



**Artemis**

FINANCIAL ADVISORS LLC

# Market Outlook & Strategy

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First Quarter of 2018

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### ***Executive Summary***

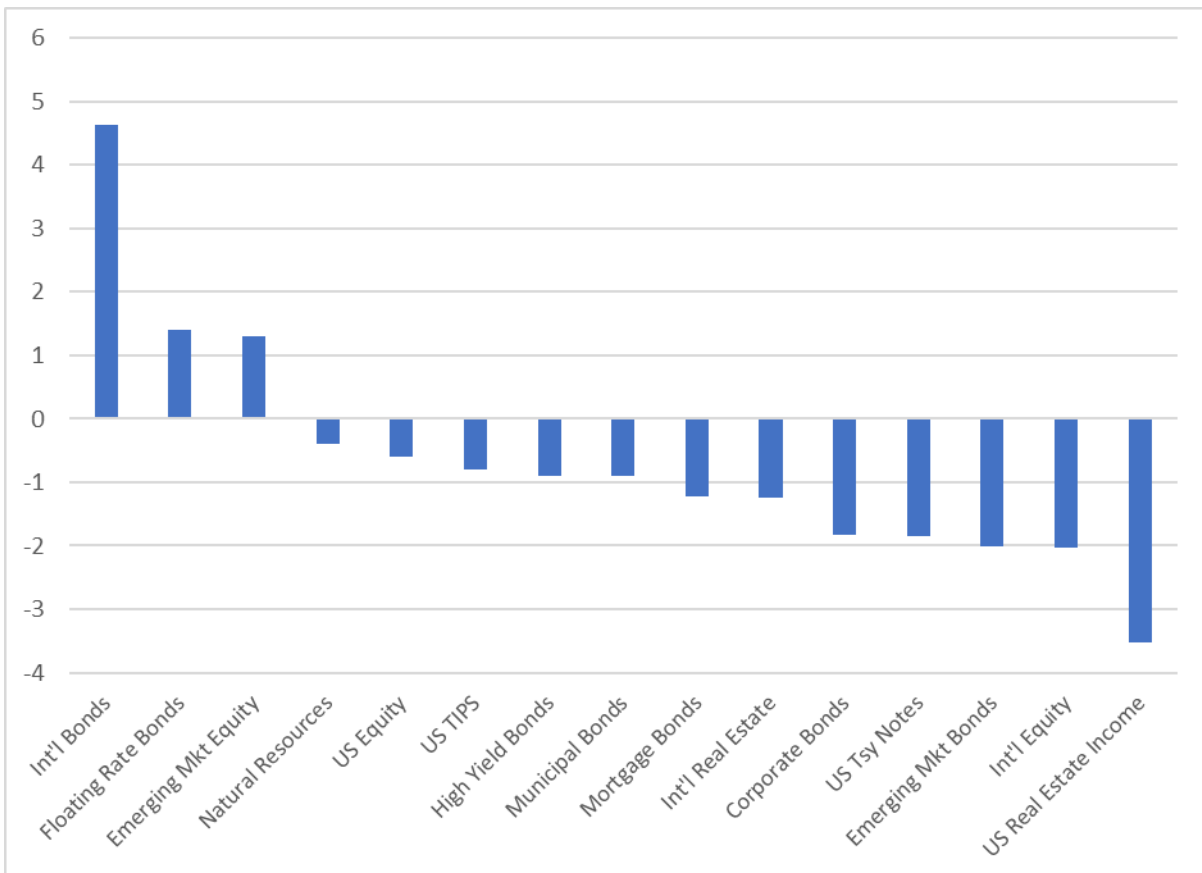
- The most salient feature of global equity markets during the first quarter was the return of volatility due to fears over rising inflation and interest rates and increased trade tension. Overall, U.S. equities ended the quarter down by -1.2%. Growth stocks continued to outperform value stocks, but for the first time in a while, smaller company stocks outperformed larger ones, on average.
- Developed markets outside of the U.S. also saw negative equity returns of -2.0% due to worries about the path of U.S. interest rates and the outlook for global trade. Emerging markets appeared immune to the concerns and were the clear winners, registering a positive return of +1.5%.
- The big move on the fixed-income side was the selloff in U.S. Treasuries. U.S. Treasury yields rose markedly across the curve as expectations of growth in inflation and interest rates shifted higher. As a result, the benchmark, Barclay's Aggregate Bond Index, returned a negative -1.5% for the quarter, thus providing no offset to negative equity returns.
- Despite expectations for higher interest rates in the U.S., the dollar continued its downward trajectory during the quarter.
- In this report, we focus on the rise of "thematic" investing as an alternative to "market capitalization" investing and discuss what it is, what it takes to be successful, and how Artemis is starting to implement some ideas in client portfolios. We can incorporate thematic investing without adding risk to our portfolios, while hopefully adding some return and enhancing diversification.
- Artemis Portfolio Strategy. Despite a benign macroeconomic environment and prospect of decent corporate earnings, we have decided to rebalance our portfolios back to their targets and take a little profit. We have been steadily increasing risk in our portfolios since the middle of 2016 and have not rebalanced in over two years. Some will argue we are moving a bit early as there are few indicators of a coming bear market. Yet, there are lots of reasons to believe that much of the positive news is baked in to current valuations, even after the corrections in February and March, and so the risk/reward payoff is not so attractive going forward.
- We are also staying short duration as a hedge against the view that *longer-term* interest rates aren't going to move up much more this year.



### ***Quarter in Review***

The most salient feature of global equity markets during the first quarter was the return of volatility. In the U.S., volatility increased because U.S. equities became caught in crosscurrents, with a strong economy and increasing corporate earnings on one side, and monetary tightening, rich valuations and heightened concerns over the Trump administration’s trade policy on the other. Overall, U.S. equities ended the quarter down by -0.6%. (See Figure 1.) Growth stocks continued to outperform value, but for the first time in a while, smaller company stocks outperformed larger ones, on average.

Figure 1: Market Performance by Asset Class in Q1 2018 (percentage points)



Index definitions are at the end of the report.



Developed markets outside of the U.S. also saw negative equity returns of -2.0% due to worries about the path of U.S. interest rates and the outlook for global trade. This happened despite an encouraging economic backdrop in the Eurozone, with unemployment stabilizing and manufacturing indices continuing to imply solid growth. The same can be said for Japan, although the economy experienced a slight soft patch for economic growth during the quarter.

Emerging markets were the clear winners, registering a positive return of +1.3% in the first quarter, despite the rise in market volatility and uncertainty over global trade. Brazil and Russia led the way, but even Chinese equities recorded a positive return.

The big move on the fixed-income side was the selloff in U.S. Treasuries. U.S. Treasury yields rose markedly across the curve as expectations of growth in inflation and interest rates shifted higher. The benchmark 10-year yield increased from 2.41% to 2.74% by quarter end, after reaching a high of 2.95% in February. As a result, the benchmark Barclay's Aggregate Bond Index returned a negative -1.5% for the quarter, thus providing no offset to negative equity returns. The selloff affected many other segments of the bond market, including both corporate and municipal bonds, where spreads widened considerably.

Real estate investment trusts (REITs) were not immune to the increase in interest rates and sold off sharply in the U.S. (From our perspective, they appear to be very oversold at this point and so are likely to bounce back soon.)

Finally, despite expectations for higher interest rates in the U.S., the dollar continued its downward trajectory during the quarter. Markets appear to be focusing on the fact that the U.S. will have to borrow more to finance the projected large increase in the annual deficit and could end up importing more, which would put downward pressure on the dollar. Ironically, President Trump's policies may end up increasing our overall trade deficit, something he has vowed to reduce.

### ***The Rise of Thematic Investing***

In recent months, Artemis has started to implement "thematic" investing in client portfolios, primarily as a way of potentially adding a little value ("alpha" as it is called in the investing world) in the equity portion of client portfolios. As such, I wanted to explain what thematic investing is, what it takes to be successful with the approach, and how we are going about implementing our ideas.



Thematic investing is a forward-looking investment approach that seeks to capture the opportunities created by long-term structural trends. The approach stands in clear contrast to the more widely used approach of market capitalization investing, where it is implicitly assumed that past winners will continue to lead the pack, and therefore deserve more attention and weight in the portfolio. McKinsey and Company has developed the schematic shown below to illustrate some of the differences between mainstream asset-class (or relative) investing and thematic investing.<sup>1</sup>

Figure 2. Classic Relative (Asset-Allocation) vs. Thematic Investing Framework

	Relative framework	Thematic framework
<b>Asset allocation</b>	Asset classes as building blocks	Sector and country exposure as building blocks (matrix view)
<b>Portfolio construction</b>	Weight of asset classes in portfolio based on economic cycles and market conditions	Selection of themes, sectors, or regions across asset classes based on underlying market trends
<b>Alpha generation</b>	Based on security selection relative to an index	Based on selecting groups of companies that will benefit from long-term support of structural trends
<b>Decision process</b>	Portfolio managers allocate capital within defined mandates	Investment committee arbitrages opportunities across themes
<b>Investment performance</b>	Measured relative to an index (typically on an annual basis)	Measured against an absolute target or a risk-adjusted index (over a 3- to 5-year rolling history)
<b>Expertise</b>	Investment professionals with experience in a given asset class or sector	Investment professionals with a combination of in-depth regional and sector experience across asset classes
<b>Research</b>	Typically occurs within portfolios, with research performed at security level	Central group develops house views on priority themes and opportunities for institution

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<sup>1</sup> McKinsey on Investing. "From Indexes to Insights: The Rise of Thematic Investing." Winter 2014-15. See also Deutsche Bank Markets Research. "The Case for Sustainable Thematic Investing." February 20, 2017.



The basic premise of thematic investing is that in an increasingly globalized world, what is more important is investing in the companies and sectors that will benefit from the structural changes facing the global economy. These global trends will provide opportunities to investors who can take a longer-term view.

Of course, it's important to pick the right themes. In Figure 3, I outline selected themes I am closely watching, a few of which we are now (very modestly) invested in.

Figure 3. Selected Investment Themes and Their Growth Drivers

Theme	Growth Drivers	Ticker(s)
<b>Water Technology</b>	By 2030, global population is expected to reach 9 billion and will require 30-45% more water.	CGW, PIO
<b>Industrial Automation</b>	Advancement in sensors, mechanical systems, wireless communications, computing, and cameras are enabling industrial IoT, advanced robotics and many other promising technologies.	ROBO, BOTZ, ARKQ, XT
<b>Sustainable Transportation</b>	Advancements in battery technology, the computational power of semiconductors, new AI development tools, innovations in 3D road mapping, changing consumer preferences, are converging to set the stage for dramatic changes for the Auto Industry.	KARS
<b>Power Infrastructure / Smart Grid</b>	Falling costs and growing availabilities of capital for renewable energy generation worldwide, rapid reduction of battery costs and growth of distributed generation.	GRID, QCLN
<b>Cybersecurity</b>	Cyber-attacks from foreign governments, especially China, Russia, and North Korea along with non-state terrorist actors and organized criminal groups, constitute one of our most critical national security concerns.	CIBR, HACK

What does it take to be successful with such an approach?

Most experts would agree that successfully implementing a thematic investment strategy requires getting three things right: 1. Correctly identifying structural shifts; 2. Finding companies with high exposure to those shifts; and 3. Timing so as to enter early enough



that earnings and forecasts have not fully priced in the theme's potential. Admittedly, this is not easy to do. Very recently, however, the job has become a little easier due to the rise of pooled investment vehicles (both mutual funds and ETFs) that invest in a range of companies highly exposed to specific themes.

In short, my interest in thematic investing is due in part to the ability to fold a thematic strategy into our existing asset allocation framework. Very specifically, I am viewing exposure to global themes as one component of our overall international equity exposure with a goal of reducing the high correlation between international developed equities and U.S. equities.

### **Artemis Portfolio Strategy**

I must confess that the macroeconomic environment (and my job) has become a fair bit more complex in the last few months with Fed policy uncertainty, heightened trade tensions, and the increasing disarray of the U.S. political establishment. Fortunately, to date anyway, the global economy still appears to be in very good shape and the underpinnings of growth and a strong stock market that I outlined in my report last quarter are still in place.

But I also confess that I am not overly concerned about heightened trade tensions. President Trump needs a strong stock market and a good economy going into the November mid-terms, and China's President Xi needs to avoid another economic slump like in 2015. Moreover, China has a lot more to lose in a trade war with the U.S. In recent days, we have seen tangible signs that both countries will opt to negotiate their way out of the dispute. Just last week, President Xi offered to further open China's market to foreign business, increase imports, accelerate access to China's financial sector, and raise protections for intellectual property. I think a deal is at hand and will ultimately be a victory for Trump (if he is still with us) and lead to even freer trade.

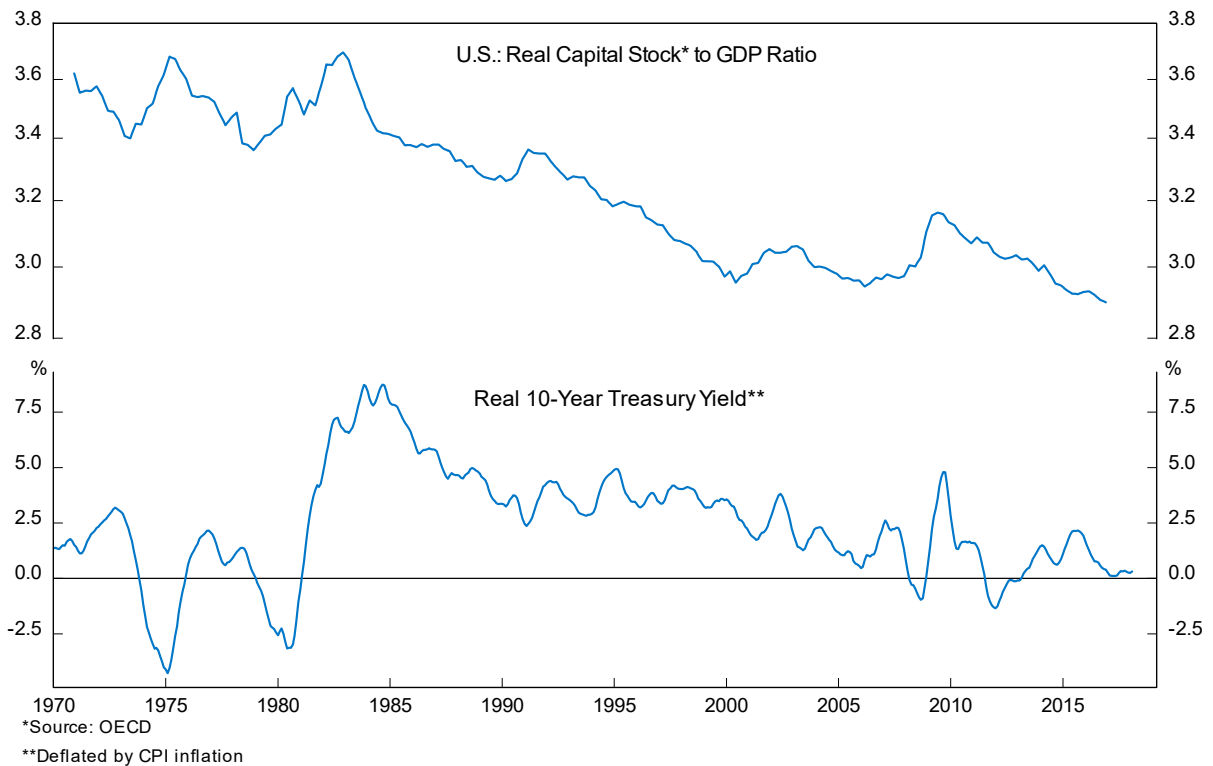
I also think the bond selloff we witnessed in Q1 is overdone. The reason why we are unlikely to see long-term yields rising very much from current levels is that the world remains awash with cash because at a global level, we are saving more than is being invested. This is giving rise to a very high demand for bonds. One of the big reasons why we have excess savings globally is that companies have become extremely capital-efficient (see Figure 4). They simply need far less capital today to create the same amount of output than before.

Moreover, at a very structural level, gross domestic product (GDP) is highly correlated to interest rates, and so unless we get a big uptick in GDP, then we are unlikely to see a further uptick in rates. GDP growth is constrained for the variety of reasons I have discussed in prior



reports (low productivity, aging population, lack of immigration reform, etc.), none of which will be resolved overnight.

Figure 4. Falling Capital Stock-to-GDP Ratio and Declining Real Long-Term Interest Rates



Nevertheless, I do think it is time to be a bit more cautious. This is a somewhat contrarian view, as many analysts are arguing that the correction we just went through is ending, and setting the stage for a rally until year-end and the “real” bear market next year. I’m feeling more cautious because I think the market has already priced in much of the good news and so the risk/reward payoff is less attractive going forward. I also believe the runup to the U.S. mid-term elections in November of this year has the potential to engender a lot of market volatility, making it more difficult for equities to advance.

Hence, we are in the process of rebalancing client portfolios back to their current equity targets and in many cases, modestly reducing those targets. If you have been following your portfolio carefully over the last two years, you will know that we have been steadily





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increasing our dynamic targets to equity. It's time, in my view, to start taking a little off the table.

We have also initiated a very small position in most client portfolios to global thematic investing, namely to robotics, AI, and various exponential technologies such as 3D printing, etc. We are doing this completely within the equity risk budget reduction I just described. As I discussed in the prior section, this is a long-term proposition based on the premise that these are very exciting technologies and that collectively, companies competing in this space will outperform more traditional global market-cap weighted indices (our default investing approach).

## Market Index Descriptions (for Figure 1)

### *Equities:*

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

### *Fixed Income:*

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of \$150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **Bank of America Merrill Lynch Global Government Bond II Ex-U.S.** tracks the performance of public debt of investment-grade sovereign issuers, excluding the U.S.



The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **Dow Jones Ex-U.S. Select Real Estate Securities** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally, excluding the U.S.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.