Santa Fe Advisors

July 24, 2019

Mid-Year Roundup

Despite concerns about market direction at the beginning of the year, particularly coming off steep market declines late in 2018, both equity and fixed income markets have concluded a first half of 2019 that can only be described as outstanding.

To be sure, the pace of gains declined from the breakneck advance of the first quarter, but was still far from shabby. The S&P 500 gained 4.3% in the second quarter to add to the 14% advance in the first quarter. For the six months, the S&P returned a very robust 18.5% – a figure that would be a big advance for a full year. The growth stock sector continued to strongly outpace value, as it has done for most of the past five years, with returns 5-8% better across the capitalization spectrum, Table 1.

Table 1

	2Q 2019			YTD		
	Value	Blend	Growth	Value	Blend	Growth
Large	3.8%	4.3%	4.6%	16.2%	18.5%	21.5%
Mid	3.2%	4.1%	5.4%	18.0%	21.3%	26.1%
Small	1.4%	2.1%	2.7%	13.5%	17.0%	20.4%

Source: JP Morgan Asset Management

Unlike in years past, most international equity markets also joined the party with strong gains, Table 2. Non-US equity markets were broadly up 13.3% in local terms and 14% in dollars, benefitting from a modest decline in the value of the dollar. Europe was the standout, notwithstanding numerous economic and political concerns, with a dollar return of 17.8%, nearly matching the US figure. Emerging markets trailed somewhat, but the return of 10.8% is hardly something to sneeze at. Japan was the laggard among major markets, with a still-acceptable return of 8%.

Fixed income investors had something to celebrate as well, with the Barclays Aggregate US bond index gaining a strong 6.1% as US rates declined after the run-up at the end of last year. Global bonds were close behind at 5.6%, while US high yield bonds continued to put on a strong show with a return of 10.1% for the period.

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Table 2

Returns	2019 YTD		2018		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	18.5	-	-4.4	7.8	0.86
AC World ex-U.S.	13.3	14.0	-10.2	-13.8	5.7	1.11
EAFE	14.1	14.5	-10.5	-13.4	5.2	1.07
Europe ex-UK	18.1	17.8	-10.6	-14.4	5.7	1.22
Emerging markets	10.2	10.8	-9.7	-14.2	8.3	1.27
Selected Countries						
United Kingdom	13.0	13.0	-8.8	-14.1	4.1	1.01
France	19.3	18.9	-7.5	-11.9	5.4	1.23
Germany	15.8	15.4	-17.7	-21.6	6.1	1.34
Japan	6.0	8.0	-14.9	-12.6	4.0	0.76
China	12.9	13.1	-18.6	-18.7	9.9	1.24
India	6.5	7.7	1.4	-7.3	10.0	1.38
Brazil	14.7	16.0	16.7	-0.1	10.0	1.50
Russia	21.3	31.6	18.1	0.5	4.8	1.53

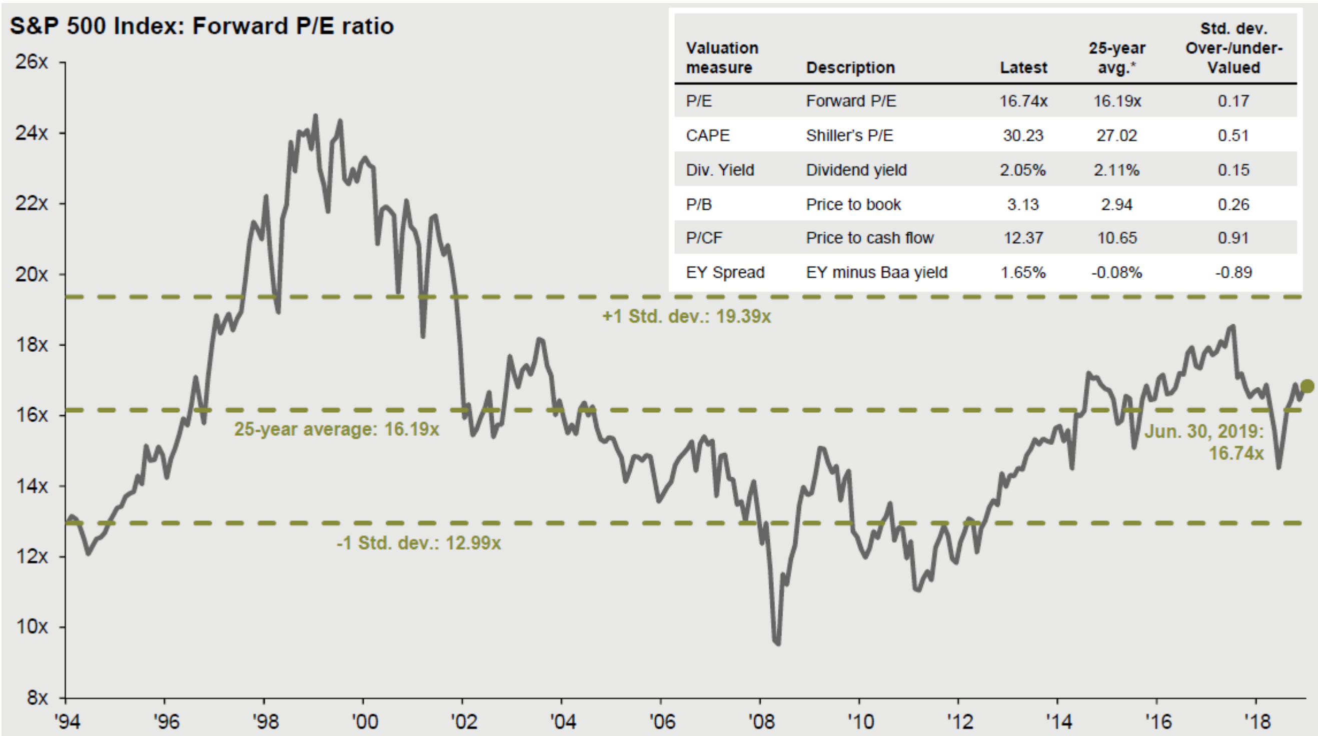
Source: JP Morgan Asset Management

Equity Risks

The robust 2019 equity returns have NOT been driven by strong earnings growth, which is a matter of some concern. We don't have comprehensive earnings data for the second quarter yet, but earnings per share (EPS) growth in the first quarter was a modest 4% (according to FactSet) – of which more than half was driven by reductions in share count. At present, consensus estimates for the second quarter are for a *decline* of 2.7% in EPS – although there is a long pattern of actual earnings coming in above estimates, so it is likely that at the end of the day, we will see another modest earnings increase.

Nonetheless, the combination of rapid price increases and much slower earnings growth has, of course, meant that stocks have become more expensive. Chart 1 shows the S&P 500 forward price/earnings ratio over the past 25 years. This shows that after a brief downward movement (a result of the declines at the end of 2018), the index has returned to a slightly above-average valuation. More telling, perhaps, is the information in the box in the upper right corner of Chart 1. This shows other valuation measures (since no single measure is always reliable). Based on this information, on four of five other commonly used measures, the market is modestly (dividend yield) to strongly (price/cash flow) overvalued. Only the earnings yield spread figure shows that the market is undervalued; we believe that this is because of the extreme unattractiveness of investment grade fixed income (which offer near-record low yields) and not because of the attractiveness of equities.

Chart 1



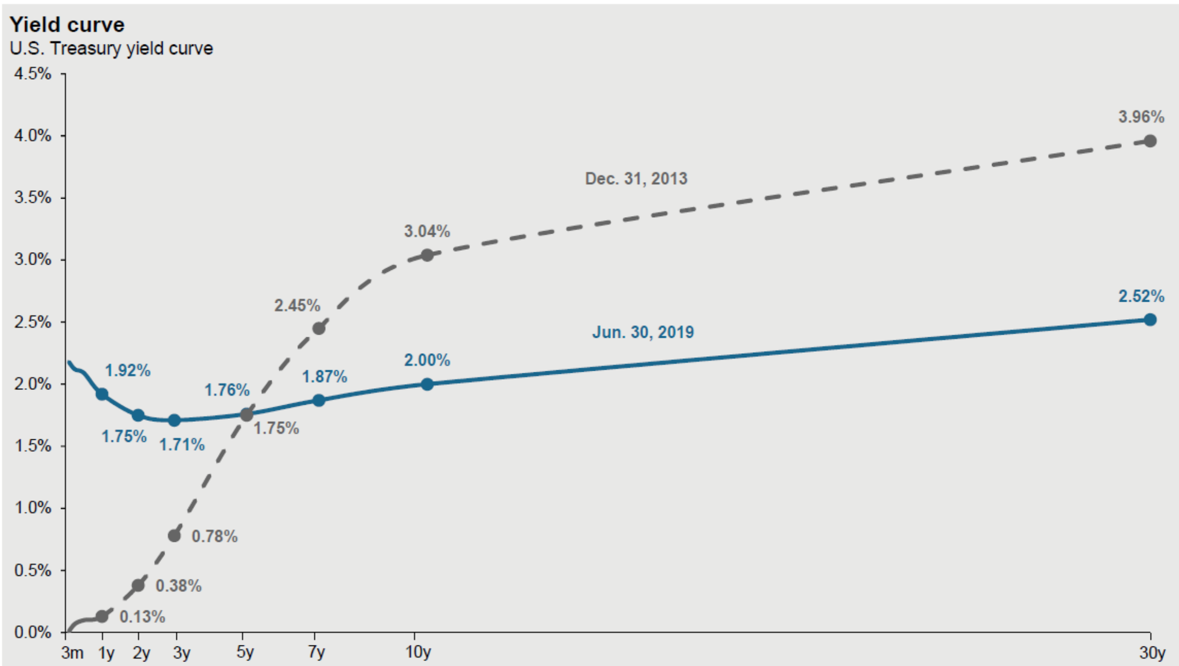
Source: JP Morgan Asset Management

Fixed Income Risk

It is impossible to talk about the prospects for equities without talking about fixed income as well. As noted above, we believe that most fixed income opportunities are poor. Chart 2 shows the shape of the US Treasury yield curve. You'll note that the curve is inverted at the short end (very short rates higher than longer rates) and is very flat through most of its extent. That means that there is very little additional yield to be gained by taking on more duration (interest rate) risk. To illustrate how this risk plays out in real life, consider the 5 year, 10 year, and 30 year Treasury bonds. Should interest rates rise by 1%, these securities would suffer losses of approximately 4%, 9%, and 27% respectively – all multiples of annual yields. A reasonable likelihood of losing 9% of principal in a supposedly safe US 10 year instrument is nothing to take lightly. Yet, the additional annual yield that one gets for buying the 10 year instead of the 5 year is a paltry 0.25%.

We have not found this risk-reward proposition one to be worth taking. To take on a small amount of additional return in exchange for a large amount of additional risk is, to us, an illustration of exactly what we should NOT be doing with client funds. And so, we have not. As confident that we are that we are doing the right thing in the long term, so far this year – with rates falling instead of rising – it has not been a profitable decision. As noted above, the Barclays Aggregate Bond index gained 6.1%, whereas our average investment grade portfolio was up in the 4% range. Nonetheless, we feel confident that "buying low and selling high" is likely to work out well for our clients in the long term, even if there are periods where "buying high" can lead to "selling higher".

Chart 2



Source: FactSet, Federal Reserve, JP Morgan Asset Management

Portfolio Positioning

Our belief is that the equity markets are being driven, to a substantial extent, by very low interest rates. We've seen (as recently as late 2018) that any movement by the Fed toward increasing interest rates to more normal levels has resulted in substantial stock market declines…nearly 20% in December alone. While there is no expectation of interest rate increases in 2019 (indeed, the Fed has signaled that it is more likely to cut short term rates than to raise them) we still believe that the fundamentals in equities (relatively high valuations driven by low rates, combined with modest earnings growth) suggest that caution is appropriate.

As our clients know, we do not invest based on our predictions of what might happen in the market over the next 3-6 months, since we have no confidence in our ability (or anyone else's ability) to guess short term market movements. We do, however, try to make judgements about whether long term fundamentals support the prices for equity, debt, and other securities, and orient our portfolios to try to focus on those areas that we think represent good value and avoid those that appear overpriced.

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Right now, we believe that equities are fully valued to modestly overpriced, while most fixed income is significantly overvalued. That makes it more difficult to invest, because there is very little that we believe is intrinsically attractive at current levels. We have addressed these issues by maintaining a modest underweight to equities (about 4% below our 50% target for our Moderate risk portfolios) and keeping the duration of our fixed income portfolios quite short. That may have cost us a little return in the go-go environment of 2019's first half, but we feel confident that these are the right risk-management decisions to properly balance risks and reward in our client portfolios, which have nevertheless enjoyed strong year-to-date gains.

As always, please contact any member of the team if you have questions or concerns. We would be very happy to discuss our views with you in more detail.

Thank you for your trust.

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Disclosures