PORTSIDE
INVESTMENT ADVISORS

Synthesis

A composition that pulls together the primary themes, analysis and portfolio views from Portside Investment Advisors

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Patience and Prudence

Markets in 2017 were extremely calm, but that is clearly not the case in 2018. The volatility in the first quarter was high by historical standards. It was *extremely* high if you put it in the context of non-recessionary periods.

Most broad equity markets globally finished the first quarter with a negative return. In the US, returns were only slightly negative (S&P 500 -1%, Dow Jones Industrial -2%, Russell 2000 -0.2%). For comparison, much of the rest of the world was far worse (Japan -6%, Germany -6%, UK -8%).

Within the US market, the ability to generate positive returns was limited to only two of ten economic sectors, technology and consumer discretionary. Even within these sectors, the returns were driven by a narrow group such as Amazon (+25%) and Netflix (+50%). It's not surprising that these high flying stocks started to come under material pressure as well as the market volatility picked up.

On the surface, it feels like the economy is chugging along nicely and corporate earnings are going to see large growth. So why the lack of return? Is this just an obvious buying opportunity?

It's important to remember that markets feel like they are reacting to today's headlines, but the overall trend is more about looking to the future. The current challenge is that markets through January had been looking ahead to very strong earnings (approx. 20% annual growth) and significant economic gains (early estimates were 4% GDP growth). These are very high hurdles even if everything goes well.

Besides having high expectations already "priced in" to the markets, there have been some cracks to emerge. First quarter economic growth in the US is likely the be around 2%, not bad but not exactly huge news. The new jobs created in March were only about 100,000, much less than expected and were again centered on part time jobs. Construction jobs actually declined for the first time in two years (although weather can play a big part from month to month.)

The bond market is typically the first to react to economic divergences. Despite inflation concerns leading the Federal Reserve to continue raising short term rates, the difference between longer yields and shorter yields is converging. A ten year Treasury bond only yields about 0.5% more than a two year Treasury bond. If the market believed inflation was coming, there would be very little appetite for this sort of differential.

The economies in Europe and Japan are lagging expectations by much more than the US. Japanese economic activity (composite PMI index) reached its lowest level in a year and a half. It is still in growth mode, but relatively slow. Keeping this in perspective, the ten year bond in Japan is yielding 0.04% and Germany is 0.50%. It's certainly not high interest rates that's causing these markets to struggle.

The market is looking forward and seeing that all of the massive central bank intervention globally has very little to show in the way of real results. The forward looking worry is that if the economy slows more, or tips into recession, monetary policy may not be able to help much.

These emerging risks may or may not be a high probability but with equity valuations still high by historical standards we are choosing to both lock in profits and maintain the capacity to purchase assets at cheaper valuations. We believe it is appropriate at this stage in the cycle to limit risk taking. We are still participating in the market but want to have capacity to deploy cash at better prices. So far, we have had many market chops but we have not reached a point where valuations are attractive enough to be fully exposed to equities.

We are in a period where prudent risk taking will be rewarded when opportunities emerge but only if we demonstrate the proper patience in waiting to that point.