North American Management

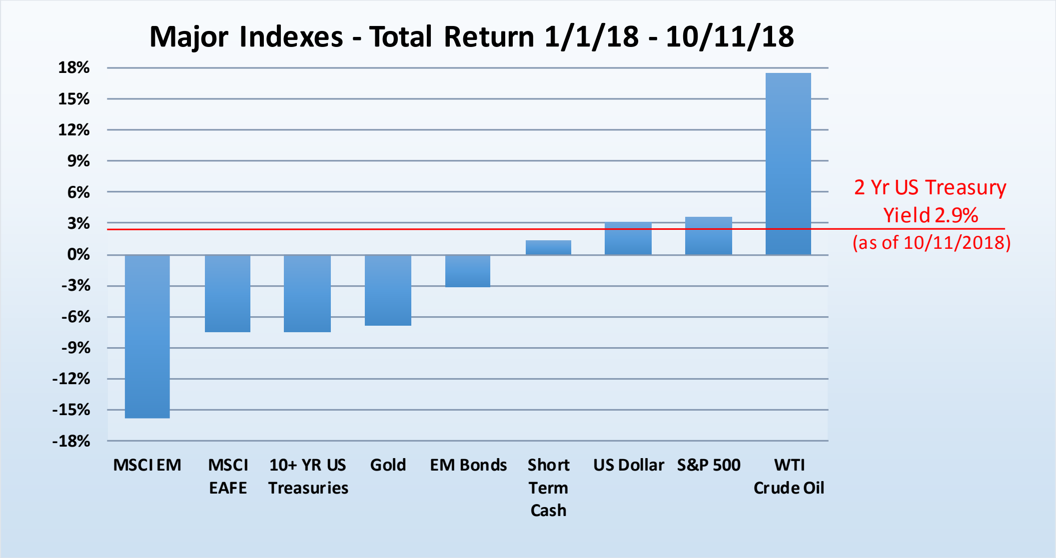
Q3 2018 INVESTMENT LETTER

Solid gains in Q3, Sharp Reversal in Early October

It is beginning to sound like a broken record, but U.S. stocks outperformed the rest of the world's equity markets once again in the third quarter, their fourth consecutive quarter of relative gains. In fact, U.S. stock indexes have generated more than double the return of non-U.S. equities over the past ten years[1] – a remarkable run that appears immune to reversion but almost certainly is not. For the quarter, the S&P 500 jumped 7.7% and the small-cap Russell 2000 rose 3.6%, while the MSCI ACWI ex USA gained a modest 0.7%. Year-to-date those indexes are up 10.6%, up 11.5% and down 3.1%, respectively. The MSCI Emerging Markets Index fell 1.1% in the third quarter, ending down 7.7% year-to-date, while Europe gained 0.8% on the quarter and is down 2.5% year-to-date.

U.S. stocks continued to outperform other regions, while yields on short-term U.S. Govt. bonds became more attractive.

Sentiment changed dramatically in early October after Federal Reserve Chairman Jay Powell fired a shot heard round the world. While commenting on U.S. interest rates, he said, "We may go past neutral. But we're a long way from neutral at this point, probably." In our opinion, Powell was speaking more about the journey (to the point where Fed policy is neither stimulative nor restrictive) than the pace of it, but market participants reacted poorly, selling both stocks and bonds with a vengeance. By close of trading on October 11, most stock markets around the globe had dropped 5% to 10% and the Dow Jones Industrial Average had fallen over 1300 points in two days. Though markets have stabilized and recovered a bit as we write, volatility is likely to remain elevated through earnings season. Nervous investors have options: Note that the U.S. two-year T-Bill yield exceeds the rate of inflation and cash is outperforming a variety of longer dated bonds, foreign equities and gold year-to-date through October 11 (see chart below[2]). This is not consistent with the synchronized global growth narrative we all heard from prognosticators at the start of 2018.



Cash has outperformed almost all risk assets year-to-date through the October 11 sell-off, except U.S. equities and Oil.

Chart of the Quarter:[3]

While inflation pressures have gradually increased, liquidity conditions (displayed here as the change in M2 and a concurrent rise in mortgage rates) are getting tighter.

Inflation Gradually Rising, Liquidity Tightening

Equities will generally tolerate rising interest rates and other input costs well (usually synonymous with higher growth) – until they don't. The inflection point is imprecise, but often comes when wage growth exceeds 4%, and we are not there yet. It is more concerning to us that accelerating growth in the U.S. is not transmitting well to other regions and prices for industrial metals like copper are down sharply this year. It isn't helpful to see trade wars dampening growth prospects in China, the world's second largest economy and a major commodity purchaser. Then there is developed Europe, still addicted to the fading effects of monetary stimulus, and seemingly incapable of passing the type of fiscal and regulatory reforms that have raised confidence levels and inflation expectations in the U.S. At this point, the European Central Bank seems to be fresh out of "shock and awe," and Brussels does not have a constructive fiscal response to Italy or Brexit. Although the Fed may not be finished raising rates, liquidity is already receding in the U.S. – higher interest rates and oil prices had begun to cool the housing and auto markets months before Chairman Powell made his comments (see chart above).

The policy gap between the U.S. and the rest of the world is making investors nervous.

While we think there is still upside for equity investors, prospects may be dimming for lower quality and momentum-driven stocks that have produced outsized returns over the past five years. Rising interest rates usually have that effect. Although their movements are difficult to predict, the ebb and flow of such compensated risk factors like quality, momentum, value, size and low volatility are well documented, and we pay close attention to them when constructing and evaluating portfolios. Many investors who were underweight quality and low volatility, for example, suffered disproportionately during the recent sell-off. If liquidity conditions continue to tighten and recent volatility moves from equities and interest rates to credit spreads, such diversification within portfolios will become even more important. In the meantime, we will be more concerned about inflation if growth rates outside the U.S. accelerate.

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Endnotes

[1] FactSet, S&P 500 Total Return versus MSCI ACWI ex USA Net Return.
[2] FactSet. Referenced indexes: MSCI Emerging Markets Index, MSCI EAFE Index, S&P US Treasury Bond (10+ YR) Index, Bloomberg Gold Index, Bloomberg Barclays Emerging Markets USD Aggregate Bond Index, Bloomberg Barclays 3 Month T-Bill Index, U.S. Dollar Index (DXY), S&P 500 Total Return Index, Crude Oil (WTI, NYMEX Global Spot, $/bbl).
[3] FactSet, U.S. Bureau of Labor Statistics.

Source of data not specifically cited: BlackRock, FactSet.
All return data through September 30, 2018, in U.S. Dollars, unless otherwise stated. All equity returns include dividends.

Disclaimer

If you have any questions regarding the content of this letter, or would like to discuss your investment strategy, please contact your wealth advisor/relationship manager.

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