FLEURUS INVESTMENT ADVISORY

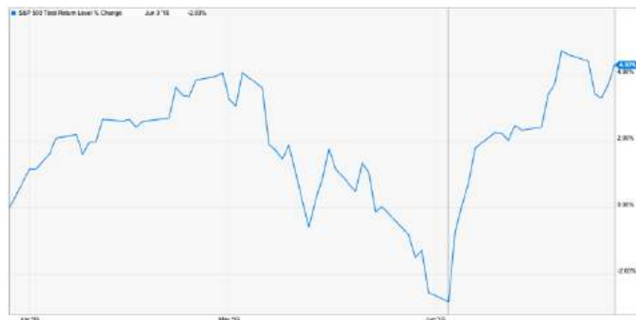
July 2, 2019

Overview

In June, The Federal Reserve Bank (FED) came to the rescue of equity markets once again and propelled them to new highs. The S&P's 500 rose by 7.05%. The Nasdaq Composite added 7.51% and the Russell 2000 (US Small Caps) 6.87%.

It was more of the same with international markets. The S&P EPAC BMI (developed markets) rose 5.57%, emerging markets were up 6.24% (MSCI EM) and frontier markets a lesser 3.90%.

The chart below is that of the S&P's 500 (total return) over the past three months. The vertical bar marks June 4, the date when FED Chair, Jerome Powel, indicated the FED's openness to a potential reduction in interest rates, as a result of increasing trade tensions and their impact on the global economy.



Oh! What a man can do! If anyone had any doubt about the power of the FED….or of the market to push the FED to do its bidding.

Fixed income markets performed well in June. The prospect of an easing cycle by the FED benefitted particularly intermediate corporate and high yield bonds (up 2.45% and 2.28% respectively). The US long bond yielded 1.33%, bringing it to a stellar 10.98% performance so far in 2019.

In June, our client portfolios were up from 3.31% to 4.27%. This compares to a monthly performance of 3.80% for a portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy). On a Year-To-Date (YTD) basis, our portfolios are up from 10.14% to 14.10% (net of fees) vs. 11.08% for our benchmark.

As a reminder, the equity allocation in our clients' portfolios ranges currently from 30% to 60%, depending on their risk profiles.

Market developments

There were quite a few data points worth of mention this month. Let's concentrate on the major ones: 1) the persistent inversion of the yield curve, often a predictor of economic recession, 2) the FED's indicating its willingness to reduce the FED fund rate going forward; the two being intimately related.

Below is the one-year chart of the yield differential between the 10-Year US treasury and the 3 months Treasury bill. When the line goes below zero it means that the 90-day bill "pays you" more than the 10-year Treasury. This is generally interpreted by market participants as a sign of weakening economic prospects.

Note that the first inversion occurred in April but was short lived. The current inversion started at the end of May and is still on-going. Surely this was on the mind of the FED Chair when he spoke in early June. It had to be a critical piece among the array of data that prompted him, and the rest of his colleagues, to send a clear signal to investors that they were willing to reverse their interest rate policy and to become more accommodative (lowering interest rates). It is clearly what the market expected and the rest of the month, more or less, saw equities rising worldwide. All the more as the ECB (European Central Bank) was sending similar signals.

I would not do justice to this data-rich month without mentioning other events and news that played a part: 1) Good retail sales in the middle of the month that helped move equities higher, 2) the downing of a US drone by Iranian forces that reversed the course of equities until, 3) the White House decided to respond with restraint, pushing equities back up again and, 4) the comforting words on trade coming out of the G 20 meeting in Osaka, Japan, that further moved markets upward.

All of this contributed to a spectacular month for equities worldwide after a rather dismal one in May.

Tilts and Allocations

Market sentiment has been quite volatile in the past three months. The prospects of an amicable resolution of the trade negotiations between China and the US, together with a stable interest rate environment signaled by the FED in early January, pushed equities up resolutely in the first four months of the year. A good half of these gains was lost in May as trade tensions rose unexpectedly.

In June, the combination of positive trade signals and of a more accommodative FED have reassured markets again and we are now back to new highs for most US equity indices.

How long will this last? I do not know.

What I do know is that the signs of a less supportive economic environment are increasing in number, if not yet in intensity. The inversion of the yield curve, the soft manufacturing sector, the ups and down of the trade negotiations with China, the lower consumer confidence level in June and the generally high stock valuations, all warrant more investment caution.

With this as a backdrop, here are some of the actions that I took in June. 1) I sold a good part of our US small caps and invested the proceeds in value stocks, reducing the overall risk of the portfolio as a result, 2) I took some profits on our utilities positions (XLU) after we had enjoyed a 20% increase from September 2018 when we initiated this position. Utilities are trading now at a 19 P/e multiple (price/earnings ratio): a bit too high for my liking, 3) I sold some of our ultra-short bond positions in favor of intermediate corporate bonds, as a result of a more supportive interest-rate environment.

Overall, our equity allocation remains unchanged, but the risk embedded in it has been reduced. Also, the duration of our fixed income portfolio has been stretched from about 2-year to a current 3-4 year. At this stage, I feel comfortable with our overall position.

We are conservatively exposed to US and international equities, ready to benefit from an improving international trade environment and from favorable interest rate policies worldwide. Yet, we remain underinvested in the sectors that would likely suffer the most should the economy deteriorate rapidly (small caps, technology, other growth equities and high yield corporate bonds).

Concluding remarks

We are now entering a period of the year when, more often than not, equities underperform. This is the result in part of lower market liquidity that tends to exacerbate the impact of negative news, be they political or economic in nature.

On the agenda this month are two particularly important dates:

1) The beginning of the second quarter earnings season, sometimes in the week of July 15, 2) the FED's next interest rate decision to be announced on Wednesday July 31. Based on current market and economic data, I expect the Federal Reserve to decrease the FED fund rate by .25%. That should keep equities stable or support them a bit higher in August.

Until then, the economic data, including the important unemployment number for June (released this coming Friday), will set the tone for equities this month, absent other market-moving geopolitical events and negative corporate earnings news.

I wish you all a great month of July and a Happy July 4th celebration! May the memory of the Founding Fathers and the greatness of their accomplishments inspire us all, even if only for a brief moment.

Jeff de Valdivia, CFA, CFP.