PORTSIDE
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Depiction

A summary of graphical and quantitative information that is part of the research at Portside Investment Advisors

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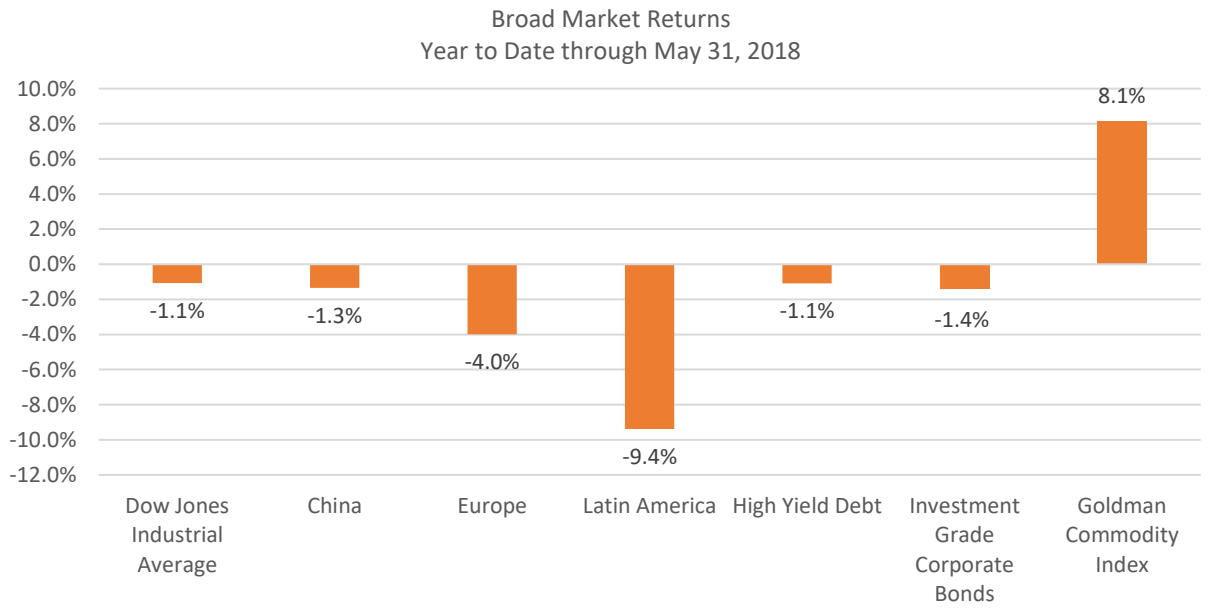
May 31, 2018

A New Ballgame

Over the last few years, many investors have gotten accustomed to positive returns on their investments well in excess of inflation and with limited volatility. The signals so far in 2018 are that we have entered a different environment. Returns this year have been low (negative in many areas of the market), putting perspective on capital protection in addition to capital appreciation. As seen below, the US has actually faired well compared to other countries' equity markets.

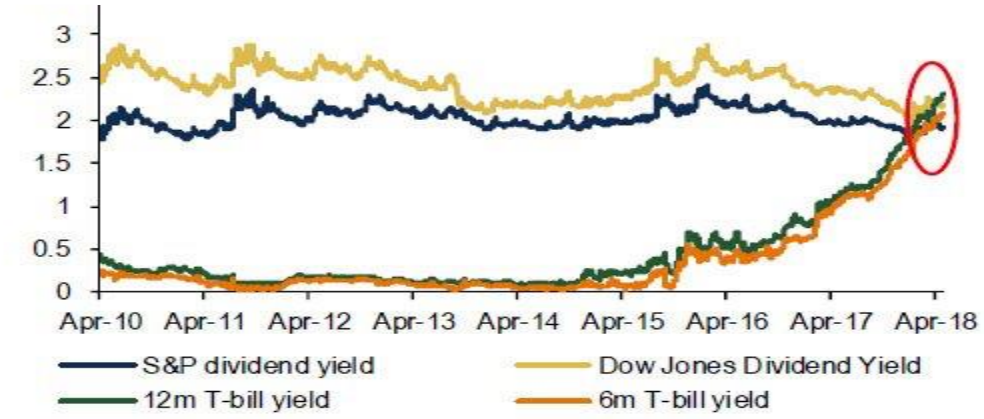


Making Sense of the Low Return Market

Basic fundamentals on the surface seem quite resilient right now, so what's going on with market returns? The economy is still growing, corporate earnings are very strong and interest rates are still very low by historical standards. Sure, there's been some concern around trade wars and other geopolitical events, but those are smaller issues in the broad picture. Here's a look at some of the factors causing markets to stumble along:

Interest Rates

The rise in interest rates should be viewed relative to how low they had been for many years. When comparing asset classes, a simple comparison of short term interest rates to the equity dividend yield shows the material change. The fact that short term interest rates are now greater than equity dividends doesn't by itself signal the need to sell all equities. But, there are many investors (including institutions) who will, for income purposes, make some shift – this has likely helped keep a lid on equity returns.

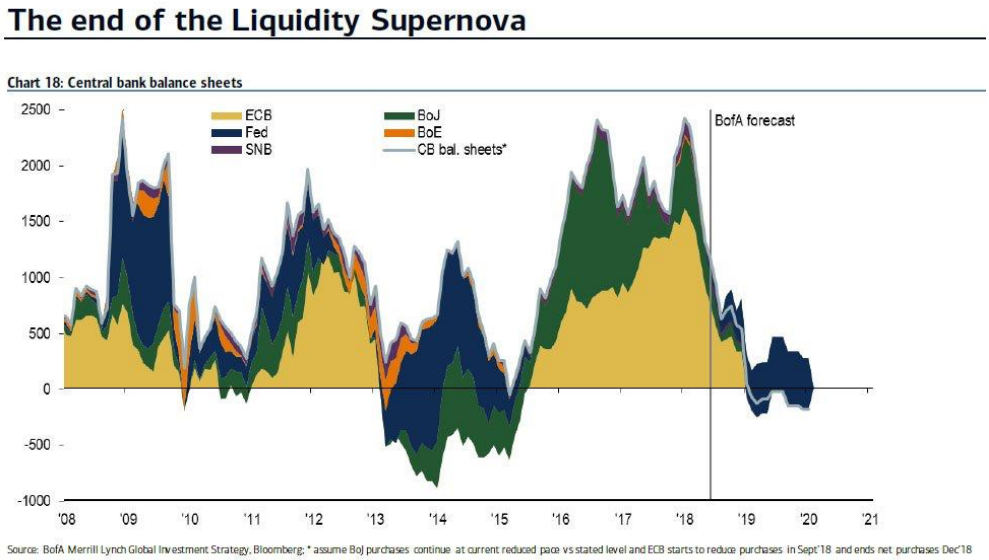


Source: Bloomberg, BofA Merrill Lynch Global Research. Gross dividend yields (%).

Another way to look at the relationship of interest rates and equity prices is to see that over the last couple decades, both equities and bonds have been in a bull market. Amazingly, long duration bonds have actually performed in similar fashion to equities. With interest rates having risen recently, the relationship has held – in reverse - and thus stocks are trading at lower valuations.

Monetary Policy

The use of monetary policy to purchase securities has been epic in recent years. The amount of assets owned by central banks has added a large amount of liquidity to the financials system which in turn has helped increased asset prices. However, all indications are that this will coming to an end soon. The Fed is already reducing its balance sheet and others have indicated they will at least be stopping or slowing purchases. The market is looking ahead to this change and realized one catalyst for higher values will likely not be present.



Positioning

When considering current market movements, it is always important to understand where the speculative money has already positioned itself. In late 2017 through current, there has been a sharp rise in traders expecting reflation (higher interest rates, commodities and equities). History has shown that even if the traders are correct, by the time the actual headlines emerge, the markets have already reflected it in prices. It is possible that the sideways markets this year is in part due to last year's positioning.

Valuation

Corporate earnings are growing well over 20% in the US. All things being equal, this usually means share prices should get a boost. However, it needs to be realized that equity valuations were at elevated levels coming into 2018. The fact that earnings are rising without share prices is simply showing that the market has decided to mark down the valuation levels, likely given the higher interest rates and less monetary stimulus.

Source: Research compiled by Portside Investment Advisors, LLC unless otherwise noted.

Takeaway

Most segments of global markets in 2018 are floundering despite a fairly positive fundamental environment. There are some cracks in the global growth narrative, but most are outside the US. The lack of positive returns are a result of a market adjustment period coupled with a few threads of uncertainty. The change in interest rates and monetary policy are likely to continue forcing markets to adjust when viewed in the context of almost a decade of loosing the purse strings instead of tightening. As always, the markets will be dynamic and with that comes opportunities to find value!