FLEURUS INVESTMENT ADVISORY

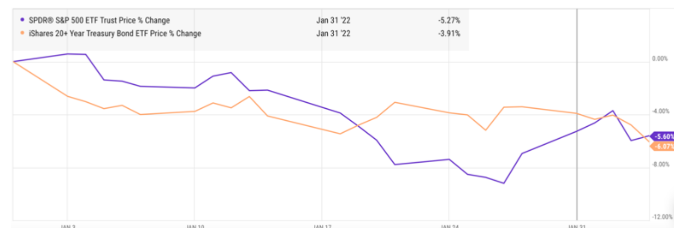
February 4, 2022

Overview

The year started anxiously for most investors. Inflation fears coupled with uncertainty about the pace and depth of the Federal Reserve's monetary response pushed market volatility significantly up. Equities went down across the globe, with few exceptions other than for equity markets tied to oil.

The S&Ps' 500 went down **5.17%.** The Nasdaq Composite suffered more with a loss of **8.96%,** after entering correction territory earlier In the month. The Russell 2000 (small caps) registered a **9.63%** loss. Internationally, developed markets declined with the S&P Epac BMI down **5.80%**. Emerging markets performed a tad better with the MSCI Emerging Markets index down only **1.89%,** due to the positive contribution of oil-dependent economies that benefitted from a continued surge in oil prices.

There was little relief to expect from fixed income markets. They suffered losses as well, as shown below:



The chart illustrates the YTD performances of SPY, the S&P's 500 ETF (purple line) and of TLT, the ETF for US bonds (orange line). The vertical line marks January 31. At that time SPY was down 5.27% and TLT down 3.91%. A balanced portfolio of US equities (50%) and US bonds (50%) would have lost about 4.6% in January. Shorter duration bonds (these are bonds with shorter maturity and or less sensitivity to interest rates movements) did only marginally better with monthly losses hovering between 2% and 4% in most sectors.

Last month, the performance of our clients' portfolios ranged between losses of **3.64%** and **5.59%.** Over the same period, a portfolio consisting of 50% ACWI (All Country World Index) and 50% AGG (US Bond Aggregate) declined **3.28%**. The equity allocation in our clients' portfolios varies currently from 40% to 70%, depending on risk profiles.

Market developments

For the most part, what happened to markets in January is the consequence of uncertainties surrounding the pace and magnitude of the Federal Reserve's monetary response to inflation in the US economy. The main tool at the Fed's disposal in its fight against inflation is the Fed funds rate, the rate that anchors the interest rate that banks use for all their lending activities. The higher the Fed funds rate, the higher the cost of borrowing in the economy. As interest rates increase, the economy slows and, it is hoped, so does inflation. But why would that cause equities to drop or to vacillate?

As interest rates rise, the present value of a flow of earnings drops. Since this is the base of equity valuation, all things equal otherwise, higher interest rates put a downward pressure on all equities and, by the way, on all other assets. It is just a matter of time (think housing here…).

Over the foreseeable future, the Fed is going to try to bring inflation down from its current annual rate of 6%-7% to a more manageable 3%-4%. It will attempt to do so without jeopardizing the strong employment and economic rebound that the US economy has enjoyed since April 2020. This will require on their part as much artistry as technical skills.

In this complicated context, it is no surprise that markets would wobble. This condition is likely to continue until more clarity comes out of the Fed, particularly with respect to the size of the interest rate increases that are expected to start in March and until the duration of the inflationary pressures in the economy becomes clearer.

Adding to this rather complicated environment is the situation with Russia and its menace over Ukraine, and Europe in general. While it is impossible to evaluate precisely what effect this situation has on equities, it can only increase uncertainties.

Tilts and Allocations

Early in January, I started selling our BUFTX investments. This investment disappointed me in 2021. With a growth and mid-cap orientation, this mutual fund should have done better than the 14% they achieved last year. I accelerated the selling of BUFTX throughout the month as the rotation away from growth stocks that had started in November gained more momentum by mid-January. As of the end of January, most portfolios no longer hold BUFTX positions.

Additionally, I sold all our investments in EWG, the German equity ETF. What prompted this decision was the combination of deteriorating equity market conditions overall, as discussed previously, AND the actions of Russia in Eastern Europe. Germany being the European economy most exposed to Russia, I felt that reducing further our total equity allocation by divesting from Germany was a good way to reduce our overall risk. Taken together, the sales of BUFTX and EWG have reduced the equity allocation in most clients' portfolio by close to 10%. As of now, I see no reason yet to reverse course.

On a different subject, in the recent past several clients have asked me about investing in gold. The problem I have with gold is that its price behavior is unfathomable (to me and to many others). One argument used to justify an investment in gold is that "it is a good protection against inflation". The evidence that gold is a good hedge against inflation is flimsy at best. It has not been true historically, except for very rare periods of extreme distress caused by wars mostly.

The fact that GLD, the ETF that tracks the price of gold (below), has not budged since the beginning of the current inflationary period, for the past year, should give any would-be gold investor some pause.

Conclusion

We have entered a new and intricate phase of the economic and monetary cycle. One that requires a reversal from the very loose monetary policy of the past few years. Whether that reversal is executed appropriately, in a way that reflects the reality of the economic situation we are in, remains to be seen.

If the Fed does not tighten enough, inflation could persist and eventually erode confidence in the economy. Equities would suffer. If the Fed tightens too much and too fast, it could bring about a recession. Equities would suffer. Doing it the right way, with US and international politics adding another layer of complexity to the situation, will require dexterity and luck.

Until I know how the Fed is going to execute this delicate balancing act and until more inflation data is available, remaining a bit under-invested seems warranted.

Thank you for your continued trust.

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