2nd Quarter 2015 Commentary
The Greek Distraction

With the second quarter in the books, many continue to worry about the implications of a Greek default. Since we covered the majority of our thoughts in our column published earlier this week we are not going to devote much additional time to the topic.

Greece may have given the world markets a black eye, but it is not a knockout punch. Furthermore, we have seen this matter unfold for the last six years. Anyone who has been caught off-guard simply has not been watching.

Despite Greece being a non-event, it still caused a fair amount of volatility in the financial markets.

The Dow Jones Industrial Average is now down about 1% for the year. The S&P 500 is up slightly at the half-way point.

This is the seventh year of the bull market in the U.S. The S&P 500 has never risen seven consecutive calendar years.

Valuations for the stock market continues to be full, if not expensive.

We have used, and continue to use, the recent volatility to sell off lesser quality names and increase higher quality holdings.

Not only does this allow us to sleep better at night, but it generally increases the dividend cash flow to our portfolios too.

S&P 500 PE Ratio

For the Shiller PE10 Ratio, see Shiller PE.

Chart | Table   Share

Current S&P 500 PE Ratio: 20.24 +0.13 (0.64%)
2:38 pm EDT, Tue Jun 30

Mean: 15.54
Median: 14.59
Min: 5.31 (Dec 1917)
Max: 123.73 (May 2009)

Price to earnings ratio, based on trailing twelve month "as reported" earnings.

Current PE is estimated from latest reported earnings and current market price.

As Warren Buffett mentioned at the Berkshire Hathaway annual meeting, if interest rates stay low the stock market may be viewed, in high-sight, as quite reasonable.

As the quarter ends, the yield on the 10 Year US Treasury pays a slim 2.33%.

Additionally, there continues to be much conjecture over when the Federal Reserve will raise interest rates and by how much. The conventional wisdom says the Fed will raise short rates 0.25% either in September or December.

Either way, we see this as more of a symbolic move. The economy remains too weak to raise rates in a meaningful manner. Unfortunately, they have talked so much about how the economy is improving that they appear to have backed themselves into a corner.

We do not envision much more in the way of rate increases anytime soon. Regardless of what comes out of Washington, the economy remains too weak. GDP growth is positive, but below average. The Labor Participation Rate is still at the lowest levels since 1978.

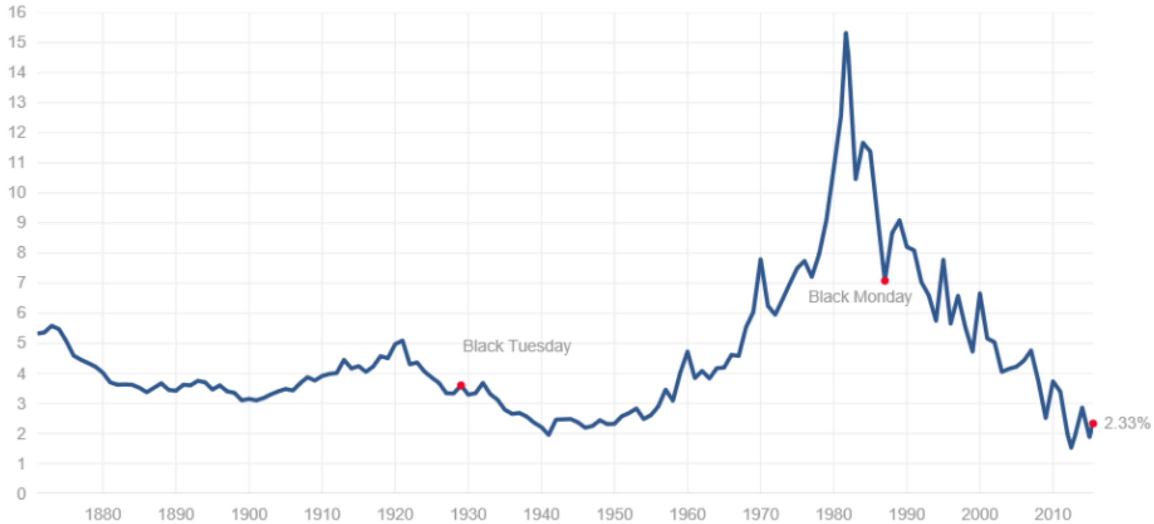


Chart | Table Share

Current 10 Year Treasury Rate: 2.33%

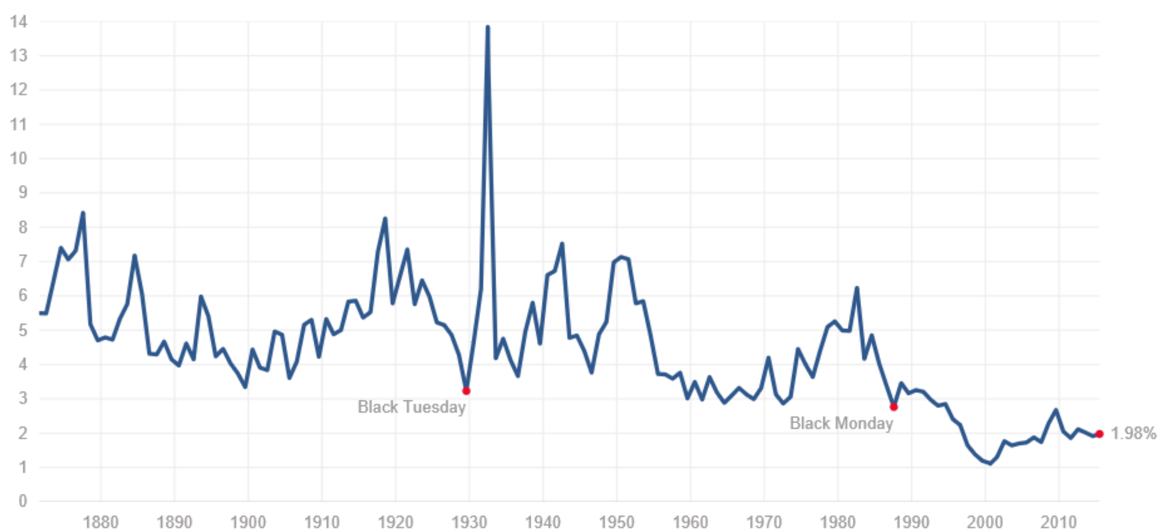
At market close Mon Jun 29, 2015

Given the low interest rates, many investors continue to look to stock market assets to produce cash flow.

The dividend yield on the S&P 500 as a whole is right at 2%.

Many higher quality stocks are paying above 3% and offer the added benefit of lower taxation due to their tax qualified nature.

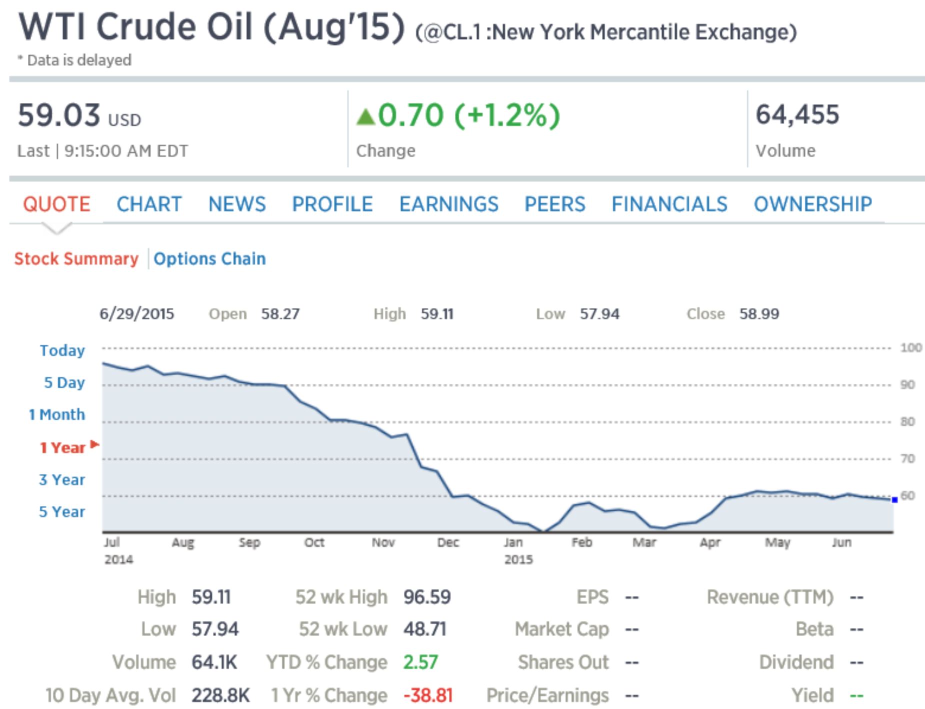
S&P 500 Dividend Yield



Although oil is roughly flat for the year, it is down nearly 40% over the last year.

This has been the largest drag upon GDP and is especially noticeable in Texas.

However, lower oil prices should deliver goods and services a bit cheaper and make filling up your car a little easier on the pocket book too.



The US Dollar continues to show its strength relative to world currencies. This is a mixed blessing. If you are going to take a trip outside the US, then the dollar buys more. If you are going to buy a new foreign car, it should cost a bit less.

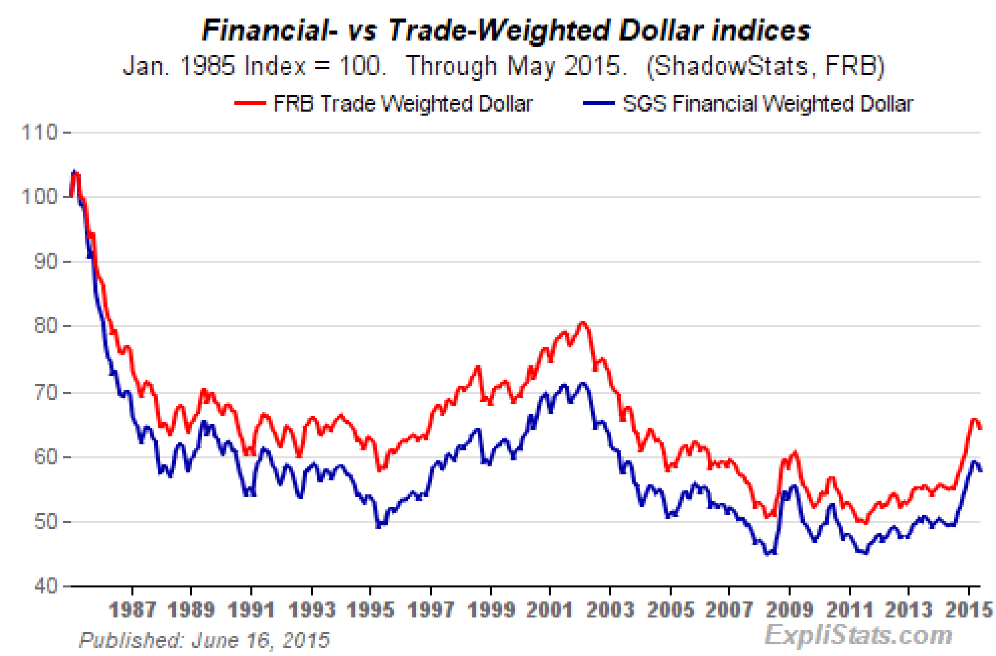
However, the strong dollar also means it is harder for the US to have strong exports.

The strong dollar also has an odd impact upon multi-national corporations. Take Philip Morris International, for instance. The big cigarette maker sells 100% of its product outside of the US.

However, it produces its financial statements in US Dollars. Although this can be seen as primarily an accounting issue, Philip Morris is showing earnings of $4.73 per share in US Dollars. Conversely, if their earnings were not accounted for in US Dollars they would show earnings of about $6.50 on a constant currency basis.

This has nothing to do with operational efficiency. As such, the earnings of multinationals needs to be assessed properly. Many multinational corporations will miss their earnings expectations simply because of currency translation issues.

In our opinion, over long periods of time currency issues seem to work themselves out. As such, we would not penalize a company for currency matters. True operational efficiency will matter far more over a ten year cycle.



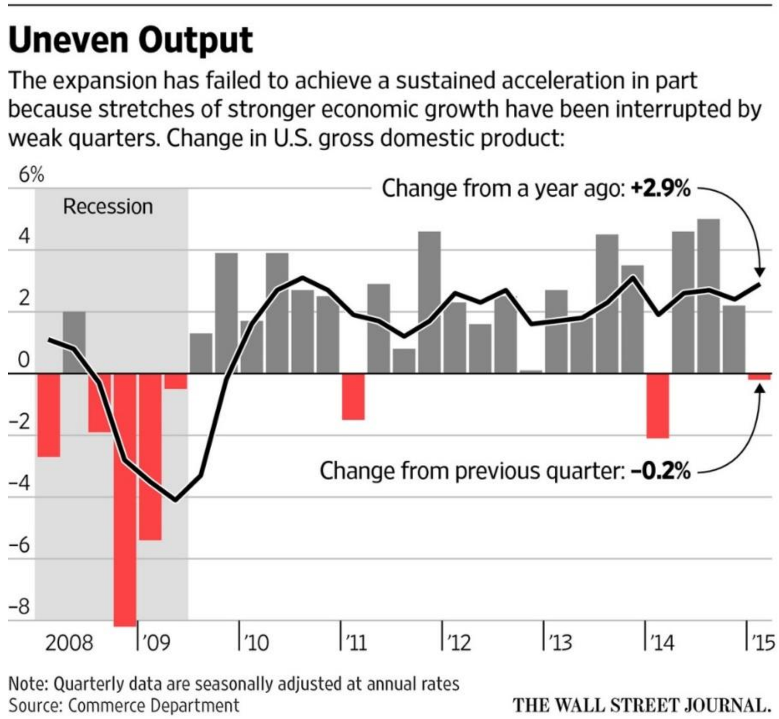
First quarter GDP was revised up, but still negative.

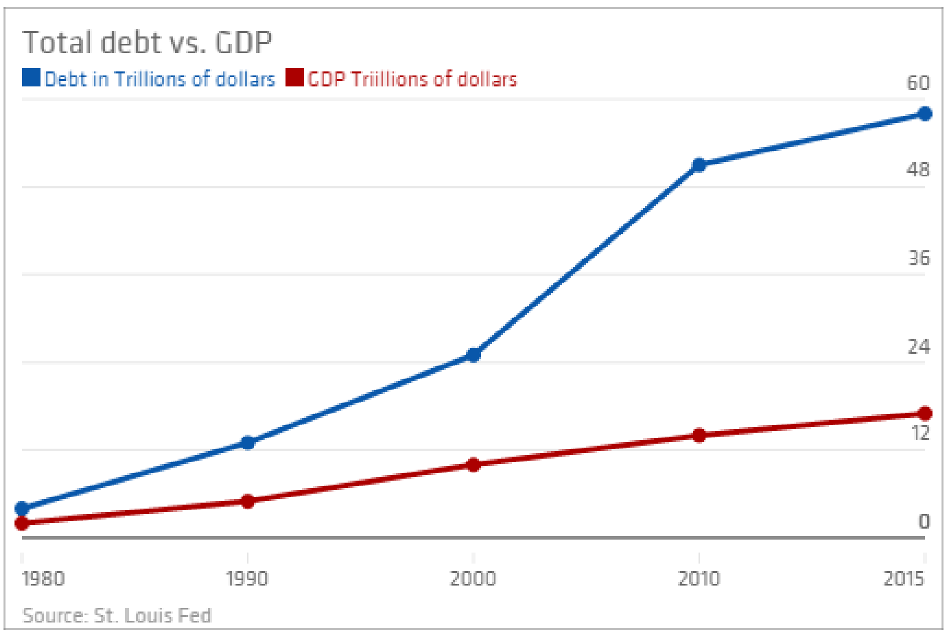
Although there were many weather related issues contributing to this, the fact remains that the economy is not nearly as robust as hoped for.

The U.S. contributed more to global GDP growth than China for the first time since 2006.

All things being equal, we consider this to be a positive.

Economic output for the remainder of the year is anticipated to be better, but still not great.





One factor boosting GDP is our continual addiction to debt.

Fortunately, with interest rates as low as they are currently, indebtedness is not as onerous as may have historically been true.

None-the-less, debt still has to be paid back at some point.

We are fortunate the US has an economic engine capable of propelling us forward—albeit at slow rates.

Despite the negative GDP revision in the first quarter, wages and salaries are gaining some traction. Wages increased 2.6% in the first quarter. However, this still remain well below previous levels on an inflation adjusted basis.

As we say good-bye to the first half of 2015, we recognize things could be much worse. The U.S. continues to be the best place in a very difficult world. Despite our flaws, there is no place we'd rather be.

Recognizing this, we wish you a Happy and Safe 4th of July.

Sincerely,

Dave | Warren

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