

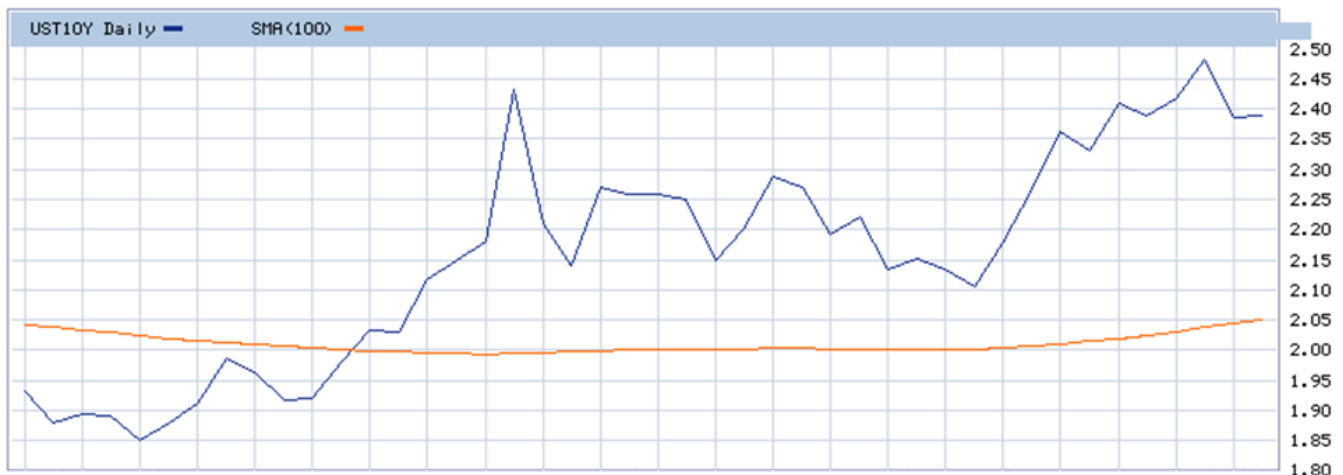
June 2015

Market Update

Domestic equities were up in May with small companies outperforming large caps by a percentage point. On the year, large cap is up 3.2% while small companies have grown 4%. Economic releases are still providing mixed results. In May, housing and employment data looked positive, but manufacturing and consumer spending weakened. International equities pulled back slightly as the MSCI EAFE Index lost a percent and Emerging Markets fell by 4%. These two asset classes are still the best performers year to date; International up 7% and the EM space up 5.8%. Much of the disruption overseas last month came from uncertain monetary policy and currency shifts. Interest rates went up in May, leading to a slight loss of 0.2% in domestic bonds. Global fixed income also fell on the month, slipping 1.1%.

Don't Look Now....

With all the discussion on whether or not the Federal Reserve will raise the Fed Funds rate .25%, you would think that we would notice that it is irrelevant; interest rates have already gone up. Just a quick glance at the US 10 year shows an increase from as low as 1.85% to 2.4%. If my math is correct, that is certainly a lot higher than the 25 bps that we have been talking about for the greater part of three years now. Of course, we do note that 10 years is a great deal longer than a Fed Funds overnight rate, but we need to be attentive to where the market is putting their money a whole lot more than to what the analysts are saying.

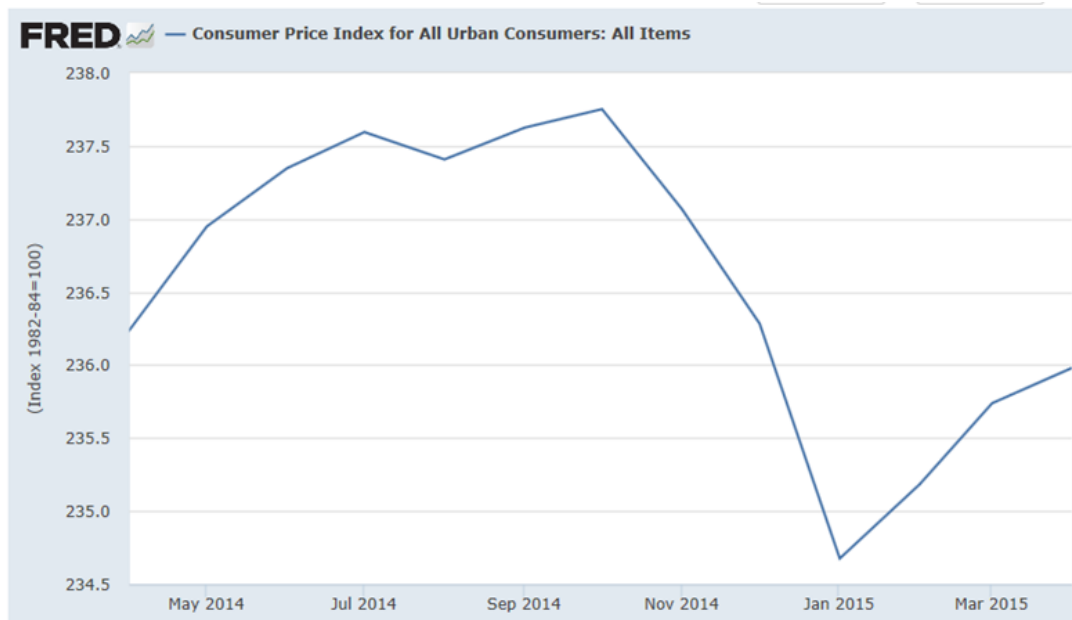


Does this mean that interest rates will continue to rise? This will be influenced quite a bit on people's expectation of inflation. As the chart suggests, over the past 12 months, inflation is down, not up. We have seen a blip up in the last several months, but not nearly enough to compensate for the decline in inflation over Q4 of last year. As with most large aggregate data sets, we need to look at the details to see how, or if, our economy is changing.

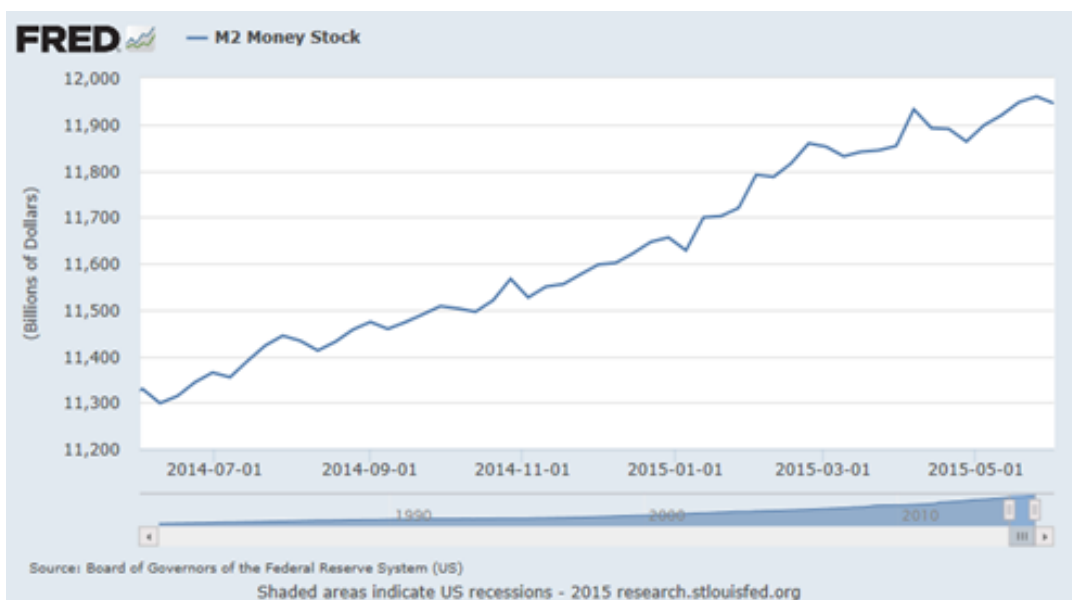
But before we do, let's first identify what inflation is and what it isn't. Let's take a look at two reasons that prices go up. First, let us look at supply and demand issues. This is clearly what has impacted worldwide oil prices. With the increase of US production by way of fracking, supply jumped dramatically. Demand did not increase correspondingly. The dramatic price decline was clearly impacted by this supply/demand issue. I don't think there would be anyone who would claim that monetary policy had a major impact on the price of oil over this time frame.

May Benchmark Returns			
Domestic Benchmarks		May	Q1 YTD
Large Cap: S&P 500		1.3%	3.2%
Small Cap: Russell 2000		2.3%	4.0%
International Equity Benchmarks			
Developed: MSCI EAFE		-1.0%	7.0%
Emerging: MSCI EM		-4.0%	5.8%
Fixed Income Benchmarks			
Domestic: Barclays Aggregate		-0.2%	1.0%
Foreign: Barclays Global Aggregate		-1.1%	-0.7%
Other Benchmarks			
Municipal: Barclays Municipal Bond		-0.3%	0.2%
High Yield: ML High Yield Bond		0.4%	4.6%
Commodity: Dow Jones UBS Commodity		-2.7%	-3.2%
Real Estate: FTSE NAREIT All REITS		-0.2%	-1.4%
Risk Free: US Treasury CD 3 Month		0.0%	0.0%

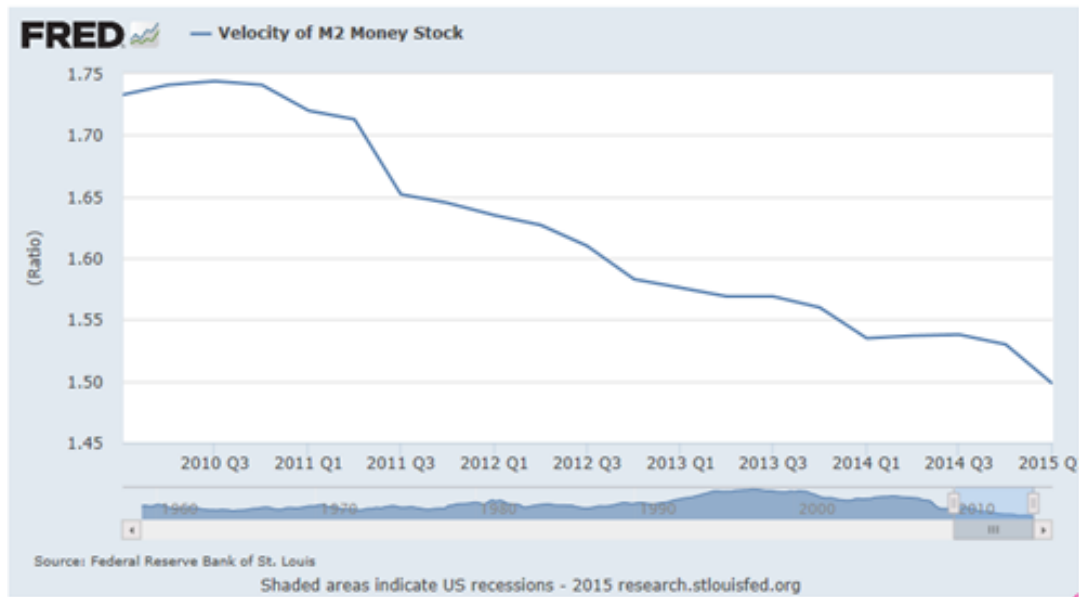
A second reason that prices go up is the result of an increasing amount of money in the economy that is chasing too few goods. This is monetary inflation. A common illustration of monetary inflation is if I took \$10 trillion dollars in \$100 bills and dropped them evenly across the US economy, would the economy grow? The economy would not grow, but prices would rise \$10 trillion dollars. There might be a false sense of growth, but there would be no real growth. To illustrate that differently, what would happen if tomorrow, I could wave a magic wand and move the decimal place to the left one place for every financial transaction in the world? Economically would anything have changed? Sure, millionaires might become \$100,000aires, but their purchasing power would be exactly the same.



So let's look at the inflation in a different light. Many people complain that while the inflation data (CPI) shows there is no inflation, things that they are buying are going up in price. As a result, there must be inflation (monetary inflation). This is not wholly correct, especially at the grocery store. Over the past couple of years there have been many issues that have impacted supply/demand of grocery items, more so than bigger portions of the CPI, such as housing. In the beef category, there was a large drought that caused a lot of cattle ranchers to slaughter their herds, not because the beef prices were going lower, but because the feed costs were getting too high. They could no longer support their herd with the additional costs on the food, so they placed a large portion of their herd to market. This caused beef cost to fall dramatically over a year, but now, because our national herd is so small, beef prices are rising dramatically. There is a similar issue occurring with eggs. The recent avian flu outbreak has caused the slaughtering of millions of US chickens that bore eggs. Egg prices will rise because there are not as many chickens hatching the little oblong wonders that we make food from. This is a supply/demand issue, not inflation. Over a market cycle, we will see both of these items return to normalized prices.



This brings out the trillion dollar question, should the Federal Reserve raise rates based on supply/demand issues within the CPI or is there really inflation out there? The traditional measure of money in the economy does show an increasing amount of money inflation in the market. This is known as M2. Year over year we are seeing money increase at a rate between 5-6%. This would suggest there is monetary inflation coming to the market. The reason that we have not seen it show up is because the velocity of money, or how fast money moves in our economy, has actually been reduced over the past five years.



Combine these two data points and one has to wonder if the Federal Reserve really needs to raise interest rates. Instead of looking at oil prices, beef and egg prices, or even housing prices (which are still down significantly from their highs), they might want to peek at why money is not moving through the market at fast as it used to. It is clear, in our opinion, that there is not much that Federal Reserve Policy can do to change it.

Asset Valuations and Expected Returns

Interest rates and the corresponding impact on currencies are having the largest impact on asset prices during 2015. The equity markets are holding their collective breath every time the FOMC meets. Large positive movements in the US dollar relative to the Euro cause a correspondingly large decline in US equity prices. What these price movements are not taking into consideration are earnings. Over the long run, earnings drive stock prices. In the short run, we have many factors that can influence pricing.

As long term investors, we are less concerned with day to day price movements and more concerned about the long term prospects of each asset class. As such, it can take some time for an investment thesis to play out to its full potential. Our current expectations for domestic equity returns have become quite muted over the past couple of years. We have seen higher than average returns without the corresponding increase in future earnings. Multiples have expanded, and must continue to expand to provide the historic market returns that are expected. This is quite a long shot given the expectation that interest rates will become elevated from prior years rates; employment costs will rise even higher; and capital expenditures must increase from historically low levels.

While this is what the market is giving us from a long term perspective, there have been periods in history where the market has become irrational for long periods of time. We do not expect this to occur in this environment. While most memories are short, losing money in the market gets burned into our consciousness. We still grapple with investors with historic memories of their parents in the great depression. The miserable performance of the decade of the 2000's has been hard to forget for many investors.

We already see many analysts and investors trying to predict the next major downturn and its cause. Bond managers are petrified of the upcoming interest rate hike and what that will do to the liquidity of the bond market. After all, there are many bond traders and managers that have never seen a sustained interest rate hike in their lifetime. The behavioral issues will drive the day. On the stock side, many investors have given up and put all their money in index funds and hope that the politicians and the Federal Reserve will be able to manage the economy toward better returns. The reality is that the headwinds for economy driven investing in the US are incredibly strong.

Historical expectations of market returns will need to be tempered quite a bit moving forward, especially on the domestic side. Bleak by historical standards, a 6% average return over the next three years would be considered healthy by our projections. On the fixed income front, the bond index might be able to eke out a 1.5% average return over the next three years. Expectations of making money in fixed income should be tempered quite a bit. The reason to hold fixed income for the foreseeable future is return OF capital, not return ON capital.

The international side looks much better. Valuations are lower and growth rates are higher. There are other trade-offs one must consider. Currency risks are now heightened, political risks are elevated, security risks continue to plague certain countries, and volatility is much higher than domestic securities. These risks should be compensated through excess returns over the longer run, but short term underperformance and added volatility risk is a necessary byproduct.

As we continually evaluate our portfolios to accomplish the returns that we expect, we must also view the risks that we take. While some investment areas look very promising, we must be continually vigilant about what we can know, and what we cannot know, that can have an impact on our clients' capital. Our process of using Investment Policy Statements to continually evaluate risks keeps us grounded in understanding that while we may be correct in our thesis, there are unpredictable risks that we must account for.

Our current portfolios are over weighted to International and Emerging Market asset classes. We have been asked many times if we should increase our weightings to these spaces. Our evaluation now is based on what additional risks would the portfolio take by increasing our position and would the return be adequate to accommodate those added risks. Our consideration also has to take the time frame that we would be willing to work from. Would added exposure to these asset classes mean we would need to extend our time horizon an additional three years? Would that be appropriate for our clients' capital?

We will continue to evaluate this and other risks as we continue in this low expected return environment. As with every investment we make, there will be a pro and a con. To be academically honest, we know we will not always be right, but we must not sacrifice our clients' goals for a risk that may not have a meaningful impact on their lives.

Thank you for your continued support.

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