FSA INVESTMENT GROUP

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Quarterly Market Commentary
November 2018

Imbalances—Tipping the Scale in Portfolios

Imagine a giant scale where the market weighs out all of your investable assets. Over longer periods, you would expect a balanced push and pull of the market with some assets acting as return drivers and others as risk mitigators. Some of the asset classes perform better in high-growth environments, while others tend to outperform in low-growth environments. For this reason, a well-diversified portfolio can be expected to meet return targets over time. However, over shorter periods, imbalances can lead investors to ask the question: Why own these other asset classes?

Shifting Market Backdrop

As you can see in Figure 1, the scales have tipped in favor of U.S equities year-to-date. International equities and core fixed income are negative on the year. Even though inflation has been on the rise, commodities have been negative. As we evaluate fixed income, the riskier parts of credit (e.g., high-yield bonds) have provided positive returns, while the safer part (e.g., core bonds) has exhibited negative returns. This creates an environment where multi-asset class portfolios struggle to meet investors' expectations.

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ABOUT OUR FIRM

We are dedicated to providing investment management and strategic wealth planning to Indian tribes and high net worth individuals. Simply put, we strive to be our client's trusted advisor. As a financial advisory firm, our primary focus is to provide unbiased opinions that are designed to achieve long term investment results.
FSA Investment Group does this with the highest levels of trust, integrity and respect while always collaborating using a team approach. We are dedicated to professionally supporting, educating, and providing informed direction to each and every client.

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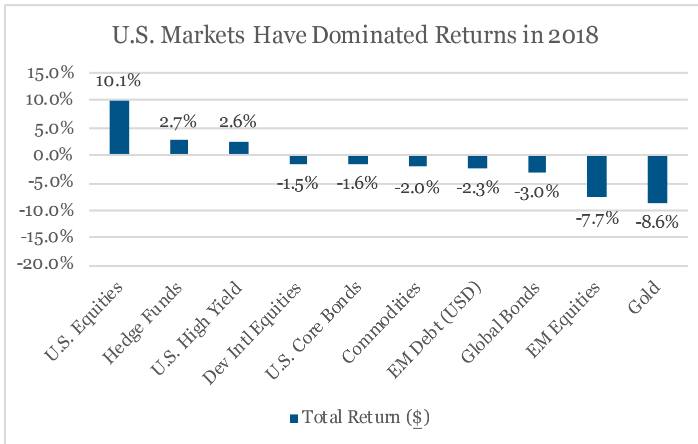
Figure 1



Sources: FactSet; Highland Associates; Total Returns year-to-date through Sept. 2018; Representative benchmarks used: U.S. Equities = S&P 500; Dev Intl Equities = MSCI World ex USA; EM Equities = MSCI Emerging Markets; U.S. High Yield = Bloomberg Barclays U.S. High Yield; U.S. Core Bonds = Bloomberg Barclays AGG; Global Bonds = Bloomberg Barclays Global AGG; EM Debt (USD) = Bloomberg Barclays EM Debt U.S.-dollar denominated; Hedge Funds = HFRI Fund-Weighted; Commodities = Bloomberg Commodities Index; Gold = NYMEX $/ozt futures

While this can be a challenging environment for diversified portfolios, stressful markets cause even greater pain in concentrated portfolios. This is why earlier this year in "Building the Perfect Beast," we reminded investors benefits of diversification: reduced portfolio volatility, smaller draw-downs, and faster recovery periods. FSA also presciently wrote that "the return of volatility creates additional uncertainty, as investors come to grips with expectations for higher levels of interest rates and inflation." It is this theme of divergences-economically, geopolitically, and monetarily that is currently a driving force in the market. This could explain investors tilting the scales in favor of the U.S.

Global Growth Divergences

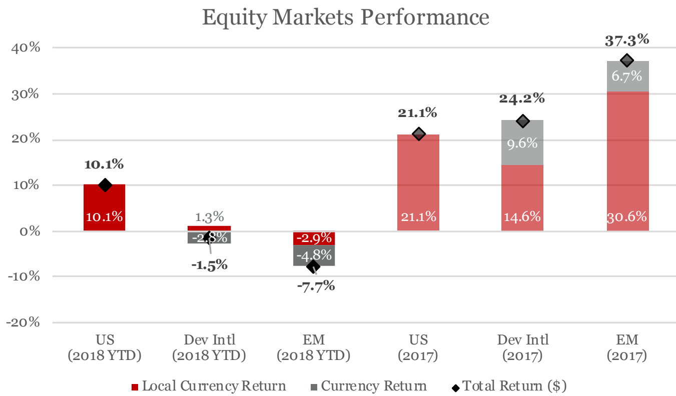
In 2017, the buzzword for markets was "global synchronization." This was a period when economic growth and the markets were rising for the U.S., Europe, Japan, and emerging countries. During this time, FSA had tactical overweights to equities over fixed income and within equities toward international markets due to their cheaper valuations. The U.S. dollar also declined during this period which was positive for international equity returns.

While 2017 was all about synchronized growth, this year's market can be portrayed by global divergences. Divergence in performance was brought about by the market's recognition of many ongoing factors including monetary policy, economic growth, and trade policy.

Central bank policies are diverging now in a meaningful way leading to higher rates in the U.S. than other developed nations. We feel this is mostly a reflection of how strong economic growth is in the U.S. and how much further along we are from exiting crisis-era monetary policies. To put this into perspective, the Fed's Central Bank balance sheet has decreased post-quantitative easing to 21% of GDP, while the European Central Bank (ECB) remains at 40% and the Bank of Japan (BOJ) leads at 97%. It is expected that the ECB will end its asset purchase program later this year, while the BOJ will continue to target its yield curve and make purchases only when yields rise above a certain limit. Market strategists expect 2019 to be marked by negative asset purchases for the first time since 2015 as central banks stop quantitative easing-era purchases and let existing securities mature to reduce central bank balance sheets. The result of all these changes is expressed in the shift from a liquidity-fueled market to a fundamentally driven market. This is one of the reasons we believe U.S. 10-year Treasury yields have moved above 3.0%. Increasing rates due to fundamentals such as strong economic growth are a positive market signal.

Interest rate and growth differentials have also manifested in negative currency returns for U.S. investors. U.S. investor returns are affected by the strengthening U.S. dollar which has been responsible for a majority of negative returns year-to-date in international markets. This is much different from what investors saw in 2017 (see Figure 2).

Figure 2



Sources: FactSet; Highland Associates; Total Returns year-to-date through Sept 2018; Representative benchmarks used: U.S. = S&P 500; Dev Intl = MSCI World ex USA; EM = MSCI Emerging Markets

Figure 3

Total U.S. and Chinese imports data as of 12/31/2017; imposed tariffs as of 9/30/2018 Sources: COMTRADE; USTR; Chinese Ministry of Trade; PolitiFact; Highland Associates

Trade tensions have also caused divergences with the U.S. taking a strong stance against trading partners. Uncertainty created by these trade negotiations has been a driver of higher volatility in the markets. As of September, the U.S. has imposed tariffs on 50% of Chinese exports, or $253 billion of the $504 billion total exports. Meanwhile, China has retaliated with tariffs on 77% of U.S. exports, or about $100 billion of the $129 billion total exports (see Figure 3). FSA estimates that this places the U.S. and China as entering a "trade feud" as defined in the last edition of our Capital Markets Quarterly. An escalation from trade game to trade feud has broader implications on global growth and could stir up inflation. Isolated industries, such as beverage and automotive are seeing price pressures caused by tariffs on aluminum and steel. Abroad, both Europe and China's growth has moderated.

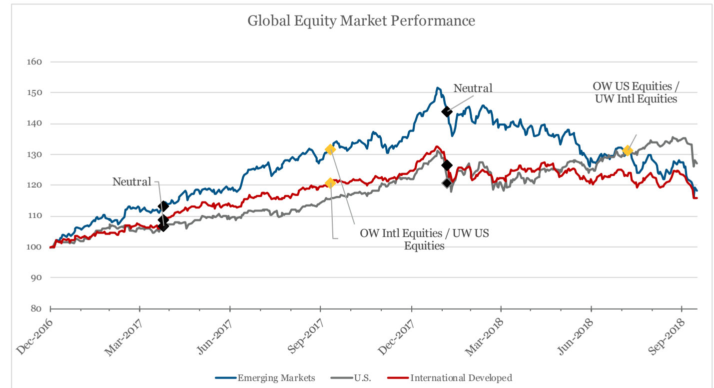
In the U.S., economic growth remains strong, supported by fiscal stimulus, and new orders appear to be unaffected as of yet by trade tensions. Although there could be some relief when Trump is expected to meet with Chinese President Xi Jinping later this year, most likely "tariff talk" will only escalate further. On a positive note, the U.S., Canada, and Mexico reached a new trade agreement to replace the North American Free Trade Agreement with the U.S.-Mexico-Canada Agreement. We feel this resolution removes one potential drag of uncertainty from the markets.

uncertainty from the markets. Emerging markets have had their own reckoning with economic and political disturbances revealed by rising U.S. interest rates, weakening EM currencies, and escalating trade tensions. Of MSCI Emerging Market countries, 40% have had to raise rates in 2018 to contend with global risks. Argentina and Pakistan have had to handle mounting external debt burdens with International Monetary Fund (IMF) bailouts, while Turkey deals with similar issues of swelling debt and falling currency, leading many to speculate another IMF bailout could be issued early next year. This all results in increased volatility as fundamentals drive fund flows and divergence in global growth dominates.

In addition to the global ripples from trade, regional political risks are mounting. As highlighted in our recent piece on the Eurozone, there are major elections in 2019 that could reshape the face of monetary and fiscal policy for the 28-country union. At the same time, risks of a hard Brexit will not subside until Prime Minister May has Parliament's approval of her recent deal with the European Union (EU) that would allow for a smooth exit in March 2019. Lastly, there's Italy and its new government which is pushing back against the EU's rules regarding deficits. We expect developments in Europe along with a recent slowdown in economic data to keep volatility elevated in the region, and our firm remains convicted in our underweight to the region.

Monetary policy, currency, trade, and politics have dominated investors' psyche in 2018. These factors manifested in equity market performance divergences starting in the first quarter of 2018, which is when we removed our tactical overweight within equities out of international markets. Later in the year, as it became more apparent that U.S. equities were more resilient, FSA made a tactical shift to overweight U.S. equities. While we believe these divergences help to explain the performance differential between U.S. and international equities, investors should beware of the uncertainty that is created by these divergences, which could likely lead to additional market volatility like we have experienced throughout 2018.

Figure 4



Sources: FactSet; Highland Associates; Total Returns year-to-date through Oct. 15, 2018; U.S. = S&P 500; Dev Intl = MSCI World ex USA; EM = MSCI Emerging Markets

Focus on the Framework

How are investors supposed to stay disciplined when it feels like the scales aren't tipped in their favor? Follow a framework to distill through the noise. FSA & Highland accomplish this via their investment framework which looks at both short-term and long-term opportunities.

Our tactical, or short-term, decisions are useful because the scale of the market always tilts but rarely balances. A walk through recent equity positioning exemplifies this best and is depicted in Figure 4. In the second half of 2017, Highland recommended an overweight to international equities to capture the positive growth in overseas markets at the time.

Global growth convergence was starting to fade in early 2018 before investors fully realized it. As discussed above, monetary policy, currency, trade, and politics were beginning to deviate from their projected paths, and so we moved to a neutral regional positioning as global markets digested the policy changes (i.e., end of quantitative easing, shift towards dollar strength, veering from open trade to threat of higher tariffs, etc.). In August of this year, we had conviction in U.S. equities as interest rates, growth and currency differentials ultimately favored the region and earnings growth and fiscal stimulus provided an additional tailwind.

FSA remains overweight U.S. as these factors remain intact. As the example of regional equity weighting illustrates, Highland weighs the market's momentum, or strength in price trend, to distill the noise. While fundamentals favor investments abroad over the long run (reiterating our global opportunity set outlined in Investors Without Borders I and II), we are mindful of the divergences that run rampant over shorter periods. With the preponderance of evidence from economic data supporting this favorable shift toward the U.S. combined with the support of the market, we maintain our current overweight position.

On a strategic level, FSA continues to take risks consistent with the Highland Diffusion Index framework by overweighting risk assets such as equities and hedge funds. Both of these overweights come from an underweight to fixed income, which we expect to experience lower returns over the next decade from historically low interest rates.

In October, it has not been favorable for U.S. and broad equities which have not been able to deflect this latest bout of volatility. FSA remains comfortable with our positioning because the market has experienced a correction rather than a change in economic or market fundamentals. Our framework, which reviews economic

fundamentals and market sentiment, continues to reinforce our positioning. Fundamental factors, such as strong leading economic indicators and declining unemployment, illustrate that economic growth should remain robust. Long-term momentum metrics remained positive through the end of September. Furthermore, telltale indicators that would typically point toward a more prolonged sell-off, such as spread widening in credit or a decline in Treasury yields, were not present. In fact, we saw the yield curve steepen.

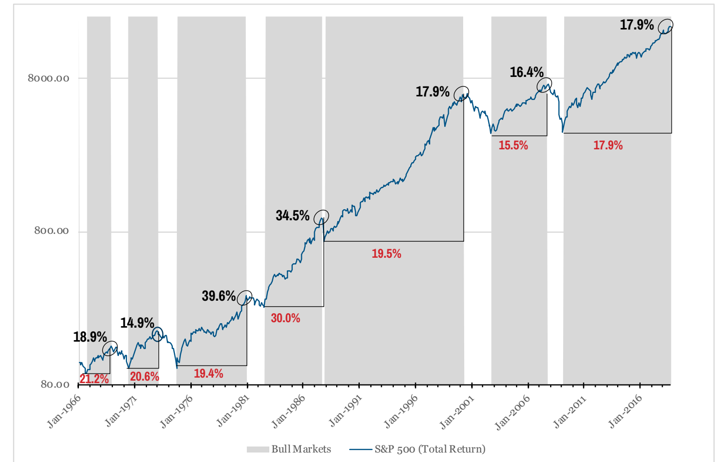
We also remain watchful of Fed policy and its impact on the yield curve. While policy remains accommodative and the yield curve has cushion between longer and shorter term rates, there is the risk that an unexpectedly aggressive Fed could raise rates too high/too quickly, harming economic growth and return-seeking assets. A shift in these indicators would have us reconsider our tactical positioning toward U.S. equities and strategic positioning toward risk assets. FSA remains vigilant.

Having the Courage to Stay Convicted

The importance of the framework, noted above, is that it keeps us disciplined in periods of "scale-tilting" divergence. The S&P 500 is in the midst of the longest bull market in history at 3,492 days through September 30, 2018. With the length of the bull market and the notable lead U.S. assets have over global allocations, is there room left still to run? It is nearly impossible to determine when the true end of a cycle will be, but here is why we stick to our framework to stay convicted: Roughly 20% of returns in a bull market occur in the last year. As the saying goes, bull markets end with a bang, not a whimper, and with muted future return expectations over the next ten years, one could make the case against an early exit (see Figure 5). The U.S. hasn't been without its bumps this year, but it continues to be the right place to be.

Speaking of bull market bumps, this year alone the S&P 500 has sustained a -10% correction and -9% pullback only to deliver a positive year-to-date return through October 25th.

Figure 5



Source: Highland Associates; BCA; FactSet; Total Return monthly through Sept. 2018
The black numbers in the chart represent the last 12 months of a bull market's annualized return; the red numbers represent the annualized return for the entire bull market.

While corrections can be painful in the short term (e.g., international markets year-to-date), bear markets, or periods of equity market declines of 20% or more, are the real trouble. For example, if you stayed fully risk-on for the -50% drawdown in equity markets starting in October 2007, which lasted for 17 months, you would have had to remain fully invested for another 41 months, or almost 4 years, to earn back the capital you lost.

Proper positioning of portfolios can help mitigate the painful declines. Highland's Diffusion Index, with data back to December 31, 1985, is designed to help us avoid bear markets, which put portfolios at the greatest risk of capital impairment. Signals from the index would have correctly positioned us for the last two major bear markets (March 2000–October 2002 and October 2007–March 2009) and just missed the flash crash of 1987.

Acknowledging that bull markets end, momentum shifts, and business cycles come to a close, FSA remains vigilant of economic and market indicators and would change portfolio positioning in response to a negative shift. However, given that we believe that market fundamentals support a continuation of this bull market, we will remain focused on our framework in order to remain resolute in our assessment of the facts in the face of transitory divergences of the market.

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