July 27, 2018

Financial Markets Commentary 2nd Quarter 2018

Summary

Stocks rebounded last quarter - at least here in the U.S. Trade war fears drove up the value of the dollar on the idea that tariffs would lower America's trade deficit, which would mean fewer (and therefore more valuable) dollars in the world for commercial purposes.[ii] The U.S. economy depends a lot less on importing goods than most countries, so it can better afford to substitute intra-national for inter-national trade. That said, most institutional strategists believe that a full-on trade war will not happen; this is a big reason why the S&P 500 gained 3.43% last quarter. As a firm responsible for protecting investors' principal, however, the trade conflict makes us nervous. History is full of disasters that just didn't seem all that bad at first.

As mentioned, U.S. stocks enjoyed a nice rebound from the first quarter's modest loss. The first half of 2018 saw a gain of 2.95%[iii]. If you are an old school Dow Jones Industrials fan, stocks rose just 1.09% and are down -1.05% for the first half of 2018. On the other hand, if you set your course by the tech-heavy NASDAQ index, stocks rose 6.61% during the second quarter and 9.37% through June 30th.[iv] Obviously, what you owned made an unusually large difference last quarter, a fact we will elaborate on in the Commentary section. Small cap U.S. stocks were a beneficiary, to a large extent, of the trade war fears in that they are less likely to be major exporters than larger companies.

The performance of foreign equities in dollar terms was pretty awful. Emerging markets (-7.96%) were hit the hardest by trade concerns. The issue is that certain countries borrowed substantially in dollar terms, which allowed them to pay less in interest costs because the buyers of those bonds then carry dollar risk, not lira or peso or rupee risk (just to name a few). The risk is that if the dollar rises sharply (as it has recently) the issuing country has to exchange a lot more of its currency for (the same amount of) dollars in order to pay the bondholders. This was felt most acutely in Brazil, Argentina, and Turkey, but everybody else suffered as well. While Latin America was the biggest loser at -20.86%; there were no winners in dollar terms.

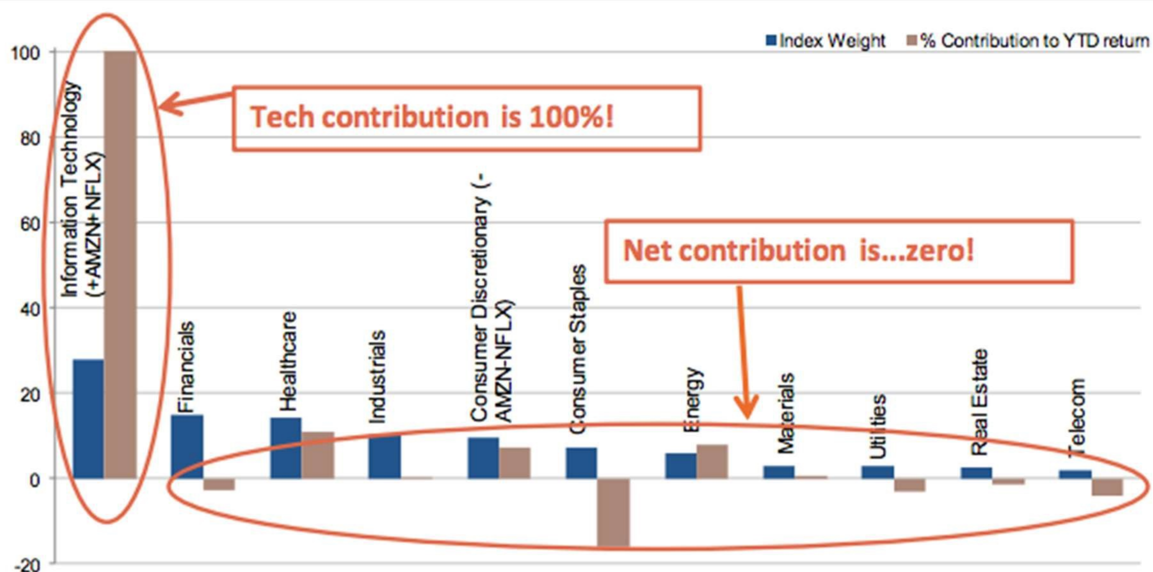
Bonds came oh-so-close to breaking even last quarter, losing just -0.16%. This brought their year-to-date performance to -1.62%. It was just a tough quarter for conservative investments as bonds, utility stocks, real estate, and dividend-oriented equities all declined. Floating rate debt managed to eke out a modest gain last quarter, as did short term bonds. Interest rates have climbed to where the yield on short term debt is now high enough to overcome the negative effects on principal. The best performing sector of the bond market was high yield municipal debt, which rose over one percent. Emerging market debt lost a staggering -5.4%[v].

In most portfolios we keep a very small amount in gold as an inflation hedge. This detracted modestly from performance over the course of the quarter.

Activity

With the dollar suddenly very strong, our job one was making sure we were not overly exposed to emerging market stocks or bonds. Because of their favorable long-term potential and diversification benefits, we trimmed but did not eliminate those positions. Nobody rings a bell when a sector hits bottom, and in fact often the rebound from sharp sell-offs can be quite strong. Our second priority was making sure we had enough exposure to the higher growth areas of the market, such as small cap stocks and momentum growth stocks. In an environment where the combined performance of every sector except information technology was essential zero[vi] (see Item 1), you absolutely had to own some tech. The third priority was making sure the duration of the bond portfolio was low enough such that what you might lose to rising interest rates was more than compensated for by yield. This was true of both taxable bonds and municipals (where it still pays to take a little extra credit risk).

Item 1



Source: Seeking Alpha[vii]

Outlook

Our crystal ball is even hazier right now than usual. The two biggest issues for the stock market at present are interest rates and trade policy. The fact that after surging in the first quarter interest rates were little changed last quarter helped investors feel more at ease. Investors are concerned about the trade war, but they seem to be operating under the idea that it is a mixed blessing for the U.S. while a devastating blow to foreign countries. Pundits talk about winners (companies and industries that do not export) and losers (companies that export) while assuming every foreign company is a trade war loser. That thinking fails to understand that in local currencies foreign markets rose 3.47%[viii]. The bottom line for us is that we can't see the current strength of the U.S. continuing beyond another quarter or two. As our currency appreciates, our exports are becoming too expensive to foreign buyers. Eventually this will translate to lower sales and profits for our exporting companies.

That said, stocks have gotten a bit of a reprieve from interest rates as the trade war has intensified, because investors assume it will slow down the global economy. There are those that now think the Federal Reserve will only hike rates one or two more times this economic cycle, which, if true, would be very stock friendly (as long as the global economy doesn't slow down too much). Goldilocks, you'll recall.

One of two different scenarios will play out. One is that the trade issues will be resolved and the stocks, countries, and currencies that depend on world trade will bounce back strongly. In this scenario the global slowdown will prove to have been a "breather" that sets us up for two or more years of expansion (much like how the late 2015/early 2016 slowdown pushed interest rates down and fueled a two-plus year market rally). The other, less likely scenario (in our opinion) is that the stock market already reached its cyclical peak on January 26th. That view stems from the fact that U.S. stocks as a whole have not been able to make a new high, and neither investor optimism nor market breath is nearly as strong now as it was back then.

Commentary – The Tortoises and the Hares

Economic conditions change often drastically from one market cycle to the next, but human nature doesn't change much at all. There is a certain path we as investors almost always follow as the cycle progresses. Coming out of a recession, nearly all stocks go up because every company's earnings are expected to improve, yet investors are fearful and therefore underperform. Once investors are sure the recovery is for real, they seek out companies that have relatively better growth prospects while they reduce their holdings of companies they held primarily for safety and yield. This process progresses in fits and starts (because economic data

is never a smoothly ascending or descending line) until the peak of the cycle. At that point, all of the market's net advance is fueled by earnings growth-oriented

companies. Defensive and dividend-oriented companies often decline in value because investors don't prize their relative safety anymore. Even modestly growing
companies see their shares stagnate as overconfident investors focus on the biggest winners. With fewer and fewer stocks carrying the market, the burden of the expectations placed on those companies rises until it ultimately becomes too great. Over-owned at this point, they usually suffer the largest declines when the next recession hits and investors turn back to the safety of stocks that pay a nice dividend.

While it is never possible to know exactly where you are in the market cycle, it is significant to note that the top ten technology and consumer technology stocks accounted for 122% of the S&P 500's gain in the first half of 2018 (see Item 2). The cumulative performance of the other 490 stocks in the S&P 500 was less than zero.[ix]

Item 2: <u>10 stocks have contributed more than 100% of S&P 500's year-to-date Return</u>

Ticker	Company	Cons. 2019E sales growth	Total return	Mkt cap weight	% of SPX Return
AMZN	Amazon.com Inc.	23 %	45 %	2.1 %	**36 %**
MSFT	Microsoft Corp.	10	16	2.9	**18**
AAPL	Apple Inc.	4	10	3.8	**15**
NFLX	Netflix Inc.	24	106	0.4	**15**
FB	Facebook Inc.	27	11	1.9	**8**
GOOGL	Alphabet Inc.	18	7	2.8	**7**
MA	Mastercard Inc.	12	31	0.6	**7**
V	Visa Inc.	11	17	0.9	**6**
ADBE	Adobe Systems Inc.	19	37	0.4	**5**
NVDA	NVIDIA Corp.	14	25	0.5	**5**
Top 10 contributors		**16 %**	**20 %**	**16 %**	**122 %**
S&P 500		**5**	**3**	**100**	**100**

Source: Seeking Alpha. Data as of June 28th, 2018[x]

We might generalize the performance of growth stocks and dividend stocks as hares and tortoises respectively. When they are both at their best, it is difficult to

see why anybody would bet on the tortoise. Unfortunately, hares have a nasty habit of sleeping and otherwise getting distracted while tortoises just plod on toward their goal.

At least they used to. Over the past several years the hares have built a huge lead over the tortoises. So large in fact that even though tortoises have won more races historically than the hares, nobody seems to believe the hares will ever lose again. "Things are different this time", they argue. "Hares are more focused now, and the race course contains obstacles that hares can more easily get over, and the length of the course and the temperature, etc." All of which may be true, but these are the same things they said back in 2000. Moreover, the fundamental nature of hares is that they are not built for long races. The energy that drives rapid acceleration is very difficult to sustain over time, whether you are a rabbit or a multi-billion-dollar corporation.

Will today's hares (Amazon, Apple, Netflix, Facebook, etc.) have endurance? Time will tell. Their current valuations suggest investors believe that they will.

So how does this apply to your portfolio? Obviously when the hares are running strong you want to have some exposure there. On the other hand, hares surrendered <u>more than half their value</u> in the 2008-09 financial crisis AND during the 2000-02 technology crash. Your risk with the tortoises is not so much what you lose in a crisis but <u>what you don't make</u> in the expansionary phase when hares are doing so well. A well-diversified portfolio contains both tortoises and hares, but it is human nature that while we get frustrated both with plodding turtles and sleeping hares, we tend to favor hares over tortoises because their potential speed is higher. They can make us the most money in the least amount of time.

This presents a challenge for most investors[xi]. If they want to participate in the current rally they have to own the popular stocks that are almost certain to fall the most after the cycle peaks. If they want to play it safe, they are probably going to earn very little until the cycle turns. The allure of growth is understandably extremely strong right now. That said, if experience teaches you anything in investing it is that great returns never come from doing things that are psychologically easy. Following the herd is comforting for long periods of time and then it becomes terrifying during those times when the herd is in full panic.

So please remember this if the temptation gets strong to sell the tortoises and load up on hares. We are at the part of the cycle where expectations for certain "hares" are very high. Diversification may not make a poor man rich, but it will also not make a rich man poor. We strive to blend assets that have strong growth potential (but are currently quite expensive) with those that are cheap and promising (but currently facing challenges) and others that are reliable (but not that exciting). We

don't always get that balance just right, but we never lose sight of why it is important to try in the first place.

PLEASE NOTE:

When a manager chooses a benchmark (whether conservative, aggressive or something in between), they are inviting you to compare their returns to what an unmanaged portfolio might look like. More importantly they are signaling that they look at performance as a *relative* measure. This enables the manager to talk positively about their performance even if the client loses money. For example "the benchmark was down fifteen percent but we only lost nine". While this is noteworthy performance, it still mean the client has nine percent less to work with. The alternative is to think in terms of *absolute* performance, where you strive to manage to a positive number and take steps to keep the downside to single digits no matter how much the stock or bond market loses.

We want our capital preservation-oriented clients to know that we have been working on two new absolute return models because sometimes any negative number hurt, and you really don't want us to be chasing the "hares" (so to speak) on your behalf just because the benchmark we are tracking own them. We believe it would be to your benefit to spend some time discussing this with us. Let us know when you would have the availability to meet with us and have a conversation about this in detail.

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[ii] **That said, adopting from the outset the notion that trade deals have a winner and a loser and we intend to win makes it very difficult to negotiate, because by definition you are demanding that the other side(s) agree to lose.**

[iii] **Russell 3000 stock index, the broadest measure of U.S. stock return.**

[iv] **Equity indices are per Morningstar.** [v] **Emerging Markets Hard currency debt, per Lipper (Barrons, 7/9/2018)** [vi] **Counting Amazon and Netflix as tech stocks, not consumer discretionary stocks. Per SG Cross Asset Research.**

[vii] **https://seekingalpha.com/article/4185933-high-tech-small-world**

[viii] **MSCI EAFE net return, local currencies (per Morningstar)**

[ix] **Source: https://seekingalpha.com/article/4185933-high-tech-small-world** [x] **https://seekingalpha.com/article/4185933-high-tech-small-world**

[xi] **Not for aggressive investors who will buy the "hares" and endure the inevitable periodic bouts of high volatility, nor for the very conservative investors for whom an all-tortoise portfolio will provide modest income and "sleepability".**