BRIDGES INVESTMENT MANAGEMENT

Think Forward

Market Comments
July 2, 2015

S&P 500	2077
10 Year yield	2.38%

What are the most important things investors should know at the halfway point of 2015?

1. Capital markets returns were modest in the second quarter and for the first half of 2015:

Index	Second Quarter	First Half
S&P 500 Index	0.28	1.23
S&P MidCap Index	-1.06	4.19
S&P Small Cap Index	0.20	4.15
MSCI EAFE Index	-0.37	5.94
MSCI Emerging Markets	-0.24	4.25
Barclays U.S. Aggr Bond Index	-1.68	-0.10

2. The S&P 500 ended the second quarter at 2063, down slightly from 2068 at the end of the first quarter (dividends in the second quarter made the total return for the quarter marginally positive), and up slightly from 2059 at the end of 2014. U.S. equities have seen considerable day-to-day price volatility thus far in 2015, but stocks have essentially moved sideways, finishing the first half the closest to "unchanged" in a first half of a year since 1928. We expect continued, if not increased volatility in the second half of 2015. It would not be a surprise to see either a 20% decline or a 20% gain in the S&P 500 over the next twelve months, or both.

3. Stocks remain close to our estimate of "fair value" and we believe are currently priced to provide mid-to-high single digit returns from current levels over the next several years, albeit with increasing levels of interim volatility. If stocks were to decline by 20%, we believe they would provide excellent long-term value; we would be inclined to reduce commitments to stocks in the event of a 20% increase in stock prices in the short-term.

4. We currently estimate "fair value" for the S&P 500 at ~2200-2250 for year-end 2015 (17-18x estimated earnings of ~$120-125), and ~2300-2400 for year-end 2016 (17-18x estimated earnings of ~133-140). Our fair value estimates imply total returns for stocks of ~6-9% in the second half of 2015, and ~10-15% from current levels through the end of 2016. We define "fair value" for stocks as the valuation level from which long-term future returns will be dependent solely on earnings growth and dividends, because valuation, in terms of the price-earnings multiple investors place on stocks, is "fair" – the level at which stocks are neither significantly undervalued nor overvalued. At present, we believe stocks are fairly valued at 17-18x earnings, in line with long-term historical average valuations for U.S. equities. If long-term interest rates remain between 2-3% (for the 10-year Treasury), we believe that a somewhat higher P/E for stocks would be justified (~20x). We believe that stock valuations currently discount an eventual return of interest rates to 3.5-4.0%.

5. We believe bonds remain unattractive because current interest rates remain very low on both a nominal and real (nominal yield less inflation) basis. Given the unattractiveness of bonds, we remain both underweighted in bonds relative to other stocks, and defensively postured within bond portfolios. If interest rates rise from current levels (2.0-2.5%) to 3.0-4.0% over the next several years, it is likely that bond returns will be negative. We continue to expect that stocks will outperform bonds over the next three to five years, or until such time as interest rates return to more normal levels.

6. Corporate earnings growth remains a critical factor to our constructive long-term outlook for stocks. Second quarter earnings season will provide a good insight into the effect of a strong dollar on the earnings of U.S. corporations, and we will be closely watching management guidance for earnings for the second half of 2015 and 2016. Aggregate S&P 500 earnings are being slowed by a stronger dollar and lower energy prices, but helped by ongoing strength in health care, technology, and some consumer discretionary sectors, as well as by ongoing share repurchases by companies with excess cash.

7. We are looking for opportunities to increase our exposure to international equities, which have performed better than U.S. equities since mid-2014. On the one hand, international equities are “cheaper” than U.S. equities, and the strong dollar has increased the attractiveness of non-U.S. stocks, but economic growth outside the U.S. remains sluggish; long-term, we continue to favor U.S. equities over international stocks.

Summary

Overall, capital markets returns in the first half of 2015 were modest. We expect rising volatility, as investors weigh economic risks in Europe (Greece), the impact of a strong dollar, and the effects of an eventual end of the accommodative Federal Reserve stance.

In the current challenging capital markets environment, we remain very defensively postured with respect to bonds, and we continue to focus equity investments on those companies with strong and enduring business franchises, demonstrable records of growing shareholder value, growing levels of free cash flow, and attractive long-term valuation characteristics.

Our current capital markets expectations are attached.

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President