August 2018 Market Review

The disconnect between US stock returns and international stock returns has really heated up in the past couple months. The S&P 500 returned 3.26% in August bringing its year to date return to 9.94%.[1] The star performer was the Nasdaq Composite which returned 5.85% in August, its best month since 2000 (an ominous time frame), bringing its year to date return to 18.32%. Meanwhile, on the other end of the spectrum, emerging markets stocks returned -2.68% bringing year to date returns to -6.99%. International returns have been so weak this year that if one were to invest in an index fund that tracked perhaps the broadest index out there, the MSCI All Country World Index, the year to date returns would only be 3.76%.[2]

What is creating such a large difference in returns? It is hard to pinpoint exact reasons but strong economic data in the US combined with a strong momentum trade (momentum trading is buying yesterday's stock outperformers in hopes that they will continue to outperform going forward) seems to be a large part of the explanation. The US economy posted a very large 7.6% nominal Gross Domestic Product (GDP) growth (nominal GDP is real GDP which was 4.2% and is reported in the headlines plus inflation) in the 2nd quarter and 5.4% year over year (YOY) nominal GDP growth.[3] A lot of publically traded stocks that make up broader indices tend to have a little higher revenue growth rates than the US economy as a whole and the S&P 500 revenue growth was over 10%, an impressive number. Our economy currently has fiscal stimulus in place. The tax cuts and extra spending are having very real positive effects on our economy which was already doing well. There are lots of investors putting money into the stock market, particularly low cost exchange traded funds on the heels of this solid economic backdrop, and those funds are pushing some stocks to levels that are making many seasoned fundamental investors shake their heads in disbelief. The likelihood of growth continuing at its recent pace is very small.

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[1] bloomberg
[2] bloomberg
[3] bloomberg

The problem is that stimulus is short-term in nature since there won't be tax cuts every year and there are plenty of ominous signs ahead. For instance, inflation adjusted wage growth has trended down to close to 0% as inflation has picked up more than wage growth.[4] Our economy is almost 70% consumer spending so outside of transitory tax cut spending, continued slow inflation adjusted wage growth can't support meaningful growth going forward. There are definite signs affordability is slowing down the housing and auto markets, two important economic engines in our economy.

The tax plan also creates good incentives for capital investment and this area has seen solid growth which is a welcome sign. Strong capital spending is needed to improve sluggish productivity. It remains to be seen if this positive trend can continue in 2019 and beyond. Some of the best economic growth quarters have occurred in times like 2005 and 2006 and 1999 and 2000, all right around the time of peak growth and before recessions were to soon follow. Those were very bad times to be fully invested in the stock market. There are lots of economic data points that are flashing red right now despite solid current conditions and caution is warranted.

The strengthening of the dollar on solid economic data has led to sharp selloffs in some emerging market currencies, particularly the weaker economies that are battling either current account deficits or large fiscal deficits or both. Countries tend to run current account deficits when they import more than they export. That isn't a problem if global investors are willing to lend to or invest in that country because that becomes the means to finance the current account deficit. The US has run trade deficits for years but because of the perceived rule of law in the US and the credit rating of our country, the US has no problem financing a current account deficit. However, in a place like Turkey, current account deficits can become problematic if outside investors become wary of investing in Turkey. Rising interest rates in the United States only make it harder to attract investors to emerging markets. That has recently occurred leading to a sharp selloff in the Turkish lira. Turkey is the 17th largest global economy so it does have some significance although it only makes up .8% of the Vanguard Emerging Markets Stock Index.[5]

Inflation has also become a problem in many emerging market nations. Argentina is a country that has been struggling to contain rampant inflation and recently raised its overnight borrowing rate to levels as high as over 50% to stop inflation.[6] Of course, interest rates that high are going to slow an economy and Argentina looks to be headed to recessionary conditions.

Indonesia, South Africa, Brazil and some others all have unique factors that are leading to investor angst whether it be current account deficits or fiscal deficits or inflation running too

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[4] bloomberg
[5] World bank and vanguard
[6] bloomberg

high or politics or some combination of them all. However, the silver lining is that many of these countries don't make up a huge portion of emerging market ETF's. Additionally, the companies that make up the index often times are global in nature and not completely reliant on domestic economic growth. The Vanguard Emerging Market ETF tracks an index that is 35% China, 15% Taiwan, and almost 12% India.[7] Brazil and South Africa do start to matter beyond those 3 as they each are about 7% weightings but even those numbers are skewed higher than economic reality due to companies like Vale and Naspers which make up high percentages of indices. Then there are a number of countries than are in the 1-3% weighting including places like Indonesia. Argentina, the 21st largest economy does not even have a measurable weighting.

For the emerging markets selloff to continue from here, investor fear needs to continue to deteriorate in the core which is China. China is experiencing slower growth and the looming trade war with the United States is creating lots of investor concern this year. The good news is China has lots of financial resources to implement stimulus if the country feels like it needs to. The MSCI Emerging Markets Index trades at 12x current earnings compared to 21x for the S&P 500 and will pay you almost a percentage point higher in dividend yield vs the S&P 500's historically very low 1.7% to 1.75%.[8] Keep in mind, slower growth in China or India is still higher growth than you will get in the US. Short term interest rates in the United States are still negative when adjusting for inflation so it is a little perplexing why money continues to flee despite a massive valuation discount on the stocks of emerging markets. Nevertheless, the United States will likely continue to raise short term rates until the inflation adjusted rate is positive or close to so emerging market fear will likely persist for a while. And it doesn't appear the United States and China will come to a trade agreement anytime soon creating more uncertainty. We believe the emerging markets valuation discount is too large to ignore and we also believe heading into 2019 the growth rate for the US economy will slow measurably. Therefore, we believe an allocation to emerging market stocks is warranted.

Looking ahead, there are some prominent forecasters calling for a US stock market pullback in September. The rise in August seemed to be on a lack of data and perhaps was computer driven. The fall should bring the midterm elections, China tariff dispute and some early signs of 4th quarter and perhaps 2019 growth. We are not as bullish on the US economy as current stock market investors and time will tell if bond market investors which seem to be predicting much slower growth ahead are more correct in their viewpoint than stock market investors.

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[7] vanguard
[8] bloomberg

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Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The NASDAQ Composite Index measures the market value of all domestic and foreign common stocks, representing a wide array of more than 5,000 companies, listed on the NASDAQ Stock Market.

The MSCI AC World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The Index consists of 46 country indices comprising 23 developed and 23 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. You cannot invest directly in an index. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The Index consists of the following 23 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

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