September 2, 2019

Overview

In August, the escalation of hostilities between the US and China on trade matters contributed to a sometimes severe negative performance for equity markets around the globe.

The S&Ps' 500 lost 1.58% while the US Small Cap index dropped 4.94%. Internationally, equities declined generally more abruptly. The S&P EPAC BMI (developed markets) shrunk 2.93% during August while emerging markets sunk by 4.88% (MSCI EM).

The Trump Administration's decision to add another layer of tariffs (10%) on Chinese goods as early as September 1, caused investors to seek refuge in haven securities at the expense of riskier ones, as illustrated in the chart below:

The green and blue line represent the performance of the US long bond (TLT-Green) and of gold (GLD-Blue). They were respectively up 11.05% and 7.91%. in August. Meanwhile, emerging markets (VWO-Red) and US Small Caps (VTWO-Orange) were down 3.26% and 4.99%.

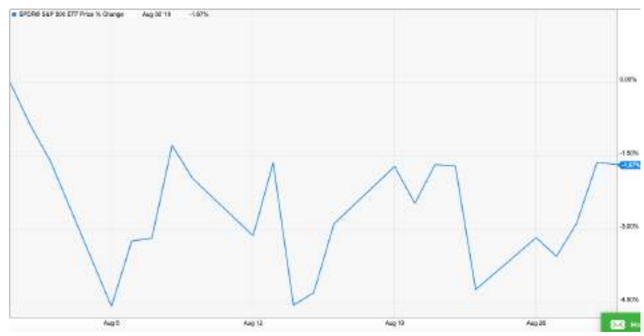
Clearly, the winning asset in August was the US long bond (up 10.50%). Other fixed income sectors did well, although not to that extent. The investment grade corporate sector was up about 3.14% while the High Yield sector did not benefit much (.40%), as expected in an environment dominated by fear.

In August, our client portfolios hovered between -.74% and .11%. This compares to a monthly performance of .29% 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 9.28% to 14.05% (net of fees) vs. 11.40% 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 plethora of economic data and trade-related announcements during the month of August contributed to making a generally volatile month for equities even more so than usual. Below is a chart of the zig zagging SPY (ETF for the S&P's 500) during August.



The index finished the month down about 1.50% but not before many ups and downs.

It all started on August 2 with the announcement of additional tariffs on Chinese imports (to be softened ten days later). This was followed by an unexpected announcement by three Asian central banks that they were dropping their reference interest rates. The market rightly interpreted this as a sign of impending global economic weakness. Signs of economic weakness were further confirmed when data showed that the UK and German economies had contracted slightly during the second quarter.

All of this prompted investors to buy the US long bond, gold and other haven assets and to lighten up in equities and other riskier assets globally. This was a classic "risk-off" move.

The selling trend was arrested on several occasions due to either a softening trade rhetoric or relatively upbeat retail sales and consumer confidence numbers coming from the US. Each time equities bounced up 1% to 2% to (almost) erase the losses previously experienced. The tone of the market remained nevertheless negative overall.

In a slow-growing world, the US economy seems to be the only source of positive momentum. For how much longer though? This is a good question and one that is not likely to be clearly answered before mid-October or later, when third quarter corporate earnings start giving us a better picture of the potential damage done by the current political and economic environment.

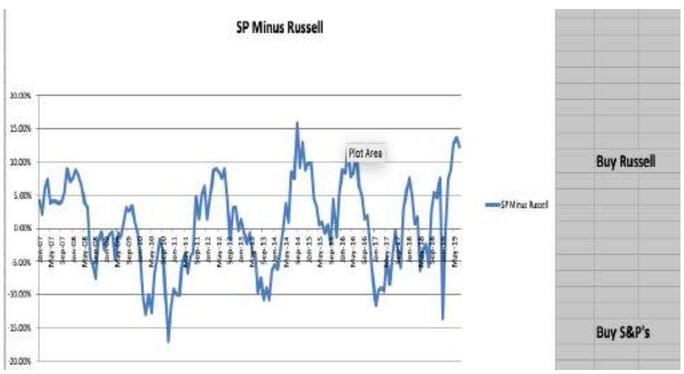
Tilts and Allocations

In August I reduced our exposure to German equities by 50% and invested the proceeds in short term and intermediate bonds.

The continuing international trade frictions combined to signs of a worldwide slowdown have caused German equities to meaningfully underperform their European peers this year (France notably). I do not think that this will reverse in the near term. The German economy is highly susceptible to trade frictions and is also significantly more dependent on the auto sector than most. As the European consumer moves rapidly away from combustion engines, the German auto sector is bound to suffer and with it the German economy.

The overall climate for world equities is worsening. The sale of German equities contributed to reducing our exposure to equities in general by about 2% across all portfolios.

Elsewhere in equity-land, the risk aversion moves in August have caused the performance spread between the S&P's 500 and its Small Cap brethren to widen again. At 12%, using the 12-month moving average for each index, it is now close to its largest gap over the past 12 years. As shown in the chart below.



The chart pictures the difference between the 12-month performances of the two indices. When the blue line is above 0% (left scale) it means that the Small Cap index is lagging the large cap index (S&Ps' 500). When it is below it, the reverse is true (the Small cap index has been outperforming the S&Ps'). Currently, the underperformance of the Small Cap index is a jaw-dropping 12%-13%. It is historically unlikely to persist.

In August, I bought the Small Cap index (VTWO) and sold the S&P's 500 (SPY) at the same time and for the same amounts, in the hope that this performance gap shrinks in the coming months. This is an arbitrage trade that I was able to initiate on marginable accounts. We shall see whether it proves lucrative or not.
I will keep you posted regularly.

Concluding Remarks

Economic and geopolitical clouds have been gathering for a few months now. The cloud cover seems to have further thickened in August.

As indicated in my previous newsletter, investors are now coming to grasp with the reality that the US economy may not be able to outperform for much longer in a no-growth world. US equities are showing signs of stress. Adding to this complicated environment is the precarious position of the Federal Reserve (FED).

It is probable that the FED will drop its intervention rate in mid-September by .25%, perhaps by more. This would not clearly be justified by current US economic data. That said, the unprecedented pressure coming from the Trump Administration and the negative international economic panorama, may leave the FED with little choice.

What concerns me is that whatever their decision, the FED will come out weakened as an institution. That worries me.

If they keep their composure and do not reduce the Fed Funds rate or do so by less than .50%, they will become subject to even more virulent attacks from an increasingly election-driven Trump White House. That will cause this major US economic institution to be further destabilized. If they reduce interest rate by .50% or more, they are likely to be viewed as pawns of the Administration and to lose credibility with many market participants.

I hope I am wrong. Nothing economically good would come from a weakened FED.

As usual, feel free to contact me with your comments.

Thank you for your trust.

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