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S&P 500 Who?

Market & Strategy Update

During the 1980's the most admired and sought after money manager/investment management firm was not Goldman Sachs, Warren Buffett or some "gunslinger" hedge fund manager, it was Fidelity Investments, or more specifically, the Magellan Fund managed by Peter Lynch. Fidelity is still a very large and respected firm, but it has been rarely held out as a performance powerhouse during the past 25 years since Peter Lynch ceased management of the Magellan Fund. Around the same time that Lynch was building his reputation, commercial real estate was the "can't lose" asset class, but after the Savings & Loan Crisis and the recession in the early nineties, investors started to prefer more liquid investments and "passive" equity indexing became very popular. That era was interrupted by the technology stock boom of the mid to late 90's during which many declared that Warren Buffet was "senile" and that he had "lost his touch" as he completely missed the astronomical technology stock returns. He was redeemed, and his "genius" status restored, once the NASDAQ "cracked" and fell over 70% from more than 5,000 to close to a 1,000 level. Despite the return of strong value-oriented stock and real estate investment trust (REIT) performance post the "tech bust", they were quickly outpaced by the outsized returns of the emerging markets and commodities as China arrived on the global economic scene in a historic way, but that passed also with the onset of the Financial Crisis almost 10 years ago. Gold dominated the first part of that nearly decade long period, but it peaked about 5 years ago and began a 40%, multi-year decline. The S&P 500 took over the lead and has dominated almost all asset classes for almost 5 years, but its time as the "only game in town" may be coming to a close and we may be asking "S&P 500 who?" sooner than we think.

Market Cycles Start with Fundamentals, but End with Societal Uniformity

In each of the above cited cases, a trend began largely unnoticed. As the investing public became aware, and ultimately more enticed, the excitement surrounding the economic/business/capital market phenomenon approached an almost religious and universal fervor. To illustrate this point, we have prepared a few comparisons of "familiar & favored" versus "obscure" investments whose recent relative performance is met by some with disbelief:

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Despite "Brexit" and the advances made in the "unlocking" of the human genetic code, the Euro ETF (FXE) has outperformed the Biotechnology ETF (FBT) by over 10% during the past 12 months (it was outperforming by over 30% earlier this year):

Despite the impeachment of the country's president, a deep recession, a Zika virus outbreak, well publicized corruption investigations, contaminated water problems and a less than impressive hosting of the Summer Olympics, the Brazil ETF (EWZ) has outperformed the S&P 500 by almost 40% during the past 12 months:

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Despite the shutting down of many pre-existing nuclear plants, the inability to overcome the regulatory hurdles involved with opening new nuclear facilities, and the general distrust of nuclear energy as a potential solution to our future energy needs, the Uranium ETF (URA) has outperformed the stock of one of the most visionary and innovative companies in existence today, Tesla (TSLA), by almost 10% during the past 12 months:

Despite the rise in natural gas usage, increasing regulatory pressures, environmentalist attacks and a global commodity bear market, the Coal ETF (KOL) has outperformed the stock of one of the most loved companies in the world, Apple, by over 20% during the past 12 months:

The purpose of these comparisons is not to encourage anyone to sell their biotechnology, S&P, Tesla or Apple shares and/or buy the Euro, Brazil, uranium and coal ETFs, but to point out that:

1) Things can change in a surprising fashion with little media coverage.

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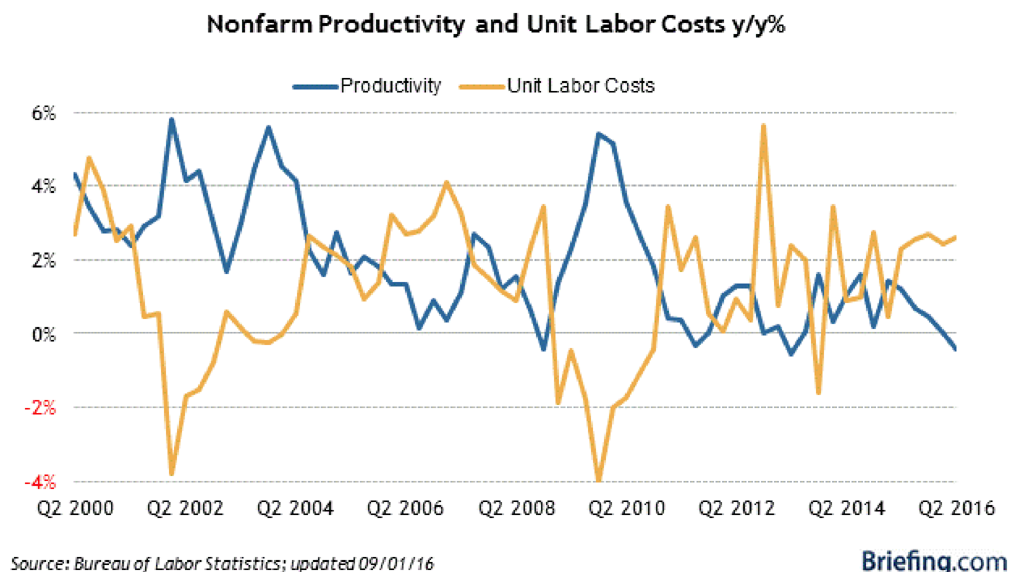
2) "Familiar & favored" investments that have performed well in the past should be routinely reviewed to insure that they remain as attractive when viewed in the light of a changing economic landscape.
3) "Ugly", "scary", "hated" and seemingly "insane" investments in many cases eventually run out of people to sell them and then subsequently offer the potential for attractive future returns.
4) The transitions of investments from "loved" to "despised", or from "abandoned" to "lauded", in many cases take years to develop. If you reviewed these same pairs of investments over a 5 year period, you would see starkly different results since these changes in leadership have only begun to emerge in a significant way during the past several months.

Strategy Implications

While we are not investing in any of the previously highlighted "obscure" but better performing investments in a direct manner, we have been increasing our commodity, cyclical, non-U.S. and emerging market equity allocations since the beginning of the year. Rather than just relying on relative price performance as a basis for investment, the motivation for these allocation changes can be seen in the changing patterns in, and relationships between, macroeconomic factors:

The S&P 500 has dominated most asset classes globally largely due extraordinary measures to stimulate economic growth. Those measures have been in place for an unprecedented length of time and that has been made possible by the extraordinarily low inflationary environment. Since the U.S. is a mostly "services" oriented economy (as opposed to a "goods" oriented economy like China), labor costs are major determinant in the path of future inflationary trends. At present we are experiencing a steady rise in employment costs, and a corresponding decline in productivity, as unemployment continues to approach cyclical lows below 5%:



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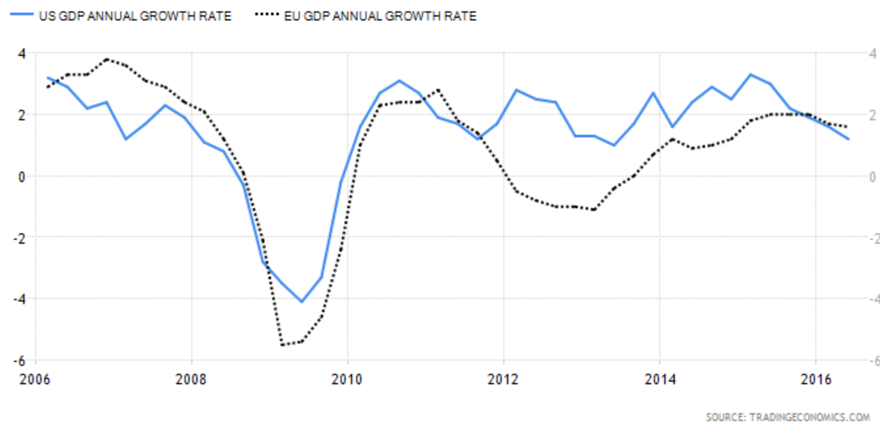
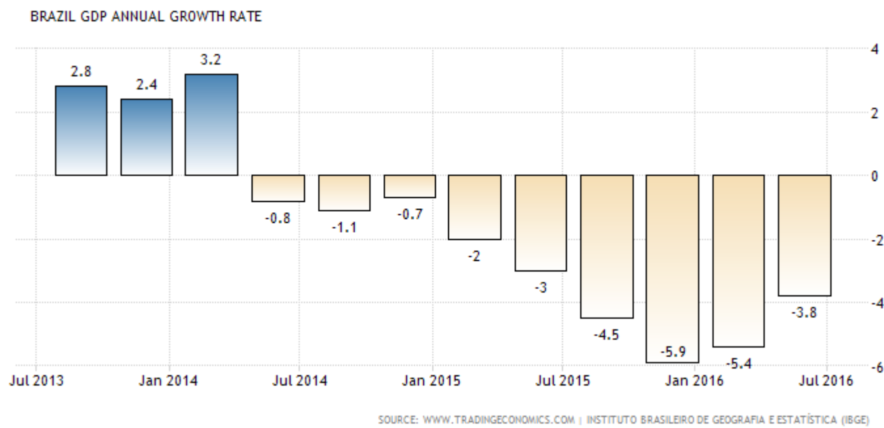
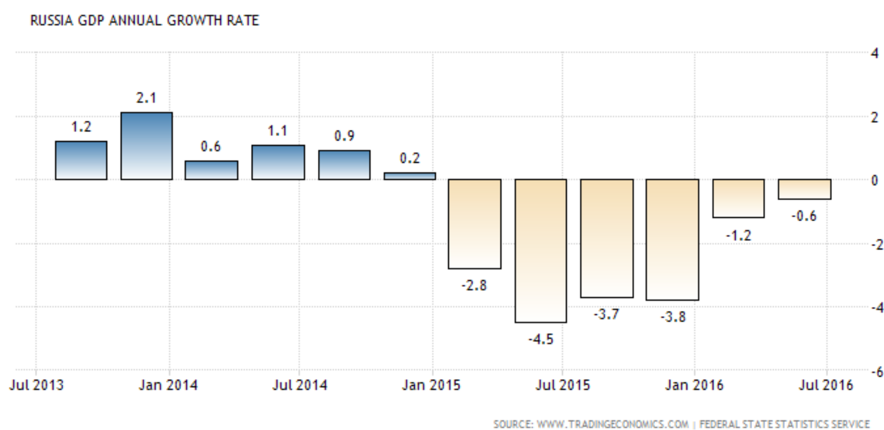
On a year-on-year basis, Euro Zone GDP has started to grow slightly faster than the U.S.:



Within the emerging market economies, Brazil and Russia appear to have passed the worst point in their recessions, China's deceleration in GDP growth has significantly moderated and India's economy is growing north of 7% with some signs of acceleration:





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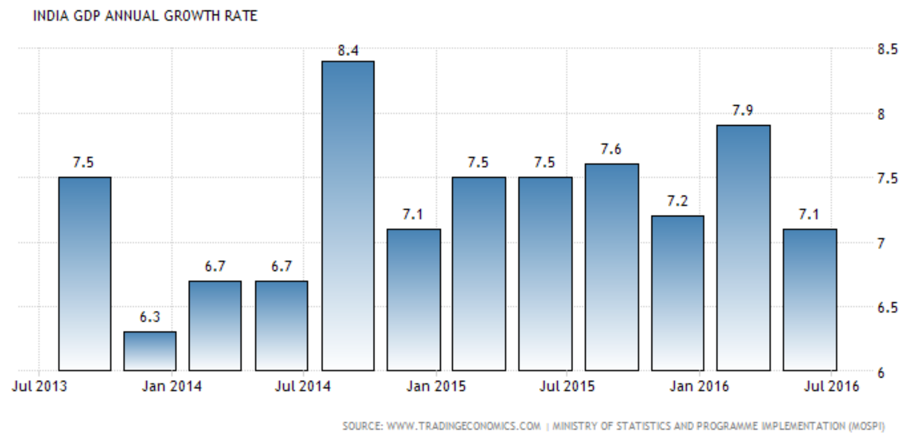

<u>The Transition from "S&P 500 only" to "S&P 500 who?"</u>

Transitions are rarely easy to detect in the early stages. In some ways, they are hard to accept even when the indicators are "flashing", and worse yet, are almost never peaceful. The seemingly endless "starting and stopping" of expectations for rate hikes by the Federal Reserve would be comedic if they weren't so frustrating. Had the Fed moved earlier, and in a more decisive way, we would likely have seen more strength in the U.S. dollar, but now the improving fundamentals of the economies outside the U.S., as well as for commodities in general, will likely dampen the strength of the U.S. dollar in response to any future Federal Reserve rate hikes. A new chapter in the history of global capital markets is starting to be written. How difficult it will be to read, depends on the course taken as we move on to the next destination.

<u>"Look to the Future, be Optimistic…but Hedge."</u>

Michael Breazeale, CAIA, CFA, FRM
Chief Investment Officer
858.764.8020
mbreazeale@juncturewealth.com
www.juncturewealth.com

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