FLEURUS INVESTMENT ADVISORY

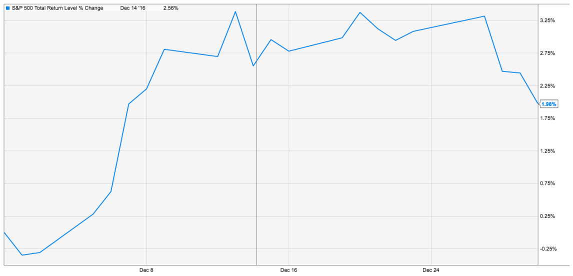
January 4, 2017

Overview

In December the S&P's 500 total return index rose 1.98%, the Russell Mid-Cap index was up 1.63% and the Small Cap Russell 2000 went up a greater 2.80%. All US equity indices kept their upward momentum. US bonds were generally unchanged, although the High Yield sector registered a nice performance of close to 1%.

International developed equity markets were up 3.01% (S&Ps' EPAC BMI) in spite of a rising USD. The USD upward push remained a strong headwind for emerging markets but many of them managed to eke out a gain. The MSCI EM was up .22% and the MSCI Frontier 100 a more significant 2.94%.

The chart below shows the advance of the S&P's 500 Total Return Index in December. The vertical line marks the date of the Federal Reserve rate increase decision of December 14.



On December 14 the Fed announced the much anticipated rate increase in the federal fund rate of .25%. There was no surprise there. However, the pronouncement that the US central bank was contemplating three, rather than two, interest rate increases in 2017 surprised the market and caused equities to move sideways to slightly down for the rest of the month.

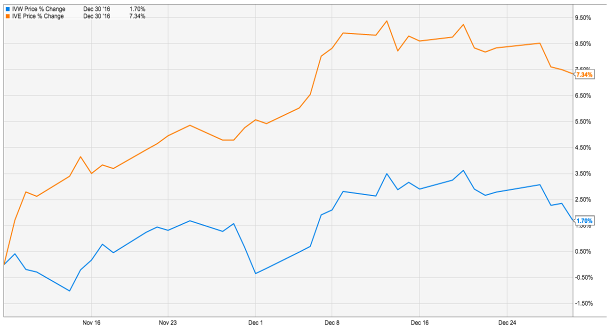
In December our client portfolios rose between .30% and .89%. Year to date (YTD) our internationally diversified portfolios are up from 3.42% to 5.80%, net of fees. This compares to YTD performance of 5.48% for a purely US-centric portfolio consisting of 50% SPY (ETF for the S&P's 500) and 50% BIV (US bond aggregate ETF proxy), over the same period.

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 expectation of lower tax rates, at the personal and corporate levels, of reduced federal regulation and of infrastructure spending by the incoming administration kept supporting US equity markets in December. The negative market implications associated with the muscular anti-trade rhetoric and the geopolitical consequences that the apparent coziness with Russia could bring about do not seem to have been factored to the same extent, or so it seems to me.

For now, all is good and the push forward continues with industrials, banking stocks and more generally the "value" sector of the equity market progressing at the expense of the "growth" sector, as illustrated below:



The period covered in the chart is from November 8 to the end of December. Since the US presidential election the S&P's 500 Value index (Orange line) has risen 7.34% while the S&P's 500 Growth index (Blue line) has progressed a much less stellar 1.70%.

This divergence in performance is significant and points to a probable investing opportunity over the next few months. As always, timing is everything and trying to time the market remains an exercise in futility. That said, a portfolio rebalancing in favor of Growth stocks seems to make a lot of sense to me and I would recommend such a move for most portfolios.

Expected Returns

As I indicated in the previous monthly letter, December is the time of the year when I go through the Equity Risk Premium (ERP) exercise. At the end of this process, I decide whether to adjust or not client portfolios' asset allocations.

The ERP attempts to measure the performance premium that an investor could expect from his/her decision to invest in equities.

It is generally measured as the premium over the yield of the 10-year US treasury, ten year forward. This number can be interpolated from the US treasury yield curve and was at 3.17% as of mid-December. In other words, the current yield curve tells us that an investor could expect to receive about 3.17% per annum from investing in the 10 year US treasury, ten years from now. Now that's "long term"!

The ERP that I arrived at for 2017 and beyond was: 3.4%. It is down from about 4% last year. All things equal otherwise this means that a reasonable investor should allocate a little less to equities than they did last year (US equities in this context). From this ERP exercise Wall Street and all professional market watchers derive their expected return projections for various asset classes over the long term. These calculations are generally adjusted on a quarterly basis. Once done with this, professional money managers make their asset allocations recommendations, increasing, maintaining or reducing US equities exposure for example. The same exercise is followed for all types of assets to arrive at recommended asset allocations for client portfolios.

As I went through the available market research from Wall Street on this subject, I found strikingly different expected return projections for US equities and other asset classes. More so than in previous years. Here are some annual performance projections for US equities, Real estate and High Yield bonds over the long term (7 years and beyond):

	US Equities	Real Estate	High Yield
MS	0.00%	-4.50%	2.80%
GS	6.80%	10.80%	5.60%
Blackrock	4.00%	4.00%	2.60%

These numbers represent the annual expected performance of US equities, Real Estate and High Yield bonds as projected by Morgan Stanley (MS), Goldman Sachs (GS) and Blackrock. The consensus from sampling four additional firms is that there is no consensus.

On the other hand, most strategists were more or less together when it came to European equities (average projection of 6.50%), with no outliers. Emerging markets are projected at an average annual performance of 7.50% and Commodities at about 4%, with little dispersion.

The main conclusion I draw from going through this exercise is that there is much uncertainty among professionals concerning the performance of US equities going forward. If anything, the allocation that one has to US equities should be reduced or at best maintained at a relatively modest level, however one defines that. As far as Fleurus is concerned, this means that no client portfolio should have more than 60% allocated to equities overall and no more than 2/3 of that (40%) to US equities.

Performance recap

Our performance in 2016 was ahead of our various benchmarks until the US presidential elections. Since then we have underperformed. There are two principal reasons for that.

First, we tend to overweight US growth equities over value stocks when allocating to US equity markets. Growth equities have significantly lagged value stock in the Trump rally. The question is: Will this continue or are we likely to see a reversal?

Second, the post-election rally came with a strong move forward for the USD. That hurt all international investments and particularly emerging equities. All of our client portfolios are internationally diversified. This is just good investment practice. Unfortunately, this hurts when a move such as the one of the past two months occurs. The USD shot up close to 9% against a basket of major trading partner currencies. The question is: Is the USD momentum likely to remain, gain strength or fade over the next year?

Looking ahead

When it comes to investment management, I tend to believe in the notion of mean-reversion and therefore am going to maintain our bias in favor of growth equities. This sector should come back and regain momentum as earnings improve and the trade rhetoric of the new administration is confronted with the realities of the rules of the World Trade Organization (WTO). I am less convinced that we have seen most of the USD push forward and am currently positioning portfolios to, at most, maintain our current allocation to non-US markets but with a bias towards reducing these exposures. I will give myself a few weeks to see how the new administration starts and decide accordingly.

One thing is quite certain: there is a higher level of uncertainty in the world as a result of the recent political developments in the UK and the US. There is potentially more of the same coming from Europe in the next few months. In that context and for now, maintaining a relatively defensive posture seems warranted.

I wish you and your family health and prosperity for 2017!