The World is Flat, But Noise Could Send You Over the Edge

"The single greatest edge an investor can have is a long-term orientation" – Seth Klarman

After two years of exuberance, global markets entered 2018 faced with a long list of growing concerns. Would President Trump's escalating trade rhetoric lead to an all-out trade war? What impact would rising U.S. interest rates and a stronger dollar have on international markets? Would U.S. tax cuts provide more than a temporary lift to economic growth? Could global economic growth continue to strengthen in the face of these on-going challenges? Six months in, many of these concerns remain, and in some cases, have become more pressing. As a result, well-diversified, balanced portfolios finished the first half of the year in slightly negative territory. U.S. equity holdings, particularly small-cap stocks, were the best performing assets with positive returns for the period. However, international stocks were down year to date, and as expected, fixed income investors experienced disappointing returns with the Barclays Aggregate Bond Index down 1.6%.

Unfazed by potential trade wars, rising oil prices, ever increasing political polarization, an immigration crisis and heightened levels of global market volatility, U.S. equities provided a bright spot and continued to climb modestly higher. A strong domestic economy continues to navigate past the many potential dangers. Unemployment is at historic lows, consumer confidence is at a generational peak, corporate earnings remain strong, interest rates are favorable and increasing slowly, and economic growth is rising. During the first half of the year, small-cap stocks excelled, benefitting the most from U.S. tax cuts and with less impact from international headwinds and on-going tariff chatter. One development to keep an eye on is the narrow leadership within the U.S. equity market. As a reference point, the Dow was down almost 1% for the year while the tech-heavy NASDAQ was up 10.6%. The majority of the gains in the S&P500 were concentrated in the technology and consumer cyclical sectors.

For most of 2017 and the first quarter of 2018, the U.S. dollar was weak as economic growth picked up steam in Europe and many emerging market economies. However, economic outperformance in the U.S. and an aggressive stance by the Federal Reserve on interest rates in response has pushed the dollar higher of late, upending investments across the globe. The rising dollar exacerbated the selloff in emerging markets by making it difficult for those countries that borrowed heavily in dollars to service their debt. The dollar is also being supported by trade tensions with China as well as U.S. companies repatriating overseas funds in response to the tax reform bill. While it appears factors supporting the dollar are likely to remain in place for the foreseeable future, potential monetary tightening by global central banks to buoy foreign currencies and minimize damage from the current trade skirmish could stem this imbalance. Despite this recent short-term underperformance, we continue to find value in these non-U.S. investments and believe future upside remains. It is helpful to recall that emerging markets equities were by far the best performing asset class for all of 2017, with emerging markets bonds surpassing all other fixed income categories for the same period.

More than ever, it is during periods of elevated volatility and uncertainty that investors need to remain focused on long-term investment strategies, asset valuations and risk vs. reward.