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Second Quarter 2015

The End of Pretend

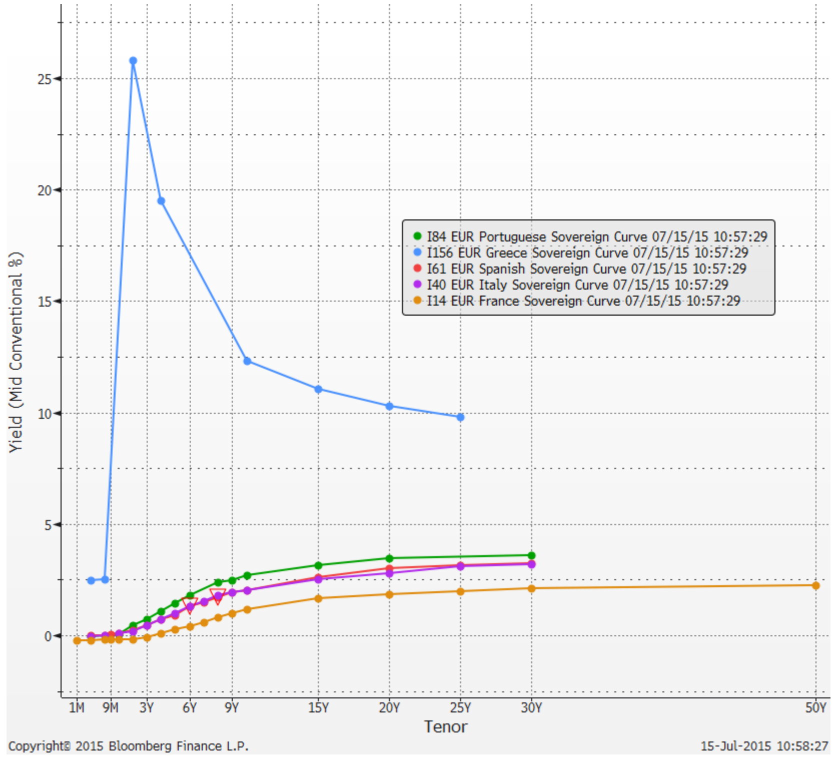
Crude oil and other commodities rebounded in the second quarter and long term interest rates rose rather dramatically in Europe and the United States, while global stock markets advanced only modestly due to heavy selling late in the quarter. The possibility of a Greek exit from the Euro and a Chinese stock market meltdown have been at the forefront of investors' concerns for several weeks, and both situations have been addressed in recent days by government actions, though their efficacy is still not certain. In Europe, this meant another round of tense negotiations between Greece and other Euro Members, the two sides sparring over reforms, austerity programs, new taxes and write-downs of existing debts. In China, where mainland stocks (A-Shares) dropped more than 30% in less than four weeks, the Party response has evolved from injections of cash to short sale bans, bans on insider selling, trading freezes and finally outright criminalization of "destabilizing activity." Most observers expect a witch hunt, though the Shanghai A-Shares Index is still up 21% year to date through July 10th, and up 95% over the past twelve months. Adding to the turmoil, Governor Alejandro Padilla of Puerto Rico stated in an interview with *The New York Times*, published June 28, that the Commonwealth's debts were unpayable. Puerto Rico is running out of cash, and is preparing to submit a debt restructuring plan to bondholders by August 30.

Index, Currency or ETF Returns	Second Quarter 2015	Year to Date 2015
WTI Crude Oil	24.94%	11.64%
S&P GSCI (Commodities)	8.73%	(0.21%)
Euro vs U.S. Dollar	3.88%	(7.86%)
NIKKEI 225 Index (Japan)	3.55%	14.39%
Euro Stoxx 50	(1.50%)	2.99%
MSCI Emerging Markets	0.81%	3.05%
MSCI All Countries Ex U.S.	0.69%	4.37%
Russell 2000 Index (Small Caps)	0.42%	4.75%
S&P 500	0.28%	1.23%
SPDR Barclays High Yield Debt	(0.60%)	1.93%
JP Morgan-Alerian MLP	(6.29%)	(11.56%)
iShares U.S. Treasury: 20+ Year	(9.55%)	(5.75%)

Total Returns in U.S. Dollars. Source: Bloomberg.

The standard toolkit for managing a debt crisis includes a combination of higher inflation, faster growth, and defaults. Ideally, monetary and fiscal measures are deployed with policy changes that reform sclerotic economies by reducing red tape and corruption. Deflation, economic contraction, high unemployment and utter lack of reform have instead crippled the Greek economy, raising pressure on the last relief valve - default. It may still be a line in the sand to most northern European creditors, but the concept of reducing Greek debt to more manageable levels is now endorsed by the IMF, the U.S., and the European Union President, Donald Tusk. It is also no surprise that other heavily indebted European countries such as France, Italy and Spain have voiced support for debt relief. Softer words have been used, such as "re-profiling," but it is our view that a new realism is emerging in the sovereign debt markets, and for municipal issuers like Puerto Rico and Illinois. This may help explain large changes in the value of "risk free" assets like government bonds relative to equities during the first half of 2015.

Another explanation for higher long term rates would be better growth prospects in Europe and the U.S., something the Fed would like to see precipitate a hike in the Federal Funds rate this Fall. Positive economic developments across southern Europe may also account for the lack of contagion from Greek travails this time around. As shown in the graph to the right, interest rates in Portugal, Italy, Spain and France remain anchored well below Greece. Investors seem satisfied that Greek debt is "ring-fenced," or held in perpetuity if need be by well funded institutions like the IMF and the European Financial Stability Facility, therefore off the balance sheets of interconnected global banks. Commentators like to minimize the impact of default or "Grexit" by mentioning Greek GDP is roughly the same as Connecticut or Louisiana. Whatever the outcome, we see problem borrowers acknowledging the need for meaningful structural reforms (the Greek Parliament voted to accept the terms offered for its latest bailout on July 15th), and lenders opening the door to soft defaults and restructurings. Things would certainly get a lot better with some growth and modest inflation, but for now we are stuck at the messy intersection of politics and finance.



Our clients know we have been underweight long term bonds in their portfolios. We, along with others, have questioned the utility of classic stock and bond asset allocation models when interest rates are so low and upside for fixed income investors is diminished. We have also studied the issue of deteriorating liquidity in the bond markets post crisis, and concluded that some investors are paying a premium for safety when they should instead be receiving a premium for poor liquidity. A lot depends on the path of rate rises which is difficult, if not impossible, to determine. Certainly the Fed would like interest rates to drift upward in a controlled fashion, and they know that persistent, elevated volatility would be unhealthy for a wide variety of markets whose valuations are sensitive to movements in government bonds. In this environment, it makes sense for us to stay focused on companies with clean balance sheets, strong competitive advantages and less sensitivity to rising interest rates, adding fixed income exposure to managers with flexible mandates, and to those who operate in the most liquid parts of the bond market.

Robert G. Scott
Chairman & CEO

David H. M. Baker, CFA
Chief Investment Officer

Source of data not specifically cited: Bloomberg.

Special Notes to Our Clients and Friends:

Earl "Bud" Watson III, our long-time Partner and friend, joined North American Management Corp. on June 16, 1983, and retired at the end of June after thirty-two years of service to the Firm. Bud graduated from Boston University in 1977 with an MBA, and received an M.S. degree in Taxation from Bentley College in 1984. From 1965 to 1970, he served in the U.S. Navy as an aviator, and retired from the Navy Reserves in 1985, having attained the rank of Commander. He has been an active member of the American Institute of CPAs and the Massachusetts Society of CPAs, and served on the Federal Tax Committee of the Massachusetts Society. As a member of the Personal Financial Planning Division of the American Institute of CPAs, he has been designated a Personal Financial Specialist.

Bud brought a special combination of knowledge, creativity, integrity and good humor to the office every day, and we will think of him often when we serve our valued clients in the years ahead. We wish him well as he enjoys the next phase of life with his family and friends.

In June 2015, North American Management was named as one of the *Financial Times'* "300 Top Registered Investment Advisers" ("RIAs") in the U.S. in the publication's second annual FT 300 list. In addition, North American was recognized in *Financial Advisor* magazine's 2015 Registered Investment Adviser (RIA) Survey and Ranking, which lists the largest RIA firms based on 2014 year-end assets under management. NAM appeared in the survey's $1 Billion and Over Asset category and was ranked as the 145th largest firm out of 562 participating RIA firms across the nation. More information is available on our website, www.namcorp.com, but we thought our readers would like to know. It is gratifying to be on these lists, more so to be working with the team that made it possible.