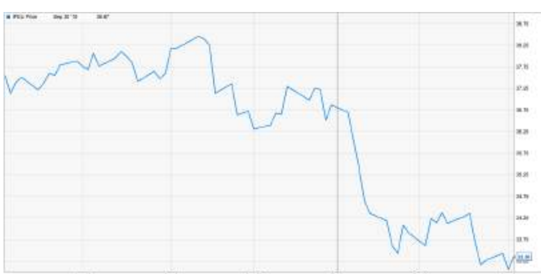
November 4, 2016

Overview

In October the S&P's 500 total return index dropped 1.74%, the Russel MidCap index lost a larger 3.50% and the small cap Russell 2000 an even more painful 4.75%. The damage was not limited to equities. The US treasury long bond index dropped by 4.82% while even the steady S&P's muni index shed .91%, its second month of consecutive losses.

The pain was a little less intense abroad where the Epac BMI stock index for developed economies dropped 2.35% and emerging markets eked out a gain of .21% (MSCI EM Index). Unlike in previous years, geographical diversification continues to work in 2016.

Commodities were flat this month with the DJCI index down a tiny .16% in spite of a severe move down in the oil markets in the later part of the month. As for Reits they experienced a nasty correction both domestically (down close to 6%) and internationally (-10%). The chart below illustrates the performance of IFEU, the European Reits ETF. The vertical line marks the beginning of October.



In October our client portfolios dropped between 1.17% and 1.73%. Year to date (YTD) our internationally diversified portfolios are up from 3.88% to 6.40%, net of fees. This compares to YTD performance of 4.69% for a purely US-centric portfolio consisting of 50% SPY (ETF for the S&P's 500) and 50% BIV (US bond aggregate ETF proxy), over the same period.

As a reminder, our allocation to equities currently varies from a minimum of 30% to a maximum of 60%, depending on the risk profile of each client.

Market developments

No corner of the investment markets was spared in October from investors' reactions to two distinct factors and developments: 1) The quasi-inevitability of a rate hike by the Fed in December, 2) The tightening spread between the two US presidential contenders, days from the election.

The previous chart illustrates the first point.

Reits, utilities and other sectors of the investment landscape have inordinately benefitted from the multi-year accommodative policies of monetary authorities around the globe. With one of its major advocate, the FED, clearly set on raising rates, investors have now concluded that "regime change" (from accommodative to not-so-accommodative) is afoot. Consequently, investors have decided that October was a good time to revisit the lofty valuations of some asset or sub-asset classes. A drop of 10% in European Reits is one not so subtle way to express it. A similar, if less painful one, is the 6% drop for US Reits.

As interest rates increase, valuations go down, all things equal otherwise. Going forward, there will be less wind behind all types of risk assets. The most vulnerable among them are the ones that have experienced the longest and most pronounced moves up: Utilities, Reits, Long duration municipal bonds, to name a few. The rotation out of these assets has started. It is likely to continue.

The second point reflects the recently increased odds in favor of a Trump presidency. The decision by the FBI to reopen the email-related investigation that has hindered the Clinton campaign in the past has tightened the race for the US presidency. US and international markets do not like that and are responding with, 1) equity selling across most geographies, 2) heightened volatility across most asset classes.

A Trump victory would likely push equities down across the globe, at least initially. Many investors have raised cash in anticipation. The depth of the correction that would ensue is hard to gauge. It would depend on the new president's first economic and geopolitical utterances.

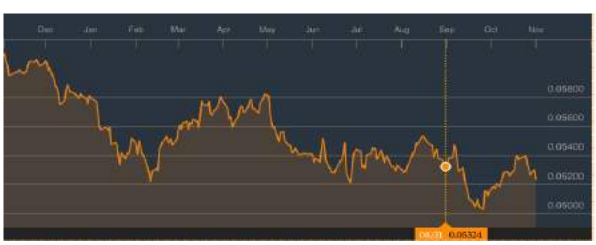
Tilts and allocations

In October we continued and finalized our exit of the Reit sector. Proceeds of these sales have been left in cash or short term US treasury. This allowed us to avoid most of the damage in that sector, if not all of it.

We refrained from other actions until the FBI Director dropped its electoral bomb on Friday October 28. The resulting tightening of the presidential race caused us to marginally reduce our exposure to the small cap US sector, across portfolios. Here is the performance chart of the Russell 2000 index (small cap) vs. that of the S&P's 500 in October.

The vertical line marks **the closing prices** for the S&P's and Russell 2000 on the day of the FBI announcement, October 28. As is clearly visible, the drop of the orange line (Russell) during that day (the section just before the vertical line) is steeper than that of the S&P's 500 (in blue). This is typical of a risk-off trade. Risk increases, investors reduce their allocation to the most risky assets. Small caps are riskier than large caps. They go down faster. They also go up faster…So if you want to play the election game, here is an area that offers some potential.

In the same vein, and for the most speculative investors among you, playing a reversal or an acceleration in the rate of decline of the Mexican peso (MXN) against the USD is another way of trading for a profit around the result of the US elections. Here is the chart of the MXN/USD since the beginning of the year.



The vertical line marks the beginning of September and is followed by the precipitous drop associated with the increasing odds of a Trump victory at that time. Conversely, the October reversal in the value of the Mexican peso correlates positively with the odds of a Clinton victory. Finally, the chart shows the drop in the value of the MXN, following the announcement of October 28.

Conclusion

As important as economic and investing considerations are most of the time, they pale in comparison to political ones at certain times in history. I believe that now is such a time. So let me exceptionally veer from my usual investment and economic thoughts to share with you other views that appear to me to be more relevant today.

I have heard people say: "at the end of the day, the markets will find their balance whatever the results of this election. It does not really matter who is in charge. The institutions of our country are strong enough to withstand whatever the shortcomings of our next President." As an attentive student of political history, I disagree.

The person we elect as the head of the most economically and militarily powerful nation on earth matters a lot. It matters to our institutions. It matters to our conception of democracy. It matters to the integrity of our electoral system and of our nation. It matters to our standing in the world and it matters to peace with other nations. As a consequence, it eventually matters to the type of economic environment in which we find ourselves and to the prosperity of this nation.

I believe that our clients' portfolios are well positioned for either outcome and hope that our nation copes with the result of this election with as much equanimity.

Feel free to call me with any questions. Thank you for your trust.