PARITAS
CAPITAL MANAGEMENT

THIRD QUARTER | 2018

INVESTMENT COMMENTARY

At a Glance

Some of the themes we witnessed in the second quarter continued into the third quarter. Inflation Hedges (Defensive Equities, REITs, and MLPs) extended the charge, resulting in its best quarter since Q1 2017. The gap between US and International equities continued to widen, although Emerging Market equities were able to wrap up the quarter with a small gain and seemed to have halted their losses for the time being.

Market action during the quarter looks reminiscent of early 2000. More and more chatter of the end of the party came into focus, but the party kept going. US technology stocks are seemingly defying the laws of gravity helping the broader US markets shrug off international weakness. It's almost as if the US is living in its own little bubble (no pun intended). Even with the September Fed rate hike bearing down, the market continued to rise.

Overall, the third quarter proved to be the best quarter of 2018 for the Global Wealth Strategy with a return of 2.37% net of fees. bringing its 3-year annualized return up to 7.06% net of fees.

Highlights:

- US Bull Market Makes History and Widens the Lead on International Markets
- Fixed Income Assets Have Mixed Reaction to Rising Rates
- Defensive Equities Lead Inflation Hedges to Strong Quarter

US Bull Market Makes History and Widens the Lead on International Markets

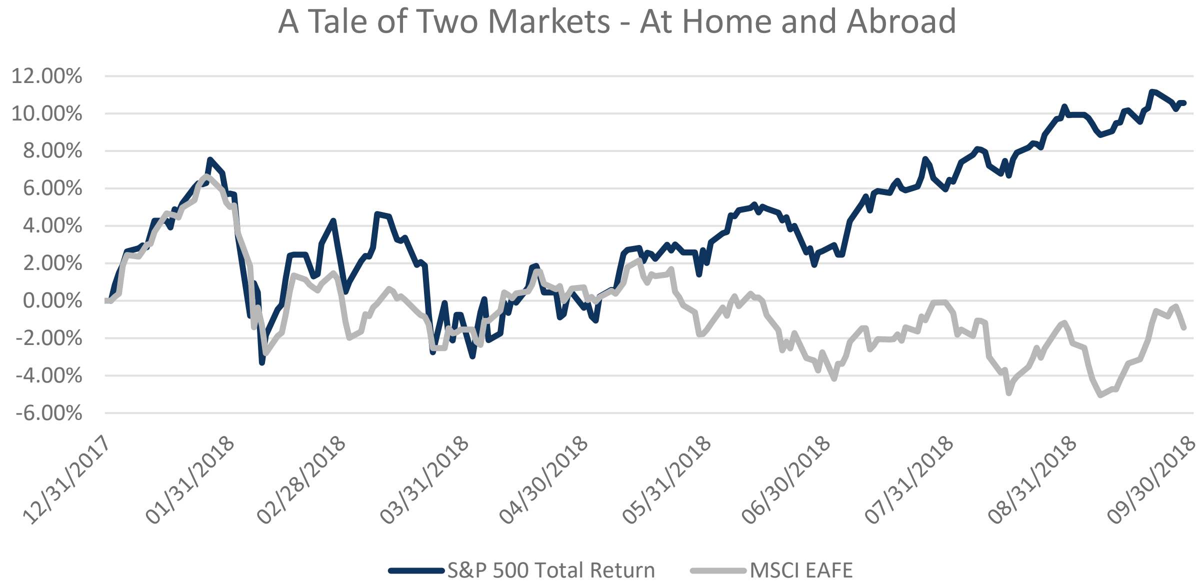
US Large Cap Equity market (S&P 500 Total Return Index) made history in the 3rd quarter with the current bull market extending to a record 114 months without a bear market (-20% return) and a cumulative return of 384.79% from March 2009 through September 2018. The S&P 500 Total Return Index continued to be the brightest spot, returning an impressive 7.71% for the third quarter.

We believe the markets responded to strong US earnings and economic growth fueled by second quarter earnings growth of 25% according to Factset and the expectation of another double digit increase for the third quarter. The economic growth was primarily driven by tax cuts, increases in consumer spending, and a continually decreasing unemployement rate. Monthly average jobless claims were reported at the lowest level since 1969 and wage growth perked up, posting its highest level since 2009.

International markets coninued to lag US markets, plagued by weak earnings, uncertainty over trade tarrifs, and Europe's slowdown in exports to China. Brexit also returned to the headlines, sending the MSCI United Kingdom Index tumbling down -1.66% for the quarter.

With the US continuing to post record economic data and international markets encountering headwind after headwind, it is easy to see that the US would be outperforming international markets. However, the magnitude of the outperformance is something for the recordbooks.

The chart below illustrates just how large the gap has become.



Source: FactSet.

Given the positive third quarter news, US equity market volatilty is in a downward trend. Our risk based investment process responded to this muted risk environment by maintaining an overweight to US equities and ultimately capitalizing on this outperformance.

Fixed Income Assets Have Mixed Reaction to Rising Rates

Upbeat economic data gave the Federal Reserve committee confidence to raise rates again, pushing the fed funds target rate to 2.25%. The 10-year treasury bond yield followed the fed funds increase and rose from 2.850% to 3.052%. This increase in yield pushed the 10-year treasury into the red for the third quarter.

Source: FactSet.

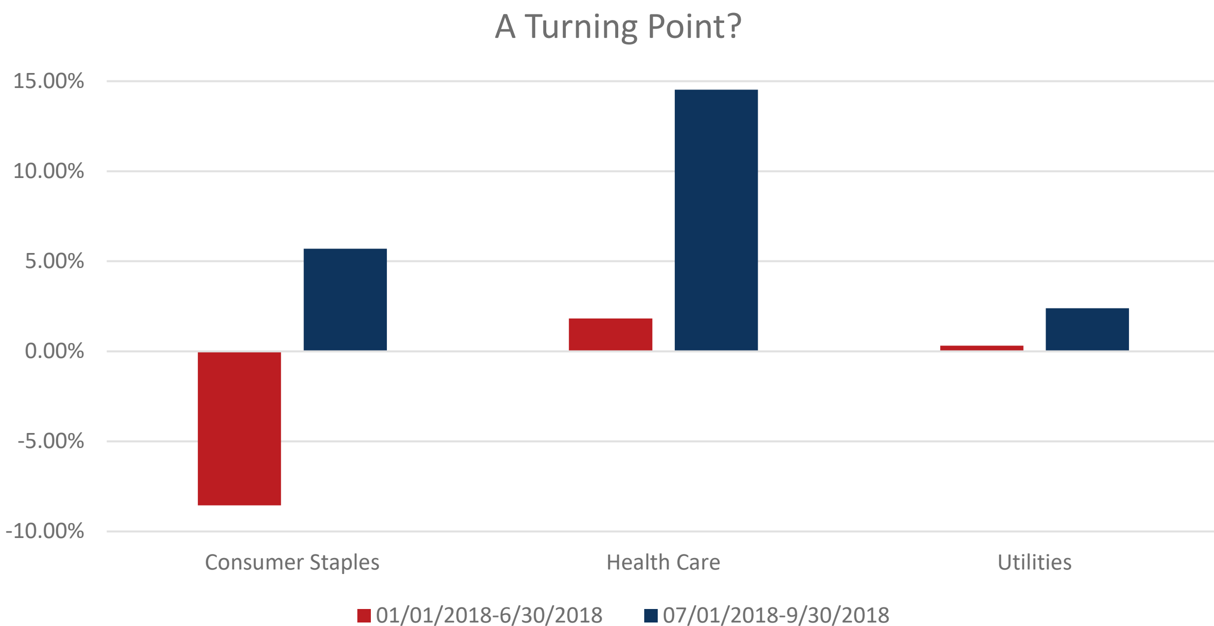
High Yield bonds seemed to handle the news of a rate increase quite well, with the iBoxx USD Liquid High Yield Index returning an impressive 2.52% for the quarter. The positive earnings and economic news from the US seemed to outweigh the increase in rates.

The gains extended into Emerging Market Bonds, which bounced back from losses in the first and second quarters, with the Bloomberg Barclays Emerging Markets USD Aggregate Index posting a strong % return that was fueled by tightening spreads and increased fund flows.

With our evaluation of risk remaining low, we continue to have an underweight allocation to US treasuries allowing for a higher percentage allocation to the more attractive fixed income segments as we head into the fourth quarter.

Defensive Equities Lead Inflation Hedges to Strong Quarter

We pointed out in our second quarter commentary that defensive equities (Utilities, Staples, and Health Care) were waking up from a long hibernation. The performance during the third quarter certainly confirmed this segment is awake. The chart below highlights the dramatic turnaround in the third quarter compared to the first six months of 2018.



Source: FactSet.

This is a vast difference from just one quarter ago where growth stocks were getting all the attention and Consumer Staples, Health Care, and Utilities stocks were left for dead.

A renewed interest in the more conservative sectors suggests that investors are beginning to find their valuations more attractive relative to other sectors or that they are repositioning their portfolios to be more defensive. If this trend continues, we could be observing an early warning sign for a more significant downturn.

Our focus always centers around analyzing risk, so regardless of the qualitative rational that may be bringing these sectors back to life, our interpretation of the favorable risk characteristics resulted in these sectors being overweight during the quarter.

Final Thoughts

As of the end of the third quarter, the 3-year annualized return for the S&P 500 Index is 17.91%, which is nearly double the 9.23% return of the MSCI EAFE Index for the same period. Heading into the fourth quarter, investors will likely be grappling with the questions: When will US large cap stocks finally take a breather? And when will international markets show some life, reducing the performance gap?

This is a perfect example of why we use changes in market risk to determine portfolio allocations as opposed to forecasting. Relying on forecasts can be costly by prematurely exiting assets that are moving higher or responding too late when market risk escalates.

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