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The second quarter saw a continuation of the frenetic volatility that has characterized the stock market environment since September of last year. The range in the second quarter was tighter, however, than in preceding months (back and forth from roughly 17,600 to 18,350 on the Dow) with essentially no net change over the three-month period. The S&P 500 returned a small fraction of 1% for the quarter, with most other equity indexes in the minus column. Stocks closed the quarter near the bottom of their recent range, bringing prices back to November levels.

With interest rates still not far above historic lows, most bonds lost money in the second quarter. Risk-free cash equivalents continued to provide virtually no return, thanks to central bank policy.

Vacillating headlines about the potential insolvency of Greece or of another bailout had a huge influence on markets, as stock, bond and currency levels moved in step with rumors and announcements. As I write, European countries are working to see whose money they will use to enable Greece once more to stave off a formal default. Realistically, there is no way Greece will ever repay all the money it owes; but the collective judgement of its creditors is that the consequences of a formal default would be worse than another episode of "extend and pretend." The markets seem comfortable ignoring reality and settling for the pretense that Greece or somebody will someday make good on the growing pile of debt.

Greece, however, is far from the only debt pretender. A recently published report from the highly respected McKinsey Global Institute highlighted the bloated, unsustainable levels of debt that have been amassed globally, and the huge risks they present when interest rates eventually begin to rise. The report made the point that rather than deleveraging since the 2007-08 financial crisis, the world has added about 40% to the debt levels that precipitated that crisis. The current amount is a staggering $200 trillion, a level that, according to McKinsey, "poses new risks to financial stability and may undermine global economic growth." The report contends that "government debt is unsustainably high in some countries." Pointing to China specifically, McKinsey voices concern that "half of all loans are linked, directly or indirectly, to China's overheated real-estate market; unregulated shadow banking accounts for nearly half of new lending; and the debt of many local governments is probably unsustainable."

While all U.S. Government promises will certainly never be fulfilled in dollars at today's value, most of those commitments lie well into the future, and the federal government has the privilege of printing more of its own currency. Minus those two advantages, Puerto Rico has recently had to admit that it is close to default on some of its $72 billion of debt. "The debt is not payable," according to Puerto Rico's governor. Many U.S. investors hold Puerto Rico bonds--directly or indirectly--because of the island's special tax exemption. According to Morningstar, 80% of Puerto Rican debt is in muni-bond funds, despite five years of recession and the island's low

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junk bond ratings. This is yet another example of the danger of ignoring risk and reaching for yield. We'll soon see who gets paid and how much.

Similarly, holders of Illinois and New Jersey debt may have reason to fear being less than fully repaid. Will the U.S. Government cover unpaid liabilities of its states, as Europe has been doing for Greece? Probably, but it's a gamble risk-averse investors should be unwilling to take.

With debt levels growing around the world and governments almost universally responding by expanding the money supply, we continue to build a small gold hedge. While deflation appears to be a more immediate concern in most countries than inflation, the dramatic increase in money supply lays the foundation for a potential inflationary spiral. So long as major central bankers continue to "print money", we will gradually expand that hedge if we can do it at progressively lower gold prices.

Abandoning all caution has been the path to maximum investment success for more than the past six years. By driving interest rates to the zero bound, the Federal Reserve and other major central banks have done their utmost to eliminate risk-free return and to push investors to take risk. Until recently, accepting such risk has been amply rewarded. Stocks and bonds have risen, and various currency plays have worked as central banks have anticipated.

Suddenly, earlier this year, the Swiss National Bank reneged on its stated policy, in place for 3 ½ years, to hold a 1.2 peg between the franc and the euro. Market pressures overcame the central bank's policy pledge. The value of the currencies diverged by 38% in just a few minutes. There was no opportunity to escape. Because of heavy leverage, some investors and a few firms were wiped out. Now comes China.

Over the past year, the Chinese equity market has been the quintessential example of a government-influenced market. To offset the negative psychological effect of an economy growing at its slowest annual rate in a quarter of a century, the government did its best to stimulate the equity market. It cut interest rates several times, injected funds into the banking system and cheered investors. The process worked as market prices soared. Even after prices had almost doubled in less than a year, the People's Daily, the Communist Party's mouthpiece, declared that "4,000 (points on the Shanghai Composite index) was just the beginning." As the belief grew that the government had investors' backs (shades of the Greenspan, Bernanke and Yellen put?), new investors flocked to open brokerage accounts. Over 40 million new accounts were opened in the year ending in May. At the peak, accounts were being added at a rate of over 3 million per week. Deutsche Bank marveled at the stunning lack of sophistication of these new investors. Two-thirds had left school before they turned 15, with a third leaving at age 12 or younger, and 6% illiterate. Because the market looked to be a guaranteed moneymaker, the idea of borrowing to make even larger investments seemed to be a no-brainer. And borrow they did, committing about one-third of a trillion dollars to the major equity markets. Such margin lending rose to as high as 20% of the total market capitalization. By comparison, it is about 2 ½% in the U.S. That lack of sophistication didn't prevent Chinese speculators from making money, however. Prices ultimately rose about 150% to the June peak, at which point the average price/earnings ratio was about 57. Everybody was making money until it suddenly stopped.

In about three and a half weeks, one-third of the value of Chinese stocks disappeared, as prices plummeted day after day. Margin calls led to more selling. Many investors were in disbelief. Where was government support?

Destroying any pretense of a reformed Chinese free market, the government stepped in with both feet. Once again, authorities have cut interest rates and reserve requirements. They suspended initial public offerings, which could divert potential investments. Directors, senior management or any owner of more than 5% of a company's stock are not allowed to sell for the next six months. Institutional holders are to refrain from selling until the Shanghai Composite rises above 4500. Companies have been ordered to submit plans to stabilize their stock prices with such measures as share repurchases or employee shareholder plans. Authorities are planning to take action against "hostile short-sellers." Chinese police and stock regulators are also announcing crackdowns on illegal stock and futures trading, spreading rumors, insider trading and stock manipulation. In case those measures should prove insufficient, over $200 billion is being made available to state-owned brokerages to buy shares directly. Bloomberg just reported that China Securities Finance has an additional $483 billion available to support the stock market. Sounds like a free market to me. Imagine how eager investors will be to put new money into a market in which they might be forbidden to sell. Wow!

This direct monetary intervention is reminiscent of U.S. bankers banding together to buy stocks to stem the 1929 market crash. In our county that worked briefly, but market forces ultimately overwhelmed artificial intervention, and prices continued their decline in the biggest stock market collapse in U.S. history. In the current environment of immense government central control--even in ostensibly free markets--it will be fascinating to see how long such intervention will outweigh fundamental market forces.

Despite seven years of historic government stimulus, fundamental conditions continue to deteriorate around most of the world. The International Monetary Fund has recently lowered its global growth estimate for 2015 to the weakest rate since the financial crisis. The White House budget office dropped its U.S. outlook to 2% from 3%. And the Fed's Federal Open Market Committee began dropping its 2015 GDP projection in early-2013 to 3.3%. In subsequent meetings, it progressively dropped its estimate to 3.2%, 3.1%, 2.8%, 2.5% and a month ago to 1.9%. Along with declining GDP projections, earnings growth estimates continue to slow, yet equity prices and price/earnings ratios have expanded, fueled by newly printed money. Expectations of improving economic conditions have been wrong for the past several years, yet faith in ongoing central bank support has held stock prices near all-time highs.

Warnings have begun to surface from respected sources. The Bank for International Settlements, the central bank for the world's central banks, expressed concern that "an unprecedented period of ultra-low interest rates masks deep weaknesses in the global economy." Former Fed governor Larry Lindsey warned that U.S. debt and capital market distortions keep building. "Eventually, the Fed will find itself way behind the curve. And that is going to be a very disturbing event for the markets and the economy."

Government support has so far overcome deteriorating fundamentals, and a great many investors have come to view those issuing warnings as "the boy who cried wolf." No matter how long prices defy weaker fundamentals, however, history argues convincingly that fundamentals will ultimately prevail. One of the unfortunate lessons of history is that the longer distortions last, the greater the number of investors who come to believe this time is different and who lose patience with time-tested valuation principles. Having had a largely negative view of debt and valuation levels since the end of the 1990s, we have great sympathy for those who have been unwilling to ignore the risks present throughout the first decade and a half of this century. Notwithstanding the past six years having marked the longest period of dissonance between price and fundamentals, we have been greatly rewarded throughout our history for remaining patient and correctly anticipating a reversion to long-term means. Our client portfolios came through the most recent two bear markets with flying colors. In the 2000 to 2002 50% stock market decline, our clients saw their portfolios grow. During the horrendous 37% S&P 500 decline in 2008, we couldn't quite put up positive numbers, but our average portfolio declined a mere fraction of one percent.

Many years earlier, we had serious concerns about the Japanese stock market that had been screaming upward for years, far outdistancing any relationship with underlying fundamentals. While we professed no significant expertise regarding the Japanese market, a profound appreciation for the dangers of severe overvaluation led us in 1987 to caution investors to avoid exposure to Japanese stocks. Stock prices continued to rise. We repeated our caution at our 1988 client conference with the market continuing its persistent ascent. In 1989 we urged readers and listeners to trust history, rather than embrace "It's different this time" thinking. While prices continued up through the remainder of the year, the bubble burst on New Year's Eve. The market closed 1989 at roughly 39,000. From there prices plummeted, hitting 14,000 in 1992 and ultimately bottoming at about 7,000 in 2009, taking prices back to the levels of the early 1980s. There's an old saying, "You can't fool Mother Nature." Similarly, you can't indefinitely defy fundamental norms that have prevailed for a century or longer, no matter how long excesses prevail.

Today's debt excesses around the world are the most severe in history. In this country, valuations exceed those throughout history but for the dot.com bubble at the turn of the century, from which point stock prices were more than 50% lower nine years later. Over the decades, there has been a very clear negative relationship between valuations at the time stocks are purchased and subsequent returns. With valuations currently stretched near all-time highs, stocks are swimming against the historic tides in the years ahead. And the experiences this year with the Swiss National Bank and the Chinese stock market demonstrate how quickly such losses can unfold.

Aldous Huxley famously observed: "Facts do not cease to exist because they are ignored." The facts are that debt and equity valuations remain at dangerous extremes, having been ignored for years. Instead, trust has been placed in government's willingness and ability to keep stock prices elevated. So far over this market cycle, that trust has been well placed. Investors are still faced, however, with the dilemma of whether to bet on a continuing divergence between equity prices and underlying fundamentals or to expect market prices to revert toward historic fundamental norms. For all but relatively short-term traders, we strongly suggest the latter alternative. It is important to recognize that, for virtually all investors, they don't get to keep what they have at market highs but rather what still remains at market lows. And given how overextended this market is after seven years of powerful government support, we fully expect there will be opportunities to get more aggressive in equities in the quarters and years ahead at lower prices--possibly substantially lower.

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