FLEURUS INVESTMENT ADVISORY

September 4, 2017

Overview

August brought heightened volatility to equity markets. Thin trading, continued White House dysfunction and geopolitics all contributed their bit. At the end of the month though, US large cap equities were basically unchanged. The S&P's 500 total return index rose .30%. The damage was a bit more pronounced for the Small cap sector with the Russell 2000 down 1.27% As of the August 31 market close, the S&P's 500 total return stood 11.93% above its January 1 opening, while the Small Cap index was up 4.42% on the same basis.

The heightened market volatility caused the US long bond to rally in August. Bond yields went down across the yield curve. The long bond benefitted the most from a perceived increase in market risk and returned 3.43%, as illustrated in the chart of the US Long Bond Treasury Futures index below. That index was up 2.86% in August.

In an environment of greater political uncertainty, both domestically and internationally, the USD managed to stay flat for the month, against other major currencies. This helped emerging market equities to another good monthly performance. The MSCI Emerging Market index was up 2.01% in August. This brings its yearly performance to 26.14% so far this year.

In August our client portfolios rose between .27% and .66%. YTD these accounts are up between 9.50% and 12.31%. This compares to monthly and YTD performances of .68% and 8.18% respectively 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 periods.

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

On August 11, the saber rattling between the US and North Korea caused markets to drop 1.5%. In a typical risk-off reaction, the yield on the US long bond dropped as illustrated earlier. With geopolitical tensions somewhat abating shortly thereafter, equities started to recover, only to suffer another 1.5% drop following the events of Charlottesville and the White House's response to them on and around August 17.

US equities were able to recover gradually over the remainder of the month with the departure of Steve Bannon, Chief White House strategist, and Gary Cohn's decision to remain as Chief economic advisor to the President, after drafting a letter of resignation over the US President's response to the events in North Carolina.

Below is the chart of the ETF that tracks the performance of the S&P's 500 over this tumultuous period. The grey vertical line marks the beginning of August.
The two large red vertical lines, to the right of the chart,

illustrate the market effects of the North Korea rethoric on August 10 and of the events in North Carolina on August 17. From a technical standpoint the blue line which represents the 50-day moving average, seems to have offered the market a good support from which to bounce.

With rising tensions between the White House, senior republican senators and the more radical elements of the Republican Party, the events of the past month have increased the likelihood that this president will not be able to implement his economic agenda. Whether related to tax reform, the passing of an infrastructure bill or negotiations over the debt ceiling, the chance of this White House accomplishing meaningful economic reforms in the near future looks increasingly compromised. I am hard pressed to think that this will be without consequences for US equities.

Tilts and allocations

In my previous newsletter I indicated that since economic conditions were relatively benign in the US and around the globe, my plan for August was to do very little in terms of asset allocation. Well! That did not happen.

The style and substance of the president's responses to the tension in North Korea and to the events in Charlottesville; the departure of three White House staff members in July; no substantive legislative accomplishments since taking office in January; and obstruction of justice charges against the president potentially looming, have all caused me to reduce US equities by 5% across all of my client's portfolios.

I am concerned that the US government is moving towards a constitutional crisis. If this concern morphs into reality, volatility between now and the culmination of the crisis will rise. This will happen in an environment where US equities are already fully valued. This mix of conditions justifies, in my view, reducing our US equities allocations.

On a related but distinct note, here is an intriguing development. Below is a chart that illustrates the bond and currency markets reactions to the events of the month of August.

When market uncertainty increases, investors here and around the globe tend to sell equities and buy bonds; US bonds in particular. This in turn causes bond yields in the US to drop (bond prices to rise) AND the US dollar to go up. This scenario did not completely unfold in August.
The blue line on the chart above is that of the Vanguard Long Term US Bond Index. The orange line is that of USDU, an ETF that tracks the relative value of the US dollar against the currencies of its major trading partners.

US and geopolitical tensions caused the US bond index above to rise about 1.7% in August. However, the US dollar stayed mostly flat over that period. A possible interpretation is that most of the bond buying was US based. Perhaps some of the international investors that usually flock to US bonds in times of heightened uncertainty are starting to wonder about the appropriateness of doing so, when a good part of the uncertainty is originating from the US. If this interpretation proves correct and enduring, the long-term market implications could be sobering.

Concluding remarks

The legislative agenda in September is heavy. The posturing in Congress remains ominous, although the devastation caused by hurricane Harvey may mollify enough members to bring about legislative compromise and avoid a debt ceiling debacle.

If the Trump White House manages to skillfully shepherd negotiations on this issue, meaningfully move forward on tax reform and shows an ability to ease tensions on the international front then the sturdy economic environment that has supported equities so far in 2017 may continue to do so a while longer.

That is an optimistic set of assumptions!

Best regards,