December 4, 2017

Overview

In November the S&P's 500 rose another 3.07% on a total return basis (dividends included) and the Russell 2000 added 2.90%. The progression was not even, as shown in the chart below. Internationally, the S&P Epac BMI of developed economies rose a more modest 1.03% thanks mostly to the good performance of Japanese equities (up 2.15% in USD) while European equities stagnated for the most part. Finally, Emerging markets flat-lined with the MSCI EM up .15%. In the Fixed Income (FI) world, US notes and bonds were marginally changed with the notable exception of the Long Treasury that managed to progress .72%. Most other FI sectors were marginally down, with the exception of the Muni sector that was down a more significant .84%.

Below is the chart of the S&P's 500 during the month of November. It tells an interesting story that the fast news cycle should not overshadow.

Basically, from the beginning of the month (left side of chart) to the mid point, US equities were flat and even dipped. They then started to progress again as the chances of success of the Republican Tax plan increased, particularly in the last days of trading (ride side of the chart). I will explain what I think about all of this in the next section

In November, our client portfolios rose between .92% and 1.42%. YTD these accounts are up between 12.64% and 16.51%.

This compares to monthly and YTD performances of 1.40% and 11.58% 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

The previous chart appears deceptively clear. After a bit of hesitation during the first part of the month, US equity markets resumed their climb. What really happened is a little bit more nuanced.

During the first part of the month we witnessed a few days of not so benign movements. High yield bonds declined 2% before finding their footing again. Emerging markets and international equities corrected a few percentage points also before finding their balance. This was a clear "risk-off" move. The reason why these moves lost momentum is that economics here and internationally are good overall. In that context it is hard to justify serious selling. So the climb resumed once signs of the likely passage of tax reform started materializing.

Similarly, the second part of the month saw some interesting developments. Among them, the drop in tech stocks in favor of financials, as evidenced in the chart below.

The blue line is that of XLF, the ETF that replicates the performance of the financial sector. The orange line is that of XLK, its tech sector equivalent. As the chances of tax reform increased on November 27 (vertical line), investors took profit on their tech sector holdings and allocated to banks and brokerage firms. This was a sensible move. After all, by some measure, tech stocks are up close to 30% YTD.

The losses in the tech sector were not insignificant. That said, they are most probably temporary. Unless interest rates move up significantly and the yield curve steepens, the odds are that this type of sector rotation will be short-lived. A sustainable rotation away from the tech sector and in favor of the financial sector is dependent on an acceleration of the rate of inflation from its current 1.5% annual clip. Inflation has remained elusive in this recovery and I have no idea when or if it will accelerate.

Tilts and allocations

This month we continued to marginally reduce the overall risk in each of our clients' portfolios. We selectively reduced emerging market equity positions, pan-European investments and cleared all portfolios of emerging market bonds even though we had "homeopathic" positions in this sector. The proceeds from these relatively small sales were left in cash or short-term treasuries.

What this accomplished was twofold: 1) we took some profit in sectors that have risen close to 25% on a YTD basis, 2) we increased our ability to react should market conditions deteriorate. We think that the odds of this occurring in the next six months rose measurably in November.

With that in mind, it is likely that I will start buying gold shortly. GLD, the ETF of the sector, is about to pass a key bullish technical level, as shown in the chart below.

When the orange line (200-day moving average) crosses the blue line (400-day moving average) on the upside, it signals, more often than not, a medium term bullish trend. I expect this to occur in the next few trading sessions, at which point I will work my way up to a 5% position. The combination of feverish market conditions and a supportive technical indicator such as this one justifies starting a position in GLD.

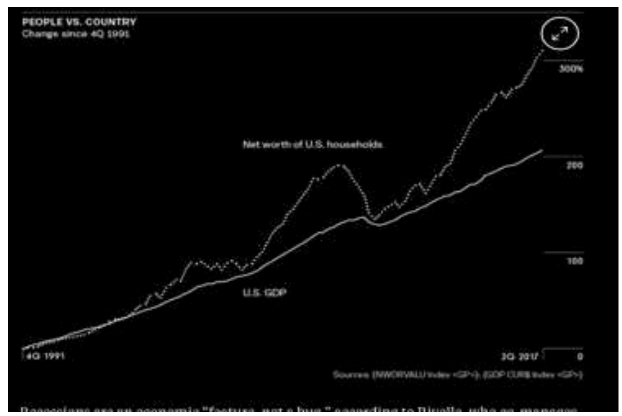
This investment should offer some level of portfolio protection should market conditions deteriorate. It will reduce portfolio performance should market conditions remain benign. Such is the price one must be ready to pay for protection.

Concluding remarks

As I have indicated on several prior occasions, we are reaching very high level of equity valuations and while economic conditions remain solid here and globally, meaningful equity performance going forward is likely to be increasingly hard to get.

We can't go on with annual equity performances around or above 15% (the average annual rate of performance for US large cap equities over the past 5 years) with an economy that is running at a 2.5% annual clip. It is simply not sustainable.

The chart below compares the progression of the US GDP since 1991 (solid line) and the net worth of US households over the same period (dotted line). The effects of the equity market bubbles of 1998-2000 (first bump above the solid line) and of 2005-2007 (second bump) are clearly visible. So are the effects of



the market corrections that followed.

The chart speaks for itself. At some point an extreme deviation from the solid line is rectified. Whether in 6, 12 or 24 months, we are due for another market reminder that gravity cannot be denied forever. With this in mind, you can be assured of my vigilance!

Investment matters have their importance. Yet they pale in comparison to solid health, peaceful family relations and good spirits. I wish you abundance of those three, a great year-end celebration and a Happy New Year.

As usual, feel free to contact me with questions or comments.

Best regards.