FLEURUS INVESTMENT ADVISORY

October 4, 2018

Overview

The S&Ps' 500 returned .57% in September while the Russell 2000 (small caps) went down a meaningful 2.40%. Internationally, returns ranged from up .44% for the S&P EPAC BMI (international developed markets) to slightly down for emerging markets. The MSCI EM was down .32% this month.

Internationally, the most notable development came from Japan. Equities there went up close to 3.45%, bucking the negative trend afflicting other international markets. Below is a chart showing the performance of EWJ (Japan equities) vs. EWG (German equities) in September.

EWJ (orange line) was up 3.45% in September why EWG (blue line) was down 1.62% during that period. All of this seems to be driven by the market's perception that the US Administration's trade policies will affect Germany more negatively that they will Japan. I am somewhat dubious.

Elsewhere, the US bond market performed poorly again with the long bond dropping 2.96% and most other subsectors down from .36% (intermediate corporate bonds) to .61% for the municipal bond sector. High yield bonds managed to perform better. The Bloomberg US High Yield index was up .56%.
So far this year the high yield sector, together with short term US treasuries (under 12 months in maturity), is the only part of the US bond market that has managed to register a positive performance (2.57%). All other sectors are down from .56% (municipal bonds) to down 5.79% for the long bond.

In September, our client portfolios were up.25% to down .77%. This compares to a monthly performance of -.04% for a purely US-centric portfolio consisting of 50% SPY (S&P's 500 ETF) and 50% BIV (US bond aggregate proxy). On a year to date (YTD) basis our portfolios are up .05% to 2.75%, net of fees. This compares to a yearly performance of 4.11% for our benchmark.

As a reminder, our allocations to equities currently vary from a minimum of 30% to a maximum of 70%, depending on each client's risk profile.

Market developments

In September we saw a continuation of the trends in equity markets that we have seen since early May, albeit in a more nuanced fashion. US large capitalization stocks went up. Emerging market equities went down, if less than previously. Oil prices went up. US bonds resumed their downtrend movement on the back of the FED's interest rate decision of September 24.

One of the puzzling consequence of this state of affairs is that there has been, so far this year, very little opportunity to make any money outside of US equities and particularly growth stocks. Geographic diversification (international and emerging) and asset diversification (bonds, commodities, real estate) have generally simply detracted from performance and provided no meaningful hedging.

Obviously, this can't go on indefinitely. The question is to know when other asset classes will rally back to catch up with US indices or when US indices will start dropping to reduce the gap in performance with other asset classes. And to position the portfolio accordingly. Timing is the issue, not whether this will happen or not.

In the meantime, some pretty strange things have been happening. One example is illustrated in the chart below:

The time period covered is from early June 2018 to today. The blue line represents the price performance of EWG (German equities) and the orange line that of VWO (emerging markets equities). Other than for the intensity of the downward movement in prices that both of these ETFs have experienced (-10% for VWO and -5% for EWG over the period), what I find staggering is the almost perfect synchronicity of price movements between the two. The correlation seems to be close to perfect. What the equity markets seem to be saying right now is that it does not really matter whether you are a German car maker or a Chinese one, we will treat you the same way and, by the way, we like Ford better. As simplistic as this approach is, it is the one that has worked over the past few months.

Tilts and Allocations

The US economy is doing well. Some would say very well. Even wage growth, so far largely missing from the bright economic picture, has started to meaningfully go up. In that context, the FED will continue to tighten monetary conditions (raise rates) over the next six to twelve months at least. It is more likely than not that periods of equity volatility will become more frequent as a result. Rising interest rates act as headwinds for the market. This does not mean that a serious correction is necessarily around the corner. But prudence is required.

Taking all of the above factors into consideration, over the past three months I have reduced the average equity allocation in each client portfolio by about 5%. I have also reduced the weight of growth stocks in favor of more conservative sectors such as utilities. So far, this has cost us in terms of performance but should do us some good when a correction takes place.

In September, I did not deviate from this approach and made a minimal amounts of investment decisions. I refrained from selling more of our emerging market and international developed equities. The selling in those sectors has been so intense over the summer months that a snap back is more than likely at some point during this quarter. It may have already started with Japanese equities (up 3.45% in September). My working assumption it that a similar and meaningful move in emerging markets and other developed market equities is probable in the next few months. We are positioned to benefit should it occur while remaining relatively conservative in our allocation to these sectors for now, in case we are wrong.

The case for such a market reaction is building, as evidenced by the return disparities of the asset classes shown below on a Year-To-Date (YTD) basis:

YTD Performance as of October 4, 2018		
VWO	Emerging Markets	-12.50%
EWG	German Equities	-8.59%
GLD	Gold	-8.22%
TLT	Long Bond (US)	-8.23%
VCIT	Intermediate US Corporate Bonds	-2.88%
JPST	Ultra Short Term ETF	1.68%
SPY	S&P's 500	9.95%

Concluding remarks

The excess liquidity that the FED has pumped in the US economy over the past ten years in response to the financial crisis is being gradually withdrawn with rising interest rates.

The consequences of this gradual tightening, here and globally at some point in the near future, will cause most asset classes to suffer. Emerging market equities have started to show how much pain higher US rates can inflict. US equities have not yet been affected, in large part due to the robust economy of the past few quarters. That is unlikely to last.

It would require mastery and luck on the part of US and global financial authorities to withdraw liquidity in such a way as to avoid an abrupt asset repricing (euphemism for "correction" in this instance) at some point in the not too distant future. Starting to position now your portfolio in anticipation of this turbulent phase makes sense to us, even if it comes with its likely (and hopefully temporary) underperformance.

As usual, please feel free to contact me with any questions.

Cordially,

Jeff de Valdivia