FLEURUS INVESTMENT ADVISORY

October 4, 2021

Overview

A confluence of factors caused equity markets to fall in September. The S&P's 500 went down **4.65%** on a total return basis. The Nasdaq Composite was down **5.27%** and the Russell 2000 (small caps) **2.95%.** Internationally, the EPAC BMI index slipped **3.31%** while the MSCI EM (emerging markets) lost **3.95%**. A rising USD did not help European equity markets. The USD was up 2% in September against the Euro and is up 5.35% so far in 2021.

In September, US fixed income markets went down **.25%** to **.75%** depending on sectors, with the exception of the long-term bond that lost a more significant **2.86%.**

Of the many factors that caused this mini-correction, one is inflation or, more exactly, the fear of rising inflation going forward.

The chart below illustrates the rising US PCE Index on a year-over-year basis, since the beginning of 2021. The PCE Index measures inflation at the level of the US consumer.

By that measure, inflation has risen from an annual rate of 1.29% at the beginning of 2021 to a twelve-month rate of 4.26% at the end of September. So far, the Federal Reserve has been able to convince most market participants that this increase in inflation was "transitory" and due to supply disruptions associated with the pandemic. However, the longer the slope of the line continues to rise, the more anxious investors will become. With investors' anxiety comes market volatility. We experienced a bit of that in September.

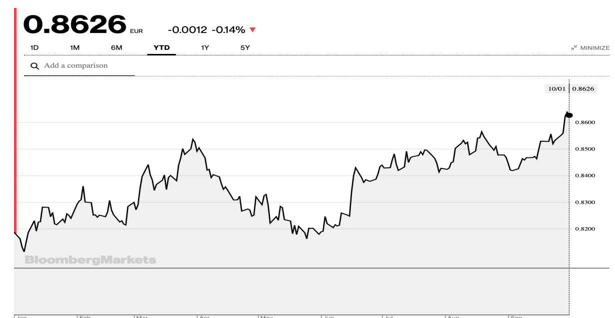
Last month, the performance of our clients' portfolios hovered between **-2.58%** and **-3.86%.** Over the same period, a portfolio consisting of 50% ACWI and 50% AGG slid **2.58%**. Year-To-Date, clients' portfolios are up from **3.27%** to **6.82%,** net of fees. Our benchmark stands at **4.77%** over the same period.

The equity allocation in our clients' portfolios ranges currently from 40% to 70%, depending on risk profiles.

Market developments

A variety of factors are behind the 5% drop in major indices in the US equity markets in September. Among them: fear of rising inflation, as illustrated earlier; profit-taking by many investors following a market run-up of 21% for the S&P's 500 as of early September; fears of contagion from the likely collapse of Evergrande, a large Chinese real estate developer; anxieties about the ability of the US government to fund itself and to pay its debts; and China's declared war on crypto currency miners. Taken separately, those points of concern can be digested by investors. When they all collide in a relatively short period of time, we have the necessary ingredients for a bit of turmoil. This is what we experienced in September.

Of those factors, which ones are more likely to endure or to have a lasting impact? My answer would be that inflation, and the likely rising interest rate environment that it would generate in its wake, presents the greatest threat to the market currently. The likelihood of such a development is in part reflected in the rising value of the USD as illustrated below, in the chart of the €/$ exchange rate:



The USD was worth €.818 at the beginning of the year. It is now worth €.863, or about 5.5% higher. While this is the result of a variety of factors, prime amongst them is the rising interest rate environment in the US, fueled by economic growth and inflationary fears. This is what investors need to be focused on.

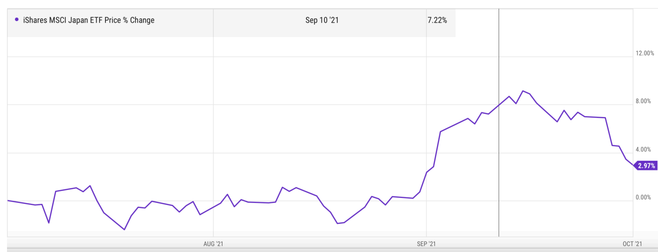
Of the other factors mentioned earlier, I believe that the second most significant reason behind the 5% market drop had to do with what professional investors call "window dressing". Of the 5% lost in September, 3% were lost in the last three trading days. This gives credence to the notion that professional investors wanted to trim their investments in their largest winners in 2021 so far, before the end of the quarter. They are likely to buyback what they just sold in a relatively short order, absent (new) negative factors.

Tilts and Allocations

Increasing market nervousness throughout the month combining with recurring inflationary anxieties and the strengthening USD led me to either sell completely or trim some of our international equity holdings. Specifically, in early September, I sold out of our ILF remaining investments. This Latin American ETF is composed, for up to 40%, of Brazilian equities and the situation in this country is definitely not improving under the Bolsonaro regime.

Overall, while we did not lose money on this investment initiated in November 2020, it has been a disappointment. Latin American economies just have not done well in spite of the economic rebound in 2021 in many other parts of the globe. Lack of access to vaccines, poor vaccine rollouts or outright political turmoil have combined to prevent a recovery there that I expected more pronounced and earlier.

Also in early September, I trimmed our Japanese equity holdings by 20% to 25% when EWJ jumped 8% in the first few days of September on the heels of the announcement of a change of Prime Minister there. The vertical line below marks the timing of our partial sale of this ETF.



Overall, these actions caused our average equity allocation to drop by 2% to 3%. I have kept the proceeds from those sales in cash, given the current market nervousness.

Our relative underperformance this month comes from the drop in value of DLR, our real estate reit, by close to 10% and that of Air Liquide by close to 7%. There are no company-specific news that could explain those contractions and I expect both investments to recover within a short order.

A final note on GBTC, the crypto currency that some portfolios are invested in: It dropped in value by 10% in September overall and….recovered 95% of these losses in one day, on October 1.

Conclusion

We have experienced a 5% drawdown in September. For some equities, the recalibration has been particularly painful. In the technology sector, some well established names saw their shares drop by close to 20%, after sometimes doubling in value over the preceding 8 months. The sale of these big "winners" in professional investors' portfolios is probably responsible for much of the mini-correction of the past month. If I am correct, and absent new disappointing developments, this selling pressure should abate and markets should be able to recover between now and the end of the year.

That said, investors will have to deal with two immediate items over the next three weeks: 1) the negotiations in Congress over the debt ceiling, 2) the beginning of the third quarter earnings season. All things equal otherwise, these are the two developments that will determine whether or not we experience more serious turbulences in October.

Thank you for your continued trust.

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