The San Diego Foundation
Growing a Vibrant Region

INVESTMENT NARRATIVE

QUARTER ENDING SEPTEMBER 30, 2018

The U.S. continued to outshine other economies with its strongest quarterly growth since 2014. Emerging market equities delivered losses as political uncertainty overseas and less stimulus from the European Central Bank has clouded the economic outlook. The U.S. dollar appreciated 1% during the quarter. Once international economic growth began to show weakness, the relative value of the U.S. dollar went even higher, pushing non-U.S. positions to underperform further.

The Fed raised the target range for the fed funds rate by 0.25% and the 10-year U.S. Treasury yield hit a 7-year high, reigniting investor concerns over rising interest rates. Despite equity market volatility throughout the course of the year, credit spreads continued to trade at tight levels, possibly resulting in investors not being compensated for the risk taken in this area. This is particularly true in high yield.

In trade, the U.S., Mexico and Canada reached a new agreement. The new deal may create mildly more favorable terms for U.S. businesses. However, the Trump Administration has implemented 10% tariffs on an additional $200 billion of Chinese imports that may rise to a 25% rate at the beginning of next year if no progress is made in the meantime. China responded with retaliatory tariffs of 5-10% on $60 billion of U.S. imports. All eyes will continue to be on negotiations between U.S. and Chinese representatives, as investors are highly concerned with the impact of trade on China.

Inflation has remained relatively muted. Although there has been occasional concern in the market over a potential spike in inflation, we have yet to see any sustained pressure on consumer prices. The potential impact of tariffs on inflation has been widely scrutinized, but it is important to note that the flow-through from import prices to consumer prices will depend on numerous factors. Material increase in inflation due to tariffs is not expected at this time.

The economy continued to add jobs at a steady pace. The unemployment rate fell further from 4.0% to 3.7% in September. The broader U-6 unemployment rate also tightened, dropping from 7.8% to 7.5%. This measure has finally recovered to below its pre-global financial crisis level. Surging job openings, along with business survey responses, suggest companies are having a difficult time finding qualified workers.

Endowment

The Endowment Portfolio returned 1.9% for the third quarter, underperforming its Policy Index by 0.6%. Overall, it was a decent quarter for the portfolio. U.S. Large Cap Equity led the portfolio up 7.7%, with Small Cap Equity also up 3.6%. It was a difficult quarter outside of the U.S., primarily in Emerging Markets Equity which returned -4.5%. After reporting Private Capital as a detractor last quarter, we have begun to see the added value over the public markets that we expect from this space. As we creep out of the “building phase”, we have seen a 2.7% return.

Non-Endowment

The Long-Term Non-Endowment Portfolio was up 1.2%, trailing the Policy Index by 0.8%. In addition to the non-U.S. theme listed above, the Long-Term Portfolio struggled in the Alternatives area. One manager in particular, which has offered the Long-Term Portfolio uncorrelated returns for several years, struggled due to a strong value orientation. Value stocks have continued to massively underperform their growth counterparts.

The Medium-Term Non-Endowment Portfolio was up 1.2% for the quarter, nearly mirroring its Policy Index at 1.3%. While the portfolio holds far less exposure to equities, its exposure to non-U.S. equities, like the others above, was the primary detractor from performance. This was offset by strong performance in U.S. equities.

The Short-Term Non-Endowment Portfolio was up 0.5% during the quarter and remains in line with its policy. As the Federal Reserve continued its tightening policy in 2018, interest rate hikes resulted in higher yields on money market funds. Continued tightening by the Fed should further boost yields.