Virginia Capital Strategies

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Second Quarter Update

As the quarter ended, Greece was making headlines for its June 30 default on a debt payment to the IMF amidst increasingly fraught negotiations with its eurozone creditors, China was in the news for its very sharp short-term stock market decline and surprise interest rate cut, and Puerto Rico announced it would be unable to fully repay its municipal debts. Losses largely resulting from these events erased earlier quarterly gains, resulting in little or no gains for most investors for the second quarter of 2015.

However, it's important to keep Greece's economic impact in perspective. Greece is only a $240 billion economy, which represents less than 2% of eurozone GDP, and less than one-half of one percent of global GDP. Also, most of Greece's debts (82%) are held by government- related, taxpayer-supported entities, not the private sector, where the potential for contagion is much higher.

U.S. stocks were flat in the second quarter but are modestly positive thus far in 2015. Our portfolios benefited from exposure to developed international and emerging-markets stocks, which outperformed U.S. markets through the first six months of the year. Despite issues related to Greece, European stocks gained 5.2% for the year through June 30. Among larger emerging markets, China was a strong positive contributor for the second quarter despite its June decline.

Diversification in our fixed-income allocations also benefited our portfolios. While core bonds declined in the second quarter as Treasury yields rose (bond prices and yields have an inverse relationship), our shorter term, international and credit- sensitive bond funds solidly held their ground.

In summary, the second quarter offered little if any gains for investors, and year to date, returns are flat to modestly positive.

The Economy

On the U.S. economic front, first quarter GDP growth was revised higher in June though it remained in slightly negative territory after a harsh winter depressed economic activity. Among the positives, job growth remained strong and the housing market appeared in decent shape as average home prices hit levels not seen since 2006. U.S. dollar strength relative to other currencies is generally viewed as a potential headwind for manufacturers; however, the dollar's pace of gains cooled after a strong first quarter and declined in the second quarter relative to the euro (though it appreciated versus the yen). The dollar is still higher relative to major currencies over the past 12 months. A stronger dollar dampens foreign earnings for the U.S. companies and makes U.S. goods potentially less competitive overseas.

The eurozone economy has shown some sign of improvement; for example, first quarter GDP growth for the region was higher than expected, though still low in absolute terms, and eurozone inflation was positive in May and June after five months of flat to negative reading, though it too remains very low. These readings leave plenty of room for additional stimulus from the European Central Bank, which launched quantitative easing (sovereign bond buying) in the first quarter, a move widely viewed as a positive for the region's economy and financial markets. Japan's stock market was strongly positive in the second quarter and for the year to date amidst improved GDP growth in recent quarters (following the country's recession during the second and third quarter of 2014).

How We View the Big Picture

We often use the term "big picture" as shorthand to represent the many external forces (global economic cycles, monetary and fiscal policy, national elections, geopolitical conflicts, etc.) that shape the environment in which we invest. This past quarter, the outlook for Greece was a dominant one. The timing of the U.S. Federal Reserve's first interest rate hike is another example, with many investors and economists anticipating the Fed will take this much-watched step in the fall or early winter. In its most recent policy statement, the Fed itself suggested a rate increase may be warranted this year, but thus far improvement in the employment picture and inflation have not been sufficient to warrant the change.

These situations and others of their kind all fall into the category of *important but unknowable.* As such, they warrant some attention from us but not, in most cases, a specific reaction. Instead, our approach is to consider a range of potential outcomes that inherently encompass a variety of risk scenarios and then build portfolios that we believe are resilient and robust across this range.

Current Positioning

We remain neutrally allocated to U.S. stocks in our balanced portfolios as the potential returns looking out across our five-year investment time period are not high enough to fully compensate us for increasing exposure. We evaluate the attractiveness of stocks by analyzing the five-year outlook for company earnings relative to stock prices across a variety of economic scenarios we believe are plausible. By this standard, U.S. stocks look less attractive, offering only mid-single-digit return potential over the next five years in our base case scenario. With corporate profit margins at historically high levels and stock prices expensive, the potential for earnings to disappoint the market's expectations (as reflected in those high prices) is meaningful. Looking back at just what we've seen so far this year, S&P 500 profit margins, while still high, have turned down over the past two quarters, and S&P 500 earnings growth expectations have been steadily coming down since last year.

We realize U.S. stocks may continue to deliver attractive returns over short- or intermediate-term periods. Supportive monetary policy can be a powerful influence, as we've seen before. Interestingly, history suggests the beginning of a Fed rate-hike period is unlikely to trigger a major stock market plunge or mark the beginning of a bear market, particularly if the Fed has convinced the markets it will be unusually gradual in its pace of tightening. That said, this has not been a typical monetary policy cycle (to say the least!) and with the federal funds rate pinned at or near zero for the six-a-half years, the first moves off of that may increase market volatility and could be a catalyst for a market correction (i.e., something on the order of 10% decline). Based on history alone, we are overdue for one. The S&P 500 has now gone almost four years (45 months) without at least a 10% decline, making this the third longest such stretch since World War II. Prior to this recent run, market corrections occurred roughly once a year, on average. We note all of this not as a short-term market prediction, but as plausible shorter-term scenario to be aware of and prepared for.

Consequently, we've continued our commitment to international and emerging market stocks as our assessment remains that expected returns are very attractive relative to U.S. stocks looking out over the next five years. Despite a rebound earlier this year, European stock market prices and corporate earnings (which are well below their long-term trend) still have room to improve, both on absolute terms and relative to the United States. The Greek situation may clearly lead to more market volatility over the near term, however, we believe we have adequately factored a reasonable worst case outcome into our 12-month downside stress test scenarios for our portfolios.

Our top-down analysis for emerging-markets stocks is similar to our analysis for European stocks, in that their prices look attractive and earnings appear to be depressed relative to our longer-term expectations. We also take into account specific risks to emerging markets, namely the potential for a sharper slowdown of growth in China and the risk from a stronger U.S. dollar. However, even when taking these risks into consideration, over our five-year investment time horizon, our analysis still shows compelling return potential relative to U.S. stocks. We also believe skilled active managers can add a lot of value in the emerging-markets space as divergence across countries and companies should be large, which can create opportunities for stock pickers.

On the fixed-income side, we are maintaining a balance between traditional core bonds and interest rate risk and specialty bond funds that focus either internationally, are short term in nature or are primarily credit sensitive.

Looking ahead, we know there are inevitably going to be shorter-term surprises, including negative ones. In fact, the potential for surprises should not be surprising, though we know they will still feel uncomfortable for many investors. This is why it's so important to take a long-term investment view when it comes to positioning client portfolios. Our recommendation continues to be to pursue a moderate risk approach, and we caution investors not to increase risk at this point in the cycle. Diversification remains key, although we realize that having investments in underperforming asset classes can be frustrating. Once lower prices ultimately occur, additional investments into risky assets will take place at that time.

As always, we appreciate your confidence and welcome questions about your individual situation.

Sincerely,

Stephen J. Bowery, CFA, CFP