Investor Intelligence

Newsletter©

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From the Executive Desk

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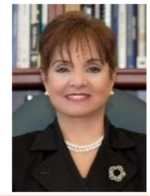
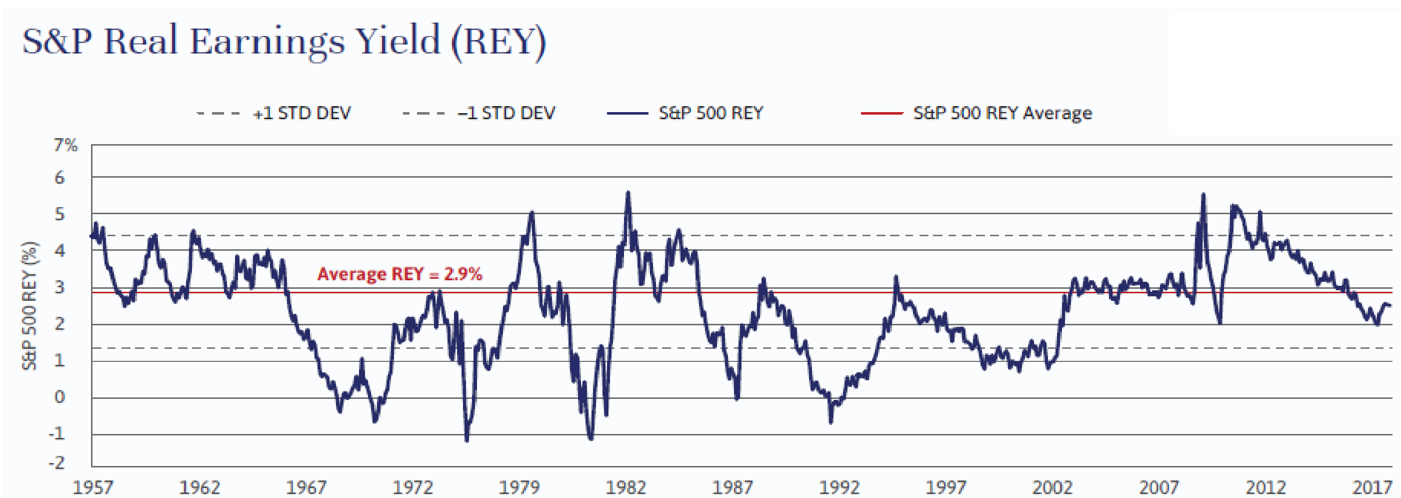
Founder & Chief Executive Officer



Investment professionals have various models to choose from when it comes to assessing whether the stock market is undervalued, fairly valued, or overvalued. However, in the current environment, where we are seeing inflation on the rise, the Real Earnings Yield (REY) model can give us great insight because it reflects the impact of inflation on valuations. The earnings yield of the S&P 500, which is the reciprocal of the P/E ratio, is highly correlated with the inflation rate on a year-over-year basis. The REY of the S&P 500 is the difference between the nominal yield and the inflation rate. The result is a mean-reversion valuation model that logically includes inflation. The model tends to anticipate bear markets when the yield falls close to zero. As seen below, the average value of the S&P REY since 1957 has been 2.9%. Presumably, the market is fairly valued around this level, undervalued above it, and overvalued below it. The REY was 2.6% during the first quarter of this year, which suggest stocks are near fair value. According to a recent paper written by John Apruzzese of Evercore Wealth Management, the REY model shows that; "Stocks appear more reasonably priced than the conventional P/E ratio suggests during periods of low inflation and rising markets, and more expensive during periods of high inflation and falling markets when they otherwise might seem cheap". Inflation is absolutely crucial for long-term investors. It's one of the most important macro factors to consider. Taking inflation into account can help investors form a truer picture of the market's value and make better asset allocation decisions.



Source: Evercore Wealth Management/Bloomberg

Economic Perspectives

Edmundo J. Garza
President

Over the past decade, publicly traded companies have benefited from a combination of low interest rates, earnings growth, and low wages, which have contributed to lofty equity valuations and record corporate profits. Today, the S&P 500 Index trades at nearly two times its historical average of 16.8. The only other times in the last 100 years when equities were this expensive were during the late 1920s and early 1990s, which preceded the Great Depression and the bursting of the tech bubble, respectively. Now the global equity landscape is starting to look increasingly uncertain. Interest rates are rising after years of low or, in some cases, negative real rates. Inflation is starting to inch higher, and equities appear expensive after a strong decade-long run. These factors have led many investors to question the market outlook. Although there are high quality businesses in the markets, few are attractively valued. As the investment environment normalizes, investors in the global stock markets should look towards managers and funds that adapt their portfolios to focus on valuation in order to achieve their return target. On the whole, as markets normalize and volatility increases from depressed levels, we believe investors who wish to successfully navigate change will need to adopt an absolute return mindset and be more selective about their holdings and portfolio construction.

Indicators (As of May 25, 2018)

United States:
CPI: 2.4% Chg. from yr. ago
Unemployment Rate: 3.8%
GDP: 2.2% Comp. Annual rate of Chg. on 2018:Q1
Ind.Prod.Index: 0.7% change from previous month
Source: *St. Louis Fed. Res.*

Japan:
CPI: 0.8% Chg. from yr. ago
Unemployment Rate: 2.5%
GDP: -0.2%, Comp. Annual rate of Chg. on 2018:Q1
Ind.Prod.Index: 0.3% change from previous month
Source: *Moody's Analytics*

Eurozone:
CPI: 1.2% Chg. from yr. ago
Unemployment Rate: 8.5%
GDP: 0.6%, Comp. Annual rate of Chg. on 2017:Q4
Ind.Prod.Index: 0.5% change from previous month
Source: *Moody's Analytics*

Puerto Rico:
CPI: 0.0% Chg. from yr. ago
Unemployment Rate: 9.3%
Payroll Employment: -4.2% Chg. from yr. ago
GDB Econ. Act. Index: -8.5% Chg. from yr. ago
Source: *Economic Development Bank of Puerto Rico*

Market Recap

Evangeline Dávila, CIMA®
Chief Research & Investment Officer

Stocks: Most non-U.S. markets also posted negative results in Q1 2018, however a weakening U.S. dollar benefited U.S.-based investors. MSCI EAFE: -1.5% in USD terms; -4.3% in local terms. Japan's equity benchmark fell by nearly 6% in local terms, but was up 0.8% in U.S. dollars due to the strength of yen. Emerging Markets were one of the only market segments to generate positive results. MSCI EM USD: +1.4%. BRICs: Brazil (+12.4%); Russia (+9.4%); India (-7.0%); China (+1.8%).

Bonds: Non-U.S. fixed income market returns benefited from U.S. dollar weakness. Currency movements drove global fixed income returns more than interest rate changes. The Bloomberg Global Aggregate ex-U.S. (hedged) returned -0.1% while the Bloomberg Global Aggregate ex-U.S. (unhedged) returned +1.4%. Credit underperformed government bonds. In Emerging markets debt delivered muted returns.

Alternatives: Commodities were among the top-performing major asset classes as strong grain and crude-oil prices offset weak livestock and base metal performance. Brent crude oil prices were at their highest since 2014 and closed the quarter at $66.31 per barrel. Commodities indices were mixed. Energy-heavy S&P GSCI Commodity Index was up +2.2% while the more diversified Bloomberg Commodity Index was down -0.4%.

The Advisor's Corner

Ernesto Villarini Baquero, MBA
Advisor & Managing Director

Growing environmental concerns are generating largescale regulatory changes across multiple industries. In early 2017, over 1,400 climate laws were in existence worldwide compared to approximately 60 laws and policies in 1971. Stringent regulations that focus on environmental disclosures, limits, and targets, have grown over the past two decades. This equates to a doubling of international climate laws every four to five years. As evidenced by the 2015 Paris climate accord, most countries around the world will continue to address environmental concerns in one way or another, and while there is growing acceptance of the impact of a company's environmental practices on its valuation and financial performance, tying the underlying factors together is rarely a straightforward process. Many factors are often subjective and difficult to track and quantify. Furthermore, they are likely to differ across companies, sectors, and regions, and change over time. A deeper understanding of environmental regulations and their impact on companies and industries, could offer investors a structural advantage when it comes to investment strategy, asset allocation and tactical management of their portfolio. Hence, some asset managers are doubling-down on bottom-up assessments to strengthen their ability to anticipate risks and opportunities created by industry shifts. They are also looking to generate unique insights into how different businesses are developing in light of the heightened regulatory environment around climate change. An investment manager's understanding of the level of integration of environmental factors in a company's management can help investors sidestep significant losses related to regulatory breaches or non-compliance as seen in the 2015 Volkswagen's pollution emissions tests scandal, and in 2010 British Petroleum's Deepwater Horizon oil spill.

What to Do?

Reflecting on the first quarter of 2018, the environment and general mood in the market appears to have shifted to a more cautious state. The broader, macro-oriented stories to watch include elevated tensions between the U.S. and other, key global trade partners (China chief among them); the pace of rises in both domestic and global interest rates and inflation; the return of equity volatility; currency trends (i.e. continued USD weakening, yen appreciation); and further policy normalization by global central banks. ***Amid an uncertain scenario we continue to recommend prudent asset allocation and risk assessment, based on future capital needs, for plan sponsors, institutions and individual investors. Due diligence reviews and an adherence to a well-developed investment policy remain the most prudent course for long-term investors. Continued fiduciary education is paramount.***

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