FLEURUS INVESTMENT ADVISORY

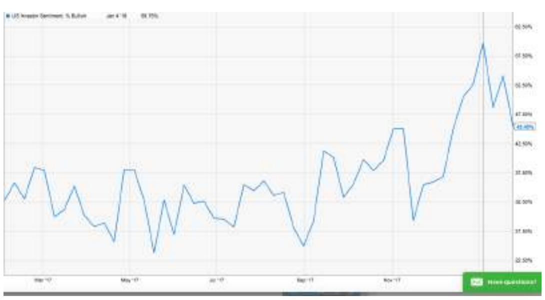
February 4, 2018

Overview

In January the S&P's 500 rose a stunning 5.64% on a total return basis (dividends included) while the Russell 2000 was up 2.68 %. Internationally, the S&P Epac BMI of developed economies rose 4.73% thanks, in good part, to a remarkable performance from Eurozone equities (up 6% on average). Finally, Emerging markets had a great month, helped by a depreciating USD with the MSCI EM up 8.33%. In the Fixed Income (FI) world, the picture continued to deteriorate with the US long bond down 3.23% and the corporate sector down .75% to 1%. Municipal bonds lost on average 1%.

Many equity investors have stayed underinvested in equities since the crisis of 2008. After missing out on several years of positive returns and after a particularly good 2017, it seems that many of them gave up at the end of December in fear of missing out on yet another leg up. Many jumped in in January to propel US equity indices to all-time highs.

The chart below represents a measure of investors' sentiment over the past twelve months. The higher it goes, the more bullish investors are. The vertical line indicates the peak reached on January 4. Since mid-November this gauge of investor sentiment moved from 29% (positive sentiment) to 59% on January 4.



Increasing bullishness in December appears to have fuelled the sharp move up in equities in January.

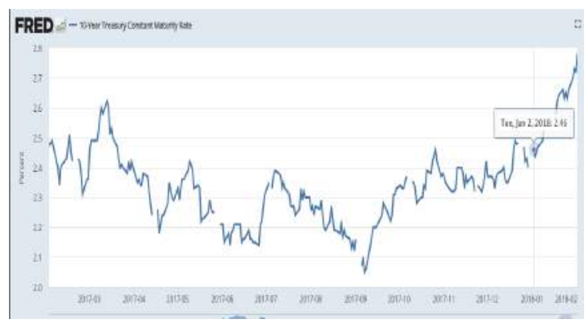
In January, our client portfolios rose between 2.65% and 3.47%. This compares to a monthly performances of 2.16% for a purely US-centric portfolio consisting of 50% SPY (ETF for the S&P's 500) and 50% BIV (US bond aggregate ETF proxy), over the same periods.

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 month of January started with a sharp rally on the first day of trading. This was followed by a short pause due to the surprise caused by the Bank of Japan (BOJ) when it chose to buy fewer bonds than expected. That caused the yield on the US 10 year note to rise .05% that day. A week later the European Central Bank sent a similar message with more evidence of growth in European economies justifying a tapering of their bond purchases. The yield on the 10-year US note went up again. But that did not stop equity bulls and US equities were up by 7% in the waning days of the month. It took two more strong economic data points (including a robust job report) for the equity market to finally take notice of higher bond yields and to reverse course.

The chart below shows how the yield on the 10-year US treasury went from 2.46% on January 4 to 2.82%, as of February 3.



The section of the map to the right of the vertical line shows how rapid the rise in yield has been. When that happens, equities tend to take a pause and sometimes correct. This is because equity prices should, technically speaking, move in tandem with the present value of their expected cash flows. When interest rates rise, all else equal otherwise, equity valuations should drop. Often they do, as was the case in the last few trading sessions.

Can we expect more of the same? Probably. That said, we are not in a recessionary environment, earnings growth continues to be market-supportive and wages are finally rising more than anemically. In the longer run, all of these items tend to be positive for equity markets.

So, at this juncture, I am inclined to see the current downdraft as no more than a healthy pause.

Tilts and allocations

In January, we increased our positions in GLD across all client accounts. We did nothing else to client portfolios.

Our rationale for buying a gold ETF tracker such as GLD is that we are concerned about a market reversal caused by geopolitical instability. Gold tends to do relatively well when political instability increases globally. It is unfortunately increasing. That said buying portfolio protection generally ends up costing money. Therefore, it has do be done in moderation and with a good understanding of the negatives (direct and opportunity costs). So far our GLD "hedge" has not cost us anything. As a matter of fact it has made a positive contribution to portfolio returns.

Since I am far from convinced that GLD will protect clients' portfolios during a more "classic" equity downturn caused by inflationary pressures, deficit concerns or other economic factors, I have been looking at other potential hedging instruments. Buying volatility could be the answer. The problem: It costs a lot and, in order to be effective, demands both speed of execution and almost perfect timing.

Since late November, I have been following VXX, the ETF that tracks market volatility. It has done poorly overall except for the past two weeks when it recovered all the ground it had lost and more...It is a pretty effective hedge in fast moving equity market downturns. The problem is that when markets are slow-moving it tends to lose value very, very fast.

Here is the chart for VXX over the past six months.

Had we bought VXX on December 1, anticipating a correction, we would have bought it at $32.92 and seen it go down to $24.85 on January 15 (down 24%!) before recovering. It takes fortitude to stay with an investment that can lose 25% of its value in just six weeks.

That said, when market correct the way they have this past Friday (down 2%), VXX does the job. It was up 13% that day! Volatility is on the rise and this time, it may not be just a flash in the pan. Properly calibrated, a VXX position may make sense at some point in the near future.

Concluding remarks

With most developed and emerging market economies back on a growth path, central banks around the world have either entered or are about to enter an interest rate tightening cycle. This means that they are in the process of reversing the extraordinary measures taken post-2008 in order to stabilize the global financial system.

We are in a new and rising interest rate cycle. After close to thirty five years of mostly declining rates, this regime shift is consequential and, as of this time, needed.

The speed at which this "normalization" process takes place will largely determine how equity markets behave over the next few months and years. If rates are raised too fast they could choke economies and precipitate a recession. If they are not raised fast enough they could fuel inflation and ultimately, higher interest rates. Central bankers have a difficult job on their hands and I see a policy mistake as one of the highest risk to the performance of equity markets going forward.

Should the Fed or the ECB, for example, move a little too fast or too slowly, the consequences could be quite dramatic and precipitate a major correction. With this in mind, keeping Janet Yellen at the helm of the Fed would have been a wise move. You don't want to change captain when you navigate troubled waters, particularly when the captain has proven herself.
In my view, the current US Administration has taken an unnecessary risk in this sector.

Let's hope that, in this area and in others, the course of events remains relatively benign and that the accumulation of these risky decisions, be they purely monetary-related as this one or defense and trade-related, doesn't come to haunt us collectively at some later point.

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

Best regards.