FLEURUS INVESTMENT ADVISORY

June 4, 2018

Overview

The month of May was particularly volatile. US equities ended resolutely up with the S&P's 500 returning 2.41% and the small cap index (Russell 2000) rising a whopping 6.07%. The picture was less rosy internationally where the combined effects of a rising USD and amped up trade rhetoric contributed to pushing the EPAC BMI (developed markets) down 2.57% and emerging market equities anywhere from - 3.75% (MSCI EM) to - 9.87% for the MSCI Frontier 100 index.

Below is a chart that compares the performance of the Amex USD index (blue line) and that of the Emerging Market Frontier 100 Index (orange line) since the start of 2018.

Notice the vertical line marking the middle of the month of April and how the rising blue line (USD), to the right of the vertical line, coincides with the beginning of the sharp decline of the performance of the emerging market Index. There is nothing exceptional here. A rising USD puts pressure on emerging markets equities. This is well known. That said, I have rarely seen it illustrated as clearly.

Elsewhere in investment land, the US fixed income markets were flat to nicely up for portfolios with longer duration. That said, US fixed income markets remain flat to negative for the year. Short term notes (less than 1 year) have generated a .60% return YTD, while medium to long term bonds have lost anywhere from 2% to 4% over the same period.

In May, our client portfolios hovered between -.27% and up .97%, net of fees. This compares to a monthly performance of 1.59% for a purely US-centric portfolio consisting of 50% SPY (S&P's 500 ETF) and 50% BIV (US bond aggregate proxy), over the same period. On a year to date (YTD) basis our portfolios are down -.32% to up 1.18.%, net of fees. This compares to a performance of -.08% for our benchmark. As a reminder, our allocations to equities currently vary from a minimum of 40% to a maximum of 60%, depending on the risk profile of each client.

Market developments

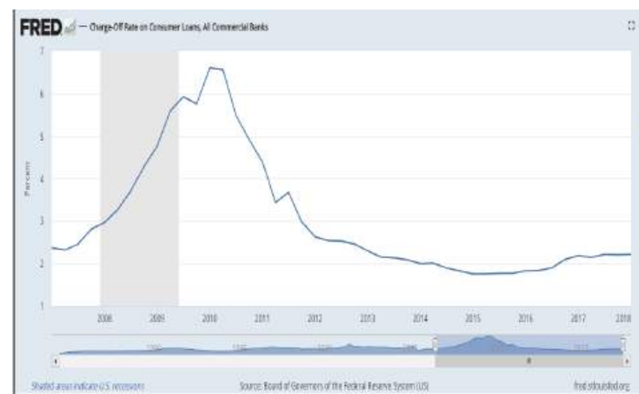
Between the amplified trade rhetoric of the US Administration, the rising dollar and European woes in Italy and Spain, markets had a lot to digest this month.

The sharp rise of the Russell 2000 this past month illustrates the return of the so-called "Trump Trade". If you recall, just after the election of November 2016 the expectations of an "America First" foreign and trade policy caused the USD to rise, small cap equities to shoot up and emerging market equities to swoon. We saw the same pattern develop in May (the only difference this time is that oil prices went up rather than down. But that can be attributed to specific geopolitical tensions (Iran-US) that were not present in November 2016).

These late 2016 investment trends were not sustained much beyond January 2017 and, by the first quarter of 2017, most of them reversed. Can we expect the same this time around? It is likely. However, at this stage, I believe that they may last a bit longer, probably until the mid-term elections in November. In spite of the howling from US allies about tariffs, the hyped trade rhetoric of the Administration begets electoral points. So why stop now!

What will that do to our long-term relations? What will be the medium to long-term economic and geopolitical consequences? Because I do not see anything particularly positive coming out of all of this, I have started reducing our risk positions. More on this in our next section.

For now, I will conclude this section with a positive note coming from the US economy. Below is the chart that illustrates the level of charge-offs (expected loan losses) on loans to consumers. As you can see, those levels remain historically low. No recession is yet in view.



Tilts and Allocations

The strengthening US dollar and tough US trade rhetoric have wreaked havoc this month with internationally diversified portfolios. To illustrate this point, below is a chart for EZU, a Eurozone ETF heavily influenced by the fate of the German economy which is itself highly dependent on exports and subject to the negative effects of US tariffs.

The vertical line marks the beginning of May. The red dot at the right of the chart, marks the day following the leak of an internal memo on the likely economic policies of the new Italian government. We sold all our EZU positions when the blue line intersected the price line, a little before the recent bottom.

In May we also cut some of our emerging market positions and, in the waning days of the month, reduced our US equity positions. All in all, we have reduced our total equity allocation by about 3% to 4% across portfolios.

While the US economy remains sturdy, risks are rising and so are the chances of a policy mistake, be it geopolitical or economic in nature. This rising risk level is happening at a time of relatively high valuations, peak or near-peak US corporate earnings and increasing US interest rates. When I take all of this in consideration, I feel that a reduction of our overall risk level is warranted.

There is no need to accelerate this movement for now. However, all things equal otherwise, I may prune further our equity investments over the summer months.

Concluding remarks

If I were to gauge how much economic data and economic policy decisions weigh on the direction of equity markets overall, I would say that beyond the daily volatility that human emotions can generate, they explain about 98% of medium to long-term market movements.

Once in a while though, they are dwarfed by political ones. Think about how wars affect markets for example. Less dramatically, think about how the 1973 decision by Opec to raise oil prices (a political decision before being an economic one) affected equities worldwide in the 70's. Or how the decision to create the Euro (a political decision before being an economic one) has affected markets and continues to do so today. Once in a while, geopolitics trump economics and from that moment onward, markets have to be assessed in a different light or with different yardsticks.

So far, when it comes to international relations the Administration has essentially controlled the narrative. That will change. At some point in the future it will have to respond to an unexpected event or series of events and will cease to control the story line. When this happens, I have some concerns about its ability to provide the most appropriate response. Serious consequences could ensue, beyond the realm of investments.

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

Cordially,

Jeff de Valdivia