FLEURUS INVESTMENT ADVISORY

February 5, 2016

Overview

What a month! In January the S&P's 500 total return lost 4.96%. This compares to -8.79% for the Small Caps index (Russell 2000), -7.27% for international developed markets (EPAC BMI index) and about -7% across emerging equity markets. Major international equity markets entered bear territory, otherwise defined as a correction of 20% or more from a previous top. This includes the UK, German, French and Japanese markets. In the US, the Small Cap sector is currently down -21% from its previous top reached in June 2015 and is also in bear territory.

In this general context, our model portfolios shrunk from -1.4% to -3.8%. We managed to reduce our equity exposures by 10% across portfolios, mostly ahead of the downdraft but not completely. This was nevertheless quite helpful but insufficient to keep us above the line, with our international diversification contributing negatively to performance.

For a purely US-centric portfolio consisting of 50% S&P's 500 and 50% US bond aggregate allocations, monthly performance was down 2% in January.

Market developments

What I find particularly interesting about the market developments of the past month is that two of the riskiest sectors ended up over performing. The high yield bond index was down "only" 1.54% and the commodities sector, measured by the Dow Jones Commodity Index (DJCI), was down only "1.65%". This is a lot better than the 5% to 8% corrections throughout equity markets.

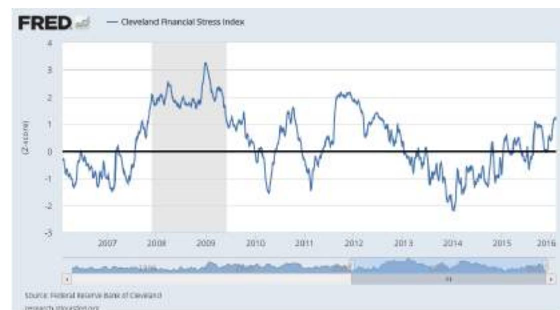
What this tells me is two things:

1) After months of underperformance, the high yield and commodities sectors brought the rest of the financial markets down with them,

2) The current slowdown in the deterioration of the high yield and commodities sectors may be anticipating a pause and possibly, if it endures, the end of the correction in equities.

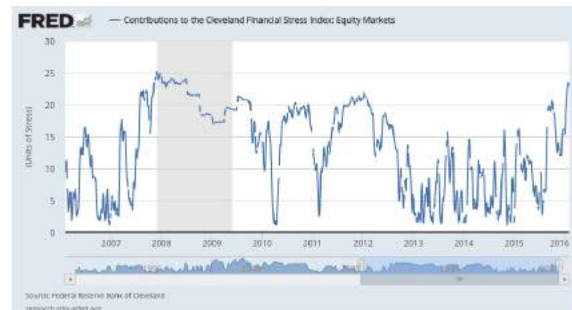
While encouraging signs are sprouting here and there, such as the relative stabilization of the high yield and commodity sectors and the outperformance of the emerging sector over the past few trading sessions, this trend may be short-lived.

Here is a chart of the Federal Reserve Stress Index.



There is no question that the index went significantly up in January and that the trend is worth keeping an eye on. That said, we are still far from the 2008-2009 crisis levels.

When looking at the equity component only of the stress index, here is what the Fed offers.



This is more worrisome. There is little doubt in my mind that caution is the order of the day. While the January correction has made some sectors potentially attractive (energy, emerging markets, high yield), the overall market context calls for continued prudence.

Tilts and Allocations

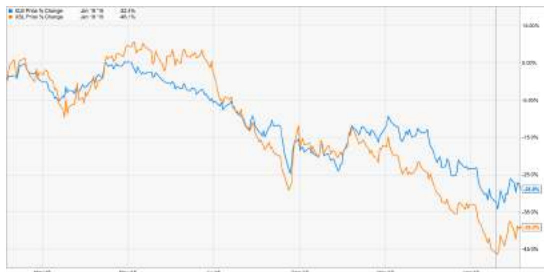
In our last newsletter we indicated that we had decided to reduce our target equity allocations for 2016 by 10%, across all our model portfolios. We executed this adjustment in early January by shrinking our US equity exposures, principally through the sale of our small cap investments in favor of cash or other investments.

More often than not we reduced the level of risk in our portfolios by switching out of one sub-asset class (small caps for example) in favor of another one (mid caps) or by trimming some positions (high yield bonds) in favor of a related asset class (investment grade bonds). Ever cognizant of the fact that mean-reversion is a powerful market force we refrained from radical moves out of the most risky sectors. More often than not we trimmed positions that were already conservatively sized and were able to bounce back with them on the very last days of the month.

Over the past trading sessions a powerful move out of the USD has helped support emerging market equities as well as oil. The high yield sector appears to have stabilized for now. Consequently, and while we remain very cautions overall, we are starting to initiate investments in XLE, the Energy ETF that is largely made of battered oil company equities (1/3 of the ETF is made of Exxon and Chevron).

We are sizing those investments in such a way as to be able to add to them should oil prices drop further, a distinct possibility. We may not have reached the bottom in oil but at $32 per barrel of West Texas Intermediate, we are probably relatively close to it.

Here is the shape of the XLE price curve over the past year (blue), compared to that of the oil ETF USL (orange).



The correlation is extremely high AND the risk is somewhat more manageable. The future will tell whether the vertical line (January 19) marks the beginning of a true rebound or of yet another dead cat bounce.

Conclusion

Markets have been particularly challenging over the past two months. Significant moves by banking regulators in the US (December), Europe and Japan (mid and late January) coupled to the ever-present fear of a Chinese-induced global slowdown and the continued oversupply of crude oil have all contributed to heightened volatility.

Oil prices may have reversed after a 20-25%% drop at one point in January. The USD has lost close to 3% against the Euro and close to 10% against the Yen in the space of two weeks. Emerging equity markets are up 7% from their low of January 20 compared to 1.5% for US markets over the same period. These are big moves indeed, with plenty of opportunities for gains and crippling losses. Given the complexity of this environment it is essential to properly size the risks in your portfolios.

Fleurus strives to do this for its clients. We adjust the risk level of each portfolio to each client's particular tolerance for losses. All of our investments and portfolios are, respectively, sized and monitored accordingly. In doing so we decrease the likelihood of debilitating losses.

As we seek to expand our business we encourage you to let those investors around you that may benefit from our disciplined approach know about us.

We look forward to your comments and questions.

Best regards to all.