Making Sense of Finance

Karagosian Financial Services 7/22/2015 Volume 18, Issue 3

Second Quarter Review

STOCK MARKET

Stocks in the U.S. in the aggregate made minor moves in the second quarter, as the major indices had mixed results. Last quarter, the NASDAQ Composite was the only one of the three large major indices with a gain, 1.75%. Both the S & P 500 and the Dow Jones Industrial Average had small losses of 0.88% and 0.23% respectively. The recent loss in the S & P 500 index ended the streak at nine consecutive quarterly gains.

The "sideways" movement in the equity markets has been supported by increased merger and acquisition (M & A) activity. Global M & A value in the first half of the year hit an eight year high. Although some investors may believe there are no bargains to be found in the current stock market, many corporations are flush with cash and are anxiously looking to make deals if the right opportunity and the right price present themselves. Also, with interest rates still near historically low levels, financing acquisitions at this time remains attractive. This in turn leads to many investors to look for what may be the next takeover.

Even though a 25% increase in oil prices in the second quarter led to an improvement in expected earnings for the energy sector, energy stocks did not reflect this increase. Stocks in this sector decreased almost 3% last quarter and S & P 500 energy companies' estimated earnings for the second quarter are still expected to decline year over year. In fact, the estimated earnings growth rate for the S & P 500 would be 2.0% instead of the predicted -4.4% if the energy sector was excluded. Again the worst performing sector was utility stocks (typically a favorite of income oriented individuals), as the rise in bond yields caused investors to seek higher yields elsewhere. Health care stocks were the best performing sector last quarter. Not too surprising since this is where the highest revenue and earnings growth are predicted. Consumer discretionary stocks also performed better

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Everyone and their neighbors have an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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than the overall market.

The developed markets of Europe, Asia, and Australia, as measured by the MSCI EAFE index in U.S. dollar terms, was also relatively flat in the second quarter, decreasing slightly (-0.37%) but still positive year to date. Uncertainties in Greece weighed on the stocks in the European Union, offset by a slight increase in the value of the Euro versus the dollar last quarter. The Japanese market (TOPIX), in local currency terms, was the best performing developed country market with a gain of 5.8% for the quarter. Much attention though last quarter was focused on the local Chinese markets, in particular the Shenzhen A shares index which rose 26% in the second quarter and 74% year to date! Since the end of last quarter some of the air has come out of this bubble. This is not a stock market for the faint of heart. The Hang Seng Index, which trades on the Hong Kong market and contains many of the largest Chinese companies, is a more prudent means of investing in China.

BOND MARKET

U.S. Treasuries declined in value in the second quarter as interest rates rose for the 10 Year Note from 1.94% at the end of March to close at 2.35% at the end of June. This in turn has caused mortgage rates to rise slightly and also has had a detrimental effect on the performance of publicly traded real estate investment trusts (REITs) as well. However, short term rates did not budge as the Federal Reserve still has held off raising the Fed Fund target rate. This is highly anticipated to be increased sometime in September or October.

The decline in bond values spanned across all fixed income sectors last quarter: municipal, government, investment-grade and non-investment grade bonds. The Barclays Aggregate Bond Index declined almost 2% in the second quarter. Generally, the longer the bond term the larger the decline in value. Companies have been rushing to issue bonds this year, sensing that we might not see rates this low for a while. Investment grade companies have sold $739 billion in bonds so far this year, about 14% more than this time last year. AT&T issued $17.5 billion of bonds (the third largest deal on record). In Europe, what started out as a positive quarter for government bonds when quantitative easing was initiated changed quickly. The 10 Year German Bund hit a record low of 0.05% on April 15th, rose to 1.0% by mid-June and ended the quarter at 0.77%. This shows that volatility is no longer just a trademark of the stock market as U.S. Treasuries also made fairly large price swings last quarter.

OUTLOOK

For the dedicated readers of this newsletter, one will notice that there is very little change in our opinion on the markets from quarter to quarter. Despite business headlines about Greece, Puerto Rico or China, we have waivered minimally in our views. This is because we understand what we can know and that we can not know. We are often asked after a major news event what we are going to do to our client's portfolio, AFTER the fact. Our response is usually that our client portfolios have already been constructed with these types of events in mind and nothing major is to be done. Our opinion is that advisors who drastically change their strategies because of headline news events simply have NOT been doing their job and are simply being reactionary. After all, what good is selling an investment AFTER it has already lost its value?

We think the stock market is fairly valued at this time, but that doesn't mean it can't go up or down; just that the easy money has already been made. This is where active portfolio management can add more value. Regarding bonds; the general rule of thumb is that bonds are safer than stocks; however, in the current extreme low interest rate environment, we don't think this is the case, particularly on longer duration bonds (over 5 years). Still, bonds as an asset class can be used to cancel out some of the volatility in the stock and real estate market.