Q2 2018
INVESTMENT PERSPECTIVES

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- **TRADE WARS:** The Trump administration made good on its threats to hit US trading partners with tariffs during the quarter, and retaliatory measures were taken by China, the European Union (EU), and others. While negotiations are ongoing, there is no end in sight, and investors are left guessing about the ultimate impact of the tit-for-tat trade levies on global growth.
- **U.S. EQUITIES BOUNCE BACK; EMERGING MARKETS FADE:** A solid Q1 earnings season and ongoing investor enthusiasm for the corporate tax reform package passed at the end of 2017 helped US stocks finish in the black for the quarter. Non-US stocks—and emerging markets in particular—did not fare as well against a backdrop of a stronger US dollar and concerns about slowing economic growth across Europe.
- **CENTRAL BANKS SIGNAL MORE TIGHTENING AHEAD:** In response to less dovish commentary from the US Federal Reserve about staying the course on its plans for additional rate hikes, investors continued to price in higher yields across core US bonds. Likewise, commentary from the European Central Bank (ECB) about ending its quantitative easing efforts hit global bond indices during the quarter.

MARKET RECAP

On the heels of a volatile first quarter of the year, global stocks had another rocky ride during Q2 2018. Talks of trade wars, quantitative tightening, and decelerating global growth took a toll on risk assets to varying degrees. US stocks ultimately fared the best while emerging markets stocks were the hardest hit.

Bond yields continued to march higher during the quarter as investors repriced expectations of central bank tightening and inflation going forward. Core US bonds—as measured by the Barclays US Aggregate Bond Index—posted consecutive quarterly losses for only the second time since 2008.

TRADE POLICY FRONT AND CENTER

Q2 2018 saw the US, China, and the EU move beyond rhetoric and into the realm of implementing tariffs on a variety of goods. The Trump administration has continued to focus on the US trade deficit—the result of the US importing more goods and services

FIXED INCOME

	USD Total Return (%)	
Index	**Q2 2018**	**YTD**
Barclays 1-10 Yr Muni	0.8%	0.1%
Barclays US Agg. Bond	-0.2%	-1.6%
BofA/ML HY Master II	1.0%	0.1%

EQUITIES

	USD Total Return (%)	
Index	**Q2 2018**	**YTD**
Russell 3000	3.9%	3.2%
S&P 500	3.4%	2.6%
Russell 2000	7.8%	7.7%
MSCI All Country World	0.5%	-0.4%
MSCI EAFE	-1.2%	-2.7%
MSCI Emerging Mkts	-8.0%	-6.7%

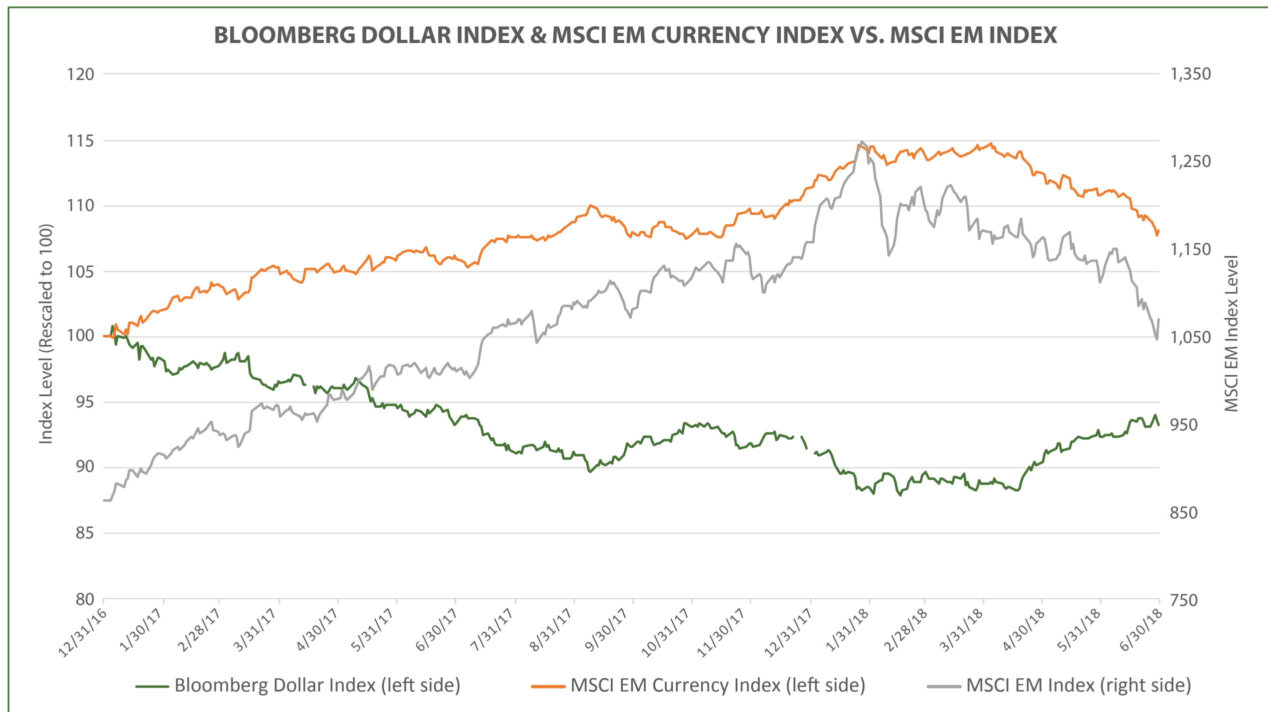
Source: Bloomberg (Data as of 6/30/18)

than it exports—while criticizing countries for taking advantage of America's relatively open trade policies. Opponents of the administration's policies argue that a focus on the trade deficit misses the corollary of the US capital account surplus—i.e., more foreign capital is coming into the US than is going out—and risks upsetting a complex, global supply chain.

The effects of the administration's approach remain to be seen, but US markets have generally shrugged off any perceived impact at this point. Negotiations between the US and others are ongoing, and US investors seem to be assuming that an agreement will be reached before businesses and consumers experience any material pain. With that said, the Fed meeting minutes from June suggested that there were already signs of businesses scaling back their investment spending plans based on the uncertainty. Perhaps the true impact will not be felt in the data for months or years to come.

STRONG DOLLAR; WEAK EMERGING MARKETS

Emerging markets equities snapped their winning streak in Q2 as US dollar strength and the aforementioned tariffs weighed on investor sentiment. The chart below highlights the trajectory of EM currencies (MSCI EM Currency Index) relative to the dollar (Bloomberg Dollar Index) in 2017 and through the first half of 2018—the orange and green lines. As the dollar declined and EM currencies rallied from the beginning of 2017 through Q1 2018, EM stocks were among the best performing assets during the period; however, a period of US dollar strength and EM currency weakness in Q2 went hand-in-hand with a period of difficult performance for EM stocks.



Source: Bloomberg (Data as of 6/30/2018)

On the bright side for EM investors, after the recent sell-off, the MSCI EM Index is trading at a slight discount to its 10-year average price-to-earnings multiple. While valuation multiples often overshoot to the upside and downside, this suggests that EM stocks are cheap relative to their historical valuation levels.

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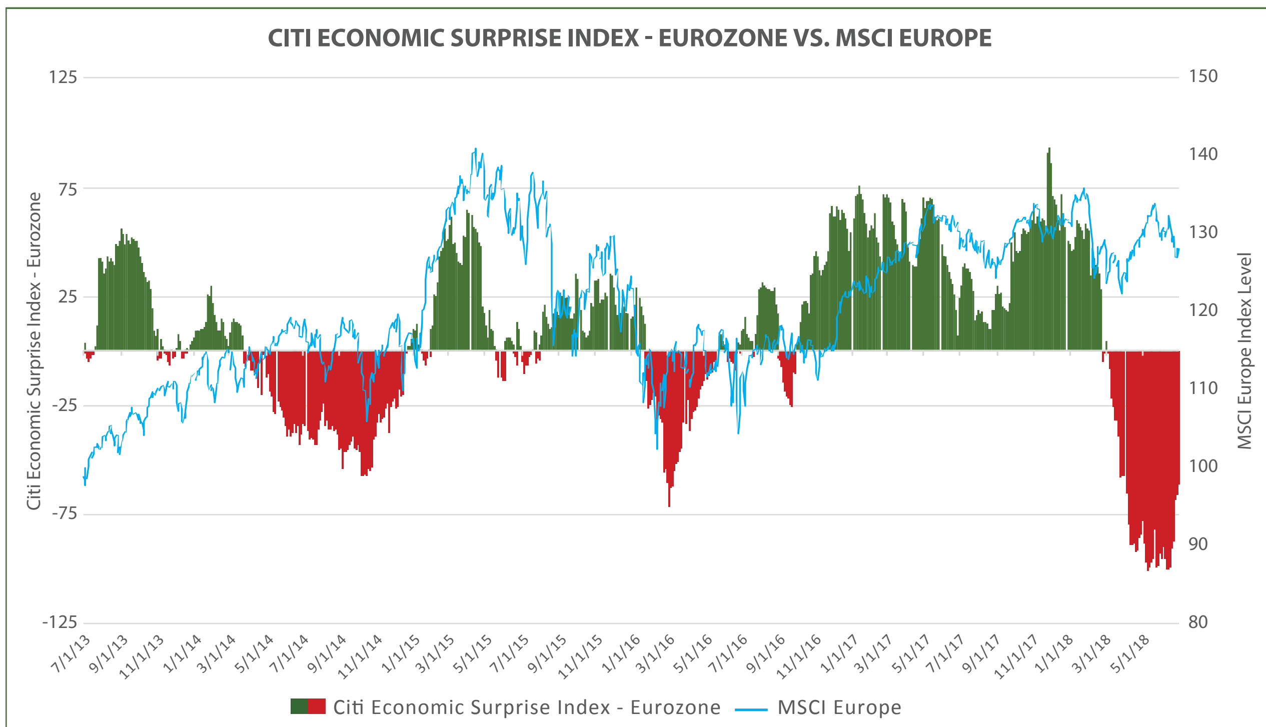
SMALL CAPS SHINE

Heated trade rhetoric and US dollar strength was perceived differently within various corners of the market. One area that reacted positively in Q2 was small cap stocks. The Russell 2000 gained 7.8% during the quarter—more than double the return of the larger cap-focused S&P 500. The core of the small cap investment thesis was that smaller companies are often more domestically oriented, therefore more insulated from potential tariffs and currency translation issues. The large, multinational companies that populate the S&P 500 are less likely to avoid any negative fallout.

In addition, analysts have argued that the US tax reform package passed in Q4 2017 should have a disproportionately positive impact on small cap companies, owing to their relatively higher effective tax rates under the prior tax regime. Expectations of higher earnings over the coming quarters have led to investors adding dollars to small cap ETFs at roughly 4 times the rate of large cap ETFs in 2018, per Bloomberg data.

EUROPE GETS AHEAD OF ITSELF

After a run of economic data outpacing expectations beginning in late 2016 and continuing into 2017, analysts set an increasingly high bar for the Eurozone as we entered 2018. The chart below shows the Citi Economic Surprise Index—a measure of economic data relative to consensus expectations—over the past five years. Positive readings indicate that data has been exceeding expectations while negative readings indicate that data has been missing expectations. As is often the case, the forecasts overshot the reality of the economic recovery, and European data began to substantially miss its marks in Q2.



Source: Bloomberg (Data as of 6/30/2018)

Despite the data generally being positive in absolute terms, markets tend to assess new information relative to expectations and on a first derivative—i.e., rate of change—basis. Failing to meet the lofty standards set by analysts and demonstrating a decelerating growth trend negatively impacted European stocks, sending the MSCI Europe Index (the blue line overlaid on the chart) down by over 3% on a year-to-date basis. Moreover,

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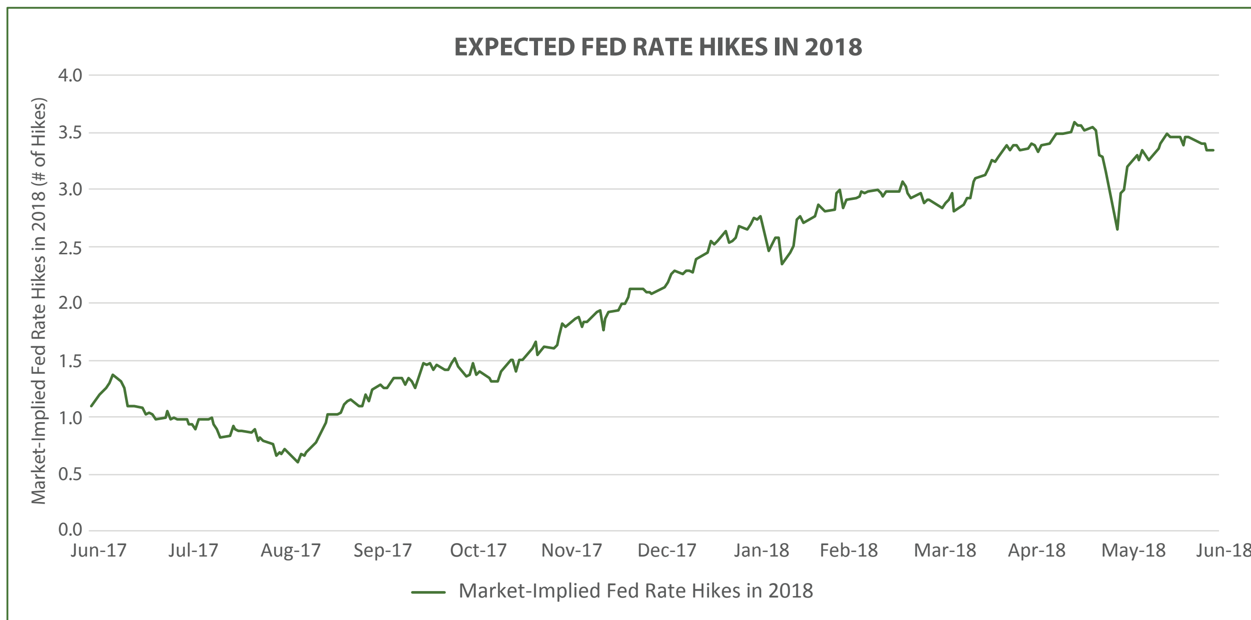
underperformance in Europe has a number of analysts suggesting that there is a breakdown in the synchronized global growth story that propelled stocks higher in 2017. These concerns dragged down developed international stocks more generally during the quarter.

CONSTERNATION IN CORE BONDS

While bond markets were relatively calm compared to Q1, the rising interest rate environment continued to push prices lower, leading to losses across the core fixed income environment. What initially looked like a simple reset of expectations at the beginning of the year has proven to be a more enduring trend; investors have become stronger believers in the Fed's message that it may raise interest rates four times in 2018. This has kept upward pressure on yields, and as yields rise, bond prices fall. Bonds with longer durations—or, greater sensitivity to changes in interest rates—have been especially hard hit.

To put this dynamic into perspective, consider the chart below that plots the market-implied expectations for the total number of Fed rate hikes in 2018. There was a time in August 2017 when investors were only pricing in roughly a 50-50 chance of a single Fed rate hike in 2018. There have already been two rate hikes this year! As the market steadily increased its expectations, core bonds have been under pressure—with the worst of the impact felt in Q1 2018. If the Fed continues with its more hawkish rhetoric and follows-through with a total of four rate hikes in 2018, expect the lackluster performance to persist.



Source: Bloomberg (Data as of 6/30/2018)

BITCOIN AS A LEADING INDICATOR?

Last quarter we explored the popping of the bitcoin bubble after prices per one bitcoin fell from nearly $20,000 to roughly $6,000—a spectacular collapse of over 65%. A number of market commentators have suggested that bitcoin may be a useful gauge of investor risk appetite. Jeffrey Gundlach from DoubleLine Capital took the idea a

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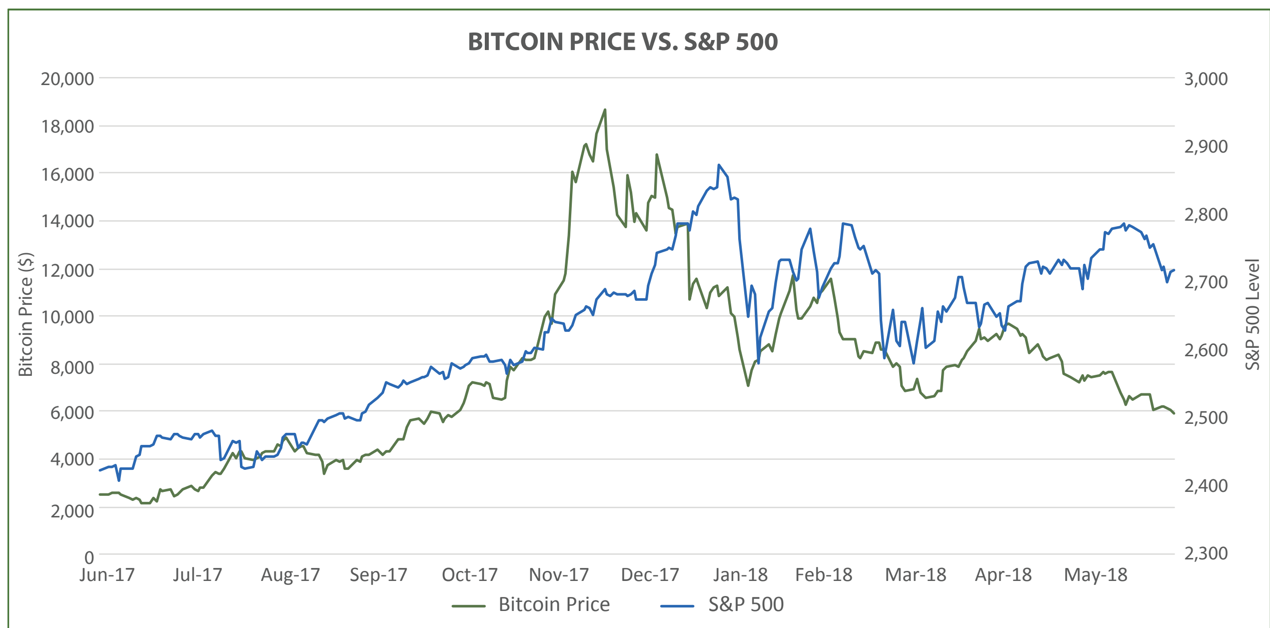
step further and suggested that bitcoin could actually be considered a leading indicator for stocks by providing a real-time look into one of the most speculative areas of global capital markets. As investors become more or less apt to take risk in bitcoin, the perception is that this sentiment trickles down into traditional markets, such as the S&P 500.

Correlation does not necessarily mean causation, but plotting the price of bitcoin and the S&P 500 does show an interesting trend over the past year. Bitcoin peaked roughly a month before the S&P 500 made its all-time high in January of this year, began to recover off its lows before the S&P 500 bounced in February, then led the S&P 500 lower through the end of Q1. Whether this is truly a robust indicator remains to be seen, but bitcoin has been a useful market barometer over the past 12 months.●

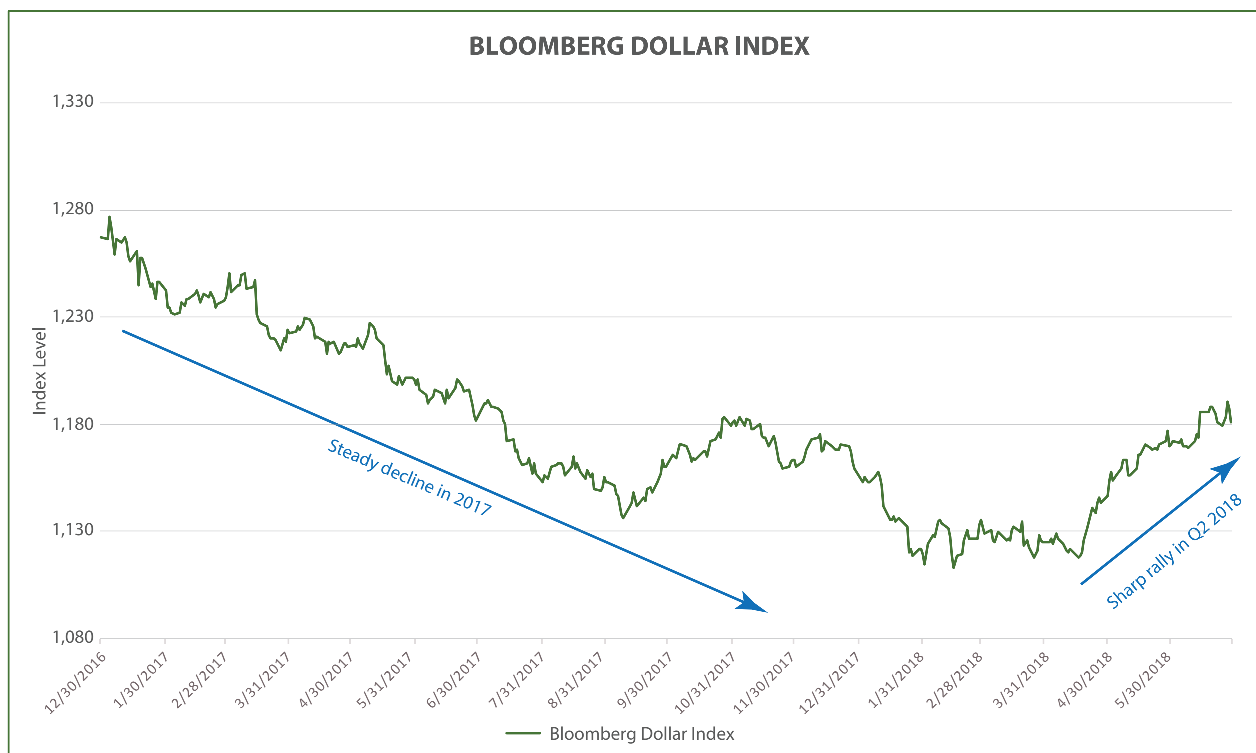


Source: Bloomberg (Data as of 6/30/2018)

Chart of the Quarter

Most analysts and economists regard the US dollar as a critical component of the overall macroeconomic landscape given the pervasiveness of the dollar as a global reserve currency, the amount of commodities, goods, and services transacted in dollar terms, and the size of dollar-based funding markets. Accordingly, when the dollar experiences a dramatic move in either direction, global markets tend to respond swiftly. Q2 2018 was no exception.

As you will see on our "Chart of the Quarter" below, after a downward trend in the trade-weighted Bloomberg US Dollar Index in 2017 and through the beginning of 2018, the Dollar Index rallied sharply in Q2.



Source: Bloomberg (Data as of 6/30/18)

While not without exceptions, periods of significant dollar strength often catalyze various developments across global markets. In our view:

- Emerging market stocks and bonds frequently suffer during periods of US dollar strength. These economies are often reliant on external funding that is priced in dollar terms. As the dollar strengthens, the effective cost of funding increases commensurately.
- Related to the prior point about EM economies, commodity prices generally suffer in a strong dollar environment. Most commodities are priced in dollar terms, so a stronger dollar—and therefore, weaker non-US currencies—tends to reduce demand. Because EM economies tend to be sensitive to fluctuations of commodity prices, EM stocks and bonds are commonly punished by investors.
- As the dollar strengthens, US goods and services become more expensive to non-US consumers. Markets often penalize export-oriented US companies that may be less competitive in a strong dollar environment.

The greenback is still king in the global financial system, so understanding the first and second order effects of a dollar rally is critical when analyzing your portfolio. ●

Our Myriad Biases

For all sorts of evolutionary reasons, we as humans are hardwired to think about the world in ways that may be suboptimal. Investing, in particular, presents a unique set of challenges for our internal decision-making apparatus. Every day is, in effect, a referendum on our current portfolio holdings and an opportunity to make a decision: buy, sell, or hold. We may attempt to reconcile cognitive dissonance via rationalizations about why an asset is on the verge of turning around, why we would never touch an asset class that appears to be undervalued, or why our rule-of-thumb about buying stocks will never let us down.

Think you are immune to these potential pitfalls because you are highly intelligent? Unlikely. In fact, research by psychologists Richard West, Russell Meserve, and Keith Stanovich actually shows that smarter people have an increased probability of falling prey to cognitive biases.

The first steps to overcoming—or simply confronting—these biases are acknowledging their existence and learning how to spot them. Here are a few of the most common biases that often influence investors and thoughts on how to prevent them:

- **Confirmation bias.** When we have a belief or idea, we are generally receptive to information that confirms said belief or idea while discounting information that contradicts it. This can be observed in all areas of life: people often gravitate toward news sources that match their ideology; researchers may cherry-pick data that supports their hypotheses; studies show that people more easily remember stories that reinforce stereotypes rather than debunk them. In investing, people often form beliefs about a company or an asset class, then subconsciously filter subsequent information to suit their existing belief—positively or negatively.

  Suggestion: Make a conscious effort to seek out information that challenges your beliefs and commit to being analytically rigorous when confronted with contradictory data.

- **Endowment effect.** Daniel Kahneman and Richard Thaler, popular figures in the behavioral economics field, have offered evidence that individuals were likely to place a higher value on something in their possession than if the same item were not in their possession. In other words, individuals irrationally inflated the value of certain assets simply because they already owned them. Within the investment realm, this bias often manifests itself around concentrated stock positions that may have been inherited (often having some emotional significance) or earned as an employee of a company.

  Suggestion: Set price targets and/or position size limits, then be disciplined about sticking to them. If you choose not to be so systematic, when considering the sale of an asset, at least ask yourself, "Would I tell my best friend to buy this asset today, at this price?" If the answer is "no," then it may be time to consider selling.

- **Recency bias.** People often use recent events to extrapolate probabilities of the same events occurring in the future. This may actually be helpful in some instances (disciplines like machine learning and artificial intelligence use a "Bayesian" approach that updates probabilities based on newly acquired data), but this bias can often lead investors astray. For instance, an individual may say, "Over the last couple of years, every time the stock market has sold off more than 5%, it has recovered relatively quickly. I will buy aggressively on the next dip." While that approach could ultimately lead to a positive outcome, the evaluation process ignores the broader context (e.g., Are stocks more richly valued now? Are interest rates more or less competitive with stocks now? Is there more or less liquidity in the system now?) and may lead to an investor taking on more risk than he or she would otherwise. This is a big reason why bubbles are formed; akin to Pavlov's dog, investors continue to add risk and chase returns because recent history tells them they will be rewarded.

  Suggestion: Evaluate decisions in a broader, historical context. As is frequently said, history may not repeat, but it often rhymes. Learning lessons from past market cycles is an important step toward avoiding similar pitfalls in the future.

- **Self-serving bias.** Across all sorts of disciplines, people frequently attribute positive outcomes to their own intellect, analytical superiority, or hard work while discounting negative outcomes as the result of an unforeseen event, someone else's fault, or simply bad luck. This type of thinking is effectively a self-protection mechanism designed to defend our ego and self-esteem. The problem is that good decisions do not always lead to positive outcomes, and

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negative outcomes can result from a strong decision-making process. We see this in investing all the time; managers that beat the market one year laud their extraordinary analysis while managers that underperform blame the market environment. The truth is generally somewhere in between.

Suggestion: Orient your focus more toward the process of making decisions rather than the outcomes, and consider documenting the steps along the way so you can be more objective when assessing your successes and failures.

- **Temporal discounting.** In general, people's brains are wired to perceive the relative value of rewards differently depending on when the rewards will occur. For instance, when offered $100 today or $120 in one month, studies show that people tend to prefer the $100 today. People typically prefer immediate gratification and view comparable rewards as being more valuable today than in the future. However, when offered $100 in 12 months or $120 in 13 months, most people opt for the $120. Pushing the reward further into the future makes people more receptive to waiting, and this phenomenon occurs in a non-linear fashion (i.e., the willingness to wait for a reward increases exponentially as the date is moved further into the future—so-called "hyperbolic discounting theory").

  Suggestion: When making a decision, ask yourself if you are truly making a rational choice, or if you are being driven by near-term gratification—and try to give a candid answer. For anyone with severe "short-termism," it may sound hokey, but research has shown that visualizing yourself in the future situation under consideration actually has an impact on your ability to make better decisions in the present. Simply imagining a situation triggers similar cognitive processes to actually experiencing it.

After telling you all the reasons why we may be prone to cognitive flaws, here is some good news: while we all have "blind spots" and inherently struggle to recognize these deficiencies, we are quite good at identifying the biases of others. Evaluating situations with a small team that is committed to calling out each other's biases and cognitive dissonance typically leads to better decisions. That may mean consulting with your spouse, business partners, financial advisor, or other trusted parties to stay on track. We may not be able to rid ourselves of these cognitive flaws, but we can thoughtfully design ways to combat them. ●

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