined with fully-valued markets, does increase our caution level from an earnings and market point of view. But we do want to emphasize that, given current public policy in the U.S., Europe and elsewhere, our most probable scenarios for economic growth are moderately positive.

What are the key macro-economic factors of note?

The policy actions and market events we underline include a global, broadly-based shift toward additional monetary ease and lower energy prices (especially with the Iran agreement), which resulted in strong employment gains and a combination of a strong U.S. dollar (which favors U.S. consumption) and weak currencies elsewhere (which favor their exports). Although this combination is bemoaned by pundits, it actually suits the historical fabric of each economy and supports growth.

That said, it’s key to note that we will continue to live with the legacy of past excesses. The U.S. private sector has broadly healed many of its self-imposed borrowing wounds, but it benefitted from passing the baton of heavy-indebtedness to the U.S. government, and that will remain a weight around our ankle for some time – not enough to sink us, but likely to slow our strokes. This debt or fiscal constraint was a widespread strategy globally, and remains true in the UK, Europe, Japan and, increasingly, China.

We see past mistakes expressing themselves in numerous ways. Puerto Rico cannot handle its exceptional debt load and has years of corrective actions ahead, in an environment of contracting population. China is struggling with the transition from a centrally-controlled, designed and manipulated manufacturing and exporting powerhouse to a more diverse economy where the government is less able to “engineer” and even invent steady and stable outcomes, be they economic, market or interest rate-related.

That said, we do feel that monetary policymakers, although not miracle workers, are watching and listening carefully, flexibly adjusting and adapting as one would hope they would, and focused on bringing about economic results that balance inflation, employment and growth. However, they won’t succeed alone. We need legislators the world over to take the baton from central banks and implement tax, labor and fiscal policies that help productivity growth. That will probably be slow in coming, so we’re not holding our breath, but the murmur is getting louder. That leaves us hopeful, if sober and realistic.

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