FLEURUS INVESTMENT ADVISORY

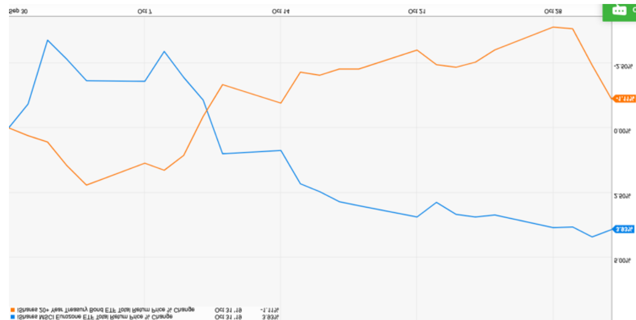
November 2, 2019

Overview

After a difficult start, the month of October turned out to be positive for equities around the world.

The S&P's 500 gained 2.17%. The US Small Cap index rose a bit more with the Russell 2000 progressing 2.63%. Internationally, developed equities did well as the US dollar lost value against major currencies. As a consequence, international markets performed generally better than US markets. The S&P EPAC BMI (developed economies index) rose 3.76%. Emerging markets equities were up too with the MSCI EM rising a solid 4.22% while the Frontier Index inched up .71%.

Below is a chart that illustrates the negative correlation between long-term US interest rates and the performance of international equities (in this case European equities).



The orange line reflects the performance of EZU (European equities ETF), during October. It was up 3.93%. During the same period TLT, an ETF that tracks the performance of the US long bond (blue line), was down 1.11%. When US interest rates drop (here long-term rates), the US dollar tends to lose steam. Which in turn causes international equities to often outperform their US counterparts.

In October, our client portfolios rose between .55% and .99%. This compares to a monthly performance of 1.48% for a portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy). On a Year-To-Date (YTD) basis, our portfolios are up from 10.46% to 15.03% (net of fees) vs. 14.07% for our benchmark.

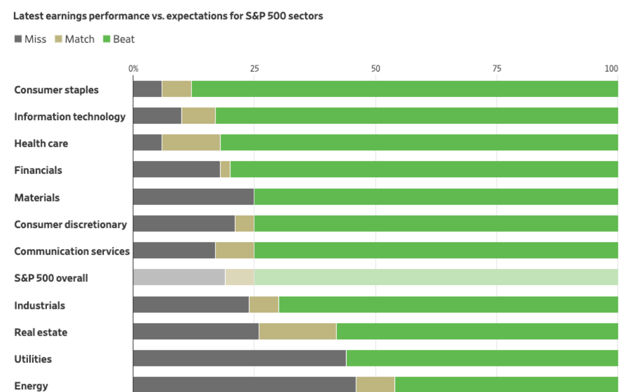
As a reminder, the equity allocation in our clients' portfolios ranges currently from 30% to 60%, depending on their risk profiles.

Market developments

The market started the month of October with a negative undertone. Industrial production data, in the form of the ISM number in particular, were weaker than expected. The September employment number, released shortly after, was also weaker than expected and added to the negativity, taking US equities down 2% to 3% in the space of a few days.

Then, on October 8, the White House announced a series of sanctions against members of the Chinese nomenklatura and technology firms associated with human rights violations perpetrated on the Uighurs, a Turkic Muslim population in Northwestern China. The very next day, China signaled its willingness to sign a "limited" trade agreement, at some point in the near future. The current White House has not made the defense of human rights the center piece of its foreign policy, to say the least. But it understands that autocratic China does not welcome bad publicity, particularly on the subject of human rights. So…

The promise of a trade agreement with China, even if limited, caused the market to reverse course. That change of sentiment was comforted in the middle of the month by better than expected third quarter earnings coming from several large banks and other corporate heavy weights. This positive earnings trend has been largely confirmed since. As of now, with 80% of corporate earnings released for the third quarter, 75% have come better than expected. Overall, third quarter earnings remain lower when compared to the third quarter last year (by about 2%). Nevertheless, investors have been reassured that a recession is not around the corner. The table below, from the Wall Street Journal, illustrates the better-than-expected earnings season:



Tilts and Allocations

As indicated in my previous market newsletter, I have been waiting for the start of the third quarter earnings season to get a better sense of the direction of the economy. I have therefore limited my activity to making investments only for new accounts and to selling all of our XLU (Utilities) positions. So far, the sale of XLU has been timely. The sector has been treading water since, while the rest of the market rose.

On a less positive note, our main US equities allocations, in the form of two mutual fund investments (BUFTX and PRBLX), have underperformed the S&P's 500 by close to 3% since early September. This results from the significant sectorial rotations that have occurred since. In mid-September, economic uncertainty caused investors to move away from technology only to get back into the sector shortly after. It caused also a move away from mid-cap equities in favor of large caps. That initial move was also partially reversed more recently. This back and forth has led our two main US equities investments to underperform. I believe this to be temporary.

As the market mood improves, I expect both funds to outperform their respective benchmarks. I have decided to keep our investments with them unchanged for now.

Finally, the arbitrage transaction that I initiated in early September has contributed positively to our performance so far, but only marginally. The US small cap index (orange line) has outperformed its large cap brethren by 1.5% since early September, as illustrated below.

I am still expecting a further gain of 5% to 7% in the coming months and intend to keep the transaction in place. Alternatively, I may remove the short position altogether (on the large cap index) and keep the long (small caps) to take advantage of the improving market tone.

Concluding Remarks

On October 30, the FED reduced the Fed Funds rate by another .25%. There is good reason to believe that the three consecutive interest rate cuts since early July will contribute to keeping the US economic expansion going for a while longer. At this stage, there is little evidence that they will not.

Sure, the trade situation remains unresolved, the impeachment inquiry adds a bit of risk for investors, and corporate earnings, while better than expected, remain down 2% from one year ago. Nevertheless, the US consumer keeps on buying, stock analysts expects an earnings recovery early next year and the employment picture remains peachy.

All in all, I am at pain to justify cutting our equities exposure further. We are already conservatively positioned.

If anything, I may add to our risk bucket a bit in the coming weeks.

Thank you for your trust.

Jeff de Valdivia, CFA, CFP
Fleurus Investment Advisory, LLC
www.fleurus-ia.com
(203) 919-4980