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CHARTWELL REVIEW

July 2015 **SECOND QUARTER 2015** Volume XXII, Issue No.2

ANTICIPATION

Anticipation, Anticipation
Is making me late
Is keeping me waiting

Greece's share of eurozone GDP is a little under 1.5%. But, its share of media "ink" this year must be over 75%. Now, with the agreement to make an agreement, or "AGreekment", having been penned, we're still waiting. There has been much kicking of cans down the road, but most market observers believe there will be little contagion effects if Greece finally defaults on its sovereign debt. The ECB will ring-fence the debt and lend whatever is required to European banks. Grexit? Looks like it might create a temporary buying opportunity for risk assets.

Another long-anticipated event is China's hard economic landing, brought upon it by profligate overinvestment in infrastructure and property development using too much leverage (like the US in 2008). We've been waiting a long time for this, and "hard goods" commodities prices have long ago tipped decidedly to the negative (China consumes more commodities than any other nation). The country's manufacturing activity continues to struggle.

Finally, the third anticipated major event is the Fed's shift of monetary policy into tightening mode. It's been just over two years since the announcement that QE3 would be wound down, which was the first step toward normalizing interest rates. During that time, the 5-year Treasury rate rose by 24bps, but the 10-year Treasury yield **fell** by 15bps, to 2.33%. The BBB bond index yields 3.94%, which is exactly the same as two years ago. As we've moved inexorably closer to "the date", term interest rates have oscillated quite broadly *while remaining essentially unchanged*.

This is a contrarian viewpoint, but we think it is quite possible the first 50bps of increased Fed Funds rates will not present a challenge strategically for either the US bond or stock markets, after some initial knee-jerk volatility.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	2Q 15	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	0.3	7.4	17.3	17.3	7.9
U.S. Top-cap Stocks	0.9	7.7	17.1	17.3	7.6
U.S. Mid-cap Stocks	(1.5)	6.6	19.3	18.2	9.4
U.S. Small-cap Stocks	0.4	6.5	17.8	17.1	8.4
Non-US Stocks (**devel**)	0.6	(4.2)	12.0	9.5	5.1
Non-US Stocks (**emerg**)	0.7	(5.1)	3.7	3.7	8.1
3 mo. T-Bills	0.0	0.0	0.1	0.1	1.4
U.S. Aggregate Bonds	(1.7)	1.9	1.8	3.4	4.4
High Yield Bonds	(0.1)	(0.6)	6.8	8.4	7.8
Global Aggregate Bonds	(1.6)	(9.0)	(2.5)	1.1	4.9
CPI, annualized	***4.3***	*0.1*	*1.3*	*1.8*	*2.0*
Bloomberg Commodity	4.7	(23.7)	(8.8)	(3.9)	(2.6)
FTSE Nareit All REIT's	(8.9)	3.7	9.0	14.1	6.4
Chartwell Global 65/35	*(0.7)*	*0.3*	*9.8*	*10.0*	*7.1*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	2Q 15	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	0.2	6.6	17.0	16.4	7.7
U.S. Mid-cap	(0.2)	6.2	17.9	16.7	8.9
U.S. Small-cap	0.6	5.1	17.5	16.6	8.6
International Lg. Cap	1.1	(3.4)	11.5	9.6	5.6
International Sm. Cap	4.2	(1.0)	15.4	13.0	7.9
Emerg. Mkt. Equity	0.7	(6.9)	4.4	4.0	7.7
Balanced/Hybrid	(0.6)	2.0	9.2	9.8	6.0
General Bond	(1.6)	1.2	2.3	3.8	4.6
High Yield Bond	0.3	(0.7)	6.0	7.8	6.8
Equity Hedge Index	2.0	2.6	8.4	6.1	4.9

*Annualized trailing returns for periods ending 6/30/15

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Economies, Economics, Prices, and Policy

	6/2015	6/2014
CPI - All, trailing 1-year	0.1%	2.1%
Real GDP Growth, 1-year *	2.9%	1.9%
Employment / Population %	59.3%	59.0%

** through 1Q 2014 and 1Q 2013*

The final estimate of 1st quarter **real domestic GDP** was released in late June. The economy *shrunk* at a revised annual rate of (0.2)%. The nominal economy did as well. The biggest swing factors in the weak quarter were a very poor import/export mix and reduced personal spending. The former was expected, given the Dollar's strength during the latter half of 2014. The weakness in consumer spending growth, after so many months of labor market gains, has economists puzzled. Businesses also restrained their fixed investment spending, while ramping up spending for inventory growth. That's a dangerous mix.

Figure 3: Breaking Down Real U.S. GDP

% Change from Preceding Period
(seasonally adjusted at annualized rates)

Factor	1Q '15	4Q '14	3Q '14	2Q '14
Real GDP Growth	**(0.2)**	**2.2**	**5.0**	**4.6**
Nominal GDP Growth	**(0.2)**	**2.4**	**6.4**	**6.8**
Final Sales	**(0.6)**	**2.3**	**5.0**	**3.2**
Personal Spending	2.1	4.4	3.2	2.5
Private Investment	2.4	3.7	7.2	19.1
- Fixed, Businesses	*(2.0)*	*4.7*	*8.9*	*9.7*
- Fixed, Residential	*6.5*	*3.8*	*3.2*	*8.8*
*- Chg. In Inventories **($bn)***	*$100*	*$80*	*$82*	*$85*
Export growth	(5.9)	4.5	4.5	11.1
Import growth	7.1	10.4	(0.9)	11.3
Government Spending	(0.6)	(1.9)	4.4	1.7

Overall, real GDP grew at a rate of 2.9% during the past year. Not an especially robust growth rate after the prior year's very modest 1.9% advance, but the upward trend is a positive.

GDP is expected to rebound during the 2nd quarter. The Atlanta Fed forecasts real growth will be reported out at an annualized rate of 2.4%. The Blue Chip consensus figure is closer to 3.0%. US growth remains the highest among developed market nations.

US employment growth was a bit weaker than expected in June, but the full quarter saw non-farm payrolls rise by 664k, versus 591k during the first quarter. The larger household survey reported that employment increased by only 408k persons, compared to 889k in the first quarter.

Despite employment growth of 2.5 million persons during the past twelve months, **wage growth** has been moderate. Adjusted for negligible inflation, median weekly earnings in Q2 declined by 2.0% from Q1, but did rise by 2.7% during the past twelve months.

The latest data on **labor productivity** is through the 1st quarter, and it doesn't paint a pretty picture. This very important measure *decreased* at an annual rate of (3.1)% in the quarter, following a similar decline of (2.1)% during the 4th. This is the first time we've experienced two consecutive quarterly declines since 2006. Reduced labor productivity puts a strain on company profit margins, and suppresses wage growth.

Tying this together, **unit labor costs** continued to increase at an elevated pace. They rose at an annualized rate of 6.7% in the first quarter, following an annualized rise of 5.6% during the 4th.

The **"headline" CPI** index (includes food and energy sectors) increased at a seasonally unadjusted annualized rate of 4.3% in the quarter, versus only 0.1% during the 1st quarter. Despite the very strong quarterly advance, this broad price index was up only 0.1% during the past twelve months, reflecting the earlier downward pull of food and energy prices. Most expect negative CPI prints are now behind us, with prospects for full year 2015 inflation in the 2.5% or higher range.

Core CPI (ex-food & energy) rose a strong 0.6% in the quarter (2.4% annualized), but only 1.8% over the past year. This still remains below the Fed's 2.2% target.

The Producer Price Index for final demand advanced 0.4% in June, seasonally adjusted. Final demand prices rose 0.5% in May and declined (0.4)% in April. On an unadjusted basis, the final demand index moved down (0.7)% for the 12 months ended in June.

While most of the producer prices decline has been due to energy costs, the PPI ex-food & energy index rose only 0.7% over the past twelve months.

Nominal retail sales in the 2nd quarter were up a low 1.7%, reflecting little "snapback" from the first quarter's 1.3% contraction. Retail sales have increased by just 1.4% since June 2014. People aren't spending.

Industrial production increased 0.3% in June, but declined at an annual rate of 1.4% during the second quarter. This was the second consecutive quarterly decrease. IP is only 1.5% above its year-earlier levels. Capacity utilization held steady at 78.4% in June, and still remains 1.7% below the long-term average.

Economic activity rebounded in the second quarter after another weak winter period, but the bounce has been muted relative to initial expectations. Most economists expect that slower growth will cause the Fed to keep overnight rates "lower for longer." The wild card is whether the inflation rate continues to firm up.

The Looking Glass Cracks

Government bond yields in Europe bounced sharply higher after deflation fears subsided and the ECB launched its own QE program. In a big unwind of the European gravitational pull on rates, this surge pushed bond yields higher across virtually all advanced economies. While global monetary policy remained unchanged or easier, the vast majority of medium- to long-term bond yields rose. In perhaps the most dramatic example, the German 10-year bund yield dropped to an absurdly low 0.05% in April, only to rise above 1% during the quarter before settling at 0.83%.

Domestic fixed income markets began the quarter on a quiet note but grew increasingly volatile in May and June. The US Treasury yield curve began to steepen in late April as global market investors repriced the path of ECB rate hikes. The rise in longer-term Treasury yields pushed yields on the US Aggregate and Government/Credit indices higher. Broad credit market yields rose marginally more than like-duration Treasuries, as the option-adjusted spread widened modestly on the former indices.

Securitized assets were not immune to the US yield curve's upward shift. The longer-duration profile of the mortgage-backed and CMBS indices (4.5 years) explains most of their total return deviation from asset-backed bonds (2.5 year duration) during the quarter. Further, spreads on the MBS and CMBS indices finished the quarter marginally wider, while ABS spreads were unchanged.

Investment grade credit bonds struggled during the quarter as yield curves in the US, Germany, and UK steepened. The second-quarter spike in government bond yields created more volatility than any other quarter since 2013's "taper tantrum". The low yield and long maturity profile of investment grade credits negatively impacted performance, with the higher credit quality profile doing little to support returns. Excess returns were also negative as spreads widened.

The greater yield advantage and lower duration of high yield corporates sheltered this sector from the sizable losses of investment grades during the second quarter. However, looking back over the past year, this was not the case. US high yield spreads widened during the last twelve months by much more than any other sector (except Greek and Russian bonds), leading to modest net losses for that period. We observe a similar, although less dramatic, pattern with BBB domestic credits, leading to their underperformance compared to the rest of the investment grade sector.

Emerging market sovereign bonds denominated in US dollars performed especially well considering the developed markets bond rout. Corporate EM bonds, with their lower effective durations and higher yields, were the EM market's best performers.

Figure 4: Primary Bond Sector Returns (%)

Index	2Q '15	1 Year	3 Years
US Aggregate Bond index	(1.7)	1.9	1.8
US Gov't: 1-3 Yrs.	0.2	0.9	0.7
US Treasury: Long	(8.3)	6.3	0.9
US Inflation-Linked	(1.1)	(1.7)	(0.8)
Mortgage-Backed (MBS)	(0.8)	2.4	1.9
CMBS	(1.1)	2.0	3.4
Asset-Backed (ABS)	0.2	1.6	1.4
Inv. Grade Credit, 1-10yr	(0.8)	1.6	3.1
Inv. Grade Credit, 10+yr	(7.1)	(0.3)	3.5
US High Yield Credit	(0.0)	(0.6)	6.8
Municipal Bonds	(0.9)	3.0	3.1
Global Aggregate, ($ hdgd)	(2.2)	3.0	3.3
Global Credit	(2.2)	1.5	4.5
Emerg. Mkts Bonds (US$)	(0.3)	0.5	4.3

Figure 5: Primary US$ Bond Yields

	Jun-15	Mar-15	Dec-14	Jun-14	*1-Year Change*
US Treasuries	(%)	(%)	(%)	(%)	*(%)*
3-month	0.01	0.03	0.04	0.05	*(0.04)*
2-year	0.64	0.56	0.68	0.46	*0.18*
5-year	1.63	1.38	1.66	1.63	*0.00*
10-year	2.33	1.93	2.17	2.54	*(0.21)*
30-year	3.10	2.54	2.75	3.34	*(0.24)*
BarCap Aggregate	2.39	2.06	2.25	2.22	*0.17*
BBB Credit	3.96	3.49	3.68	3.36	*0.60*
AA Credit	2.34	2.01	2.23	2.08	*0.26*
Agency MBS	2.78	2.40	2.60	2.79	*(0.01)*
Emerging Mkts ($)	5.81	5.57	5.64	5.35	*0.46*
US High Yield	6.94	6.63	6.71	5.28	*1.66*
UST30y-UST2yr	2.46	1.98	2.07	2.88	*(0.42)*

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Jun-15	Mar-15	Dec-14	Jun-14	*1-Year Change*
United States	2.33	1.93	2.17	2.54	*(0.21)*
Germany	0.83	0.21	0.55	1.26	*(0.43)*
Switzerland	0.11	-0.05	0.38	0.76	*(0.65)*
Britain	2.55	1.61	1.92	2.98	*(0.43)*
Poland	3.31	2.30	2.53	3.43	*(0.12)*
Italy	2.25	1.31	1.99	2.74	*(0.49)*
Spain	2.35	1.27	1.70	2.70	*(0.35)*
Greece (new bonds	15.12	11.16	9.64	5.88	*9.24*
China (5 year)	3.24	3.44	3.55	3.85	*(0.61)*
Japan	0.45	0.37	0.33	0.58	*(0.13)*
Australia	3.01	2.36	2.92	3.59	*(0.58)*
Russia	10.85	11.78	13.44	8.49	*2.36*
Brazil	12.68	13.12	12.67	12.02	*0.66*
India	7.82	7.76	7.98	8.71	*(0.89)*

US Stocks Bump Along

US stock prices were little changed in the past quarter, leaving most domestic stock indices only slightly higher for the first half of 2015. As we enjoy the seventh year of a strong and consistently upward trending bull market, the rate of progress is slowing down. The S&P's total return of just 7% over the past twelve months is once again close to, and even somewhat below, most expectations of long run average results. This follows five years of returns a full ten percentage points higher. Yet, compared to other investment choices US stocks are more than holding their own, as Figure 1 reflects.

The backdrop for equity investors in 2015 has been particularly benign, as US stocks continued to be one of the calmer markets worldwide. So far this year, US stocks have neither climbed nor fell more than 3.5%. That's the lowest volatility ever at the start of a year. Long-term volatility is also benign, as it's been more than 1,375 days since the S&P 500 index dropped 10% (the record is ≅ 2,500 days, from 1990 to 1997).

Although overall equity index returns haven't been exciting so far this year, there are a number of interesting trends within the market, with three in particular standing out. First, with global growth sluggish and in particular the Chinese economy still a bit disappointing, the commodity super-cycle has continued to unwind, leaving many energy, basic industrial and capital goods stocks struggling with falling profits forecasts and some balance sheet distress.

Secondly, the market has been increasingly anticipating higher interest rates; the likely beneficiaries of this trend in the financial sector performed well, while the so-called "bond equivalent stocks" (utilities, REITs, MLPs, and the like) have performed miserably and surrendered all of last year's relative outperformance.

Thirdly, investors continue to show a strong preference for the fastest growing companies. This isn't so apparent in the differential returns this quarter of Russell's large-cap growth and value benchmarks, which were almost identical performers. But within the growth index the fastest growers clearly outperformed, as has been the case over the past year. Indeed, over the past five years, growth stocks have outperformed value across the entire size spectrum (Figure 7).

According to Factset, Wall Street now expects second-quarter earnings for S&P 500 companies to *fall* an aggregate of 4.4% year/year, which would represent the first quarterly decline since 3Q 2012. Expectations have declined sharply as the year has progressed. At the beginning of 2015, second quarter S&P earnings were forecasted to advance 10.3% versus the second quarter of 2014. In terms of full year 2015 earnings, expectations in Janary were for a 16% gain. Today, the forecast for 2015 earnings is only 2% growth.

Figure 7: U.S. Equity Market - Size/Style Returns

		Trailing		
	2Q '15	**1-yr**	**3-yrs**	**5-yrs**
Growth				
Large Cap	0.7	11.1	17.5	18.6
Mid Cap	(1.1)	9.5	19.2	18.7
Small Cap	2.0	12.3	20.1	19.3
Value				
Large Cap	1.0	4.3	16.6	15.9
Mid Cap	(2.0)	3.7	19.1	17.7
Small Cap	(1.2)	0.8	15.5	14.8

The quarter's top performing large/mid-cap sector was once again health care, and by a pretty wide margin. The sector has returned 25% over the past year. It accounts for 20% of the S&P Growth index, but only 5.3% of the S&P Value. Top health care stocks this quarter were Gilead Sciences, AbbVie, and Eli Lilly.

The quarter's weak sectors were utilities, REITs, industrials, and energy. These sectors collectively account for almost 40% of the R1000 Value index, but less than 12% of the R1000 Growth.

Figure 8: US Sector Returns – 2nd Quarter 2015

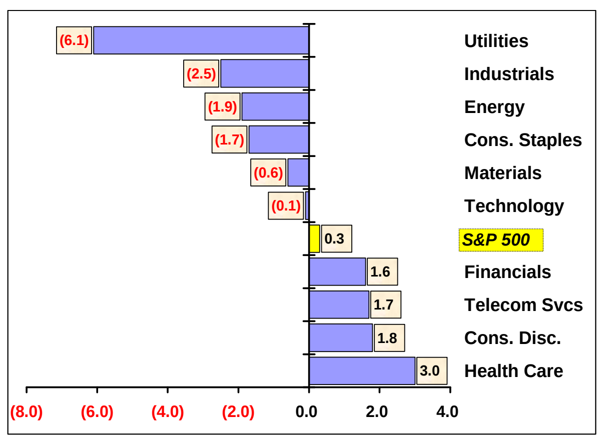


Figure 9: One-year Trailing P/E Ratios - June 2015

	Value	Blend	Growth
US Large	16.9	19.2	22.0
US Mid	19.6	22.1	25.1
US Small	20.5	23.3	27.1
EAFE		17.9	
Emerg. Mkts		13.7	

International Markets – A Greek Drama

Global stock markets produced mixed results in the second quarter. Signs of improving economic growth in the US and the euro zone were countered by fears of rising interest rates and the ongoing debt crisis in Greece. Developed markets, as measured by the MSCI World ex-USA index, rose 0.5% in 2Q. Regionally, the Pacific region outpaced Europe for the quarter (up 1.1% versus 0.4%), with the strong Japan market accounting for all of the difference. UK stocks returned 3.0%, as the pound advanced 6%, while Canada's energy-dominant market continued to slide, declining (0.9)% for the quarter despite the C$'s 1.5% advance.

Figure 10: International Equity Markets – Returns

	U.S.Dollar Returns (%)		Local Currency Returns (%)	
thru 6/30/15	2Q '15	1-Yr	2Q '15	1-Yr
World ex-USA	**0.5**	**(5.3)**	**(1.9)**	**10.5**
- MSCI Growth	*0.8*	*(1.9)*	*(1.5)*	*14.2*
- MSCI Value	*0.1*	*(8.7)*	*(2.2)*	*6.9*
- Europe ex-UK	(0.8)	4.7	(4.4)	10.4
- Pacific, ex-Japan	(2.5)	(6.8)	(3.0)	7.0
- Japan	3.1	8.3	5.2	30.8
- United Kingdom	3.0	(8.2)	(2.8)	(0.2)
Int'l Small Cap	**4.2**	**(4.0)**	**2.1**	**12.4**
Emerging Mkts	**0.7**	**(5.1)**	**0.7**	**6.2**
- EM Asia	*(0.2)*	*3.1*	*0.1*	*8.4*
- EM Europe	*4.3*	*(25.9)*	*2.6*	*0.2*
- EM Latin América	*3.5*	*(23.4)*	*3.2*	*0.3*
- EM BRIC	*4.6*	*0.5*	*3.9*	*13.8*

As the June deadline for Greece to make a €1.55 billion payment to the IMF approached, worries of a default on its debt and exit from the currency bloc sent European markets plunging during the last few days of the quarter. The MSCI Europe index still mustered slightly positive results (+0.4%) for the quarter, helped by a strong UK market and the euro's 3.9% advance versus the US dollar (recovering from multi-year lows in the process). The euro zone's largest economy, Germany, dropped (5.6)%, as economic growth slowed and the nation's business confidence index dropped. Spanish stocks slipped (2.0)%, despite one of Europe's fastest GDP growth rates of 2.7%. Other top performing EU countries were Ireland (+8.5%), Norway (+3.3%), and Austria (+3.1%).

The Pacific region rose 1.1%, led by the Japanese market's 3.1% advance in US dollar terms. The Nikkei 225 rose to its highest level in more than 18 years, helped by aggressive central bank policies and positive economic data. Conversely, the yen weakened (2)% versus the US dollar, reaching a 12-year low.

Financials were the top-performing sector in Japan, as each of its three megabanks jumped more than 18%. Japanese telecom shares gained 9%. GDP grew at an annualized 3.9%, bolstered by increased business spending and strong exports to the US and China.

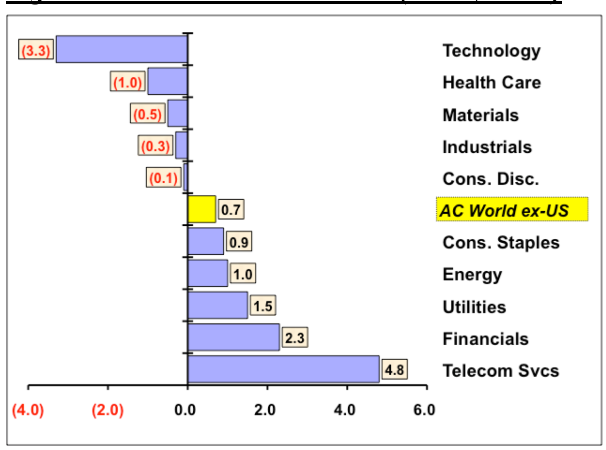
Australian stocks retreated (7.0)%. After leading the country's multi-year bull-run, rising bond yields and weakening economic conditions put the brakes on the financial sector in 2Q. The Australian dollar gained 1.3% versus the US dollar. The Hong Kong market rose 5.6%, driven by the 45% return of Hong Kong Exchanges and Clearing, its sole bourse operator. Casino operators again weighed on the market as the Macau-based gaming sector declined by double-digits.

Despite the quarter-end Greek drama, emerging markets rose 0.7% amid more accommodative policies in China and indications from the US Fed that future interest rate hikes would be gradual. EM Asia fell slightly by (0.2)%, emerging Europe returned 4.3% to once again take top honors, and Latin America posted positive results. Within Asia, despite the 30% correction in China's internal A-Shares market, the external Chinese market rose 6%. Investors continued to support easing measures as the Bank of China cut interest rates twice during the quarter.

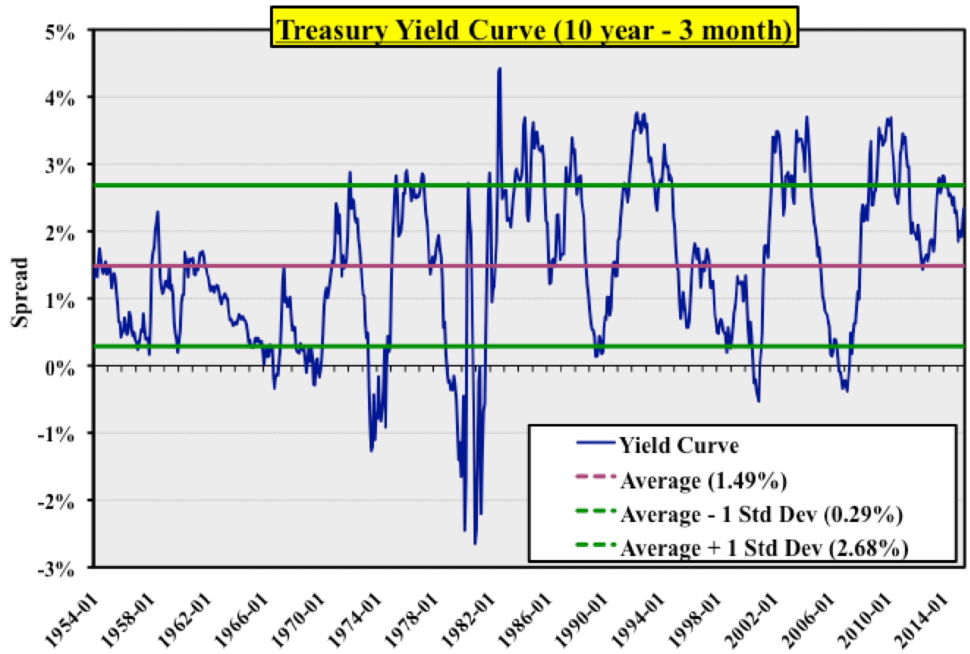
Other Asian countries did not fare as well. India slumped (3.6)% as investors took profits after a strong run. Indonesian markets fell (14)% on disappointing economic data and a 2% depreciation of the rupiah. Weak performance from technology stocks drove negative results in South Korea and Taiwan.

Higher commodity prices boosted returns in Russia and Brazil. Energy giants Gazprom and Petrobras both rebounded. Brazil's government announced budget cuts and more reform-oriented policies, spurring a 7% market gain. The Russian market climbed 7.6%, as the central bank continued to ease, taking the key interest rate down to 11.5% (from 17% at year end). Even so, the ruble appreciated 5% versus the US dollar.

Figure 11: Ex-USA Sector Returns (in US$ terms)



Back Page Perspectives: What about Bonds?



The above chart reflects the *primary* Treasury yield curve over the past **61** years, looking at the spread of 10-year Treasury yields versus 3-month Treasury rates. Lots of data. What's very clear is that the average steepness has been 1.49%, with little or no trending in that number. It's a very good mean. What's also clear is that the yield curve's steepness has hardly stayed the same for much of the past sixty years. It has been constantly changing, generally ranging from 0.3% to 2.7%. Parallel yield curve shifts (where short- and long-term rates rise and fall by the same amount) are an urban legend. Otherwise, this line would be flat.

The other important question to ask is when does the yield curve flatten? At the end of June, the curve was +2.32%, which was well above average steepness. What is the curve likely to look like when the Fed starts raising rates? We've got that chart as well, and can send it to you. What it reveals is that *every* time short-term rates rise, the yield curve has flattened, almost always approaching the 0% point. How quickly it flattens, and by how much, is a function of how firmly the Fed is hitting the brakes and what inflation is doing.

When you run some "what-if" calculations about what bond portfolio returns will look like in a few years, you've got to account for the fact that the future yield curve will be flatter. We posit the following scenario -

- The Fed raises overnight rates to 1% by June 2016. The yield curve flattens by 50 basis points;
- The Fed then raises the Fed Funds rate another 1.0%, to 2%, by the end of December 2016. The yield curve flattens by another 50 basis points, to 1.32%;
- Finally, the Fed raises the overnight rate by another 0.5%, to 2.5%, by the end of June 2017. The yield curve flattens by another 25bps, to 1.07%;
- With short rates now "normalized" above the long-term inflation rate, the yield curve *steepens* 50bps by the end of June 2018, to 1.57%.

How would various bond portfolios perform?

To keep credit/collection issues at bay, let's look at cumulative returns of three investment grade portfolios-

- ✓ BarCap Aggregate ("Core Bonds")
- ✓ BarCap Credit ('Credit Bonds")
- ✓ BarCap Long Government/Credit ("LDI Hedge")

	Cumulative Returns (%)		
portfolio	Year 1	Year 2	Year 3
Core Bonds	-0.30	-1.38	-0.44
Credit Bonds	-0.09	-1.30	-0.15
LDI Hedge	-2.92	-8.66	-10.21

You've got to ask how these returns would compare to a stock market that's currently trading at a trailing PE of 19x, with earnings growth in the low single-digits.

Sell high, buy low. See you next quarter!

Natalka Bukalo
Richard Shaffer, CFA