Monthly Commentary 3rd July 2017

June was a mixed month for many markets. Global equities were flat, but fell in the last two weeks of the month with the UK and European markets leading the declines, together with tech stocks in the US. Government bonds also suffered - especially in the last week - as yields increased notably. Still, it would be a stretch to hypothesise that this is the beginning of a more meaningful drop in equities or bonds. It has been a good year to date and the economic landscape (as well as company fundamentals) is still supportive of markets. The recent falls have not surprised us, and markets may indeed fall further. It is healthy for them to exhale after the good run.

Expect the unexpected

Markets rarely do what is expected of them. It's an old saying that "*markets are there to frustrate the maximum number of participants*". Below are eight outcomes that defied expectations so far this year. They are provided by the Wall Street Journal:

1. U.S. stock indexes

Expectation: Wall Street strategists projected the S&P 500 to end the year up about 5.5% at 2362. Many cited stocks' corporate earnings potential and an improving economy.

Outcome: They've already beaten that mark. US Stocks have had their best first half of the year since 2013, with the S&P 500 up about 8% and setting 24 new closing records.

2. 10-year Treasury note yield (benchmark US government bond)

Expectation: Investors expected a tightening Federal Reserve and the Trump administration's pro-growth policies to drive the benchmark 10-year Treasury note yield higher.

Outcome: The 10-year Treasury yield has fallen, to 2.286% on June 30th, from 2.446% at the end of 2016, amid tepid economic growth and skepticism about Mr. Trump's ability to push through his fiscal agenda.

3. Dollar

Expectations: The U.S. dollar was expected to strengthen in 2017 as Mr. Trump's agenda spurred increased economic growth and the Fed raised rates.

Outcome: The greenback has actually weakened against other major currencies as the administration's agenda has stalled and inflation data has softened. The WSJ Dollar Index is down more than 5% this year, on track for its worst first half of the year since 2011. Even the pound sterling has strengthened vs the USD.

4. Peso and emerging market currencies

Expectations: Mr. Trump's protectionist rhetoric would drag the Mexican peso and other emerging markets currencies down further.

Outcome: The peso and other emerging markets currencies have rallied against the dollar, with central banks in developing countries raising rates and the so-called Trump trade fading. While growth in China slowed slightly from its peak last December, other emerging economies have experienced a pickup in growth.

5. Financial stocks

Expectations: Mr. Trump's push for deregulation and tax cuts as well as rising rates pushed financial stocks higher following the election and the gains projected to continue in 2017.

Outcome: The rally soon faded this year, and S&P 500 financial stocks are only up about 6% for the year, underperforming the benchmark.

6. Volatility

Expectations: Geopolitical uncertainty as well as economic and policy changes in the U.S. were expected to lead to increased market volatility.

Outcome: Markets have been eerily calm, with Wall Street's so-called fear gauge, the CBOE Volatility Index, or VIX, plumbing its lowest levels in more than two decades during the first half.

7. Oil

Expectations: The late 2016 agreement between major producers to limit output was predicted to stabilize oil prices.

Outcome: U.S. oil prices fell into a bear market on June 20 and have remained below $45 since as cuts by the Organization of the Petroleum Exporting Countries failed to lower global crude inventories.

8. Inflation

Expectations: Rising oil prices and Mr. Trump's agenda were expected to drive consumer prices above the Federal Reserve's target level of 2% in 2017.

Outcome: After briefly topping 2% in February for the first time in almost five years, consumer prices are rising at their slowest pace in six months.

The takeaway from the above is that having well-thought-out opinions and basing your investment strategy on these opinions is not necessarily going to work. At Elgin, we are sticking to our strategies through our strategic allocations and only reserve a small part of portfolios for "tactical placement".

Our strategies involve:

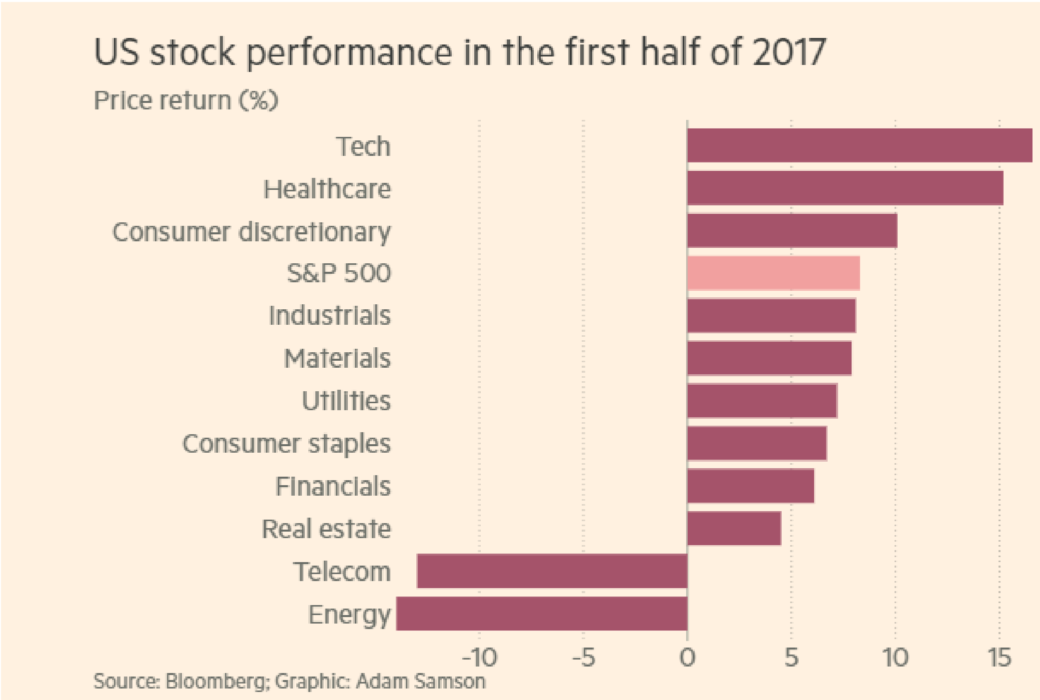
- Having a clear strategic allocation to different assets based on investor risk profile
- Implementing these allocations by investing in funds that have worked well. For example in the equity space, we seek funds that consistently outperform their benchmarks in both up and down markets. Otherwise we invest in the index through low-cost exchange traded funds. So far this year the majority of the funds we use have indeed outperformed their benchmarks.
- Wherever possible we invest in "Institutional-class" funds that have much lower costs.

The financial press is now speculating about a "tough second half of 2017". Others are optimistic. The one outcome we can rely on is that we have to expect the unexpected. That is why we do not change strategies based on forecasts and emotion.

We are often asked why we do not make larger allocations to different sectors that show promise. Again, this is a subjective. In the first half of 2017, only three out of the 11 sectors in the S&P 500 actually beat the index.

The following chart from the FT shows how each sector performed. Yes, it would have been great if we had invested in technology, health care and consumer discretionary. But the other eight sectors did worse than the index. Ironically, at the beginning of the year, when asked which sectors to avoid, the chief strategists of JP Morgan, Morgan Stanley and Citigroup said that among others, they would (respectively) avoid consumer discretionary, technology and healthcare. JP Morgan and Citi also said that they favoured Energy.

The takeaway? Being closer to the index is more boring but safer – not to mention more profitable in the long term.



The Elgin Analyst Team

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