Investor Intelligence
Newsletter©

A bi-monthly publication from Consultiva Internacional, Inc. - A Registered Investment Adviser

October 10, 2018

From the Executive Desk

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Founder & Chief Executive Officer

During his most recent press conference, Federal Reserve Chair Jerome Powell said he was optimistic about the US economy, and reiterated the Fed's intention to continue gradually raising interest rates. Powell was asked if he was concerned about the high levels of nonfinancial corporate (NFC) debt. Powell responded that he sees this as "moderate" financial vulnerability, and that from his perspective, the banking system is much stronger than what it was when NFC debt levels rose to current heights. In other words, under the Fed's supervision any problems caused by NFC debt aren't likely to become systemic for the banks. While we would not like to see this tested, there seem to be other reasons to ease concerns. True, US NFCs' debt is at a record high and well above where it was before the 2008 financial crisis, but many firms have refinanced their debt with longer maturities and at historically low interest rates. Investors are right to wonder whether servicing this debt will become too onerous for US companies as interest rates rise, but it seems interest costs will continue to be manageable for firms across most sectors, because corporate earnings, cash flow, and liquid assets are at record highs and likely to move higher. The reasons not to worry about NFC leverage are substantial, but we could argue that there are a couple of caveats: One is that the aggregate data on NFC debt does not reflect the distribution of cash among nonfinancial corporates; the other is that the aggregate data does not reflect the mix of debt maturities or credit ratings either. While some weight could be given to these qualifications, it does not seem credit markets would turn south, unless a severe US economic downturn occurs.

Economic Perspectives

Edmundo J. Garza
President

On the subject of potential doomsday scenarios, some say that risky private loans are being bundled into financial products reminiscent of the collateralized loan obligations that worsened the financial crisis of 2008. It's as if the types of risky loans that blew up during the crisis haven't gone away. Instead, they have been transferred to private lenders who are not held to the same scrutiny as regulated bank lenders, and this could pose systemic risk to financial stability. The search for yield following the financial crisis led many institutional investors to fund and grow private lending. However, regulated banks are still indirectly involved with most of these firms as they have been lending funds that are later repackaged. According to the Wall Street Journal bank loans to nonbank financial firms increased six fold between 2010 and 2017 to a record high of nearly $345 billion. They are now one of the largest categories of bank loans to companies. If these nonbank loans implode, it may reduce the rates of return realized by the institutional portfolios that own them, but since bank capital is highly regulated and well monitored, it probably isn't as vulnerable as it was during the past crisis. While private lending doesn't seem to pose systemic risk, there's still a concern about unseen risks, as private lending isn't as transparent as bank lending. Here's where investment advice and rigorous due diligence can add enormous value and help protect investments in these alternative vehicles.

Indicators (As of October 10, 2018)

United States:
CPI: 2.3% Chg. from yr. ago
Unemployment Rate: 3.7%
GDP: 4.2% Comp. Annual rate of Chg. on 2018:Q2
Ind.Prod.Index: +0.4% change from previous month
Source: *St. Louis Fed. Res.*

Japan:
CPI: 0.9% Chg. from yr. ago
Unemployment Rate: 2.4%
GDP: 0.7%, Comp. Annual rate of Chg. on 2018:Q2
Ind.Prod.Index: 0.7% change from previous month
Source: *Moody's Analytics*

Eurozone:
CPI: 2.0% Chg. from yr. ago
Unemployment Rate: 8.1%
GDP: 0.4%, Comp. Annual rate of Chg. on 2018:Q1
Ind.Prod.Index: -0.8% change from previous month
Source: *Moody's Analytics*

Puerto Rico:
CPI: 0.4% Chg. from yr. ago
Unemployment Rate: 9.1%
Payroll Employment: -2.3% Chg. from yr. ago
GDB Econ. Act. Index: -0.3% Chg. from yr. ago
Source: *Economic Development Bank of Puerto Rico*

Market Recap

Evangeline Dávila, CIMA®
Chief Research & Investment Officer

Stocks: The S&P 500 rallied to gain 7.7% for the 3rd quarter. This quarter was the strongest quarter for the S&P 500 since the 4th quarter of 2013. Historically, the 3rd quarter has been the weakest for the broad based U.S. equity index. Non-U.S. equity markets underperformed for the quarter. Investors continue to grapple with trade concerns, the lingering impact from a strengthening U.S. dollar, slowing growth and geopolitical uncertainty (e.g. Turkey and South Africa).

Bonds: Fixed income markets were challenged as yields rose across the globe. As expected, the Federal Reserve increased interest rates in September. An additional increase in the Fed Funds Rate is expected in December. The 10-Year Treasury closed out the quarter to yield 3.05%. International fixed income investors suffered losses during the quarter.

Alternatives: U.S. dollar strength has been a headwind for most commodities in 2018, outside of crude oil. A Bloomberg index that tracks the trade-weighted dollar has advanced 3.3% year to date after declining 10.0% in 2017. Gold prices have declined 11.2% from April 11 to August 31 against a backdrop of gradual U.S. Federal Reserve interest rate hikes and a strengthening U.S. dollar. Because gold is bought and sold in U.S. dollars, its price typically declines when the greenback strengthens.

The Advisor's Corner

Ernesto Villarini Baquero, MBA
Advisor & Managing Director

October Market Activity (as of 10/19/18):
With history as our guide, we can always expect the stock market to "correct" at some point. Historically, technical corrections of 10% or more have occurred on average once each decade. So far this year, we've experienced 3 drops in the US equity markets, as measured by the S&P 500, none reaching the "correction" point of 10% (**-7.8%** between January 26th and February 5th, **-7.1%** between March 9th and March 23rd, and **-6.9%** between September 20th and October 11th). For the year, the S&P 500 is in positive territory at 3.5%. US bonds, on the other hand, are down **-2.5%** (as measured by the Bloomberg-Barclays Aggregate Bond Index) so far this year, with corporate bonds experiencing the larger share of this drop; in anticipation of rising interest rates. Corrections are impossible to predict accurately, but that doesn't mean investors can't prepare for them. Here are a few pointers: **Diversify your portfolio**. This seems like obvious advice, but there are many investors who concentrate their stock portfolio in certain industries, jurisdictions or sectors. Market corrections are often driven by a singular industry, so making sure that you are not overexposed to any one sector can reduce your losses if a correction or a "crash" occurs. **Rebalance your portfolio**. Generally, we do not advise selling just because stock prices have gone up. But if a single stock or portfolio position becomes larger than it should be, you should rebalance back to your strategic long-term asset allocation. Trimming gains in your biggest positions can help you further diversify the portfolio as economic and capital market expectations change. Seek out opportunities that are less correlated with equities, but that still support your objectives and investment thesis and are in line with your risk tolerance. **"Insure" your portfolio**. Another tool to protect your portfolio from a market correction are options. Investment strategies that include buying "puts" can reduce downside risk. By buying a put contract, you own the right to sell your shares at a certain price in the future, thereby insuring a minimum value for your shares during the length of that option contract. The downside is if the stock doesn't fall, you're still out the premium you pay to buy the option, which can be substantial. Ask your advisors about these and other options to withstand the next correction.

What to Do?

The positive U.S. stock market trend continued in September, as the S&P 500 closed the month at an all-time high. However, the environment and general mood in the market remains cautious. International developed and developing markets still lag behind. In market environments like the one we are experiencing so far in 2018, it is important to remain faithful to a total portfolio's investment policy, which typically calls for a long-term outlook, a steady adherence to the policy allocation and an avoidance of changes based on short-term swings or dislocations. ***Hence, 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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