FLEURUS INVESTMENT ADVISORY

July 4, 2018

Overview

June saw US equities rise with the S&P's 500 up .62% and the Russell 2000 (Small caps) up .71%, respectively. The picture continued to deteriorate internationally. The Epac BMI (developed markets) was down another -1.82% this month and emerging market equities down anywhere from - 3.75% for the MSCI Frontier 100 to -4.57% for the MSCI EM.

The rising USD coupled to the intensifying trade tensions have pushed investors towards US small caps, at the expense of emerging market equities. The chart below illustrates this trend.

The blue line is that of a small cap ETF we invest in (VTWO) Over the past three months, it is up more than 11%. The orange line is that of an emerging market ETF we also invest in (VWO). During the same period of time it is down more than 9%.

Elsewhere in investment land, parts of the US fixed income markets were marginally up. So far this year, US fixed income portfolios are flat for the very short-term duration portfolios (those that are invested in securities maturing within one year) and down or flat for all other sectors. Municipal bonds are down -.35% YTD and High Yield bonds fractionally up (+.16%).

In June, all our client portfolios suffered due to their international exposures. Most portfolios were down between -.32% and -.92%. This compares to a monthly performance of .27% 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 -.94% to up .92%, net of fees. This compares to a performance of .23% for our benchmark. As a reminder, our allocations to equities currently vary from a minimum of 30% to a maximum of 60%, depending on each client's risk profile.

Market developments

International diversification has been a negative for investment portfolios over the past three months.

Emerging market and international equity markets in general were maimed by a widening trade conflict. The rise of the USD, on the back of increasing US interest rates, accentuated those trends and also contributed to a decline in commodity prices. With the exception of oil, all other commodities declined in June. The Dow Jones Commodities index was down 5% while oil was up bout 3%.

Commodity prices matter because they often reflect the health of the global economy. When demand for oil or copper is high for example, prices rise and that is generally indicative of growing demand around the world for two very ubiquitous raw materials. When they move in opposite directions, as they did in June, something is off.

These unusual commodity price movements are illustrated below with the price of USL, an oil ETF (Orange) and that of the DJCI (Blue), an ETF that tracks the price of all commodities.

During the month of June, USL rose over 6% while DJCI went down by more than 5%. This is not sustainable in the long run. Either the global economy slows down as a result of diminished trade, and commodity prices including oil prices all go down, or the current strength in the price of oil is indicative of resilience in the global economy, and other commodity prices will rise again soon.

It is hard to say which interpretation is more likely to be proven correct although I tend to believe that the global economy may be slowing but not drastically so.

Tilts and Allocations

We manage diversified portfolios and all our allocations to bonds, equities, commodities and sub-sectors are precisely calibrated. As a consequence, it is only after careful consideration that I drop an allocation down substantially or increase another abruptly, at any given point in time.

We did not change our allocations during the month of June. As a consequence, our international equity holdings dragged our performance down. The heightened trade tensions coupled to a more hawkish statement from the Federal Reserve (Fed) at their last June 12-13 meeting caused US investors to divest rapidly from international and emerging market equities. More than we anticipated. The Fed stance and firmness is a signal that, if not new, certainly has become clearer since mid-June.

Below is a chart that illustrates the effect of the Fed meeting on the price behavior of three ETFs during the month of June. The vertical line marks the release of the Fed meeting minutes.

The red line represents SPY (the ETF for the S&P's 500). It basically finished where it had started (up .62%). The orange line represents EZU, the Eurozone ETF. It was down 4% in June. As for the blue line, it represents VWO, the Emerging market equity ETF. It was down 6% in June. Note how the decline coincides with the time indicated by the vertical line.

In the next few weeks we will take advantage of any significant rebound in emerging equity prices to further reduce our allocation to the sector. The determination of the Fed in pushing rates up, possibly twice more in 2018, makes this decision all the easier to reach.

Concluding remarks

These are complicated times for investors. Sorting out what matters from the noise is difficult. We currently have anti-trade policies developing around the world at a time of rising interest rates in the US. Although the US economy is doing well, expecting it to overlook those two headwinds over a sustained period of time is a lot to ask.

When a government imposes tariffs it gets in the game of picking industry winners and industry losers. That, in turn, muddies the decision-making process for entrepreneurs and generally slows investments. All things equal otherwise, the economy suffers.

I saw a clear evidence of this in a recent Wall Street Journal article a few days ago. The article mentioned how a Missouri (steel) chain maker had to lay off 10% of its 200-strong workforce as a result of increasing steel prices (due to tariffs) while another Missouri-based company was seeing its business boom because tariffs were making it more competitive.

If your business prospects can be that drastically impacted by government decisions that you cannot anticipate and even less control, you are more likely than not to take a wait and see attitude when it comes to hiring or capital investment decisions. That generally does not help the economy and begets a more challenging, if not negative, investing environment.

As usual, please feel free to contact me with any questions.

Cordially,

Jeff de Valdivia