FLEURUS INVESTMENT ADVISORY

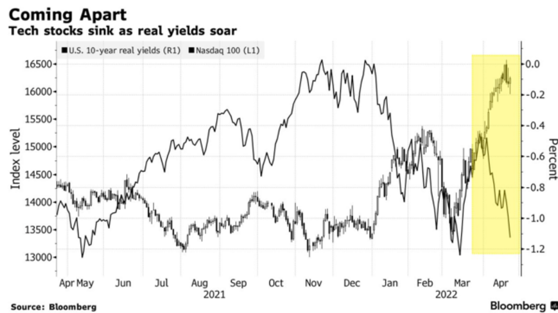
May 4, 2022

Overview

April turned out to be one of the worst months for investors in recent memory, if we except March 2020, when the magnitude of the Covid pandemic became clear. The S&P's 500 went down **8.72%.** The Nasdaq sunk **13.24%** and the Russell 200 (Small Cap Index) lost **9.91%.** The situation did not turn out much better internationally where the EPAC BM Index dropped **7.00%.** Emerging markets did a bit better due to their partial reliance on commodities (for some) and declined only **5.56%** (MSCI EM).

It is a rare occurrence when both equities and bond prices go down sharply, almost in unison. But they did in April.
The US long bond dropped **8.90%,** pushing the 10-year US Treasury yield to close to 3%. US corporate bonds declined **5.47%** overall. Muni bonds did marginally better and were down only **2.75%.**

The chart below illustrates the corrosive effect of rising bond yields on equity valuations.



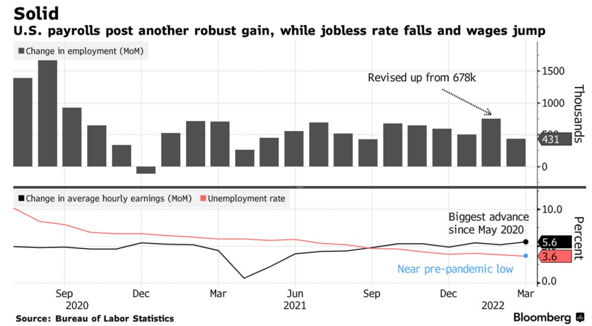
The graph is a bit busy but quite telling. It compares the real yield on the 10-year US note (yield minus implied inflation rate -right scale) to the performance of the Nasdaq 100 (left scale). Notice how as the real yield progressed in March from a low-1.2% to a high of about 0% in late April (right scale), the Nasdaq 100 first resisted and then collapsed in April (left scale), going from 15000 to about 13200. The more yields rise, the more bonds become competitive (as an investment) with equities. The equities that suffer the most in that environment are those with earnings that are discounted for the longest time, or that have no earnings to speak of. The technology sector is particularly vulnerable.

In April, our median portfolio lost **5.17%.** Over the same period, a portfolio consisting of 50% ACWI (All Country World Index) and 50% AGG (US Bond Aggregate) declined **5.94%.** On a YTD basis, our median portfolio has lost **12.84%** vs. **11.36%** for our index.
As a reminder, the equity allocation in our clients' portfolios varies currently from 45% to 70%, depending on risk profile.

Market developments

Throughout the month of April, a combination of mostly robust US economic data coupled to an increasingly hawkish tone coming out of the Federal Reserve contributed to frightening investors, pushing bond yields up sharply and causing a sharp drawdown in most sectors of the equity markets.

It all first started with a strong employment number for March, illustrated in the graph below.



Of particular interest on this graph is the black line in the bottom section. It shows a year-over-year progression of 5.6% for wages, the highest it has been in recent memory. This wage inflation is of particular concern to investors because it has the potential to become a more resilient form of inflation than the one generated, for example, by often transitory energy or commodity price hikes. Wage inflation, when viewed in the context of a US economy that offers plenty of positions but that seems unable to fill them, could become ingrained and make the Fed's job of reducing it that much harder. This storyline, if it comes to dominate the conversation, spells further troubles for equity investors.

By the middle of the month, news from China added to this already fragile investing environment. The Chinese government's decision to lock down a large part of its population, as part of its zero-tolerance Covid policy, clouded the economic environment even more. The impact that it will have on overall growth, on supply chain constraints and, as a result, on inflation cannot be clearly assessed at this stage but is adding another layer of uncertainty to an already volatile environment. In that context, equity investors accelerated their selling and April closed on a decidedly down note.

Tilts and Allocations

In April, I did not take any significant investment initiative. Market volatility, as measured by the VIX index below, is at the highest it has been in the past five years, except for the March 2020 spike (vertical line below). In this context, following a minimalist approach often yields the best outcome.

Overall, our allocation to equities remains at the low-end of our range. Our median portfolio is 50% invested in equities. It is worth noting that within this allocation, the share held by international equities is at its lowest point since I launched Fleurus, seven years ago. This is because rising yields stateside favor the US dollar vs other currencies. In turn, a rising USD generates headwinds for non-US equities, making performance in that space all the more difficult.

In addition, the short to medium term prospects for the US economy are as good or better than those of most other economies. Europe is suffering from its oil and gas dependence on Russia. I have no real visibility on China to speak of. Their heavy handed Covid policy coupled to their stance on the geopolitical chessboard make me skeptical of their ability to contribute significantly to world economic growth in the near term. As for emerging markets in general, while some do benefit from the current commodity boom, many suffer from it. All generally suffer from the rising interest rate environment that supports the US dollar.

The US dollar has been on a tear this year. It is up 13.5%, year-over-year, against a basket of major currencies, as illustrated below:

Conclusion

Equity investors have now accepted the reality of the new interest rate regime that we are in. Interest rates will continue to rise in the foreseeable future and until the Federal Reserve feels that inflation has been tamed.

I do not know how far and how quickly they will go about doing so. One thing I know though is that the tone emanating from their ranks is rather uncompromising. Therefore, the odds are that the US central bank will apply the brakes with little respite between now and the beginning of next year. In that environment, it is unlikely that equities will recoup their losses before the year is over.

That said, markets have a way of surprising. Let's remain optimistic and let's hope for a surprise.

Thank you for your continued trust.

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