

Overview

The US equity markets performed relatively well in May. The S&P's 500 Total Return Index and the Russell Mid Cap Index were up 1.3% and 1.4% respectively. The Russell 2000 (Small Cap Index), on the other hand, was flat for the month.

Most notable on the international front were the declines of broad emerging market indices such as the FTSE Emerging Market Index and the MSCI Frontier 100 Index. They dropped 3.6% and 3.9% respectively as a consequence of softer commodity prices (down 3.4%) and a stronger USD (up 2% against most currencies).

As a result of these conflicting developments, our four model portfolios finish the month flat to up .125%, after fees. YTD our diversified portfolios are up 2.6% to 3.9%, from the most conservative to the most aggressive. This compares to a YTD performance of 2.7% for the S&P's 500 and 3.9% for a portfolio consisting of a 60% allocation to the MSCI All Country World Index and of a 40% allocation to the US Bond Aggregate.

As an illustration of some of the developments during the month, below is a chart of VWO, the emerging market ETF we favor.

This ETF was down 3.6% in May, opening at \$43.9 on May 1 and finishing at \$42.3 on May 29. Our portfolio allocations to this ETF range from 0% to 5%.



Market developments

Commodity prices, measured by the Dow Jones Commodity Index (DJCI), were down 3.5% in May. The USD was up about 2.2% against the Euro and 3.7% against the Yen. The US long bond was down 2.5% and Intermediate Corporate Bonds down 1%. These moves reverse some of the price actions we saw in April and reflect the conflicted nature of most markets since the beginning of 2015.

To illustrate this point, below is a chart of an ETF that tracks the performance of the DJCI. This ETF was at \$19.2 at the beginning of 2015 and sank to \$17.8 on March 17 (down 7.5%). It then hit a high of \$19.5 on May 14 (up 9.4% from the bottom) and is now at \$18.7. Hard to figure out!



US equity valuations remain at the higher end of their historical ranges, whatever the metric used. This, together with the impending increase in interest rates that the Fed wants to engineer, contributes to a general feeling of unease for many investors.

Whether we have a correction in the next few months or not remains to be seen. That said, nobody should be surprised if we do. I tend to think that a 5% to 10% drop is the most likely scenario, in the absence of geopolitical developments that might add to an already volatile economic and monetary mix.

Yet, the US economy is doing relatively well. Europe, in spite of its problems, seems to be on a slow mend. The rest of the world, as distressing as the news may indicate, produces and consumes with India and China chugging along at a 5%-7% annual growth rate. In that context, and in spite of the worries, a retreat from the market remains difficult to justify.

Tilts and Allocations

We have not made any changes to our allocations in May. We remain overweight European equities, within our International developed equities. Our investment in this sector was up .7% in May thanks to our partial euro hedge. This position is up 10.5% YTD.

As indicated earlier, our emerging market allocation was a significant negative contributor to our May performance and more than offset the gains of our US and European equities positions. Our emerging markets positions this month were down 3.5% on average and mirror the performance of the volatile commodities markets.

The graph below compares VWO, a broad emerging market ETF, with DJCI, a broad commodity index ETN (Exchange Traded Note).



While the correlation between the two sectors is high, the market seems to recognize that there is more to the emerging markets story than commodities. VWO is up 6% so far this year. The DJCI is down 3%. Our portfolios hold VWO. We do not have a position in DJCI.

Concluding remarks

Geopolitical risk is difficult to translate into actionable investment decisions but try we must!

Currently, the Greek government is playing with its creditors. The markets seem to be rather nonchalant about the real possibility of bankruptcy and its consequences for Europe and the rest of the world.

I have heard the arguments: 1) the Greek economy is small relative to the EU, 2) European banks and insurers have had time to make themselves ready for a possible Grexit, 3) The ECB stands ready to support the banking system there....

I vividly remember the months preceding the Lehman debacle and the very public discussions about the logic of letting one of the investment banks go down. Bear Stearns was forcibly merged, in-extremis. When it came to Lehman, personal rivalries between the heads of Wall Street firms may have played a part in the fateful decision that eventually led to their demise. We are still paying a price for this economic catastrophe.

If Greece exits the Euro not only will the economic impact on Greece be severe, it might have an effect on this country's geopolitical positioning in Europe. Prime Minister Tsipras' recent visits to Moscow may not be just political theater. A rapprochement with Putin's Russia, although remote at this point, would cast a pall on Europe and the European project. Who knows where such a development might lead if it were to become a reality? There is enough there to lose sleep over it.

For now, the probability of a Greek exit from the Eurozone is increasing with each day that passes without an agreement. One way to mitigate this risk is to add to our short Euro position against the USD. This is what we did on June 2. We will unwind this additional hedge if and when the current discussions lead to an agreement.

As usual, please feel free to contact me with your questions and comments.