Markets in May were constructive for traditional assets and continued to reward investors for risk-seeking behaviors. Global equity markets rose to gain over 10% (for US investors) on a year-to-date basis, while fixed income markets rallied across the board. The Bloomberg Dollar Index fell 1.5% for the month, currency strength in particular coming from Europe on the back of a pro-EU French Presidential election run-off.

With France in the rear-view mirror, two countries of note began to demonstrate the way political risks can shape the investing landscape:

First, Brazil’s President, Michel Temer, the former Vice President to Dilma Rousseff (and man who successfully led a campaign to impeach her), became named in a bribery scandal. Brazil’s currency fell over 7% in a single day and the BOVESPA stock index halted trading briefly on May 18th.

Secondly, the Chinese central bank signaled it would be more active in the currency markets—coincidentally amidst two Chinese trading holidays—and shocked the Yuan higher at the end of the month. We believe China’s burgeoning debt problem has the potential to pose significant risk to its currency and to some closely related countries and markets; it appears Chinese authorities carry this same concern and are taking action to try and prevent it. (As a side note, we have been researching China and how we might be able to capitalize on exactly this kind of opportunity. Please contact us to learn more about it.)

Our models fared well on an absolute basis but as a firm we hold a cautious intermediate-term outlook. We are not phased by short-term bouts where risk-seeking is disproportionately rewarded, but instead are focused on taking risk when and where we believe the reward is commensurate. Generally speaking, that means avoiding many kinds of traditional betas/risk factors.

Equities

This year, large growth companies have dominated equity returns, and May was no exception.1 In May, large cap US equities outperformed small cap by 3.3% while growth outperformed value by approximately 2.6%. International equities generally outperformed US equities; in particular, European equities outperformed most developed and emerging equity indices. Our position in European equities and our overweight to international equities relative to US equities were both contributors during the month, while our smaller-cap tilt in US equities was a relative detractor.

Fixed Income

1 Apple, Amazon, Facebook, Microsoft and Google have accounted for approximately one-third of S&P 500 return year-to-date (granted, they also make up over 1/10th of the index). Source: Bloomberg.
Fixed income markets inched higher across the board as interest rates fell and spreads tightened. According to Bloomberg Barclays, the worst quality US fixed income securities (worse than CCC rated bonds, which are considered junk/distressed) remain the most profitable YTD, while a continued decline in US long-term interest rates has helped to push longer duration bonds higher.

Our position in shorter-dated high yield and our lack of exposure to interest rates were both detractors to performance, while our mortgage bond exposure was in line with our benchmark.

Real Assets

Inflation expectations fell during the month to new lows not seen since the Trump election, which did not bode well for inflation-sensitive assets. In particular, energy companies continued their downward trend and are testing support levels reached about a year ago. Gold miners were green on the month and seem to have established a strong bottom—first in January, then in March, and now re-confirmed in May. Our overweight to gold miners was a contributor to return, while our underweight in real estate was also a contributor. However, our overweight to real assets was broadly speaking a detractor this month.

Alternative Strategies

Most convergent strategies—strategies with some equity beta—were up on the month. Divergent strategies like global macro and managed futures categories were slightly up on the month as well, although market neutral had a particularly bad month. Our long/short equity and event-driven positions were the largest detractors to performance, while long/short credit and specialty were the two largest contributors. Overall, our allocation to alternative strategies was a detractor for the month as risk-seeking assets like stocks and bonds generally fared much better than risk-managed assets like alternative strategies.

Overall, the move in May is somewhat indicative of a boost to system-wide leverage. We do not believe a systemic crisis is imminent and are not positioned specifically for such an event. That said, we do believe caution during risk-seeking periods marked by stretched valuations is prudent as we look out not six to 12 months, but over seven to 10 years.

Please feel free to reach out to us if there is anything we can do for you. Our next letter will be the more in-depth quarterly commentary.

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