Market Commentary

The intelligent investor is a realist who sells to optimists and buys from pessimists.
–Benjamin Graham

While US stocks recovered from their first quarter losses with the S&P 500 returning 2.6% year-to-date, foreign equity markets remained modestly negative at the end of the second quarter with a -2.7% return from the MSCI EAFE Index. Growth stocks continued to outperform, particularly in the US, where the Russell 1000 Growth Index beat its value counterpart by over eight percentage points. Increasing US interest rates led to a strengthening dollar which negatively impacted returns of non-US assets. Rebounding oil prices and an OPEC agreement supportive of oil price stability in the current range led to a recovery in energy stocks, including MLPs and other midstream companies. Emerging markets, after a strong start to the year, suffered around a 10% peak-to-trough correction due to concerns about the strengthening dollar and potential trade wars. Intermediate-term bond indexes showed losses as rates increased during the first part of the year. Since July 8, 2016 – the date of the trough in the yield of the 10 Year Treasury Bond - the Bloomberg Barclays US Aggregate Bond Index has returned -0.78% annualized. Against this backdrop of rising rates, yield spreads for riskier bonds continued to contract, nearing the record lows of 2006. The rapidly shifting direction of markets made the first half of the year disappointing for most absolute return strategies.

Current valuations adequately compensate investors in emerging market stocks

The decline in emerging market stocks was roughly proportional to the amount of debt denominated in non-local currency owed by these countries. Turkey, with over 40% of government debt denominated in dollars or euros, was the worst performing market in the index, with a year-to-date return of -29.3%. Indonesia and The Philippines, with non-local currency government debt levels over 30%, each declined over 20%. China, with no foreign currency public debt, was the best performing market, and India, with less than 5% non-rupee debt, returned -8.1%. Unlike the 1990s where high levels of foreign currency debt spurred a rolling series of financial crises across emerging markets, approximately 75% of the MSCI Emerging Markets Index has non-local currency government debt levels under 5%. During the 1990s financial crises, falling local currency exchange rates effectively caused dollar-denominated government debt levels to balloon, rendering countries insolvent. With debt denominated in local currency, most emerging countries are now immune to this sort of funding mismatch.

While the MSCI Emerging Market Index declined -6.7% year-to-date, the trailing twelve month earnings per share increased 8.5%. This left the index trading at a forward price / earnings ratio of 11.8 at June 30, compared to 17.3 for the S&P 500. This discount adequately rewards investors for assuming the risk of further currency-related volatility and the uncertain impact of new tariffs (both of which would potentially have a negative impact on the earnings of US companies as well). Asian economic growth, particularly in China and India, has resulted in the continent being home to the majority of the world's middle class consumers. From this level, a recent study from the Brookings Institution projects 2 billion Asian middle class consumers by 2020 and 3.5 billion by 2030. This will shift the center of economic gravity away from the stagnant populations of the US and Europe. While American and European multinational companies can participate in this growth, better potential opportunities exist for local companies in these markets. Emerging market investors have the ability to invest in very mundane, well understood businesses such as retailing, insurance, local e-commerce or consumer lending that have the potential for years of double digit sales growth. These opportunities do not exist in developed markets. Fast growing companies can only be found in disruptive business models like Amazon.com or Facebook, and for this, investors pay premium valuations and assume a high level of regulatory and business model risk.

MLPs had a good second quarter

MLP valuations recovered from their first quarter lows but lagged the overall performance of energy stocks. Record production in the Permian Basin has resulted in a lack of pipeline capacity from the region. While the lack of capacity puts pipeline space at a premium, remember that much of the capacity is contracted at a fix rate, currently below current market rates. However, new projects entering service this year and next by Enterprise Products Partners, Plains All-American Pipeline and others will help drive distribution growth. Our MLP manager's portfolio yielded 7.3% at the end of June with an expectation of 6-7% distribution growth over the next twelve months.

Corporate lending standards declining

Declining yield spreads for riskier corporate credit indicate a speculative market where higher interest rates have not satiated the appetite for yield. Currently, an investor can expect to receive an additional 3.6 percentage points of yield for investing in high yield (i.e. junk) bonds instead of Treasury bonds of comparable maturities. If no defaults occur, then this investor's return would be 3.6 percentage points higher. Given the current strong economic environment, credit rating agency Moody's projects a near record low default rate of 1.7% for 2018. This optimistic scenario translates into losses (defaulted bonds typically do not become worthless) of around 0.75%, reducing the yield spread to under 3%. Historically, credit losses for junk bonds averaged 2.6%. However, in each of the past three recessions, credit losses exceeded 6%, which would result in permanent losses for high yield investors at current yield levels. Along with low risk spreads, the terms for new non-investment grade issues have become very lax, particularly in regard to the ability of management to pledge corporate assets that creditors depend upon for the security of their investment. This is particularly true with floating rate loans, where private-equity funds have used increasing amounts of financial leverage to pay dividends to their equity investors. These lax standards will reduce the potential recoveries in future defaults. We have cut allocations to non-investment grade corporate credit and have been finding value in preferred securities offering comparable or higher yields issued by companies in the financial sector which remains in strong condition due to increased regulations and reduced leverage.

Own quality assets in an uncertain world

While the global economy is currently experiencing its highest growth rate since the initial recovery from the 2008 Financial Crisis, high valuations across most financial assets make us wary. The US economy is entering its tenth year of expansion and on track to set a record for the longest period without a recession. Growth could easily continue for several more years or, alternatively, we could see a recession and bear market before the end of the decade. Portfolios need to be positioned for both alternatives. Market timing is near impossible, particularly when the cost of taxes in repositioning portfolios is taken into account. Focusing on high quality assets that will benefit from future economic growth but can survive the next bear market remains the only real option for investors.

- Stephen C. Browne, CFA
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