FLEURUS INVESTMENT ADVISORY

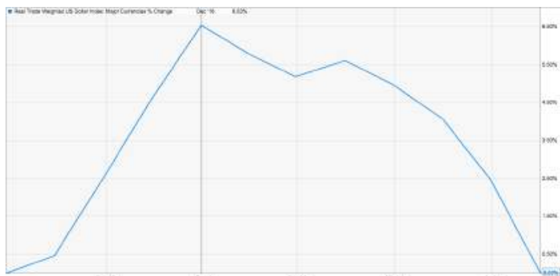
August 4, 2017

Overview

July was another good month for equities worldwide. The S&P's 500 total return index rose by 2.05% and the Small Cap Russell 2000 rose .74%. It nevertheless remains well behind its large-cap counterpart on a Year To Date (YTD) basis. The S&P's 500 total return stands 11.59% above its January 1 opening while the Small Cap index is up 5.77% on the same basis.

The USD weakened yet again in July and contributed to good performances across international equity markets. The EPAC BMI index of developed economies rose a solid 2.91% while Emerging markets had another good month with the MSCI EM index up 5.48%. That index is up 23.65% so far in 2017.

Below is the chart of the USD vs. a basket of its main trading partners' currencies. On that basis the USD is down 6.53 % so far in 2017 (from the vertical line).



Obviously this has helped USD investments in foreign equity markets, be they developed or emerging. As shown on the chart, it has in fact helped in 2017 as much as it hurt from the US Presidential elections to the end of 2016 (the portion of the chart to the left of the vertical line). As of now, the post-election Trump effect has been totally reversed. Our portfolios have benefitted from this climate change.

In July our client portfolios rose between 1.84% and 2.30%. YTD these accounts are up between 9.32% and 11.50%. This compares to monthly and YTD performances of 1.35% and 7.46% 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

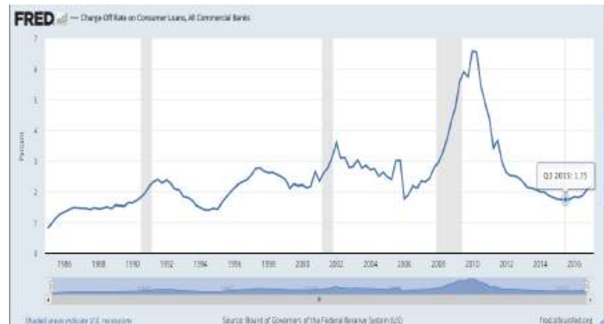
Following ECB's Chair Mario Draghi's comments of late June that momentarily spooked the global bond markets, Janet Yellen's soothing words two weeks later caused the USD to soften, emerging markets to get another steroid injection and US equities to continue their upward movement.

Central bankers are navigating in uncharted waters and investors live and will live with the consequences. This monetary policy dimension adds to the complexity of the current economic environment.

With such uncertainty, it is no wonder that some of the best minds in the world of investing are fretting about and puzzling over the chances that the current bull market will prevail for much longer. In addition, valuations are relatively high (particularly in the US), the current bull market is one of the longest in history and equity indices are moving up on the back of a narrowing number of equities.

With that in mind and the debate about the sustainability of this bull market ever present in my head, I have been paying closer attention to the credit markets. It is often the case that credit markets anticipate what will eventually affect the broader economy.

Below is the chart of bank charge-offs on consumer loan.



This is a good proxy for consumer default rates.
By that measure, consumer debt problems are relatively benign currently. That said, they have started ticking up and are past their nadir of the third quarter of 2015.
The grey areas on the map mark recessions. Notice how bank charge-offs start rising a bit ahead of recessions.

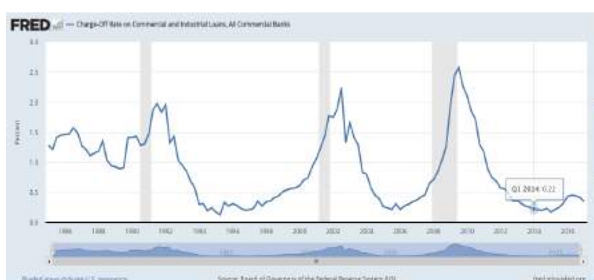
Is the current uptick a warning sign? Possibly.
It is certainly worth monitoring.

Tilts and allocations

In July, I did very little to the portfolios that are in our care. I clipped a bit some emerging market holdings. I did the same with some European investments. Fundamentals remain positive in both sectors and justifying a further reduction from current levels would, it seems to me, be premature. This is in spite of the strong performance of both sectors since the beginning of the year.

With the markets being relatively quiet lately, I have had more time to do some research and in particular to pay close attention to default rates. I have taken a close look at corporate default rates, as well as consumer loan loss experience at banks, as shown on the previous page.

Another interesting chart is the one below:



This is the chart that tracks loan charge-offs (losses) from banks on corporate loans. As with consumers, corporations are paying off their loans and their default rates remain historically low. They did rise in 2016 (right of the vertical line). That was essentially due to the malaise in the energy sector. Oil priced slumped and that caused a few players in the sector to declare bankruptcy, hence the uptick that year. Since then, default rate have leveled off.

Based on this information, if there is a correction around the bend it is hard to believe that it will be caused by corporate debt loads. A change of the speed of interest rate increases could definitely cause damage, but that is not in the cards for now.

All of this leaves me with little objective reasons to reduce market exposures, in spite of much talk from investment and economic pundits about the wisdom of doing so. In January, some of the same people spoke of the rising USD in 2017 (it is down close to 8% by some measure so far) and the likely decline of emerging markets (they are up close to 24% so far this year).

Concluding remarks

2nd quarter earnings are up about 8% to 9% compared to the 2nd quarter of 2016 for the 75% of S&P's 500 firms that have reported. More interesting even, these firms report an average top-line (revenues) growth of 4% to 5%.

The US economy is chugging along. Europe and Asia are confirming the earlier signs of accelerating economic growth. All of this is supportive of equities, even at somewhat elevated levels.

A technical correction could take place at any given point in time and August is a month with a higher than average probability in that respect... But in the absence of concrete evidence of a deteriorating economic landscape, staying put should be the right investment decision. This is what I intend to do over the next few weeks.

Best regards to all.