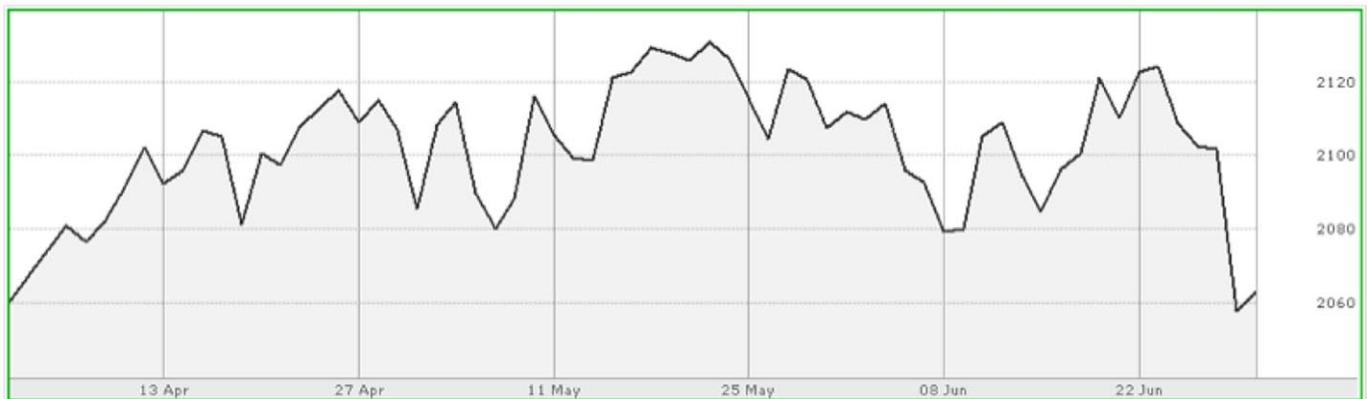


## Second Quarter 2015 Review

The S&P 500 remained trade ranged in the second quarter of 2015. The S&P 500 fought to make new highs only to see that gain reversed by geopolitical concerns domestically and abroad. As you can see below, a combination of concerns about the Chinese markets and the Greek debt crisis led to the worst decline of the quarter, occurring during the last week of June.

### This dragged the S&P 500 down 0.23% for the quarter



### Here are some highlights and interesting facts for the second quarter in the markets:

- The S&P 500 dropped 0.23% for the quarter but is still clinging to a 0.20% gain for the year.
- Treasury bonds got hammered, losing 8.30% of their value in the second quarter. This pulled Treasury Bonds down 4.67% for the year (its worst quarter since third quarter 1981).
- The U.S. dollar slipped 2.9% during the quarter, but remained up 5.8% for the year.
- International developed stocks slumped during the quarter (down 1.82%) but remain the best performing major asset class, up 8.82% for the year. Emerging Markets were up 0.70% for the quarter and up 5.63% for the year.
- Health Care, Consumer Discretionary, and Financials were the best performing sectors of the S&P 500, up 2.43%, 1.56%, and 1.23% respectively for the quarter.
- The Utilities, Industrials, and Energy sectors were the worst performing segments of the S&P 500, down 6.70%, 2.77%, and 2.59% respectively for the quarter.
- The All Countries World Index was up 0.35% for the quarter and up 2.66% for the year in U.S. Dollars. The best region (and country) was Japan, up 3.09% for the quarter and 13.62% for the year in U.S. dollars.
- Emerging Markets and the United States were the only other regions up for the quarter, up 0.70% and 0.20% respectively. The United Kingdom, Pacific Rim ex. Japan, and Europe ex U.K. all showed negative quarterly returns in their local currency, down 2.79%, 2.99%, and 4.40% respectively.

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### Market Headwinds

**Investors are eyeing several issues to determine their seriousness. The ones that I am tracking the closest are: the Fed's desire to raise rates, the Greek debt crisis, and the Chinese stock market.**

The Fed's most recent minutes continue to reflect their desire to raise the federal fund rates. The Federal Reserve typically raises rates to slow the economy. This case is a little different. Rates have been at zero percent for several years. The Federal Reserve wants to raise rates because we are no longer in a financial crisis, and they want to normalize rates over the coming years. Their plan, if acted upon, would be to raise the federal funds rate to 3% by the end of 2017.

#### What would be the impact if the Federal Reserve did start raising rates?

- Domestically, raising rates have a negative impact on bonds. As discussed in prior educational e-mails, long-term bonds would be more impacted than short-term bonds.
- The dollar would most likely continue gaining strength against foreign currencies. This would make foreign goods cheaper for us to buy (a good thing) but would also make our products more expensive abroad.
- Raising rates could impact corporate earnings. This could be due to higher borrowing costs or due to selling less products abroad due to the strong dollar.
- Real estate might be impacted due to higher borrowing rates. Three of the worst ten performing sub-industries last quarter in the S&P 500 were real estate related. As the "cost to carry" real estate goes up, less people can afford that product (in other words, same supply with less demand).
- In most cases, the markets initially drop when the Fed raises rates. These have not typically been large drops but a headwind to performance. Historically, the markets have quickly recovered from these short-term losses.

#### The Greek debt crisis is all over the media. While this geopolitical crisis has definitely affected the sentiment of the markets and there is fear that it may be symptomatic of bigger issues within the Eurozone, please take a few things into consideration:

- Greece's Prime Minister Alexis Tsipras was elected with the platform that he'd fight to reduce austerity measures forced on them by the European Central Bank and International Monetary Fund. It should not come as a surprise to anyone that this crisis has come to a head.
- Most of Greece's debt is owned by governments. This means that if Greece did default the impact would not be felt by the private sector like 2008.
- According to the World Bank, Greece is the 45th largest economy in the world. It represents less than 2% of the European Union's total GDP.
- Greece represents 0.05% of all U.S. exports. In other words, they don't buy what we produce.
- The biggest victim to date in this crisis is the Greek people.
- It seems unlikely that the Greek debt crisis will spread to other areas of Europe.

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**Surprisingly, the Chinese stock markets are getting a fraction of the media attention as the Greek debt crisis. The Shanghai Composite and Shenzhen Composite have both plummeted about 30% from their highs due to growing concerns that Chinese markets are overvalued and in a bubble. To put it into perspective, this is a loss of over \$3.25 trillion of market value or more than 10 times the amount of debt Greece holds. The Chinese government has launched a “patriotic fight” to save its stock market.**

### Here is what you should know about the crisis and what the Chinese government is doing:

- China's economy has been slowing down for some time. Their economy, the second largest in the world, has slowed from 10.4% annual growth to 7.4% last year.
- According to the IMF, 43 countries count China as their largest export partner. This means a slowdown in China impacts these countries too.
- Due to the Chinese market free fall, China has allowed more than half of China's stocks to halt trading.
- The Chinese government is lending \$42 billion to 21 brokerage firms so they can purchase “blue chip” stocks. This is on top of \$20 billion that the brokerage firms already vowed to buy on their own.
- The Chinese government also has pledged to buy small and medium sized stocks, although they didn't give a specific amount they'd commit.
- The Chinese government also announced a \$40 billion stimulus program to help stimulate economic growth. This is in addition to the commitment to speed up spending on infrastructure. China's currency has fallen heavily against the dollar in the past few weeks.
- China's central bank has cut rates to 4.85%. On the same day, they cut reserve requirements. They haven't dropped both rates on the same day since October of 2008, the height of the Great Recession.
- China has stopped any new IPO stock listings and is prohibiting controlling shareholders and board members from selling their stocks for six months.

## How Do We Invest Given the Current Environment?

Most research shows that geopolitical shocks to the market typically are short lived. One 70 year study conducted by S&P Capital IQ showed that the markets corrected approximately 2.5% on bad news and took only two weeks to recover from these short-term losses. Ned Davis Research has performed numerous studies on crisis events. The most comprehensive study looked at over 50 crisis events dating back to 1907. The median loss after a crisis event was only 2.9%. They then looked at how the market reacted in the trading days after these “reaction” dates. The median recovery 22 trading days later was up 4.6%. The returns were even greater looking out 63 trading days. The DJIA was up 6.1%.

A normal reaction to reading these statistics is “this time it is different.” It's hard to dismiss our current events as trivial. Each on their own could pose a reason for the markets to correct. The global markets have definitely reacted negatively to each of my concern points, but they also recovered shortly thereafter.



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### **As you know, Polaris manages money in a dynamic and tactical manner. Our investment philosophy is driven by our proprietary four pillars of investing: technical analysis, macro-economic analysis, sentiment analysis, and fundamental analysis.**

The global markets have not broken down from a technical stand point. There are areas of weakness but overall things remain intact. The U.S. & Japanese economies are stable and growing. China's economy is strong but slowing significantly below its historical pace. Europe's economy remains the big question. The sentiment of investors remains neutral, down from frothy high levels (which is a good thing). The fundamentals of the market are definitely in transition. Our fundamental research has not broken down to a point to make us "bearish" but this could quickly change.

One of my favorite investment phrases is "I'd rather be partially right than completely wrong." With this in mind, we recently lowered our exposure to the stock market in all of our strategies. We moved from being over weighted to stocks to market weight. As we gain more clarity into each geopolitical situation we will either lower our stock exposure further if things get worse or go back to our overweight in stocks if risk subsides. We currently remain under weighted to the bond market and remain short-term with the majority of our bond holdings.

I hope this helps you further understand how disciplined and vigilant we are in management of your portfolio. As always, I welcome your questions and comments.



**Sincerely,**

**Jeffrey J. Powell**  
Managing Partner

The following are the sources for the widely-cited studies on illusory superiority: Svenson, O. (February 1981). "Are we all less risky and more skillful than our fellow drivers?" *Acta Psychologica* 47 (2): 143-148; Cross, P. (1977). "Not can but will college teachers be improved?" *New Directions for Higher Education* 17: 1-15; Zuckerman, Ezra W.; John T. Jost (2001). "What Makes You Think You're So Popular? Self Evaluation Maintenance and the Subjective Side of the "Friendship Paradox." *Social Psychology Quarterly* 64 (3): 207-223.

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