# DANN ASSET ADVISORS, LLC

## Second Quarter 2015 Update

July 17, 2015

**2Q15 Highlights**

- Led by the consumer, U.S. economic growth likely rebounds following first-quarter contraction
- Industrial/manufacturing sectors remain soft, hurt by energy weakness and strong dollar
- International economies lag the U.S. with events in Greece adding uncertainty
- U.S. stock market flat; interest rates rise
- Chinese stocks tumble late in the quarter and into July

The table below summarizes the performance of some key indices during the second quarter and year to date:

| Market Performance | | |
|---|---|---|
| Index | % Ch. 2Q15 | % Ch. YTD |
| S&P 500 | 0.3 | 1.2 |
| MSCI Developed Markets (excl U.S.) | 0.6 | 5.5 |
| MSCI Emerging Markets | 0.7 | 3.0 |
| MSCI All Country World | 0.4 | 2.7 |
| US Aggregate Bond (1) | (1.7) | (0.1) |
| Liquid High Yield (1) | (0.7) | 1.6 |
| US Dollar Emerging Markets Bond (1) | (0.7) | 1.4 |

(1) Barclays indices

Equities. Although barely positive, the 0.3% return for the large cap S&P 500 marked the index's tenth straight quarter without a decline. The index had been on track for a larger gain but fell late in the quarter following the initial breakdown in negotiations between Greece and other eurozone countries. The year to date return of 1.2% represents the weakest six-month advance for the market since 2012. Still, it has been four years since the market has had a correction (drop of 10% or more) and the bull market that began in 2009 is now among the longest ones. At quarter end the S&P 500 was trading at a not inexpensive 17.2x 2015 estimated earnings.

As with the U.S., many international markets started the second quarter strongly but backed off as the quarter progressed. The decline in European markets likely stemmed from the negative developments around Greece. However, the Chinese market has been most in the news recently – it appreciated roughly 150% from the summer of 2014 and then declined nearly 35% over the past month. Much of this speculative bubble seemed spurred by Chinese government policies. While we are far from China experts, we believe the government's seemingly panic-driven reaction to the decline may have economic and political implications beyond the stock market. Regardless, China serves as a reminder that developing markets can be extremely volatile.

Fixed income. Yields on 10-year U.S. Treasury bonds rose from 1.93% to as high as 2.48% during the quarter, before declining toward quarter end as investors looked for safer investments in light of risks stemming from Greece and China. We believe at least part of the reason for the rise in rates is that yields on the debt of other highly rated countries rose sharply from extremely low levels during the quarter – this served to reduce demand for U.S. Treasuries (leading to bond prices down and yields up). The rise in rates led to a negative return for the Barclays U.S. Aggregate Bond index for the quarter.

General Comments. In our April first-quarter update we wrote, "[w]e expect modest returns at best for the U.S. stock market over the near term." Certainly that proved to be the case during the second quarter. Leaving aside unpredictable geopolitical issues, we believe the chances of a temporary decline in the stock market have increased since April.

The reason for our greater concern is that in recent months there has been a significant divergence between the consumer and industrial/manufacturing sectors of the U.S. economy (consumer strengthening after a weak first quarter; industrial flat to down further). We had expected this divergence to resolve with a strengthening of the industrial sector this summer (spurred by consumer demand for goods) but so far this hasn't occurred. While we continue to think consumer demand will win out, weakness in the industrial sector could be signaling a more significant economic slowdown ahead and, if that were to be the case, we'd expect a tougher period for the stock market.

## Portfolio Positioning

The fixed income component of most diversified (fixed income and equity) portfolios remains largely in short duration (three years and under), investment grade corporate and municipal bond funds. During the quarter, for many diversified portfolios, we slightly increased a position in an intermediate term, investment grade bond fund. Still, for most diversified portfolios, intermediate duration securities comprise less than one-quarter of the fixed income allocation. Assuming economic growth picks up as we still expect, we believe interest rates will rise modestly through year-end but remain low relative to historical levels.

With respect to equities, the best performing broad U.S. market sectors during the second quarter were similar to those of the first quarter. Healthcare (helped by corporate deals) and consumer discretionary (retail, entertainment, autos, etc.) again were the leading groups. Financials jumped to third place, aided, we believe, by the rise in interest rates during the quarter – over time higher rates should help net interest margins/earnings at banks.

The worst performing sectors were real estate investment trusts and utilities, down 11% and 6%, respectively, presumably in response to higher interest rates. Industrials were the third worst performing group reflecting, we believe, the weakness in this sector that we described in our General Comments above.

For most equity-only accounts we had an active second quarter. We sold the stocks of a pharmacy benefits manager and semiconductor company – managements of both had reached agreements for their companies to be acquired by competitors – and a freight brokerage services provider that we believed had reached fair value given our expectation of slowing growth. In addition to the stock sales, we sold two exchange traded funds – one focused on dividend paying stocks and the other on materials companies.

We had a difficult time finding new undervalued stocks during the quarter but for aggressively positioned equity-only accounts did purchase a small position in a company with a unique drug infusion system. In addition, for most equity only accounts we initiated or added to positions in two stock mutual funds that have generated strong long-term returns. Each of these funds has held up better than the markets during prior downturns.

## Economy

The economy contracted 0.2% in the first quarter of 2015, the first decline in four quarters. Similar

to the contraction during the first quarter of 2014, poor weather was a negative. In addition, the West Coast ports strike (ended February) hurt. The more significant factors, however, were a ballooning of the trade deficit – this subtracted 1.9% from growth (the most since 1985) – and declining business investment. Weak international economies, the stronger U.S. dollar (further hurting exports) and low energy and other commodity prices are among the causes of the higher deficit and reduced business investment. On the positive side, consumer spending continued to expand at roughly a 2% rate in the quarter. GDP estimates for the second quarter of 2015 (to be reported later this month) are in the 2.5%-3.0% range.

With good housing and auto sales and decent employment numbers we believe that consumer spending likely accelerated in the second quarter. Given substantial supply, energy prices are unlikely to rise significantly near term, and this also should be supportive of the consumer. Assuming consumer spending continues improving, consumers' demand for goods should lead to improved business conditions for the manufacturing and industrial side of the economy – the sector that has been especially weak in 2015. We believe this represents the most likely path for the economy over the next few quarters. However, if consumer spending does not pick up as we anticipate, it may turn out that the recent weakness in the industrial/manufacturing sector is the harbinger of tougher economic times ahead.

Internationally, the European economy strengthened during the second quarter. Events in Greece may have put a temporary pause in this improvement but we don't expect Greece to be a major economic issue for Europe (as we write it seems likely Greece will remain in the eurozone). Japan seems to be continuing with sluggish but positive growth. Our biggest concern internationally is China. To us, the government's actions in stimulating, restraining and then propping up the stock market indicate potentially less control over the economy than we previously have assumed. Further, the stock market bubble there was on top of previous inflation of the property market. We understand that the Chinese government can do whatever it wants domestically but with the country representing the world's second largest economy, mistakes, if they're made, easily could have a broader impact.

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