

July 2015

Market Update

The second quarter ended on a sour note as global markets were rattled in the last couple weeks, erasing previous gains. On the month, Large Cap stocks lost 1.9% while Small Cap stocks were positive at 0.8%. Halfway through 2015, domestic markets are broadly positive, Small Cap stocks up 4.8% remain favored to Large Cap stocks - up 1.2%.

Continued coverage on Greece and their ongoing battles with monetary issues led the International markets into the red 3% - while still up 3.8% through the first six months. China disrupted the momentum in the Emerging Market space and with the combination of slowed growth, a surprise rate cut, and political interference in their stock market caused a sell-off at local exchanges. The Emerging Market index fell 2.5% on the month while it is also still positive year-to-date by 3.1%.

Real Estate continues to fall after a significant run up last year, down 9.1% this quarter. Fixed Income has been a drag in 2015. Domestic markets are tipped into the red after losing 1.1% in June. Global Fixed Income fell 0.8% on the month but has a loss of 1.5% on the year.

Is the economy as bad as we think or better than expected?

Now that most of the headline news has been somewhat resolved (Greece, China) we can begin to focus on the things that matter, how is the global economy faring? Too often we want to have the response to the question be a one word answer; "great" or "miserable." The challenge is that in today's world, it's just not that simple. We are having extremely disruptive technology introduced to many different sectors with major winners and major losers in sectors. We have extremely accommodative monetary policy that has uneven impacts around the world. We have political groups arguing in favor of policies that, on the surface appear to be beneficial, but in the longer run will have negative impact on growth. How can we sort them out to determine long run asset returns? How can we get back to normal rules of thumb that we can follow and believe?

The answer is to slog through. That is what we have been doing for the past several years. While the market is up substantially since the bottom of the recession, March 9, 2009, rapid economic growth has not followed. The reality is there are converging forces that seem to be keeping exceptional price growth at bay. We begin with technology. In areas where we would presumably be seeing price increases, we are not due to more efficient ways of doing business. Notable areas are first, taxi services. Anyone who lives in a big city is cognizant of what it costs to take a taxi across the city. The new service in Uber is keeping the thought of fare increases far from anyone's mind. It is also lowering the price of entry to anyone wanting to get a new taxi

June Benchmark Returns

Domestic Benchmarks	Jun	Q2	YTD
Large Cap: S&P 500	-1.9%	0.3%	1.2%
Small Cap: Russell 2000	0.8%	0.4%	4.8%
International Equity Benchmarks			
Developed: MSCI EAFE	-3.0%	-0.4%	3.8%
Emerging: MSCI EM	-2.5%	0.8%	3.1%
Fixed Income Benchmarks			
Domestic: Barclays Aggregate	-1.1%	-1.7%	-0.1%
Foreign: Barclays Global Aggregate	-0.8%	-1.7%	-1.5%
Other Benchmarks			
Municipal: Barclays Municipal Bond	0.0%	-0.7%	0.2%
High Yield: ML High Yield Bond	-1.3%	0.5%	3.2%
Commodity: Dow Jones UBS Commodity	1.7%	4.7%	-1.6%
Real Estate: FTSE NAREIT All REITS	-4.1%	-9.1%	-5.4%
Risk Free: US Treasury CD 3 Month	0.0%	0.0%	0.0%



medallion. While this does not help the current holders, it does help those wanting to get in the business, keeping prices down.

There are many other areas of technology that are keeping prices down, such as AirBNB, in the hotel space, Cloud technology in the hardware space, and the saturation of phones in the mobile market.

Second, we continue to see pressure on prices in the overall commodity space, driven by falling energy prices. This can have a couple of different notable effects. First, it could cause overall prices to decline. When inputs to a product decline, a manufacturer can lower the price to gain a competitive advantage and take market share. This, however, is not happening. What we are seeing is that companies are just keeping prices stable and pocketing the differences in the new input cost. Why would they be doing this? They could be just greedy, or, more likely, they have little expectation that commodity prices will continue to stay low. They are holding on for the eventual price increase that will come in a higher interest rate environment. They will then be able to hold prices stable for a longer period of time. They could also be looking at new technology that could substantially lower their overall margins. New competitors with new manufacturing techniques can destroy the old guard. (Think 3d printing coming to a store near you.)

A third converging force is that of interest rates and foreign currency markets. We all know that US interest rates are so low that they eventually have to go up. As we have stated in past, while US rates are low, they are still the highest rates in the developed world. As such, we will continue to see foreign investors flock to the relatively high rate of the US 10 year Treasury note at 2.3%. This will bring in foreign funds for US dollars, strengthening the US dollar even further.

Another converging force is that on the housing market. While we see that home affordability is very low from a historical perspective, and the housing numbers seem to be going in the right direction, they are not moving nearly fast enough as monetary policy should suggest. With a 30 year mortgage hovering around the 4% mark and threatening to rise, there should be an all-out rush to buy new properties. There is not. The converging force is that of that pesky 20% down rule to get rid of private mortgage insurance. This is putting a damper on new homebuyers. Imagine getting out of school, getting a good job, getting married and then getting ready to buy your first house, but you need a big chunk of money to put down first.

It is clear with all these converging forces, that prices are not headed up any time soon. If monetary policy gets too tight, we will again see prices start to fall. This is something the Fed will not tolerate. In our last market update, we suggested that markets rates have already been raised, as evidenced by the increase in the 10 year Treasury yield. While appropriate, the Fed has control over the very short term part of the curve, not the 10 year. The Fed will eventually increase the short end of the curve, causing a flattening of the yield curve. This does not bode well for long term growth in the long run.

In the meantime, however, we are in for a slog in the US markets. Big companies are fighting for their turf, not over market share, but profitability, regulation and technology. This slog will continue a bit longer than it should, but will eventually be worn down. The next big growth segment should come from new companies taking on the old line companies on their turf with new technologies. Hopefully these companies will be formed by US students, perhaps from STEM (Science, Technology, Engineering & Math) programs.

Europe will continue to battle the EU debt fights with Greece, without any meaningful resolution (but it doesn't matter anyway.) And the Emerging Market sector will continue to add up the growth numbers. We may not see it due to currency issues, but when they work themselves out, as they always do, US investors will be well rewarded.

Until next month.

Thank you for your continued support.

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