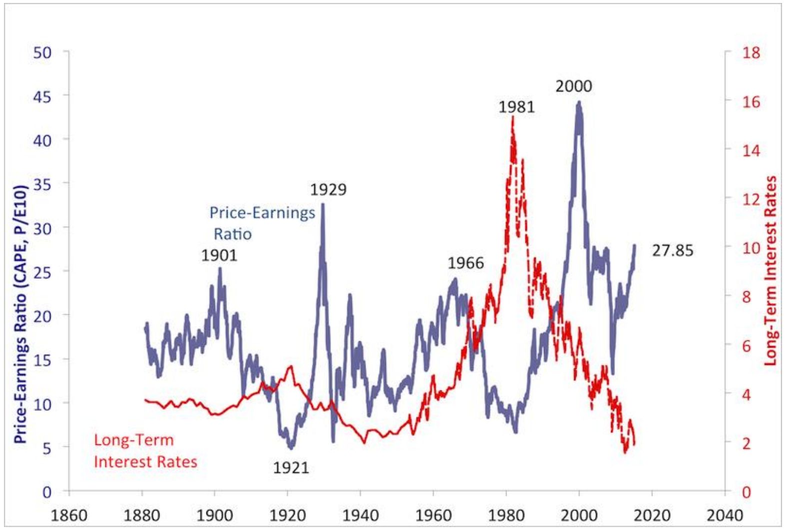
Market Recap

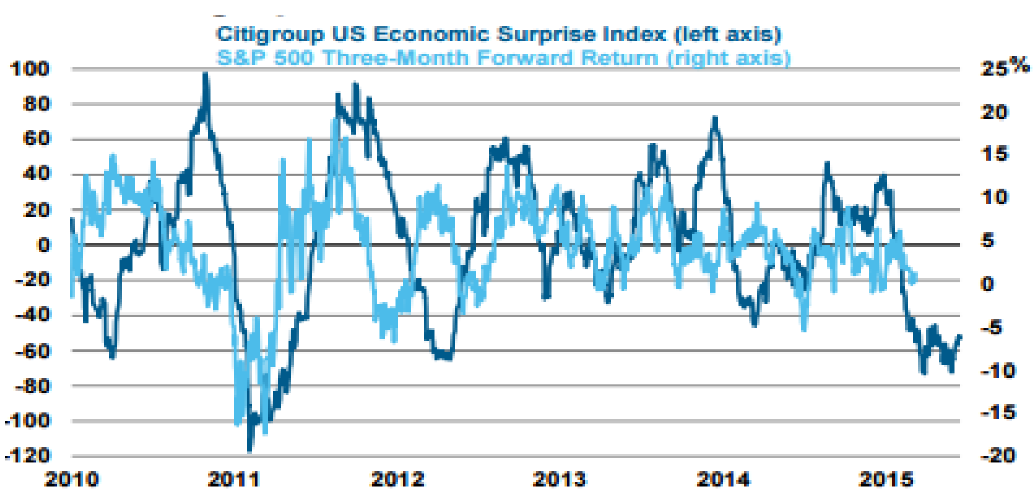
Cyclically Adjusted Price/Earnings versus 10-Year Treasury Yield



Source: Robert Shiller

There is a commonly-held notion that today's high stock valuations (Price-to-earnings ratios) can be rationalized due to historically low interest rates. When considering the opportunity set available to them, investors are willing to pay more for stocks in lieu of placing funds into low-yielding bonds. Ironically, it is the low interest rate environment itself that makes today's valuations difficult to justify. Low interest rates have inflated the earnings side of the price-to-earnings ratio, making valuations appear far cheaper than they would otherwise. For the better part of a decade, company profit margins have been buffered by cheap borrowing costs. Once interest rates begin to trend higher, increased borrowing costs will drive profit margins down. In turn, valuations will soar even higher, revealing just how expensive stocks have now become.

Stocks and U.S. Economic Data



Source: Morgan Stanley

Much of the U.S. economic data released during the first quarter of 2015 fell below expectations, fueling concerns about the broader economic recovery in the U.S. The majority of the disappointing data was blamed on the brutal winter weather across much of the country, the strengthening dollar, and the West Coast port shutdown. In the second quarter, some economic news has recovered, with the biggest surprise to the upside being the May jobs report. In addition, the increased Central Bank stimulus in Europe, Japan, and elsewhere is giving investors reasons to be optimistic. Typically, such improving financial conditions would be applauded, however today this good news is overshadowed by concerns that an improving economy will accelerate the interest rate tightening cycle.

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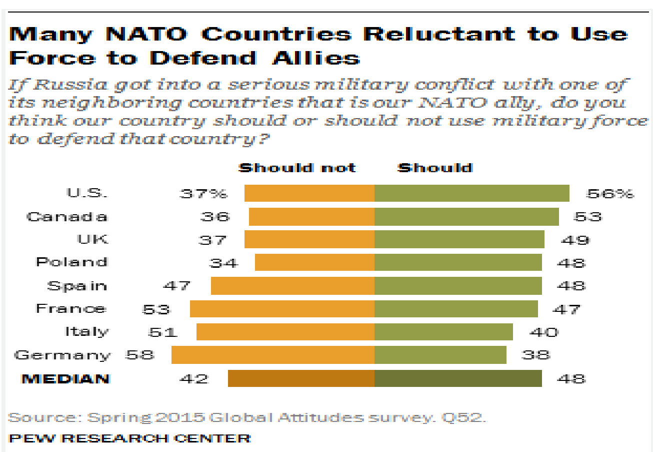
Income Growth Can Make a Significant Difference Over Time

	Stock A		Stock B	
	Dividends per Share	Dividend Yield	Dividends per Share	Dividend Yield
Year 1	$2.50	2.5%	$2.50	2.5%
Year 2	$2.50	2.4%	$2.75	2.6%
Year 3	$2.50	2.2%	$3.03	2.7%
↓	↓	↓	↓	↓
Year 5	$2.50	2.0%	$3.66	3.0%
↓	↓	↓	↓	↓
Year 10	$2.50	1.5%	$5.89	3.6%
Assumptions				
Capital Appreciation per year		5.5%		5.5%
Initial Yield		2.5%		2.5%
Dividend Growth per year		0%		10%

Source: Barclays

The Strength of the NATO Alliance



Source: Pew Research Center

While many dividend investors focus on current yield, it is also important to consider a company's ability and willingness to increase dividends over time. These companies usually have the same interests as value investors whereas they focus on high return on investments (ROI), and pursue increased efficiencies in their operations. Also, these companies usually carry less debt, which helps them in a rising rate environment and usually translates into higher returns to investors through increased dividends. The increasing dividend can add significant value to an investor over time compared to a company that has a similar stock price and current dividend yield, but that does not increase its dividend. As illustrated, a modest annual dividend increase vs. a static dividend leads to a significant divergence in dividend yield over time.

The most basic tenet of the North Atlantic Treaty Organization is written into Article V of the group's charter: an attack on one member is an attack upon them all. This collective defense principle is backed up by the premise that all member nations would band together in the face of any singular attack. Increasingly, political analysts are asking what would *actually* happen if Russia made some sort of military provocation against any of the NATO states along its border (Estonia, Latvia, Lithuania). Public opinion surveys reveal that, while most nations would prefer not to engage, the nation least likely to come to the defense of NATO members in that area, by a factor of 3-2, is Germany—crucial in that Germany is widely seen as a de facto leader of the European contingent on these matters. The German government would clearly be in a serious quandary – potentially without the support of its people - if this scenario were challenged.

Contact: If you have any questions or comments, please do not hesitate to contact us at 703.992.6164. For more information about Harbour Capital Advisors, please visit our website at www.harbourcapitaladvisors.com.

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