



Artemis

FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Second Quarter of 2019

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Executive Summary

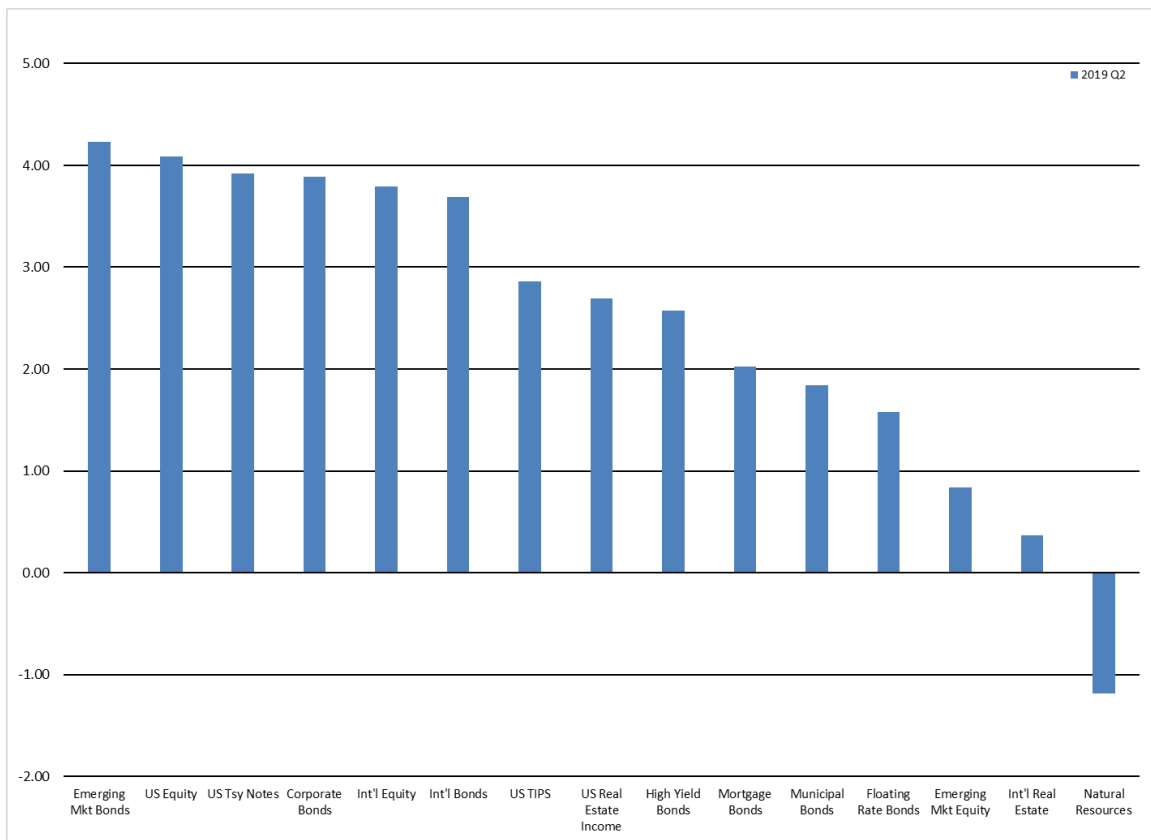
- Despite a market wobble in May, global equity markets performed well during the quarter. The U.S. market led the way returning +4.1%. Once again, technology (growth) stocks led the way.
- Volatility returned in large part due to the U.S.-China trade war escalating in May after President Trump raised tariffs on China and threatened Mexico with new tariffs. Momentum changed sharply in June, however, as he backed off, and Fed Chairman Powell hinted that rates may be coming down later in the year.
- Developed markets outside of the U.S. also had a decent quarter, returning +3.8%, largely for the same reasons. In general, developed markets in Europe outperformed those in Asia, as the latter were more affected by the trade tensions during the quarter.
- In contrast, emerging market equities lagged in Q2, increasing by only +0.8% overall. Growth in the Chinese economy fell to its slowest pace in nearly three decades in Q2.
- A salient feature of the quarter was a strong bond rally, in part due to expectations of rate cuts later in the year, but also because the demand for fixed income is strong. The overall U.S. bond market increased by an impressive 3.1% during the quarter.
- In this report, we discuss the challenges associated with making good asset allocation choices late in the business cycle when investors start to get skittish and growth slows. We also discuss how various “tilts” have fared recently, including our structural tilt toward value versus growth and smaller companies versus larger companies.
- **Bottom line:** It’s been a tough slog of late as recent performance has been driven by large technology-driven companies (of which we include Amazon), but with value-oriented and smaller companies underperforming. The U.S. market has also dominated all others, largely due to very high levels of fiscal stimulus, stock buybacks, and our relatively large technology sector.
- **Artemis Strategy:** Our only significant move this quarter was to add a new theme to our global thematic lineup, focused on the genomics revolution, including gene therapy, bio-informatics, bio-inspired computing, molecular medicine, and pharmaceutical innovations. The idea is to invest in those companies that are substantially expected to benefit from extending and enhancing the quality of human and other life by incorporating technological and scientific developments in genomics into their business.



Markets in Review

Despite a market wobble in May, global equity markets performed well overall during the quarter. The U.S. market led the way, returning +4.1%. See Figure 1. For the first half of the year, the U.S. stock market is up by almost +19%, nearly erasing all of the losses experienced in Q4 of last year. Once again, technology (growth) stocks led the way.

Figure 1: Index Returns by Asset Class in Q2 2019 (%)



Volatility returned in large part due to the U.S.-China trade war escalating in May after the U.S. raised tariffs on \$200 billion worth of Chinese imports and added Chinese telecommunications group Huawei to a trade blacklist. President Trump also threatened Mexico with higher tariffs. Momentum changed sharply in June, however, as the U.S. and China agreed to a truce and a resumption in trade negotiations, and Trump “indefinitely suspended” the Mexican tariffs. Moreover, Fed Chairman Powell hinted that rates may be coming down later in the year unless the economic outlook changes, which also helped to propel the market in June.



Developed markets outside of the U.S. also had a decent quarter, returning +3.8%, largely for the same reasons just mentioned. In addition, ECB President Mario Draghi said in June that monetary policy would be loosened as needed. Developed markets in Europe outperformed those in Asia, as the latter were more affected by the trade tensions during the quarter. In fact, the Japanese market declined in Q2 by -2.4% in U.S. dollar terms, and the yen appreciated against the dollar, driven partly by its perceived safe-haven status at times of geopolitical risk.

Emerging market equities lagged in Q2, increasing by only +0.8% overall. The index was pulled down by low returns in China and Korea, both of which were negatively affected by the trade war. In addition, the Chinese government's recent attempts to stimulate its economy have not yet borne fruit. Growth in the Chinese economy during Q2 fell to its slowest pace in nearly three decades.

A salient feature of the quarter was a strong bond rally, in part due to expectations of rate cuts later in the year, but also because demand for fixed income is very strong. Surveys suggest that investors are concerned about the global economy and are playing it safe by adding more fixed income to their portfolios. U.S. yields are also being affected by low and, in some cases, negative yields resurfacing again in Europe and Asia. For all of these reasons, the overall U.S. bond market increased by an impressive 3.1% during the quarter, and the yield on the 10-year Treasury note fell by 0.4% to 2.0%. As Figure 1 indicates, all fixed income sectors had positive returns.

The rise of both equities and bonds in 2019 is a complete about-face from late 2018 when stocks sold off as bonds rose, and serves as a reminder that the correlation between asset classes is highly dynamic, especially over short periods of time. See Figure 2 (next page). In this case, the high correlation between bonds and stocks is likely a reflection of the hope for broad-based monetary easing later this year.

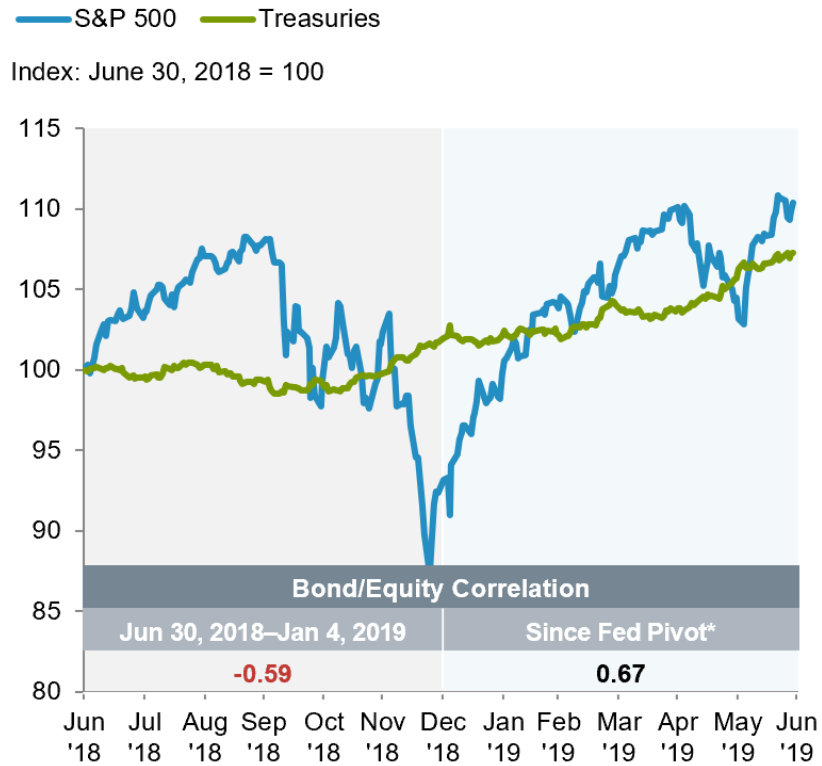
Asset Allocation Choices – Late Cycle

At Artemis, our overarching investment strategy is to provide our clients with global, balanced portfolios that are tailored to their particular goals, time horizon, and tolerance for taking investment risk. By global, we mean that we invest in both U.S.-based and international companies, including those in developing countries. (We do shy away from what are called frontier markets – very poor countries with nascent stock markets.)



Figure 2. Recent U.S. Bond/Equity Correlation

U.S. Equity and Treasury Bond Returns



Source: Fidelity Investments

By balanced, we mean that our portfolios also contain some fixed income, both as insurance against a falling equity market, and as a source of income (admittedly paltry at current interest rate levels). Our approach is grounded in research and historical experience that demonstrates that over long periods of time, globally balanced portfolios have a very good track record of delivering decent equity-like returns, while lessening the risk of severe annual portfolio drawdown.¹

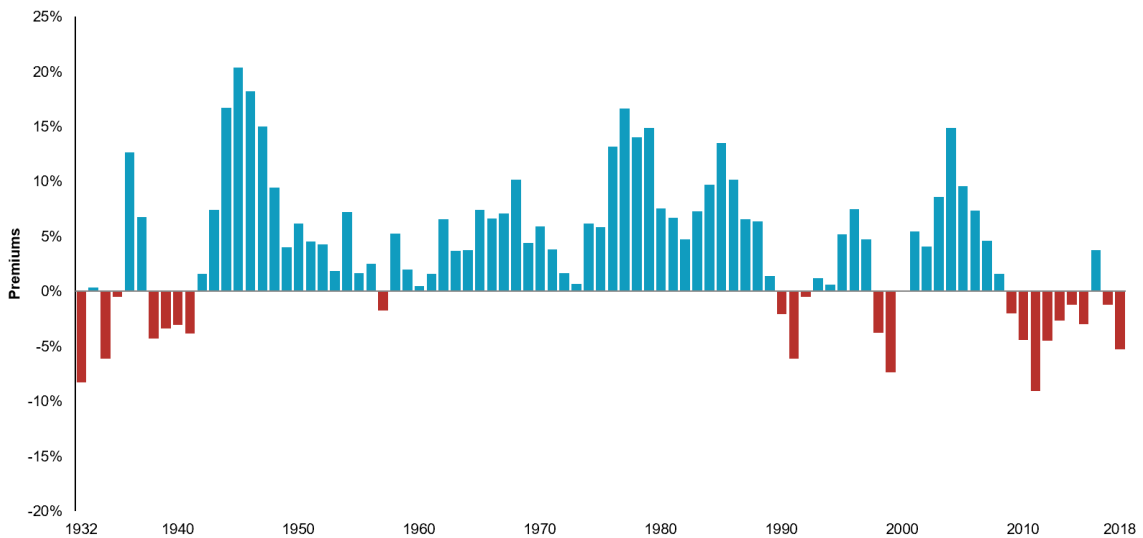
¹ While not a review of the literature, some of the research is summarized in a Brief I wrote several years ago entitled “What is the Right Retirement Portfolio?” You can find a copy on our website at www.artemisadvisors.net.



A second pillar of our investment approach is to modestly favor value over growth and smaller companies over larger companies. Value investing involves finding companies that are believed to be underpriced by the market and whose prices the investor expects will eventually rise significantly. Warren Buffett is a well-known advocate of value investing. See Figure 3.

Figure 3. U.S. Value Company Returns Minus Growth Company Returns Since 1932

Value minus growth: US Markets
1932–2018



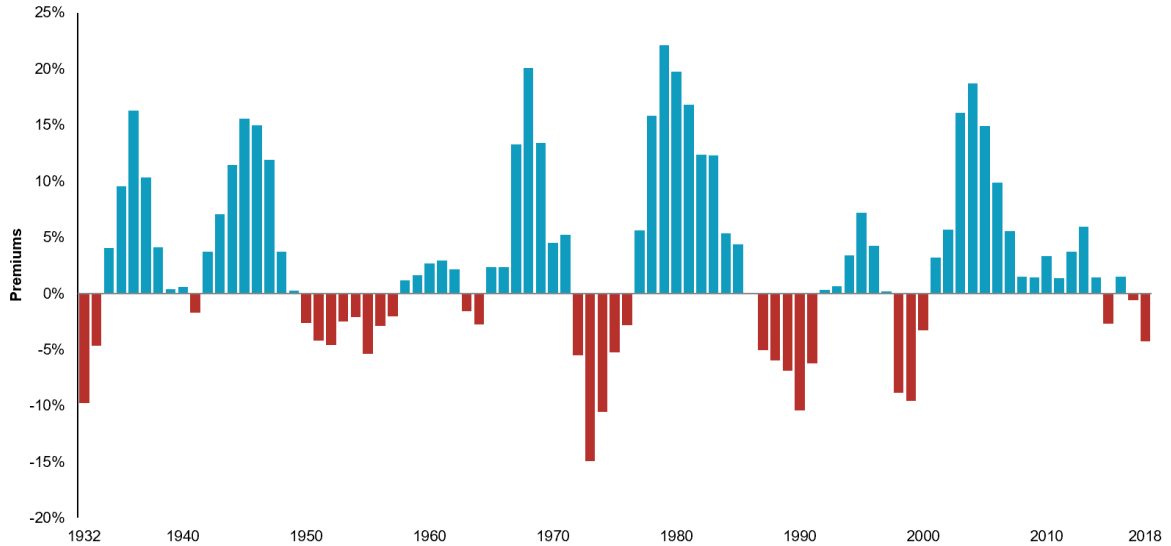
As for favoring smaller companies, investors have long been rewarded by favoring smaller companies, even after taking into account that such stocks are more volatile. This small company premium has been pronounced and fairly stable, although like any asset class, it underperforms at times. See Figure 4 (next page).

Of course, any time you make a bet to lean one way or another, you can risk being caught on the wrong side at various points in the cycle. Late-cycle investing is particularly challenging as investors' concern that at recession is around the corner increases and growth starts to peak or slow down.



Figure 4. U.S. Small Company Returns Minus Large Company Returns Since 1932

Small cap minus large cap: US Markets
1932–2018



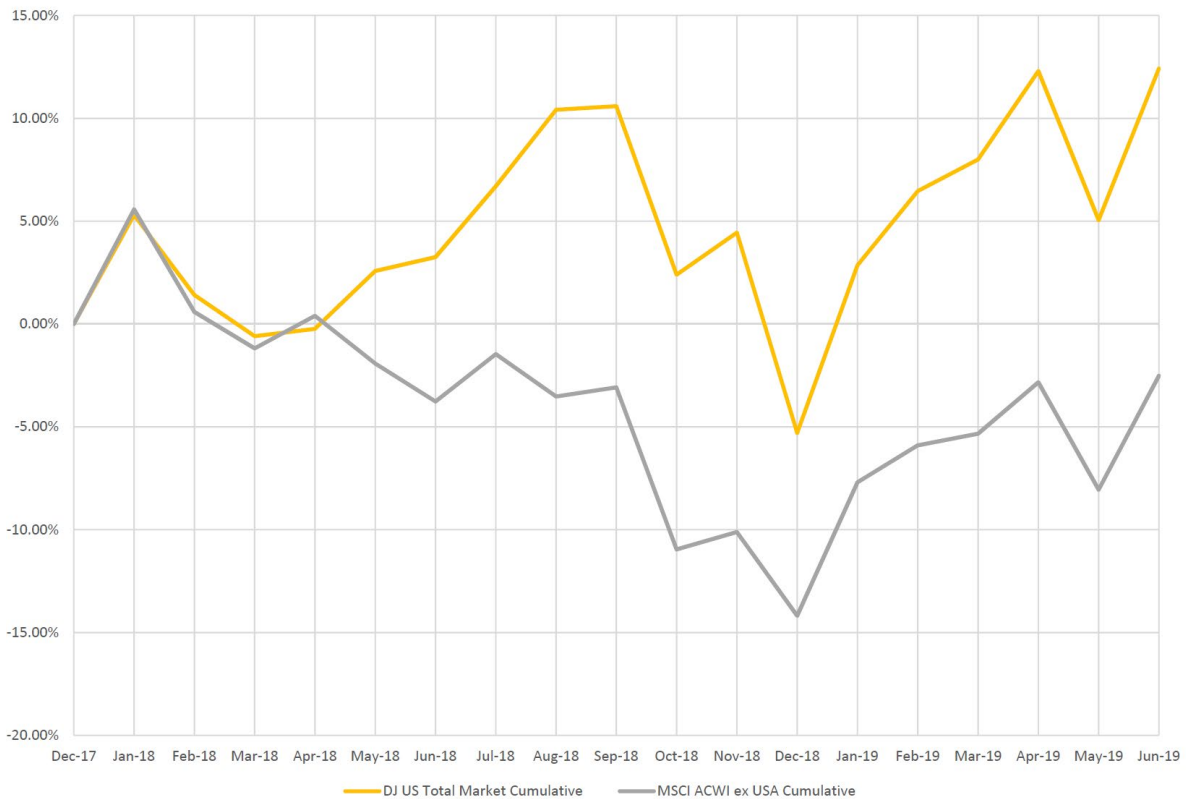
Source: Dimensional Fund Advisors.

Let's start by looking at the recent performance of the U.S. versus the rest of the world. Figure 5 on the next page shows the relative performance of the U.S. stock market versus the rest of the world since the beginning of 2018. As shown, the U.S. market began outperforming in the early summer of last year. The gap opened up quickly and to date, at least, has remained. (In fact, the gap is a bit wider today than it was 12 months ago.) So yes, those holding U.S.-centric portfolios have become a bit richer in the last year compared to those holding global portfolios.

There are several reasons why this has happened. First, you may not have noticed since manufacturing is a small (and decreasing) part of the U.S. economy, but the manufacturing sector is still significant globally and is has been in a recession due to slowing growth in China and Europe and the trade wars. To date, the U.S. has been the only country of size willing to use significant fiscal stimulus in the form of tax cuts (and outright subsidies) to bolster manufacturers, which has supported the increase in the domestic market. Second, many U.S. companies have been on a stock buyback binge, which is always supportive of stock prices.



Figure 6. Recent Stock Market Performance: The U.S. Versus the Rest of the World



But the view that the U.S. stock market is going to continue to outperform is not widely shared. I just read a fascinating piece by a highly respected analyst *written last December* in which he essentially argues that the relative dominance of the U.S. stock market in the last few years is a bit of a house of cards – “a massive debt for equity swap with firms issuing massive amounts of corporate bonds of very low quality and effectively leveraging themselves up.” This, in addition to this analyst’s view that the U.S. market is “extremely expensive,” leads him to conclude with the following statement:

Ask yourself how much exposure you have to the U.S. stock market. Then ask yourself what is the minimum amount you could own. We at GMO own essentially zero in our unconstrained portfolios, but then again we



are used to career risk and would rather run it than allocate to such an expensive and risky asset.²

In a similar vein, large-company, value-focused investors have been lagging large-company growth investors, and the gap is pretty extreme at the moment. Figure 6 is a little complicated but nicely highlights that the outperformance of U.S. large-company growth is currently at a whopping 2.5 standard deviations above its long-term trend. As show, this bull market in large-company growth stocks has lasted over 11 years, with mid- to large-cap growth outperforming mid-to large-cap value by 90% since mid-2007. But the chart also aptly demonstrates that value can and has outperformed growth over several recent periods as well, and value has definitely outperformed growth looking back over decades. See also Figure 4 again.

Figure 6. Large-Cap Growth vs. Value: A Long-term View



² See Montier, James. "The Late Cycle Lament: The Dual Economy, Minsky Moments, and Other Concerns." GMO White Paper, December 2018.



Why is growth beating value? Nobody knows for sure. One often-speculated view is the observation that growth stocks usually do well during “boring times” when interest rates are low and stable, growth is modest, and Fed policy is not contractionary. The idea is that during these stable but boring times, investors are more willing to pay a large premium for companies that have perceived high growth potential. This is the “buy growth when growth is slow” hypothesis.

Some of the reason growth is beating value likely also has to do with the extremely high levels of technological innovation we have been experiencing, a key driver behind our firm’s decision to begin allocating some of our client assets to specific technology themes over the past year.³

Finally, larger companies have been outperforming smaller companies over the past year. During this period, the Russell 2000 (the most common index of U.S. small companies) has lost -3.3%, compared with the S&P 500’s +10.4% rise. This is a more recent pivot and is somewhat surprising because smaller companies typically outperform when the dollar is strengthening and trade wars are brewing because smaller companies are less levered to the global marketplace. Perhaps it’s simply the rush of money into growth stocks sucking the wind out of most other segments of the market.

Bottom Line:

Asset allocation choices always get harder late in the cycle when volatility increases as some investors start weighing the odds of a recession and get more defensive. Our view at Artemis is that the forces of mean reversion are inevitable and reassert themselves over time. History also demonstrates that the performance of countries and asset classes varies over time, and when the size and value premiums will appear is unpredictable. In such a world, we believe the best way to capturing the premiums is to hold a globally diversified, balanced portfolio, tilted to capture the premiums, even when investors start to get skittish. Such a portfolio will not always be the top performer, but it will likely be the most consistent performer over long periods of time, which is the investment horizon for most of you.

³ This hypothesis is explored in more detail in Mackintosh, James. “The Agony of Hope Postponed, by a Value Investor.” *Wall Street Journal*. July 14, 2019.



Artemis Strategy

As you may recall, we got more defensive earlier in the year when we shifted away from what the industry calls “spread product”; that is, high-yielding fixed income focused on lower-credit-quality companies, towards safer segments of the fixed income universe such as municipal bonds and Treasury debt. A good move? So far this year, holding almost any kind of fixed income has been helpful to returns, and particularly so during this last quarter (see Figure 1 again). We may see more good news out of fixed income as the year progresses since the Fed is signaling rate cuts ahead.

Our only significant move this quarter was to add a new theme to our global thematic lineup, focused on the genomics revolution, including gene therapy, bio-informatics, bio-inspired computing, molecular medicine, and pharmaceutical innovations. The idea is to invest in those companies that are expected to substantially benefit from extending and enhancing the quality of human and other life by incorporating technological and scientific developments in genomics into their business.

But investing in this space is not for the meek. The ETF we are using to implement the theme is twice as volatile as the S&P 500, which itself, is highly volatile, and so (for the most part) we are only implementing this theme in our more aggressive portfolios.

We are also in the midst of doing some mid-year tax-loss harvesting and using the opportunity to modestly lighten up on our value tilt. We make this move with some trepidation, but believe our overweight has gotten to be a little too painful for many of you.

Finally, we are about to reduce our currency-hedged international allocation as all signs point to a weaker dollar in the months ahead with pending interest rate cuts, and Trump’s ever-louder calls for a weak dollar policy. We are using the opportunity to reduce our overweight to Asia in our international allocation. This bet hasn’t panned out as China’s fiscal stimulus has been insufficient to reignite global manufacturing and trade, and a definitive end to the trade war seems ever-more elusive.