Beacon Trust Quarterly

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Second Half Outlook

While temperatures across the country are sizzling in seasonal fashion, first half investment returns from major asset classes were quite tepid. Given the hysteria surrounding Greece, China, and timing of the first Federal Reserve rate hike, broad asset class returns were essentially flat. Our expectation that the US stock market would outperform bonds was barely realized. The S&P 500 produced a total return of 1.2% versus -0.3% for the Barclays Aggregate Bond Index. Stock market volatility was also muted. The VIX Volatility Index actually declined 5% during the first six months despite anticipation of higher short-term borrowing costs in the US, divergent monetary policies globally, and a seemingly eternal Greek bailout drama. Bond volatility, on the other hand, skyrocketed. (We commented during this period that perhaps bonds were the new stocks.) The Merrill Lynch Option Volatility Index (MOVE) for bonds increased by one-third during the half. We attribute this primarily to the vast curtailment of dealer underwriting capacity and proprietary trading stemming from Dodd-Frank legislation and the Volcker Rule. International equity market returns comfortably exceeded that in the US. Developed market (DM) international equities returned 6.5%, and emerging market (EM) equities delivered 3.3% or one-half the DM result. Investors were lured by quantitative easing (QE) and growth prospects in the eurozone and Japan. Low valuations attracted investors to EM equities despite the slowdown in China, dollar strength and weak commodity prices. The Dollar Spot Index (DXY) rose 6% against major foreign currencies. The price of West Texas Intermediate (WTI) crude oil rose 4.6% during the period to $59.47 but hit a low of $49.65 on St. Patrick's Day (3/17). From an asset allocation perspective, very few asset classes stood out. It was a fairly boring though eventful first half.

It appears that the first quarter mild contraction in real GDP was indeed due to transitory factors (weather and West Coast dock strike). Several key economic indicators point to the soft patch being over. Our key barometer of the economic outlook , the ISM Non-Manufacturing Index (NMI), which covers 90% of the economy, continues to anticipate 4% nominal GDP growth during the short run. With low inflation a likely prospect, real GDP should approximate 3% during the second half. Key to this forecast is the mood and spending of the consumer. Underpinning the outlook for moderate growth in consumer spending is accelerating wage rates. As suggested in our March 6 commentary, "The Great Wage Debate - Take the Over," wage rates have turned the corner.

The accompanying charts depict wage acceleration as measured by the Employment Cost Index and the NFIB Small Business Survey. Other supportive indices include Average Weekly Earnings, Personal Income Salary and Wage Disbursements, and the Quit Rate. Higher wages give rise to increased purchasing power. There are other factors supporting our moderately higher consumer spending outlook. These include lower energy prices, a higher savings rate, and improvement in household formations.

With wage rates accelerating, the inflation rate stable, and the unemployment rate (5.3%) close to the Fed's full employment range of 5.0%-5.2%, we believe funds rate liftoff will commence in September. Fed Chair Yellen has also given stronger hints of near-term action in recent speeches and testimony. We agree with her position that the path of rate hikes is more important than the timing and that the path will be gradual.

We are maintaining our 2,240 upside target for the S&P 500, representing a 9% gain from the December 2014 average. Our main guideposts of dividend return and corporate credit spreads are intact, although the latter bears watching as it is close to the top of our estimated range. In addition, S&P 500 earnings might surprise to the upside this year as consensus expectations were driven lower by the plunge in oil prices and the strong dollar. Oil prices have recently dipped further, perhaps in anticipation of a less favorable demand/supply balance and the lifting of Iran oil sanctions. Regarding the dollar, we believe the year-to-date peak in the Dollar Index at 100 will hold during the near-term, implying a stable rather than strong currency.

We continue to forecast that bond yields (10-year Treasury) will remain flat on average for 2015 at 2.50% or slightly lower. This would result in a modest positive return from bonds, but one trailing stocks. Stable inflation and institutional demand for bonds should support our forecast. Bond volatility is likely to remain elevated due to the aforementioned dealer constraints.

International developed market equity returns could keep pace with that in the US based on QE and economic recovery. Emerging market returns might continue to lag, however, due to slower growth and weak commodity prices.

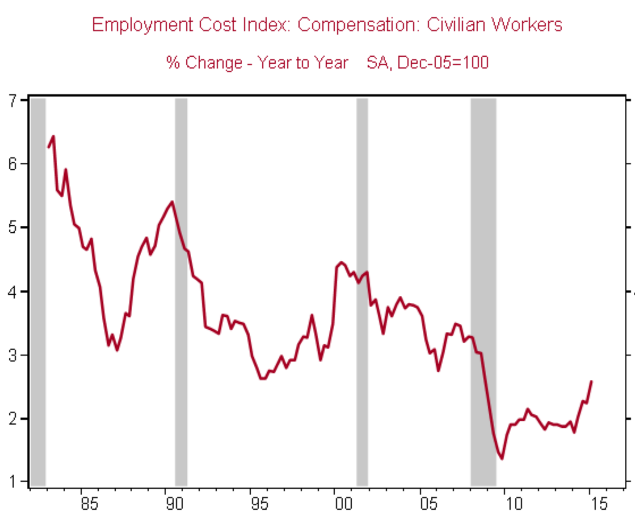
Geopolitical risk will remain a troubling aspect of the landscape. Greece has passed the baton to China where government stock market intervention has introduced a supersized version of QE. While the timing and location of the next event is in doubt, rest assured it is coming.

Closing Thought

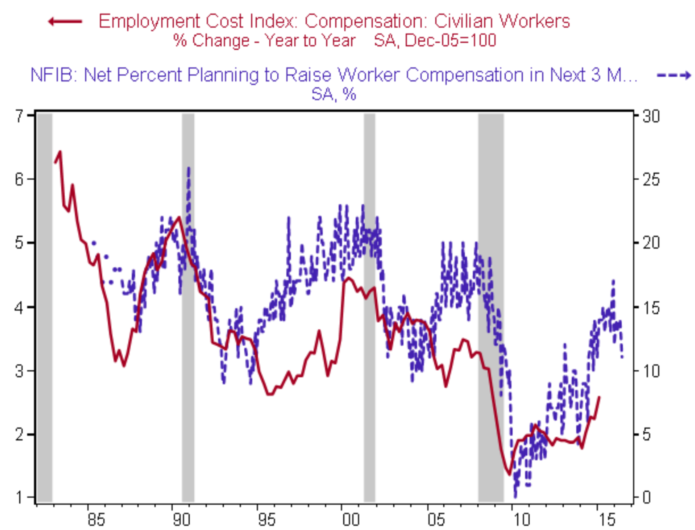
Active management is an integral part of all our strategies and models. In other words, we seek returns greater than market benchmarks, such as the S&P 500, by selecting securities or asset classes that, based on our analysis and judgment, will outperform. We are not closet indexers.

That said, we recognize the value of long-term investing. A recent quote from BlackRock makes a cogent point, "Time in the market produces better results than trying to time the market". The rewards of long-term investing are achieved with patience, low turnover and talent.

Alan D. Segars, CFA
Chief Investment Officer



Source: Bureau of Labor Statistics



Source: BLS, National Federation of Independent Business