FLEURUS INVESTMENT ADVISORY

January 4, 2019

Overview

The S&Ps' 500 sunk 9.03% in December. The Nasdaq Composite went along with a 9.40% drop and the Russell 2000 (US Small Caps) was down 9.92%. Internationally, things were a bit less dramatic. The S&P EPAC BMI (developed markets) was down "only" 5.17% while emerging equities were down a comparatively low 2.92% (MSCI EM) and 3.40% (Frontier 100 Index).

What we saw in December in the US was a continuation of the market correction that started in early October. This is when US equity markets first moved down, playing catch-up with other international equity markets that had corrected earlier in the year.

Below is a table that summarizes the annual performance of some representative asset classes in 2018, for a US based investor.

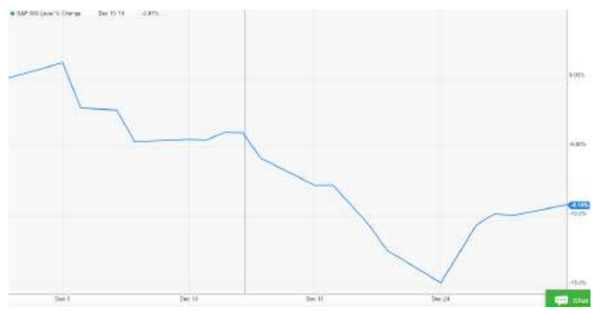
Select Asset Classes 2018 Performances		
German Equities	EWG	-21.40%
Emerging Markets	VWO	-14.80%
Commodities	DJCI	-11.80%
US Small Caps	VTWO	-11.10%
World Equity Markets	ACWI	-9.42%
S&P's 500	SPY	-4.57%
US High Yield Bonds	HYG	-2.02%
US Long Bond	TLT	-1.61%
US Municipal Bonds (intermediate)	VWITX	1.01%
US Cash/Short Term	VUBFX	1.95%

2018 was not a good year for investors. International equity diversification had a decidedly negative impact on portfolios, while diversification with bonds, commodities and real estate either did not meaningfully improve overall performance and, more often than not, made matters worse. In retrospect, 2018 was that rare year where staying in cash or quasi cash ends up being the correct investment management posture. If history is any guide, this should not last.

In December, our client portfolios were down from 3.07% to 4.23%. This compares to a monthly performance of 3.33% for a purely US-centric portfolio consisting of 50% SPY (S&P's 500 ETF) and 50% BIV (US bond aggregate proxy). On a year to date (YTD) basis our portfolios are down 2.70% to 7.75%, net of fees. This compares to a yearly negative performance of 2.38% for our benchmark. This underperformance is entirely due to our allocation to non-US markets in 2018.

Market development

Many factors contributed to the December US equity meltdown that we just experienced. The month started with concerns about a general global economic softening and doubts about the ability of the US and China to arrive at a meaningful trade arrangement. The S&Ps' was down by about 4% by mid-month as a result (vertical bar in the graph below).



That is about the time when relentless sniping from President Trump on the FED's Chairman, Jay Powell, combined with a poorly received post rate-setting conference by the same, accelerated the movement downward.

Add to that President Trump's last-minute reversal on the government funding issue (December 20) and Secretary of Defense Mattis's resignation (December 21) and you get the calamitous downward movement through December 24. By then the S&P's had gone down close to 15%. Only a sharp and somewhat unexplainable post-Christmas relief rally of close to 5% on December 26 brought the index back up to where it stands currently.

Last month, at this time, I mused that perhaps we would enjoy a quieter end of year based on Chairman Powell's (expected) soothing words and hopeful China-US talks. This was not to happen. What has materialized instead, bluntly, are the effects on market psychology and behavior of abrupt and unexpected actions on the part of the President.

Of the 15% correction in December (from beginning of the month to the nadir of December 24), 5% to 6% can be directly connected to the President's actions. If we include the unrelenting "Powell sniping" in the early part of the month, I assess the politically-induced damage to markets at about 7% to 8%.

Tilts and Allocations

My main action in December, as this unstable environment developed, was to further reduce our high yield bond exposures in favor of short term bonds. This has proven positive so far as fears of an economic slowdown brought US interest rates down a bit and pushed bond performances up for the month.

I continued to do some tax-selling and to monitor the price behavior of BUFTX, our main US equity allocation. With respect to this growth fund, I am happy to report that it has held its own relatively well during the past two months, after correcting surprisingly in October. It has done slightly better that the S&P's since, significantly better than the Nasdaq and a bit better than another more value-oriented fund that I am considering as an option. As a result, I have refrained from selling more of BUFTX. I stand ready to do so should market volatility continue and signs of economic softness materialize further.

Currently, most portfolios have equity exposures ranging from 35% to 55% and remain at the lower end of their typical range (45%-75%). Within this lower equity allocation, risk has been further reduced by investing in the utilities sector. Currently, considering the increasing risks of an economic slowdown, an uncertain monetary policy environment and elevated political risk, I see no reason to change my investment posture.

Finally, going forward I will use the All Country World Index (ACWI) instead of the S&Ps' 500 to benchmark client portfolios. The equity allocation in the ACWI is about 60% US equities and 40% "rest of the world". While clients' portfolios are not invested identically and will move at times significantly away from this allocation, the ACWI is a more appropriate benchmark than the S&Ps' 500 given my inclination to diversify portfolios internationally, as a matter of policy.

In a nutshell, starting this month, I will move from a 50% SPY (S&Ps' 500 ETF) 50% BIV (US bond market ETF) benchmark to a 50% ACWI-50% BIV benchmark. This change should provide a better metric for performance comparison purpose.

Concluding remarks

I concluded Fleurus' previous newsletter with the following commentary: "…the odds are that 2019 will be another trying year. It is unlikely that US equity markets will remain the sole providers of positive returns globally. But does this mean that international markets will recover from their 2018 swoon, or that US equity markets will join their international brethren and correct further?".

Well, we have the answer now! It is just happening a little bit ahead of schedule. US markets corrected further in December and started catching up with international markets. It is just the type of catch-up nobody likes.

Going forward, investors have to gain more clarity on several issues before equity market recover their balance. Specifically, in the coming weeks investors will try to gauge: i) the direction of the US economy and the severity of a slowdown, should one materialize, ii) the quality of the interaction between the US President and a House of Representatives under Democratic control, iii) the substance of the soon-to-come China-US trade negotiations, iv) whether the Federal Reserve loosens its monetary policy. There is much to weigh here while trying to stay immune to the daily ups and downs of the markets.

It is not too late in the new year to wish you all a Happy, Peaceful 2019.

Thank you again for your continued trust,

Jeff de Valdivia