SFA
Santa Fe Advisors

July 20, 2018

The Water is Never Fine

After a wild start to the year, during which the US stock market staged a powerful initial rally followed by a swift and larger decline, volatility dropped and relative calm returned in the second quarter. Whereas economic growth in the Eurozone and Japan has slowed in recent months, the US economy continues to show broad-based acceleration, with strength increasing in leading economic indicators, consumer and business confidence, and housing and labor markets. US companies began announcing quarterly earnings results, with consensus expectations for profit growth of close to 20% compared to the second quarter of 2017.

Against a backdrop of ubiquitous political rancor in the US, geopolitical concerns have again come to the forefront in an almost dizzying manner, with new governments in Italy and Mexico, and the UK government weakened by contentious "Brexit" negotiations. On the trade front, NAFTA negotiations have stalled, and the US and China have escalated their dispute, with both applying new tariffs and threatening more. US summit meetings with North Korea and Russia, as well as tensions within the NATO alliance (including increased authoritarianism in Turkey), have added to the mix and have introduced, as is usually the case, both upside and downside risk variables.

Nevertheless, despite (or perhaps because of) incessant negative news headlines and the fears they engender, the US stock market has quietly ground higher in recent months, and as of this writing, has recouped most of February's losses and has returned 5.9% for the year, putting it within 2.5% of January's record high. Indeed, in our last market commentary "Risk Cuts Two Ways," (4/17/18) we noted that retail investor sentiment (often a counter-indicator) had turned decidedly negative in early April, a development that almost perfectly presaged the recent US stock market rally.

Other markets fared less well in the first half of 2018. International stock markets posted single-digit losses, with Developed Markets impacted by slowing economies, and Emerging Markets facing headwinds from a stronger dollar and trade concerns. Investment grade bonds had modest negative returns due to rising interest rates. REITs recouped steep losses and posted slight gains, as strong real estate fundamentals overcame fears of higher financing costs. Oil spiked almost 23% amid supply concerns, and gold declined 4%. Overall, most diversified investment portfolios moved little in the first half.

****

Wall Street strategists love acronyms, and often find audiences willing to believe that investing can be reduced to simple themes. One example was BRIC, a term coined by a Goldman Sachs strategist in 2001 which refers to Brazil, Russia, India, and China. While these countries and their economies differ greatly and therefore pose very distinct investment risks, they were all large, populous countries at somewhat similar stages of economic development. The idea was that these countries (and Emerging Market countries in general) would benefit greatly from increased globalization and growth, and as a result would offer investors outsized return opportunities, which they indeed did, until they didn't: after several years of strong gains

leading up to the 2008 financial crisis, Emerging Market stocks in aggregate have yet to recover to pre-crisis levels (while the S&P 500 is 80% higher than its 2007 peak).

This is worth noting for two reasons.

The first is a cautionary note about the risks of theme-based investing, particularly when the theme has become quite popular (and therefore often "crowded" by investors who do little analysis). A recent theme that has been wildly popular has been to invest in "FAANG" stocks, a recent acronym for Facebook, Apple, Amazon, Netflix, and Alphabet (Google's parent). This strategy has rewarded investors well: these stocks currently represent over 11% of the S&P 500s market value, and have contributed almost half of the market's 2018 return. They are also a very expensive group: all but Apple have Price/Earnings (P/E) ratios well in excess of that of the broad market. The risk associated with excessively rosy expectations was highlighted yesterday, when Netflix's stock briefly fell over 13% after a disappointing earnings announcement.

The second reason is that, just like we need to guard against unrealistic exuberance, we also need to identify opportunities when they are out of favor. One potential opportunity that we are currently discussing is in fact in Emerging Markets stocks, which are down over 6% this year, in part of because trade fears and a stronger dollar. As a result of the recent price decline and (as in the US) strong earnings growth, Emerging Market stocks have cheapened considerably, and now trade at a significant P/E discount of 37% to the S&P 500, relative to the average historical discount of 23%. We are currently considering a tactical increase of Emerging Market stock exposure in our portfolios, and will keep you informed of our decision.

10 Year History of S&P 500 and MSCI Emerging Markets Trailing P/E Ratios

Source: Bloomberg

As we often do, we'll close by stressing the importance of choosing an investment risk profile appropriate for one's personal objectives and risk tolerance, and then sticking with it throughout market cycles. Investing means taking risk, and while it should be done in a thoughtful and cost-efficient manner, a "safe" time to invest is rarely obvious: ***the water is never "fine."***

In markets as in life, good things happen over time. Just this month as much of the world paused for the soccer World Cup, tiny Croatia reached the final, and new revelation Kylian Mbappe joined Pele as only the second teenager to score in tournament history. And in Thailand, all 12 members of the Wild Boars boys' soccer team and their coach were safely rescued, after over two weeks trapped in a cave. Gratitude and respect to Thai Navy SEAL Samarn Kunan, who gave his life in the monumental rescue effort, so that the boys might live.

Thank you for your trust and support, and please contact a SFA team member with any questions.

David E. Marion, CFA
Partner
(505)501-6201
dmarion@santafeadvisorsllc.com

Disclosures

The information contained within this letter is strictly for information purposes and should in no way be construed as investment advice or recommendations. Investment recommendations are made only to clients of Santa Fe Advisors, LLC on an individual basis. The views expressed in this document are those of Santa Fe Advisors as of the date of this letter. Our views are subject to change at any time based upon market or other conditions and Santa Fe Advisors has no responsibility to update such views. This material is being furnished on a confidential basis, is not intended for public use or distribution, and is not to be reproduced or distributed to others without the prior consent of Santa Fe Advisors.