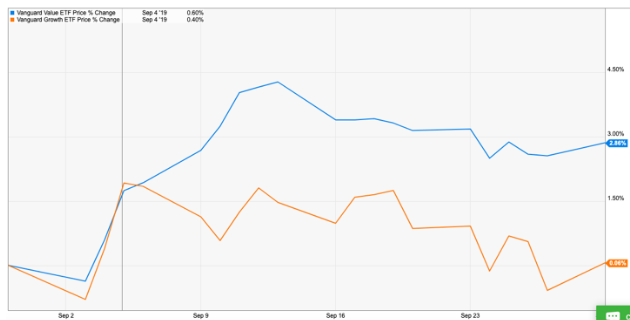
October 3, 2019

Overview

September was a positive month for equities around the world. A lessening of trade tensions between the US and China helped. So did the absolute spanking that Boris Johnson received from the UK parliament, thereby reducing the odds of a hard Brexit. That helped European equities outperform their US counterparts.

The S&P's 500 gained 1.87% in September. The US Small Cap index rose a bit more with the Russell 2000 progressing 2.08%. Internationally, developed equities did well.
The S&P EPAC BMI rose 2.68%. Emerging markets equities were mixed with the MSCI EM rising a solid 2.10% but the Frontier Index dropping 1.56%, mostly as a result of the political turmoil in Argentina.

This month saw an unexpected and interesting development: US value stocks outperformed growth stocks.
This seems to have been caused by a re-calibration of interest rate expectations, with investors feeling that perhaps interest rates were not going to go to zero after all. Below is a chart comparing VTV and VUG in September. VTV is the Vanguard ETF for value stocks and VUG its growth equivalent.



The vertical line marks September 5, when a stronger than expected manufacturing data (August ISM) surprised investors by its robustness. The blue line (VTV) started going up from there with VTV finishing the month up 2.86% while the orange line (growth stocks) stagnated (up .06%).

In September, our client portfolios hovered between 0% and up .71%. This compares to a monthly performance of .82% 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 9.98% to 14.35% (net of fees) vs. 12.36% 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

A lot happened in September. As indicated earlier the stark parliamentary defeat of the UK Prime Minister in early September, followed more recently by the resounding loss inflicted by the UK highest court, caused European equities to soar and maintain a positive tone throughout the month. The chances of a hard Brexit are now low, and investors seem a bit reassured on that front.

Meanwhile, a less acrimonious tone between the US and China and the promise of a resumption of trade talks in early October helped support US equities throughout most of the month.

In mid-September, the Federal Reserve pushed the reference interest rate down a notch (.25%) and that seemed to satisfy investors given the relatively positive economic data released in early September: From good wage growth in August, to sustained consumer confidence numbers and volatile but not downright negative manufacturing data (in contrast to the beginning of October).

The US economic environment is mixed to slightly positive and, in my view, not one that would justify reducing drastically risk exposures (selling equities). Nevertheless, my daily encounters and discussions with investors clearly indicate a general state of nervousness and anxiety.

Let's gain some perspective on this by taking a look at the Federal Reserve Stress index. As its name indicates, it is a measure of stress in the financial system.

Currently, the index sits at -1.284. This compares to -.516 in January 2016 when we experienced a bit of market turbulence. To give a broader perspective, that index rose to 5 in November 2008, its highest historical point. The risk, as measured by this index, is low. Things could change quickly. However, it is unlikely that we will go from a -1.284 index to a crisis level 2 or 3 in the next two or three months.

Tilts and Allocations

In September, our market activity was low and limited to deploying cash on new accounts or on those accounts that benefitted from large cash additions.

Our best performing investment this month was XLU (utilities ETF). Although I reduced our exposure to this sector in August and, consequently, did not benefit as much from its subsequent 5% jump in September, I do not regret shrinking our position. The valuations in this sector are historically high and bound to decline or underperform going forward. Next, in terms of positive performance, was our allocation to developed equities in Japan (up 5%) and Europe (up on average 2.5%).

These strong gains were offset by the abrupt rotation out of US growth stocks early in the month. It caused our US equity investments to underperform vs. the S&P's 500. While these investments have significantly outperformed their benchmark on a year-to-date basis, their underperformance in September was disappointing.

Finally, the arbitrage transaction that I described in my last letter (Long US small caps and Short US large caps) was marginally profitable this month. Portfolios gained about .75% on the position. This is not meaningless but a far distance from the 5%-7% that I expect overall. I will give it another month or two.

The first days of October are painful and vindicate our prudent and marginally defensive attitude towards equities since earlier in the summer. Most client portfolios remain under-allocated to equities compared to their targets.

At this stage, I see no reason to change my relatively conservative stand. Third quarter corporate earnings will decide whether an even more defensive posture is warranted. Their release will start during the second part of October.

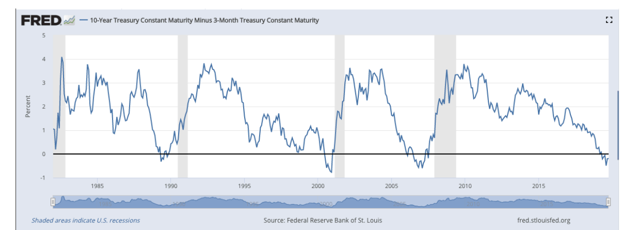
Concluding Remarks

President Trump seems to have forgotten for now about the FED and Jay Powell. I am guessing that the impeachment inquiry is taking a bit of his time. That's a good thing. As I indicated last month, attacking the FED is not likely to bring about anything good for investors. I am glad that the pressure seems to be off for now.

The rest, from tariffs to manufacturing woes worldwide and the inversion of the US yield curve, remains disquieting and a reason to be particularly cautious when considering additional equity investments.

Below is a chart that I have shared with you before. It pictures the yield differential between the US three months bill and the ten-year US note. As of this writing, it is still negative (below the horizontal line).

The grey areas show periods of economic recession. They generally materialize six to twelve months after an inversion bottoms out.



If this pattern repeats itself, the next recession could materialize around the time of the next US Presidential election.

Thank you for your trust.

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