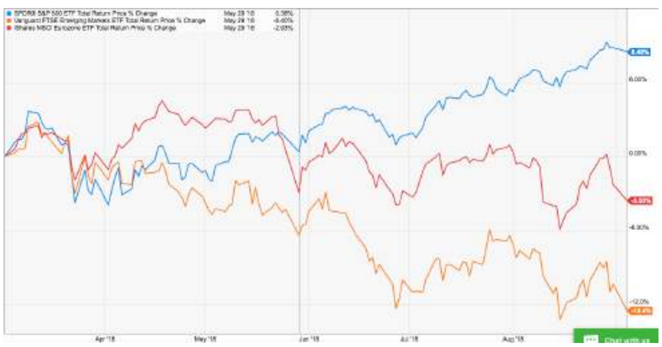
FLEURUS INVESTMENT ADVISORY

September 4, 2018

Overview

August was another spectacular month for US equities. The S&P's 500 was up 3.26% while the Russell 2000 (small caps) registered a 4.31% performance. Internationally, the situation was bleak. The EPAC BMI (international developed markets) was down 1.72% while the MSCI EM dropped a more painful 2.90%.

The chart below illustrates the divergent performances of the US equity markets and those of some parts of the international equities markets over the past six months (in USD terms).



Since early March, SPY (S&P's 500 ETF), in blue, is up 8.49% while EZU (Eurozone ETF), in red, is down 3.53% and VWO (emerging markets) is down a whopping 12.4%. The vertical line marks the end of May when the US Administration started imposing its first tariffs on Chinese goods and the rhetoric morphed into something more biting. For now, investors seem to think that deteriorating global trade conditions will disproportionately impact international equities and, strangely, leave US equities unscathed.

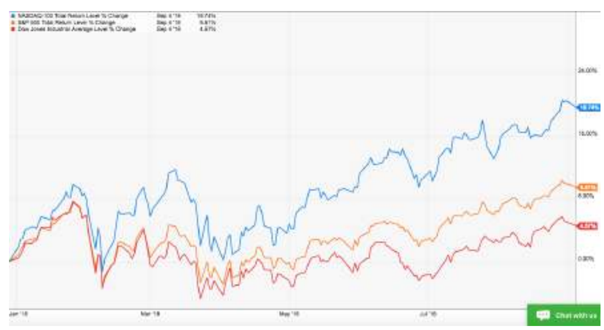
In August, our client portfolios rose from .56% to 1.38%. This compares to a monthly performance of 1.98% for a purely US-centric portfolio consisting of 50% SPY (S&P's 500 ETF) and 50% BIV (US bond aggregate proxy). On a year to date (YTD) basis our portfolios are up 1.05% to 3.25%, net of fees. This compares to a yearly performance of 4.12% for our benchmark.

As a reminder, our allocations to equities currently vary from a minimum of 30% to a maximum of 60%, depending on each client's risk profile.

Market developments

August is, more often than not, a volatile month when it comes to US equity performance. This is in large part due to the reduced liquidity associated with the dearth of market participants. This year was no exception. The trade entanglements with China, Mexico, Canada and the Eurozone waxed and waned all month long and so did equity markets, perhaps with more "élan" than usual given the low market liquidity. In the end, international and emerging market equities were down significantly while US equities, and the tech sector in particular, were meaningfully up.

The US tech sector, has pushed forward noticeably this year. The chart below compares the YTD performance of the Nasdaq 100 vs. some of its US brethren (S&P's 500 and Dow Jones Industrials).



The Nasdaq 100 (blue line) is up 19.74% in 2018 as of this writing. The S&P's 500 (orange line) is up 9.51% and the Dow Jones Industrials (red line) is up 4.57%. All numbers reflect the performance of these indices on a total return basis (dividends reinvested).

So far this year, the winning approach to equity investing has been: 1) avoid international diversification (international equities are down 4% to 15% in USD terms and depending on the sector), 2) in the US market, disproportionately favor the US tech sector (up 20%), 3) avoid hedging with gold or other commodities (flat to down 5% overall).

While I fully understand the rationale for the better performance of US equities (faster GDP growth, higher corporate earnings, stimulative fiscal policy…), the dichotomy with international markets appears to be overdone, notwithstanding rising US rates.

Tilts and Allocations

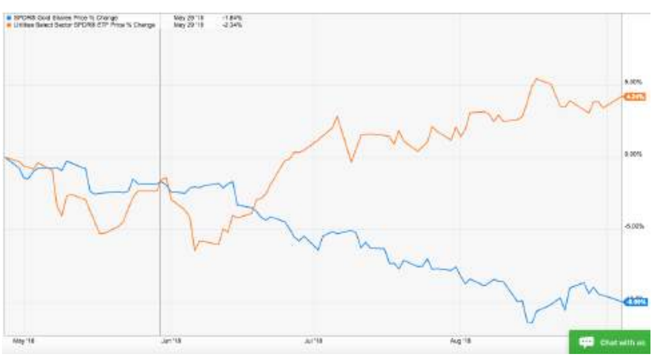
Since the end of May, I have been surprised by the persistence of the return disparity between US and international equities markets, in particular with international developed markets. This situation is clearly linked to the trade rhetoric and actions of the US Administration. As a result, I have refrained from meaningfully selling our international equity positions, other than in the emerging market sector. This has cost us and completely explains our underperformance vs. our US centric benchmark.

Looking ahead, more of the same is possible until the mid-term US elections. However, I do not intend to alter our equity investments significantly until then. I expect the situation to "normalize" once the political environment clears up and international equities to make a comeback by year-end. Selling Eurozone or Japanese equities now, when I expect them to rise in November, just does not make sense. In the meantime, our investment stance may generate some unease, pain and underperformance.

Since I believe that the level of overall risk in US equities is rising, I have looked at how to best protect our portfolios, other than by drastically reducing our total equity allocation that is already quite conservative.

Until mid-August I have used investments in gold as a way to mitigate global political risk. It has worked miserably. GLD, the gold ETF (blue line below), is down 10% since the end of May, when the trade rhetoric morphed into tariffs retaliations (vertical line). As a hedge against rising US equity risk, XLU, the US utilities sector ETF, has worked better.

The chart below illustrates the performance of GLD vs. that of XLU.



In August, we sold our GLD investments and bought XLU. In doing so we have mitigated our US equities risk by allocating to a conservative sector while giving us a chance to generate a positive return (in the form of dividends). This should serve us better than GLD, for risk mitigating purpose.

Concluding remarks

The gradual tightening of US interest rates by the Federal Reserve and the attendant USD strengthening against most other currencies this year largely explain the downdraft experienced by emerging market equities worldwide. But they do not fully satisfy when attempting to explain the severity of the performance gap between US and non-US developed market equities.

I think that what matters more, when it comes to this second point, is trade and the threat to global growth that higher barriers to commerce represent.

At this point, I am cautiously optimistic that once the trade environment becomes less confrontational (I expect all of this to be resolved by the time of the US mid-term elections) international equities should enjoy a meaningful rebound. Should I be wrong and trade negotiations result in significantly higher barriers to commerce, the damage would be likely to hit the US equity markets as well.

My working assumption for now is that we will not get there and that negotiations will eventually lead to favorable arrangements. This, in turn, should make for a positive last quarter equity performance, across geographies.

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

Cordially,

Jeff de Valdivia