March 5, 2017

Overview

In February the S&P's 500 total return index rose 3.97%, the Russell Mid-Cap index was up 3.10% and the Small Cap Russell 2000 rose 1.93%. US bonds were generally up and monthly performances ranged from close to 0% on short-term treasuries to 1.03% on intermediate maturity corporates and 1.45% on high-yield bonds (Bloomberg High Yield Index).

In February, the USD was up 1.6% against a basket of major currencies. In spite of this, international developed equity markets were up again a respectable 1.49% (S&Ps' EPAC BMI). The picture was even better for emerging markets. The MSCI EM was up 3.06% in February. It seems that a rise in the value of the USD no longer automatically translates into negative performances for international equities. This is a good development for geographically diversified portfolios such as the ones that we advocate and manage.

Below is the 3-year chart of the S&P's 500 with its 200 (orange) and 400 (blue) moving averages. At the bottom of the screen (in blue) is a measure of relative strength (momentum).

This chart tells a rather bullish story for now. The orange line has decidedly moved above the blue one. That said, the relative strength indicator at the bottom signals a likely pause in the rally. If only on that basis, a bit of caution is warranted.

In February our client portfolios rose between 1.25% and 1.60%. YTD these accounts are up between 2.73% and 3.92%. This compares to YTD performance of 3.30% for a purely US-centric portfolio consisting of 50% SPY (ETF for the S&P's 500) and 50% BIV (US bond aggregate ETF proxy), over the same period.

As a reminder, our allocation to equities currently varies from a minimum of 30% to a maximum of 60%, depending on the risk profile of each client.

Market developments

Below is a chart that pictures the performance of the SPY (ETF for the S&P's 500 index) and of one of Vanguard's Intermediate bond ETFs since the beginning of 2017.

As of March 3, SPY is up 6.6% YTD (blue line), while the intermediate term bond proxy (orange line) is flat to slightly negative. It is unlikely that US equities markets will continue on this path for much longer without additional fuel in the form of fiscal stimulus and/or real infrastructure spending.

Tax breaks at the individual and corporate levels are not likely to come before August, as per the new Secretary of the Treasury. That is an aggressive timing and many believe nothing will happen before next fall. As for infrastructure spending, it will have to wait probably until 2018 and long after any possible "repeal and replace" of the ACA. The bond market in February appeared to reflect those doubts. The long bond rallied 1.65% during the past month injecting some doubt in the post-election narrative of a US economy ready to accelerate. It may not accelerate or not as fast as the equities market have been suggesting.

Where does this leave us? We know with almost quasi certainty, barring a black swan event, that the FED will hike interest rates in March or June at the latest. We know that equity valuations are stretched. Add to this relatively challenging short-term environment a market where individual investors are only now, late in the game, pouring in and you have many of the ingredients for a market pause or even a bit of a correction.

While I do not see yet enough reasons to pull back from US equities, the reasons for adding to existing positions are few and far between. There may finally be better opportunities internationally.

Tilts and allocations

In February, we added marginally to our Eurozone positions. EZU, the Eurozone ETF that we use to invest in the region, has gone up nicely since the beginning of the year (4.74%). We are of the opinion that it will continue to do so in spite of the heavy political uncertainty surrounding three of the founding members of the European community: France, Germany and the Netherlands. A relatively weak Euro that helps German, French and Dutch exporters in particular, encouraging signs of acceleration in consumption, and an improving employment picture should all contribute to continued equity markets gains across the region.

In addition, Eurozone equity markets are currently valued at 14 times forward earnings vs. 18 times for US equities. Momentum and relative pricing are favorable to increasing exposure to the region.

Technical indicators support our view. Below is the chart for EWG, the ETF that tracks the German equity market. I love the way it looks!

Elsewhere internationally, the outlook remains also supportive of emerging markets. Here is the chart for ECON, the ETF that follows consumer stocks in emerging markets**.**

As long as the USD does not run upwards too fast, international equity markets seem to offer a relatively benign risk/reward environment. We are positioning portfolios to take advantage of it.

Concluding remarks

Political uncertainty, stateside and abroad, dominates the news coverage.

The toxicity of the political discourse in the US is eroding the institutions that support and guarantee our democracy. The press, the FED and the Judiciary are recurrently disparaged by the new administration. In this corrosive environment the chances of getting anything done in terms of economic policies are diminished.

In Europe, and in France in particular, the stress of a two-decade economic stagnation combined with persistent ethnic strife and the more recent migratory flows from Africa and the Middle East are all contributing to a distressing political environment. If France elects Marine Le Pen as its president, in early May, the unraveling of the European project might become almost unstoppable. If, on the other hand, reason wins over emotions and a moderate is elected, Europe could finally be in a position to decisively reassert its core values of openness, tolerance and reaffirm its commitment to economic liberalism. This is what I expect will happen.

A lot is at stake, here and over the Atlantic.

Best regards to all.