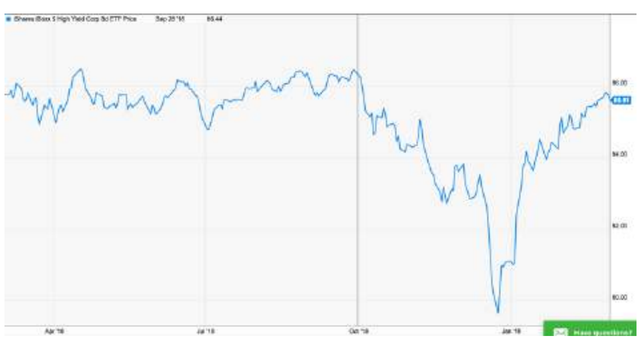
March 4, 2019

Overview

February was another “risk-on” month. Investors poured money back into stocks after many had missed, or partially missed, the spectacular market rebound in January.

The S&P’s 500 rose 3.21%. The Nasdaq Composite added 3.60% while the Russell 2000 (US Small Caps) rose 5.20%. International equity markets rose but in a more muted fashion. The S&P EPAC BMI (developed markets) went up 2.08 while emerging equities rose a less exhilarating .22% (MSCI EM) and .86% (Frontier 100 Index). Oil futures were up 6.35% during a month that saw most commodities rally.

Meanwhile, the US fixed income markets saw an unexpectedly strong GDP number for the last quarter of 2018 cause the long bond to lose about 1.22%. Most other fixed income sectors were relatively calm with the exception of the high yield sector that added another 2.43% in February. Below is a chart for HYG, the high yield ETF. The vertical bar marks the beginning of the market correction.



The price recovery in that sector, just as for US equities, seems to be about complete.

In February, our client portfolios were up from 1.76% to 2.96%. This compares to a monthly performance of 1.19% for a portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% BIV (US bond aggregate proxy). On a Year-To-Date (YTD) basis, our portfolios are up from 6.30% to 9.13% (net of fees) vs. 6.12% 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 development

The recovery in equity markets continued in February, supported by: 1) Strong US employment statistics at the beginning of the month, 2) Soothing commentary from the Federal Reserve (FED) on monetary policy and from the White House on international trade and, 3) Surprisingly strong US GDP numbers in the waning days of February. Internationally, the ECB (European Central Bank) added to the positive mood when it intimated that it would take a more accommodative monetary stance once again, should signs of weakening economic conditions in Europe persist.

All of this, comforted investors into believing that a more “equity-supporting” interest rate environment was globally back. This is an environment that is generally characterized by controlled/subdued inflation, moderate economic growth and continued employment gains (that do not justify a rapid tightening of monetary conditions). In the space of three to four months investors have gone from a mood of despair to one of exhilaration, taking equity markets along for the ride. The S&P’s 500 went down close to 20% from early October to late December 2018 and is now up 19% from this trough.

Where does that leave us? Market swings of such magnitude and policy changes such as the recent FED’s reversal reflect the high level of economic uncertainty that most market participants and decision makers have to grapple with.

The FED will likely push interest rates a little bit higher going forward. This will continue to create headwinds for equities. But that is not necessarily a problem if economic numbers remain as strong as they have. That said, the chances of that happening are not insignificant, but perhaps less than 50% in my view. After all, this recovery is now close to ten-years old and long in the tooth. If it gets to the month of June, it will become the longest economic recovery ever-recorded.

All of these simultaneous and often contradictory currents make life hard for an investor. They are undeniably difficult to assess. In this environment, volatility is likely to rise again. In such conditions, it is particularly important for investors to control their (investing) emotions and to understand their behavioral biases.

Thinking long and hard before making any investment decision, understanding why your portfolio is positioned the way it is and knowing what your natural (investing) inclinations are as your stress level rises, can make the difference between weathering well sharp market fluctuations or being mauled in the process.

Tilts and Allocations

In February, we increased our overall risk posture, albeit in a rather measured way. Specifically, we continued to add to emerging markets equities and started to switch out of XLU (a defensive sector) in favor of a broader US equity market exposure (PRBLX). These two actions have increased our total equity allocation anywhere from 2% to 4% and reflect our perception that market conditions have meaningfully improved.

Together with our early January investment decisions, these moves have allowed us to outperform our benchmark so far this year.

The chart below reflects the US equity market advance, across five sectors, since the beginning of 2019. It gives us reasonable comfort as to what to expect in the coming months.

YTD, Industrial sector equities are up 18.63% (Green), Technology is up 16.65% (Purple), Energy is up 15.87% (Blue), while Consumer Discretionary equities are up 12.21% (Orange) and Financials (Red) 12.05%.

The broad-based nature of the rebound in the cyclical sectors (Consumer discretionary, Technology and Industrials) is reassuring. It seems to indicate that investors do not expect an economic downturn in the next few months. This renewed sense of optimism is confirmed by the behavior of the high yield sector which is up 6% YTD.

Concluding remarks

The S&P's 500 has now recovered close to 75% of the ground it lost in the last quarter of 2018. Another 3.5% to 4% progression will be necessary before the damage can be completely erased, as illustrated in the following chart.

The economic data out of Europe is not encouraging. Neither is that out of China and Japan, although indicators there point to less challenging conditions overall.

Stateside, while the earnings season has been relatively good and supportive for equities, moving upward from here may require maintaining the status quo on the interest rate front, positively concluding trade negotiations with China and continued good news on the growth and inflation fronts. It is difficult to think that all these conditions will be maintained or achieved, without some surprises along the way.

As a consequence, I expect market volatility to rise again over the next few weeks and months. We are invested accordingly.

Thank you again for your continued trust,

Jeff de Valdivia