FLEURUS INVESTMENT ADVISORY

July 3, 2015

Overview

The US equity markets were down in June, by an average of 2%, except for the small cap sector. The S&P's 500 Total Return Index and the Russell Mid Cap Index dropped 1.9% and 2.0% respectively. Bucking the trend, the Russell 2000 (Small Cap Index) managed to eke out a .50% gain. The picture deteriorated also in the bond markets with yields going up (prices down). The Lehman bond index (long bond) was down 3.8% this month while the High Yield sector dropped about 2%.

Internationally things were worse with the Chinese equities in a serious correction and European markets down an average of 4% across the Eurozone.
As a result of these negative developments our four model portfolios finish the month down by an average of 2%. YTD our diversified portfolios are up from .5% to 1.7%. This compares to a YTD performance of 1% for the S&P's 500 (total return) and a flat performance for a portfolio consisting of a 60% allocation to the MSCI All Country Word Index and of a 40% allocation to the US Bond Aggregate.
Our slight outperformance so far is primarily due to our small cap allocation. Since the beginning of the year we have maintained our small cap exposure while reducing our large cap positions. This has paid off as illustrated below:

The dark green line is that of the small cap index while the lighter one is that of the S&P's 500. The differential, in YTD total return performance, is about 3% in favor of the small caps.

Market developments

Negative international markets dominated most of the month and more than offset the relatively good economic news that came out of the US in the form of strong unemployment numbers in early June, providing initial support to US equities.

By the middle of the month Chinese markets had started to correct and the situation in Greece had become increasingly unpredictable.
Below is a chart of the Shenzhen Stock Exchange Index over the past year:

The vertical bar marks the beginning of 2015. This index had gone up 110% in six months before starting to deflate in early June. Since then the market drop has reached 24% and has bled a bit into the more developed and significant Hong Kong markets, as illustrated by the chart of the Hang Seng Mainland 100, below:

Frenzied speculation by Chinese nationals (on the Shenzhen Index) is starting to affect its more developed and internationally open brethren in HK. While there may not be a direct consequence for US markets, these types of market drops tend to increase investors' nervousness globally.

Additionally, the uncertainty in Greece continues to destabilize markets worldwide. In my last letter I mentioned the increasingly worrisome situation caused by the inability of the Greek government and their European partners to agree on how to deal with Greece's unsustainable debt level.

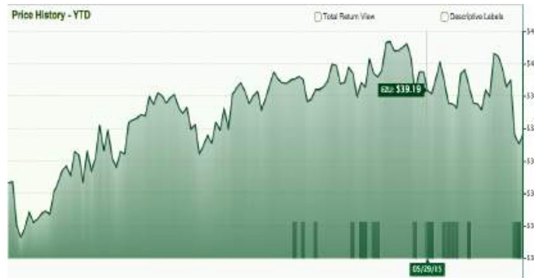
As of this writing, the Greek electorate is set to participate in a hastily called referendum and is being asked to answer by a Yes or a No a question that may not be formulated as clearly as it should.

The Greek government presents a No answer as a No to austerity and is encouraging it as a way to improve its negotiating position with its European partners. The opposition and the rest of Europe want a Yes as a condition for Greece to keep the Euro. It seems that No answers one question (do you want austerity?) and Yes another one (Do you want to stay in the Eurozone?). With so little clarity I am afraid that we will end up with a muddled majority and an unclear mandate. The upside, if any, is that a Yes would likely precipitate a change of government for Greece. Based on the erratic performance of the current one, I can't say that this would be a bad thing, both for the Greek population and the markets in general.

Tilts and Allocations

At the beginning of June we increased our short Euro/long USD position as a way to further hedge our exposure to European equities. By mid-June, with tension increasing over the Greek affair, we directly reduced by 33% our European exposure.

The first move has not helped our portfolios so far. The USD/Euro has remained volatile but largely unchanged from beginning to end of June. The reduction of our position in EZU, the Eurozone ETF, has helped and we have mitigated the impact of its drop by 4.2% this month, as shown below:



Elsewhere in our portfolio, our continued tilt in favor of the US small cap sector proved helpful within our total US equity allocation, as indicated in our introductory remarks. We intend to maintain this bias over the foreseeable future.

During the month we were penalized by our allocations to emerging markets as a result of the market correction in China and continued volatility in the oil market. However, we do not yet see a compelling reason to alter them. We may change our bias should the current downtrend gather momentum.

Concluding remarks

We are in a complicated market environment.

US rates interest rates have started to climb, creating headwinds for already stretched equity valuations. The flurry of corporate mergers, traditionally associated with the later stages of a bull market, continues unabated. All of this is happening in a relatively supportive economic environment, from a US perspective.

Internationally, the landscape is generally less positive and, in the short run, likely to remain dominated by Europe and how it ends up handling the Greek debt crisis.

When looking at the whole picture, it is no surprise that US investors have become increasingly bearish. That, however, is a contrarian indicator!

Our allocations are conservative, at the lower end of our equity exposures, in all portfolios. We do not see yet compelling enough reasons to reduce them further.

We wish you all a Happy 4th of July Celebration and invite you to call us or email your questions.

All the best,