GREECE AND CHINA DOMINATE THE SECOND QUARTER
A standoff between Greece and its creditors and the bursting of the Chinese stock market bubble tripped up global stock markets in the second quarter. The Greek government surprised financial markets by calling for a national referendum on the latest proposed terms of a bailout extension from its creditors. Stunned by the unexpected decision, the European "troika" withdrew from negotiations and refused to release any more bailout funds. This move led to a breakdown in talks and set Greece on a course to missing its scheduled payment of €1.6 billion to the International Monetary Fund and raised the prospect of an exit from the euro. Meanwhile, the Chinese stock market, which raced up into bubble territory this year, crashed in June losing $2.7 trillion, or almost 25 percent of its value since June 12.

STOCKS: LACKLUSTRE QUARTER FOR U.S. EQUITIES
Worries from Greece and China hit U.S. stocks, which retreated from all-time highs in May to end the quarter down. Total returns were slightly positive because of dividends.

The Standard & Poor’s 500-stock index of U.S. stocks delivered a total return of 0.3 percent and the Russell 2000-stock index of small companies returned 0.4 percent. Healthcare, boosted by the Supreme Court’s decision on the Affordable Care Act, was again the best performing sector, gaining 2.8 percent. Financials also did well as interest rates rose. Rising rates are a positive for banks and insurance companies. On the other hand, higher interest rates are a headwind for utility stocks. The utility sector fell 5.8 percent in the second quarter. International stocks did a little better than U.S. stocks. The MSCI EAFE index returned 0.6 percent while the MSCI Emerging Markets stock index was up 0.7 percent. Russia was a standout as oil prices rebounded from their lows, while German stocks fell due to the standoff between Greece and Germany on the terms of the bailout.

BONDS: SANITY IN EUROPE
After falling into negative territory in the first quarter, yields rebounded across the Eurozone during the second quarter. Signs that the European Central Bank’s bond purchase program was working was largely responsible for the brutal sell-off in bonds. The Eurozone economy accelerated during the second quarter and consumer prices rose for the first time in six months. Germany’s 10-year bond yield, which reached a low of just 0.05 percent in the first quarter, rose to 0.0 percent before settling at 0.77 percent by the end of the second quarter. Yields on the U.S. 10-year Treasury
note rose from 1.93 percent to 2.35 percent as bond prices fell. The Barclays U.S. Aggregate bond index fell -1.68 percent in the second quarter. Yields on investment-grade corporates increased more than Treasury yields and the sector had the worst returns in the quarter — down 2.88 percent. The yield curve steepened during the quarter with the spread between 30-year and 2-year government bonds rising by 0.55 percent. This caused long-duration bonds to perform poorly relative to short-duration bonds. The longer duration Barclays Long Term Gov/Credit returned -7.57 percent for the second quarter. High yield bonds were flat during the quarter with the higher yields of this sector providing a cushion to the increase in rates.

**COMMODITIES: A REBOUND FROM FIRST QUARTER LOWS**

Oil prices rebounded 24.9 percent from their lows of the first quarter as the U.S. dollar weakened against major currencies. The Bloomberg UBS commodity index, which tracks 22 commodities, rose 4.7 percent in the second quarter of 2015. Prices of agricultural commodities also rose due to falling acreage planted and lower inventories.

**OUTLOOK 2015**

At Alerus Wealth Management, we expect the Federal Reserve to begin raising interest rates in the fourth quarter of 2015. The European Central Bank and the Bank of Japan, on the other hand, are expected to continue on their paths of easy monetary policies to combat modest growth and deflationary conditions in their respective economies. These differences in monetary policies imply the dollar should continue to strengthen relative to the euro, the yen, and emerging market currencies.

With inflation as measured by the personal consumption expenditure (PCE) price index down around 1.2 percent, we believe the Fed will “be patient” when moving to higher rates. A stronger dollar and U.S. interest rates that are higher than those of other large economies such as Germany and Japan will also attract foreign investors to the U.S. bond market. As such, we expect rates to stay low for longer and favor fixed-income portfolio durations that are neutral relative to an investor’s benchmark. We also like high-yield corporate bonds, which should do well in a rising rate environment.

While the Fed will begin tightening, other central banks in Europe, Japan, and China will continue to play a large role in supporting their economies and financial markets. This is an environment that favors international stocks, although U.S. equities should do well too. We prefer European equities. Within the U.S., we like the health care, technology, and consumer discretionary sectors, which should benefit from stronger economic growth and low oil prices. We believe emerging market stocks, currencies, and local bonds will be hurt by the stronger dollar as the Fed begins to raise rates.

Low oil prices may be with us for a while. High U.S. oil output along with the potential of new supply from Iran should keep a lid on prices. We plan to be underweight commodities. A stronger dollar, slowdown in China’s economy, and excess supply are not great for commodities. China is dealing with its own credit real estate bubble and an economy that is slowly transforming from investment spending to consumer spending.

**KEY RISKS TO OUR OUTLOOK:**

- **Eurozone Uncertainty** — while there is a bailout agreement in place we are not confident in the Greek government’s ability to implement the plan. We could see calls for a Greek exit from the euro emerge in a few months
- **Interest Rate Risk** — as the Federal Reserve begins to hike interest rates, we could see a correction in the stock market.
- **Earnings Risk** — low oil prices hurt S&P 500 earnings as the pick-up from consumer and transportation stocks may not be sufficient to overcome earnings decline from energy and industrial companies. A stronger dollar will also hurt earnings of large U.S. multinationals that have operations overseas.
- **Geopolitical Risk** — emanating from potential action by Russia. The Russian economy faces the prospect of a severe recession due to sanctions imposed by the West and the fall in energy prices. Vladimir Putin’s popularity in Russia remains very high and there is a possibility that he will become even more aggressive with Ukraine and some of the other neighboring countries.