March 4, 2018

Overview

In February, the S&P's 500 dropped 3.69% while the Russell 2000 sunk 3.87%. The damage was a bit more pronounced internationally as a result of the appreciation of the USD against major currencies. The S&P's EPAC BMI, our reference index for international developed markets, went down 4.59% while the MSCI EM (emerging markets) index dropped 4.61%.

There was no relief to be expected from the fixed income market. The US long bond was down another 3% and other sectors of the bond market were down from .85% (Bloomberg High Yield index) to .46% for one of the S&P's municipal indices that we track.

The chart below represents the VIX, a measure of equity market volatility, over the past six months. The vertical line marks January 26, when US equities started their correction. Over the following days, VIX doubled in value as the S&P's 500 corrected about 10% from peak to trough.

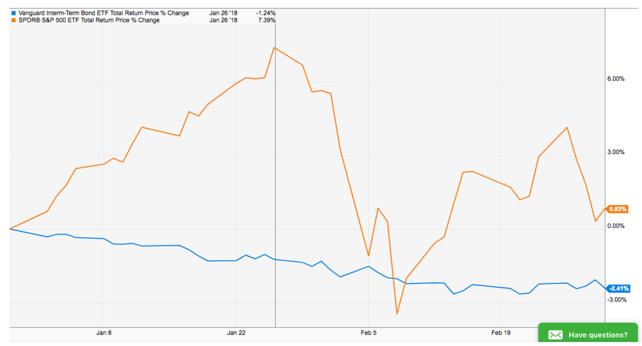
As indicated earlier, there was no relief to be expected from bond holdings as the correction itself resulted principally from a fear of more numerous Fed interest rate increases than originally anticipated.

In February, our client portfolios dropped between -1.90% and -2.98%. This compares to a monthly performance of -2.33% 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 up .20% to .84%, net of fees. This compares to a performance of -.27% for our benchmark. As a reminder, our allocation to equities currently varies from a minimum of 40% to a maximum of 60%, depending on the risk profile of each client.

Market developments

The month of February started in the middle of an equity correction triggered by interest rate fears. As the correction was taking place the yield on the 10-year US treasury rose from 2.60% to 2.90%, providing no protection against declining equities.

The chart below shows the performance of SPY vs. BIV since the beginning of the year.



YTD, BIV is down 2.41% (as of March 2) while SPY is up .85%. As clearly illustrated, BIV provided no succor against the sharp drop in equities from January 26 (vertical line) to February 8.

When equity markets correct, investors often flock to the relative safety of US treasuries, therefore pushing their yields down. It has not happened this time around, perhaps in part because the concerns that investors have about the direction and speed of interest rate increases does not appear to be shared by the Administration or Congress. These two branches of our government act as if our current debt level and fiscal imbalances were sustainable and/or acceptable.

That lack of attention to this issue adds to the general anxiety of market participants and fuels further an already tense and volatile environment.

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Tilts and allocations

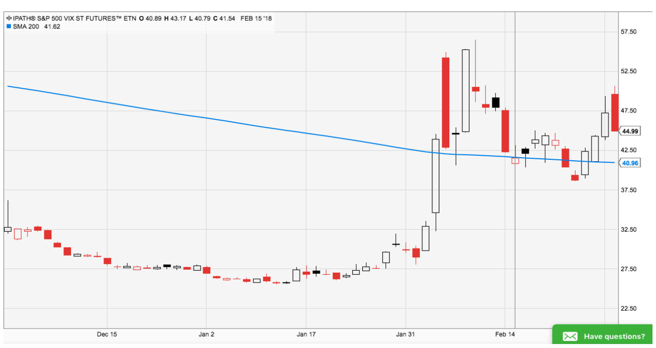
Given the market turbulences in February, we limited our activity to adding to positions that had been beaten down or to protecting portfolios.

We added to our investment in EZU, the Eurozone ETF, when it first dropped to the level of its 200 moving average, as illustrated below:

So far, that move has been marginally additive to performance. The most recent market weakness in Europe will either be amplified by the results of the Italian elections on Sunday or fade. We remain optimistic that Eurozone equities will soon reverse their short term negative momentum. Fundamentals there are still supportive.

As I have mentioned in the previous newsletter, the only way to hedge against equity corrections seems to be to buy volatility. The problem: It is expensive and requires quick feet.

We gave it a try. On February 16, we bought VXX for all of our client portfolios. We unwound that position on March 1, at a profit, as shown in the chart below:



We bought VXX at about $41, at a session low, sometimes during February 16. We sold the position on March 1 at about $49, at that day's session high. Between the times of our purchase and of our sale of VXX the S&P's 500 dropped about 4%.
The hedge worked. In retrospect, both our buy and sell orders were timed almost perfectly. I do not expect that to happen too often…

Trading in volatility requires such a high level of attention that VXX should only be bought by professional managers or investors who can live with daily fluctuations of 10% and more without losing their aplomb!

Concluding remarks

US equities markets started stabilizing on February 14 when the Department of Labor released its CPI report for the month of January. While that number was a bit higher than expected, equity investors interpreted it as "good for growth and not so fast after all…".

The next CPI will be released on March 13. It will be preceded by the employment number, next Friday. Investors are nervous. I would expect quite a bit of market volatility around these two dates.

Additionally, the steep tariffs that the Administration has threatened to impose on steel and aluminum imports further cloud the short-term investment landscape. If and when they are imposed there is little doubt that counter-measures will ensue with consequences that are difficult to assess but none of which are positive. This will in all likelihood affect the value of the USD, emerging market equities and commodities in particular. Possibly more asset classes.

In that general context, market volatility will likely remain elevated and positive market returns elusive over the foreseeable future.

As usual, feel free to contact me with questions or comments.

Best regards.