PORTSIDE INVESTMENT ADVISORS

Synthesis

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

October 31, 2018
Time of Transition

The undercurrents of financial system change have been churning all through 2018 and the month of October has now confirmed the change with a meaningful drawdown in the US equity market. For US investors in stocks, the year had felt fairly sanguine (minus a spurt of volatility in the spring). However, the tide of rising risk had already started permeating most other asset classes and markets globally.

Starting with foreign equities, most of the markets outside the US had already been diverging. China peaked in January and has dropped about 30% since then. Europe is a similar story, where stocks are down about 20% since the January peak never having made a new high. Most currencies have depreciated against the US dollar during the year as well which added to losses if foreign assets were owned.

Within the US, there was already significant deterioration of equity prices even though broad markets were making new highs. In September, the overall US market was at a new high level but only about 10% of all individual stocks were concurrently making new highs themselves. This was primarily due to a few very large companies (Amazon, Apple, etc.) being the only ones to continue appreciating. October saw that dynamic change in a hurry, for example, with Amazon (which had reached a $1 trillion valuation!) losing 20% of its value.

The depreciation of asset values has been seen across asset classes as well. Industrial commodities such as copper are much lower than at the start of the year. Oil is still modestly higher but has given up substantial gains recently. In the bond market, most prices are lower since the beginning of the year due to both higher Treasury bond yields and wider credit spreads.

To put all of this asset value depreciation in context, we need to evaluate the drivers that have been themes of ours all year long. As usual, these themes are intertwined but we will list separately for sake of simplicity:

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Central bank monetary policy
There has been a ground shaking shift in policy by developed market central banks over the last year or so. Total assets held by central banks have now plateaued and are set to start declining. This means that the largest buyers of financial assets over the last decade are now effectively sellers. Additionally, policy interest rates have been rising. Most notably, the Federal Reserve has taken short term rates from zero to over 2%. This has also been seen in Europe and even Japan, although to a much lesser extent. These shifts in policy cannot be ignored as they impact most everything in the financial system. The system had become highly dependent on accommodative policy.

Fiscal policy
The corporate earnings of 2018 have been spectacular in major part due to the tax cuts taking effect. However, the markets are starting to be concerned about the limitations of the future fiscal situation due to the growing deficit along with higher interest payments on the outstanding debt. There is a related issue in Europe and Japan where the debate is about how much to restrain spending versus any capacity for stimulus. China has been discussing some stimulus but may be also limited in capacity due to the financial excess in certain segments such as real estate and over built infrastructure.

Economics
The US economy has in fact been the star globally this year. Domestic growth has been stable and resilient in the face of foreign slowdown. Asian economies are seeing significant deceleration which is far greater than any impact from trade disputes with the US. China has to be a large driver of global growth, but evidence shows that growth is deteriorating materially. In Europe, there has been further disappointment of domestic activity and strong trade ties to China have been a hindrance. The question remains how long the US can stay unaffected by the broader global slowdown.

Market positioning
Certain market dynamics cannot be ignored. For example, there had become a very significant amount of leveraged investment in the segment of certain technology stocks. The price movement of very large companies such as Facebook, Amazon, Apple and Netflix have been truly historical. Amazon for example had grown by about $500 billion just during 2018. That growth amount by itself ranks as one of the largest companies in history. These sorts of moves have virtually never continued without increased volatility or material pullbacks. When prices move with that velocity it tends to attract investors for speculative reasons with less research tied to the fundamentals. The market is likely now sorting out certain investment position excesses.

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The bottom line is that very few assets anywhere have made positive movement in 2018. This has been an environment to preserve gains from many years of good times and judiciously look for opportunities as they emerge.

These themes are ones our team has stuck with throughout the year. They are likely to be with us for some time ahead as well. Our goal has been to effectively transition portfolio strategy ahead of the market transitions. As the market sorts out the numerous uncertainties, we seek to be in a strong position to once again make positive gains.

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