October 3, 2017

Overview

September was a good month for equities worldwide, with the exception of emerging equities that struggled with the rise of the USD during that period. After a rather uneventful first two weeks, the outcome of the Fed's monetary policy meeting (20th), German elections (24th) and Tax reform talks (25th) all combined to provide some market excitement. When all was done, US large cap equities were up 2.01% (S&P's 500 Total Return), Small caps a whopping 6.24% (Russell 2000 Total Return) and international developed markets up 2.19% (S&P EPAC BMI).

US interest rates rose during the month as a result of a more hawkish monetary policy tone coming out of the Fed's meetings and the resumption of the Trump trade with the resurgence of talks of tax reform. The chart below illustrates how the Small Cap sector (blue line) and the Long Bond (orange line) reacted to these events and trends during the month.

The vertical line marks the release of the outline of the tax reform plan of the Trump Administration on September 25 and the immediate effect it had on small caps (up) and bonds (down). However, by the last day of trading, investors seemed to recalibrate expectations of radical tax reform. Gains for small caps and losses on bond portfolios started moderating.

In September, our client portfolios rose between 1.15% and 1.66%. YTD these accounts are up between 10.65% and 13.88%.

This compares to monthly and YTD performances of .56% and 8.83% 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

The month started with the USD weakening vs. its main partners' currencies. On September 7, the USD went down 1%. At the time, uncertainty about negotiations on the debt ceiling weighed on the currency. That caused emerging market equities and some international developed markets to rise. The movements of the USD are often inversely correlated to the direction of international equity markets and particularly, emerging equities. When the dollar strengthens, these equity markets suffer and vice versa.

The chart below is that of USDU, an ETF that tracks the performance of the USD (blue line) and ECON, one of the ETF that we use to invest in emerging market equities. The chart goes from September 30, 2016 to today.

The vertical line marks the beginning of the year. Notice, to the left of the line, the effect of the US election. From that time until the beginning of the year the USD rose and emerging market equities swooned. With the new-year, the USD started its decline and emerging markets their climb. Finally, notice at the very right of the chart the trend reversal for both lines caused by the late September tax talk. Here is how the narrative goes: corporate tax rates down, earnings up, interest rates up, USD up, emerging markets down.

I think that this time around, unlike after the elections of last November, this story will be subdued and possibly short lived unless and until the Administration finally delivers on one its promised reforms.

Fortunately for equity markets, corporate earnings are likely to come to the rescue. Signs are good that third quarter corporate earnings will be strong, providing a well-timed support and assuaging fears of market overvaluation. I would not be surprised to see the S&P's 500 finish the year 1% or 2% higher. That would not be a small feat since it has already registered a strong 13.99% performance, through September 30.

Tilts and allocations

With so much on the economic agenda at the beginning of the month we proceeded with caution. First, we reduced our US equities allocation by 5% across all customer accounts as a consequence of the high political volatility in the US and high US equity valuations overall.

Second, we maintained or increased our European equity exposures as economic growth across European countries continues to surprise to the upside and is gaining in breadth. That decision proved to be timely. International developed markets performed as well as US markets in September and our French and German investments at double that rate (4% to 5% in September).

Our call for additional European market exposure since March has served us well and explains in good part our outperformance so far this year.

Below is the chart of EZU (orange line) and SPY (blue line). EZU is our choice European ETF and SPY is the ETF that tracks the performance of the S&P's 500.

The vertical line marks the first round of the French presidential elections in April. Since then, European equity markets have been able to sustain their initial climb thanks to a combination of positive economic news throughout the EU and, more recently, to the ability of the French president to deliver on reforms aimed at relaxing employment laws in France.

Looking ahead, except for the effects of a sharp rise in the value of the USD over the next few weeks and months, I expect European equities to continue on their positive trend throughout the remainder of the year.

In October, we will pay particular attention to Angela Merkel's ability to form a working/lasting government coalition. This will impact not only German internal politics but also European politics and President Macron's desire and ability to further integrate European institutions with the creation of pan-European ministries. Finally, we are keeping an eye on the events in Catalonia. If the situation were to become more violent, there is little doubt that European equities could be derailed from their upward trajectory.

Concluding remarks

Investment-wise, the year so far has been good. Our average client portfolio has captured about 85% of the S&P's performance while taking about 50% of the risk. This is the type of risk-adjusted return that Fleurus aims for.

The last quarter of the year is more often than not positive for US equities. Third quarter earnings are expected to grow meaningfully and lend some support to otherwise stretched valuations. Finally, investor sentiment remains cautious or negative (a bullish indicator).

When I put all of this together I estimate the odds of equities finishing the year higher at about 50% and conclude that a significant correction between now and the year-end remains, as of now, a low probability event.

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

Best regards.