

Assessing the Investment Climate - AUGUST 2018

U.S. corporate earnings continue to provide some upside surprise to estimates. Since the market correction in February, and as corporate earnings continue to accelerate, the market's overall price/earnings ratio (P/E ratio) has become cheaper. The market isn't super expensive, relative to history AND we are witnessing a near economic "boom", something we haven't seen since the 1990's.

For even more "wind in its sails", the US stock market has become the place to be for global investors. The below chart is the S&P500 index for the year, to help you "see" what we're about to discuss.



Yet, as summer nears a close, we are reminded that September/October are historically two of the worst performing months of the year in the US stock market. What does that mean? Nothing, in and of itself.

It does however beg the question... what dynamics could conspire to make that historical observation valid in 2018? We oft see things like that in technical analyses, asking ok, what event will cause the chart to fill in the way we expect it to. And typically, some piece of news confirms the trend. Not quite the same here, but we must wonder what out there in the investment markets may conspire to make the late summer/early

fall the weakest period of the year, as they tend to want to do ( maybe even in a mid-term election year)

Interest rates helped the market push down it's valuations back in February, yet right now, they appear to be more stable, but still pointing upwards. The markets can handle slow protracted "glidepaths" to a 4% 30 yr bond. It's just above 3% now. Shocks is what they don't like. We can't see a shock to rates coming. Long term rates going from 3% to 4% in a few years time, we can see. No issue for the stock markets to handle.

Another data point that does however concern us, our earnings momentum model using the InvestorsBusinessDaily database, which has been kicking out between ten and thirty names when we've run the screen over the last year, is now only kicking out three or four names. Earnings accelerations are definitely decelerating rapidly, especially amongst the larger companies. In fact, the few stocks still making through our screen are smaller companies. So , even as earnings are very robust, we see the "seeds" of their decline amongst a vast database of shares. This data can also be found on FACTSET, another database of corporate results. So, earnings growth is clearly decelerating.

The market has preferred small cap stocks to large cap stocks all year, opining that corporate tax cuts will help those smaller companies more, and that smaller companies are less exposed to international trade issues ( which is not entirely accurate btw). What we are seeing is a de-acceleration of those earnings gains, which implies that the overall market will also lose its momentum, even as that momentum has become much more volatile and choppy than the near straight line it went up last year. It should be noted that smaller companies are the main engine of economic growth and prosperity in America, as they tend to employ the vast majority of workers. So, we wishfully hope the small company rally continues on for a while, as it benefits many, many workers.

So rates ok – check; earnings sill robust but decelerating – check. Finally global capital flows and currency – dollar still strong and US still a safe haven – check.

Here however, is where forecasts get really murky –global economics - can the U.S continue to act as a "safe haven" for global investors and therefore, will the dollar remain strong?

Quizzically, this last week, Turkey's imprudent nationalism proved to be a pimple on a rats arse to the global investment markets....what sent the markets up and down more were Chinese regulators giving TenCent a hard time, and oil prices. Turkey who? It sure isn't like the Asian currency crisis of old. China is MUCH MORE MEANINGFUL than even in 1998. Turkey and Iran are not entirely insignificant though.

Oddly, and uncomfortably to us, most emerging markets funds and indexes have a huge position in TenCent and AliBaba. Nevertheless, the one asset class that has performed miserably this year, after a stellar performance last year ( we lightened up in the asset class last fall), is emerging markets. This before the big TenCent fall this week.

Its all about China.

Part of the job of an investment professional is to look out over the next horizon, and see where the opportunities may lie. We know that “buying assets cheap” sets up its own opportunity sets due to values. International assets are very cheap right now to US investors. Most international markets have had 10%+ declines this year without major relief rallies, unlike the US markets. Additionally, our dollar has continued to strengthen against most foreign currencies, which has the effect making foreign assets look cheaper in dollar terms.

Unlike the earnings “rollover” which we have data on, we can’t see what would cause the US dollar to have a major decline, providing a positive currency return to foreign holdings. This is where our forecasts get incredibly murky. Yet, it is unlikely to remain this strong forever, and foreign assets have repriced risk in their own markets, which leads us to logically ask if we ought be bumping up overseas holdings, as there are now two good reasons to, a strong US currency, and markets which have corrected. Cheap. Cheap.

As a political comment, as President Trump uses economic leverage to achieve foreign policy goals, it seems to strengthen the dollar even more so. We’ll have to ask our economist friends about that. And why Europe is so economically “dead”.

In overseas investing emerging markets as opposed to developed international markets, are not for the faint of heart. That asset class can go multiple years with no results, and then put up 50%. We use emerging markets exposure ONLY in growth portfolios with a longer than ten year investment horizon for that reason.

Developed overseas markets, however, can be used in most balanced portfolios, even those designed for income primarily. In fact, we recently added global bonds back into our balanced portfolios through a few select closed end funds, and earlier this year/ late last year, began to use Vanguard’s Global Wellington in addition to their U.S. – based Wellington active balanced fund.

The “big stick” President Trump is swinging about is US economic hegemony. Ironically, this has created some “unclear expectations” in global markets causing large investors to park their big dough in US dollar assets. It has certainly helped fuel our relatively strong markets here. What we don’t know is what triggers will cause this trend to unwind. For now international risks still cause a flight to the safety of US assets, and the President is out there trying to reassert U.S. economic hegemony.

The interplay of interest rates, corporate earnings, and global capital flows are the three most important dynamics affecting the capital markets. We don’t see any major risks to those dynamics, other than the recent deterioration of the growth rate of corporate earnings (especially amongst large companies) , which could derail this bull market in that late September/ October time frame.

We had the longest recession in U.S. history recently end, and now we have the longest running bull market in U.S. history, continuing to augur on. For now.

Always curious as to how the next monthly newsletter will read when we finish the last, and we are more intrigued and curious than ever! What will this fall bring?

Time to go “back to school!”

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