October 2018
Investment Commentary

As we enter into this fall season, we get to enjoy cooler weather, changing leaves, and the anticipation of upcoming holidays with family. Here at Glen Eagle we also use the new season as an opportunity to continue analyzing the fundamentals of the markets and the geopolitical risk associated with them. As a result, we thought it would be helpful to provide our view of the current investment environment through the lens of various geographic regions:

Europe

- Europe continues to be defined by uncertainty and as result, we do not advocate increasing investment allocation to this region. At the root of the problem is the fact that the European Union creates a single market place without allowing for a fully unified monetary or fiscal policy. This allows each country to act independently, resulting in the constant tension we see between the southern European countries, which in general tend to have large debt burdens, and the northern countries, such as Germany, France, and Britain, which have been tasked with lending money to their neighbors while simultaneously forcing them to cut back on spending.(1)
- Britain's June 2016 vote to leave the EU ("Brexit") has only fueled the fire of uncertainty as France and Germany are left as the EU's lenders of last resort. Furthermore, Britain's Prime Minister Theresa May still has yet to convince the EU or her own political party that she can successfully complete a deal that will allow Britain to leave the EU while maintaining many of the economic benefits that Britain experienced as part of the Union.
- The election of a populist government in Italy in May has also led many investors to flee Europe as they fear that the new government will be unable to reign in the government's spending habits. As the ninth largest economy, Italy has the ability to temporarily stall economic growth in the entire EU region if reforms are not passed.

Emerging Markets

- This past year has not been great for the authoritarian leaders of some emerging market countries. For example, both Turkey's President Erdogan and Venezuela's President Madura continued their controversial consolidation of power and the financial markets have reacted very negatively. Similarly, the US' tumultuous relationship with Russia and Iran (most notably the US decision to withdraw from the Iranian nuclear deal), has prevented significant foreign investment in either country.
- Last winter, we viewed the downfall in emerging markets as a buying opportunity for long-term investors. Unfortunately, the continued strengthening of the US dollar and the talk of trade wars has had the opposite effect on emerging market economies. Currently, emerging market countries have a total of $8 trillion of debt, which must be paid back to their lenders in US dollars. Unfortunately, the Federal Reserve has simultaneously been raising interest rates which means that it becomes harder for these emerging market governments to pay back the

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debt they owe since it continually takes more of their local currency to pay back one US dollar of their debt. Essentially, they are in an overflowing pool of debt holding a tea spoon. While from a diversification perspective it still makes sense to have some exposure to emerging markets, we are no longer recommending overweighting exposure to emerging markets.

- Although there are not many attractive areas within emerging markets right now, India and Mexico do seem relatively attractive compared to the underperformance of other emerging market countries. The potential return to some trade normality between the US and Mexico could further support the Mexican economy. In addition, India continues to offer the global economy both a population in which 65% of the individuals are under the age of 35 and a service-driven workforce.[2] The Indian Government's bureaucracy still partially inhibits foreign investments but should not prevent the country from continuing its rise to economic power in the next twenty years.

United States

- The United States has once again been leading the rest of the world in terms of market growth. Following the recent decrease in taxes and increase in government spending, corporate earnings have continued to grow healthily leading the S&P500 to rise 8.9% so far in 2018.
- In the short-term, the biggest risk to the US market remains political volatility. This past week's announcement of the US-Mexico-Canada trade agreement (termed "USMCA") has provided financial analysts with a much-desired sign that these trade conflicts may not escalate into a long-term trade war with some of our closest trading partners. The USMCA agreement along with the softer negotiating tone the administration has taken with the European Union over trade issues this past summer has led many experts to conclude that the administration is shifting its attention regarding trade primarily to China. Time will tell, however, whether the US Government will be equally successful at pressuring China into both lowering their tariffs and stopping their continuous efforts at stealing the intellectual property of large American corporations – an issue that many congressmen and congresswomen on both sides of the aisle feel passionate about.
- Originally, as the trade conflicts ramped up, we advocated investing in small publicly-traded companies and ETFs (i.e. "small caps") because smaller companies are typically less internationally-focused and as a result derive more of their revenue from the US. So far this year, this has been the correct call as small caps have outperformed large caps. Additionally, we expect that if the Chinese-US trade conflict is dragged out over a long-period of time, small caps will continue to benefit. However, if the trade conflict is limited to primarily China and the US, there will continue to be plenty of room for larger cap companies to perform.
- Value versus growth is also a theme that investors should be considering. In preparation for the ultimate end of the current bull market, we believe that investors should start to selectively tilt toward value holdings. It is likely that this tilt will result in near-term underperformance versus growth stocks, but as we have mentioned in the past, when the next correction comes it is likely that many high-flying growth stocks will come down more than value holdings.
- From a historical perspective, since 1946, the S&P500 has never declined in the year following a midterm election.[3] This is merely a trend rather than any indication of any fundamental data but it does support our view that while we may experience a market pullback, we do not expect a recession within the next twelve months.

As a final note, it is helpful to remember that investing over a long-time horizon in a diversified portfolio is a proven strategy for wealth creation. For example, if someone had the bad timing to invest in a relatively conservative portfolio (60% equity, 40% bond) at the peak of the market before the recession in 2007, that unlucky investor would have still realized an average annualized return of 6.7% through September of this year.[4] By focusing on the long-term and continually reassessing your financial goals, you can avoid the stress that often comes with the ups and downs of the market.

Wishing you a happy and healthy Fall season,

The Glen Eagle Investment Team

1) https://www.blackstone.com/docs/default-source/public-affairs/q3_2018-the-market-implications-of-global-disarray_v13-(1).pdf?sfvrsn=5226ecad_2
2) https://www.theguardian.com/commentisfree/2014/apr/08/india-leaders-young-people-change-2014-elections
3) https://www.barrons.com/articles/what-a-pivotal-midterm-election-could-mean-for-investors-1538181587
4) Assuming a 60% investment in VTSMX and 40% investment in VBMFX

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