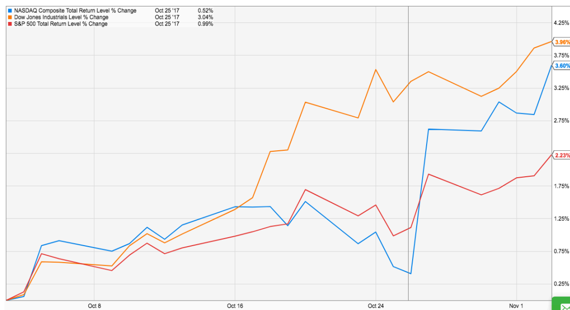
FLEURUS INVESTMENT ADVISORY

November 4, 2017

Overview

October was another good month for equities worldwide. The S&P's 500 rose a solid 2.33% on a total return basis (dividends included) and the Russell 2000 a more modest .84%. Internationally, the S&P Epac BMI of developed economies rose 1.89% thanks in good part to a spectacular 5.28% gain in Japanese equities following the electoral win of Prime Minister Abe Shinzo's governing coalition. Finally, Emerging markets were up 3.45% (MSCI EM) in spite of a 2% appreciation of the USD during the month.

Below is a map of three US equity indices during the month of October. It illustrates investors' responses to third quarter earnings announcements. While all indices moved together until the mid month, abrupt sector rotations around October 16 caused them to diverge, with the Dow Jones (Orange line) accelerating at the expense of Technology Stocks (Nasdaq-Blue line) and the broader market (S&Ps 500-Red line) after several positive earnings announcements from the manufacturing sector. The vertical line marks the day of the Amazon earnings announcement. The effect it had on the Tech sector caused the divergence between indices to shrink considerably.



In October, our client portfolios rose between .81% and 1.32%. YTD these accounts are up between 11.00% and 14.90%.

This compares to monthly and YTD performances of 1.18% and 10.18% respectively 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 periods. 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

As of this writing, 81% of S&P's 500 companies have reported their third quarter earnings. On that basis, these earnings have grown about 5.9% when compared to the same period last year. This is altogether market-positive and helps explain the good equity performance this month. Looking ahead, most corporations expect similar progress over the coming fourth quarter.

All is good then! Well, a bit of historical perspective may give us some pause. The 12-month forward P/E for S&Ps 500 companies is projected at 18x. It is well above its 5-year average of 15.7x or its 10-year average of 14.1x.

On the other hand, the new US tax bill, if passed as presented, will provide additional lift to US corporate earnings. This, together with a global economy on a positive growth path almost everywhere, makes it hard to justify reducing equity allocations. In this environment, what appear as more appropriate are portfolio adjustments and reallocations rather than outright sales and risk reductions. More in this in our next section...

Also noteworthy this month was the spectacular rise of Japanese equities. Below is a chart of EWJ, the ETF that we use to allocate to Japanese equities.

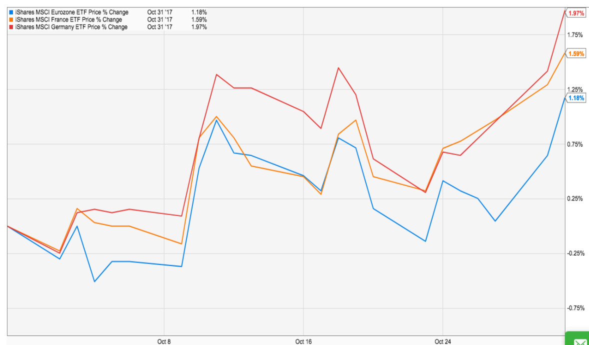
The vertical line marks the beginning of October. Since then, EWJ has catapulted 6% to 7% forward as a result of a weakening Yen (favorable to Japanese export-driven manufacturers) and to the spectacular win of Abe Shinzo's governing coalition in parliamentary elections.

Finally, this month saw a meaningful rise in the price of oil of about 4.39%. A growing global economy and the premises of an agreement to support the oil market by Opec members beyond March 2018, helped drive oil and commodity prices up in general.

Tilts and allocations

This month we reduced our allocation to Spain, as the situation in Catalonia became more and more confused before finally settling, more or less, at the end of the month.

Rather than reducing our European equity exposure altogether we re-allocated away from Spain (by selling EZU- Blue line below) and in favor of French and German equities (EWQ and EWG- Orange and Red lines). This proved to be a correct move. While all three European ETFs progressed in October, the French and German ETFs rose 1.5% and 1.9% respectively vs. 1.2% for EZU.



Second, we marginally reduced our emerging markets equity allocation as the rise of the USD continued. Nevertheless, the case for a further reduction of our allocation to this top-performing sector this year (up close to 30% in 2017) is hard to make. While the USD is going up and this is generally negative for emerging market equities, the sector has still a lot of catching up to do when compared to US equity indices over a three and five year horizon. Also, and as previously mentioned, the global economy is growing and commodity prices are firming up. All are factors that are supportive of emerging market equities.

What we may do instead is reducing our allocation to emerging market bonds. While this allocation is small in most portfolios, the likely increase in short term interest rates in the US over the coming year will continue to provide strong headwinds. Emerging market bonds have not progressed over the past six months, as illustrated by the chart of PCY, below. They are unlikely to progress meaningfully, in the near future.

Concluding remarks

As indicated earlier in the letter, US equity valuations are historically high. In spite of the positive economic environment, this gives us pause. We also know from experience that radical moves, such as selling or buying equities and consequently reducing or increasing equity allocations by more than 10%, at any given time, cause more often than not long-term portfolio performance to suffer.

What are we to do then? Should we reduce US equities because they are historically over valued? Should we instead stay put or even increase our equity allocation since most US indicators are flashing green?

I have heard from some of you recently. Often you have expressed concern over US equities, the state of our politics and the uncertainties around the globe. I have interpreted this as meaning "Should we not reduce risk/equity exposures in the portfolio?". I have resisted those "soft" suggestions so far, for the reasons mentioned earlier. Simply put, the current economic environment does not justify it.

Should I ignore these suggestions? Certainly not! No one knows how markets will perform tomorrow and let alone over the next few months. A call to reduce US equities now could be timely, after all.

However, in the absence of major economic or political catastrophes, economic considerations drive markets. That is what equity investors should always keep in mind. Currently, reducing equities in a meaningful manner is simply not justified, as long as your portfolio equity allocation is well thought-out.

The better approach is probably to adjust the portfolio rather than to radically alter it. That means, for example, shifting risk from one sector that has rapidly grown to another that has yet to do so. That means raising cash in the absence of any compelling investment opportunity, and being ready to pounce should market correct. Overall, that means remaining in a heightened state of alert. That is what I intend to do over the next few months.

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

Best regards.