Sabrient Commentary – September 2019 (as of 9/16/2019)
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The first half of September has brought an exciting and promising change in character in the US stock market. Capital has been rotating out of the investor darlings of the past 15 months – including the momentum, growth, and low-volatility factors, as well as Treasury bonds and "bond proxy" defensive sectors – and into the neglected market segments like value, small and mid-caps, and cyclical sectors favored by Sabrient's GARP (growth at a reasonable price) model, many of which have languished with low valuations despite solid forward growth expectations. *This welcome turn of events has helped Sabrient's portfolios gain significant ground against the S&P 500 benchmark.* The question, though, is whether this is just a temporary "reversion to the mean" or the start of a healthy broadening and rotation from the larger, high-quality but high-priced stocks (which have been bid up by overly cautious sentiment, passive index investing, and algorithmic trading, in my view), into the risk-on market segments that would normally lead a rising market. A real breakout finally may be in store if this rotation can continue.

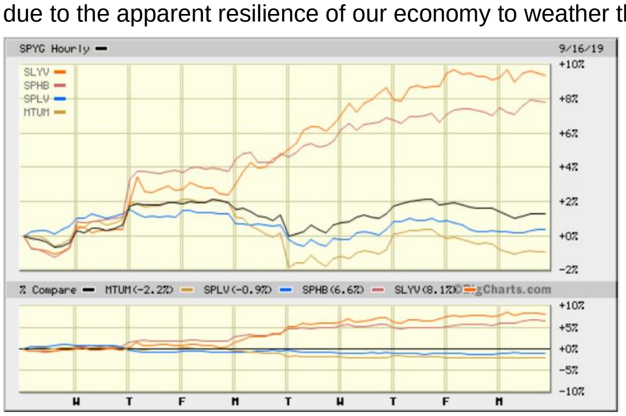
I have been regularly writing about a dramatic market bifurcation that began in mid-June 2018, driven by a stark escalation in the trade war with China and an "autopilot" Federal Reserve tightening schedule. The S&P 500 was hitting new highs and the financial press was claiming that investors were *ignoring* the trade war, when in fact they weren't ignoring it at all, as evidenced by narrow leadership coming primarily from the mega-cap secular Technology names and large cap defensive sectors (risk-off). In reality, such market behavior was unhealthy and doomed to fail in rising much further without a broadening into higher-beta cyclical sectors and small-mid caps, which is what I was opining at the time. Of course, you know what happened, as Q4 brought about an ugly selloff.

Fast forward to today, and Q3 of this year was looking much the same to me. And even as the S&P 500 hit new highs this summer, it was what S&P Global called a "low conviction rally" led by the Low-volatility factor (risk-off), opining that the significant outperformance of the S&P 500 Low Volatility Index (SPLV) versus the S&P 500 Index was "unusually strong performance for a defensive index in a rising market." While large cap indexes continued to hit new highs through July, the S&P 600 small cap index remained at least 10% below its high from 8/31/18.

As has become expected given its typically low-volume summer trading, August saw increased volatility – and also brought out apocalyptic commentaries similar to what we heard from the talking heads in December. In contrast to the severely *overbought* technical conditions in July when the S&P 500 managed to make a new high, August saw the opposite, with the major indices becoming severely *oversold* and either challenging or losing support at their 200-day moving averages or even testing their May lows, as investors grew increasingly concerned about a protracted trade war, growing protectionist rhetoric, geopolitical turmoil, Hard Brexit, slowing global economy, and a US corporate earnings recession. Utilities and Real Estate were the leading sectors, while Energy trailed. Bonds surged and yields plunged. August was the worst month for value stocks *in over 20 years*.

First Trust published a graphic illustrating the extreme relative outperformance of large caps and defensive sectors during the roughly 18 months spanning 3/8/18-8/26/19 in which there were really only about three months where cyclicals and small caps provided leadership (mostly during the post-meltdown rally of 12/24/18-3/1/19). And over the past year (between when small caps peaked on 8/31/18 through 8/31/19), small cap value trailed large cap growth by more than 20 percentage points (pps). One would think that falling interest rates would *benefit* small caps given their typically higher leverage. And although the market's year-to-date performance looks really good – with the S&P 500 total return an impressive +21.2% while the Russell 2000 is up +18.7% as of 9/16/19 – much of it simply has been recovering ground lost during 4Q18. Once the S&P 500 hit its 2018 peak on 9/20/18, it has really only gone sideways ever since, with a few failed attempts to break out to the upside, while the Russell 2000 is still nearly 10% below its 8/31/18 high. JP Morgan has described what it sees as an *historically large relative valuation divergence between Low-volatility/Defensive sectors over Value/Cyclicals*, i.e., a valuation bubble that it believes is destined to re-converge.

Alas, we may have just seen a "blow-off top" in bonds, and perhaps the Value factor has found a bottom. All of a sudden, the major topic of conversation among the talking heads has been the dramatic rotation from risk-off market segments to risk-on. The Energy sector had been a persistent laggard, but the short sellers have been covering as oil prices have firmed up. Financials have caught a bid as US Treasury prices have fallen (and yields have risen). Small cap value has been greatly outperforming large cap growth. It seems investors are suddenly less worried about a 2020 recession, ostensibly due to renewed optimism about trade talks, or perhaps due to the apparent resilience of our economy to weather the storm.

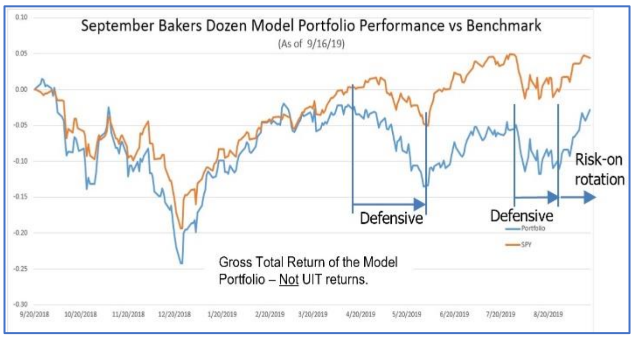


The chart to the left illustrates September's dramatic rotation from the investor darlings of momentum, growth, low-volatility defensive sectors, and Treasury bonds, and into the long-neglected risk-on market segments like value, high beta, small-mid caps, and cyclical sectors. Note the approximate +7 percentage points (pps) outperformance of SPDR S&P 600 Small Cap Value (SLYV) over SPDR S&P 500 Growth (SPYG) in just the first two weeks of September. Also shown for comparisons are the Invesco S&P 500 High Beta (SPHB) significantly outperforming both the Invesco S&P 500 Low Volatility (SPLV) and iShares Edge MSCI USA Momentum (MTUM). And here is another interesting comparison not shown on the chart: Over the same timeframe, the highly cyclical VanEck Vectors Steel ETF (SLX) is up +14% while the iShares 20+ Year Treasury Bond ETF (TLT) is down about -6% – a performance gap of 20 pps in two weeks!

As a reminder, David Brown and his team here at Sabrient don't *force* cyclicals and small caps to be in our GARP portfolios, but rather our quantitative model identifies stocks having good earnings quality and less-aggressive accounting practices that are expected to achieve solid earnings growth while still selling at an attractive price – and those names tend to come from the cyclical sectors *when we are in a growing economy*. But fickle investor behavior has been common for much of the past four years – essentially since mid-2015 when the last presidential campaign commenced and the Fed began signaling its intentions to tighten (with the main exception being the 15 months of post-election risk-on rally from November 2016 until the February 2018 correction). Such behavior has allowed many quality companies with solid earnings growth expectations to fall to single-digit forward P/Es. But now, I think the market is at a critical turning point. We may be seeing acknowledgment among investors that perhaps the economy is likely to hold up despite the trade war. And perhaps large cap multinationals with a lot of international exposure are no longer the best place to invest. And perhaps many large cap Tech names, along with the defensive sectors that have been leading the market for so long, are largely bid up and played out at this point such that the more attractive opportunities lie in the unjustly neglected areas.

As for the **September 2018 *Baker's Dozen*** portfolio, which is coming up on one year since launch, it began with an overweight 54% allocation (versus only 17% in the benchmark S&P 500) to three highly cyclical sectors of Industrials (23.1% vs. 9.2%), Energy (15.4% vs. 5.3%), and Materials (15.4% vs. 2.7%), and an underweight in Technology (7.7% vs. 24%). Moreover, it had an 85% allocation to small-mid caps (vs. the S&P 500 being solely a large cap index). In addition, although we consider all our stocks selections to have solid growth outlooks, our GARP portfolios typically have a Value tilt by First Trust's definition (primarily based on price/book), so the portfolio officially carried only a 23% allocation to the Growth factor (vs. the benchmark's 59%, which is typical of a cap-weighted index).

Although the specific holdings might vary, these allocations are generally representative of all our portfolios since last summer, as cyclicals tend to display the greatest earnings growth in a growing economy, and large caps have been largely "bid up" to high valuations, according to our model. Nevertheless, because these allocation "tilts" are quite different from the cap-weighted S&P 500 benchmark's composition (sectors, market caps, value/growth ratio), they have hurt our relative performance during the buildup of this historic relative-valuation "bubble." However, our model continues to tell us that these tilts represent areas in which an investor should want to be positioned – and especially for a re-convergence of the relative-valuation bubble, which might have already begun.



Ticker	Company Name	Return	Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
HZNP	Horizon Therapeutics Public Limited	38.1%	9.6	14.1	85.1%	99.1%
NXST	Nexstar Media Group, Inc.	29.6%	9.8	28.2	53.3%	59.8%
NMIH	NMI Holdings, Inc.	19.7%	11.8	10.0	63.7%	78.4%
POST	Post Holdings, Inc.	9.5%	18.9	22.3	34.4%	20.1%
TRV	The Travelers Companies, Inc.	9.1%	12.1	13.1	46.4%	27.6%
AIR	AAR Corp.	1.7%	16.4	17.6	61.3%	54.9%
ALSN	Allison Transmission Holdings, Inc.	-10.8%	9.4	8.8	43.4%	51.4%
IIVI	II-VI Incorporated	-15.1%	19.4	14.3	64.2%	70.7%
COP	ConocoPhillips	-17.0%	16.0	15.4	77.5%	69.2%
HFC	HollyFrontier Corporation	-18.4%	9.6	11.1	68.7%	71.2%
STLD	Steel Dynamics, Inc.	-31.4%	8.2	11.5	55.1%	29.5%
UFS	Domtar Corporation	-33.6%	11.3	13.1	48.8%	59.9%
ARCB	ArcBest Corporation	-33.7%	14.0	10.3	38.0%	46.7%
	Average	**-4.0%**	**12.8**	**14.6**	**56.9%**	**56.8%**
SPY	SPDR S&P 500 ETF Trust	4.3%				

The September 2018 portfolio launched the day that the S&P 500 peaked, while small caps had peaked just a few weeks earlier. Although it made up significant ground against the benchmark during the post-Christmas Eve recovery rally through 3/1/19, gaining +29.3% vs. 19.7% for the SPY, defensive sentiment returned in mid-April and again in late-July, which hurt. But this latest risk-on market rotation has been helpful, as the portfolio has gained 7.0% vs. 3.3% for the SPY during 9/3-9/16.

Looking at the individual holdings through 9/16/19, unlike some of our better-performing portfolios that have benefited from at least one breakaway position – like the October 2018 *Baker's Dozen*, which has Lattice Semiconductor (LSCC), up 170%, or December 2018, which has LTL trucker Saia (SAIA), up 80% – the September 2018 portfolio performance has been hampered by not having such a standout. The top performers so far are biopharma Horizon Therapeutics (HZNP), +38.1%, TV station operator Nexstar Media (NXST), +29.6%, which as benefited from political advertising, and private mortgage insurer NMI Holdings (NMIH), +19.7%, which has benefited from the resurgence in housing. All three have topped earnings estimates, and two of them (HZNP and NXST) have seen their forward P/E multiple expand considerably. The actual aggregate earnings growth of the overall portfolio so far has hit right on the estimates upon launch, and the aggregate forward P/E has been rewarded with about 14% expansion. Nevertheless, the total return is negative due to lowered (or even negative) EPS growth expectations for the next 12 months for several of the names.

The best performers are from Healthcare and Consumer sectors (including consumer finance and insurance), while the worst performers are from the highly cyclical Energy, Materials, and Industrial sectors. Those laggards include trucking company ArcBest (ARCB), - 33.7%, paper & packaging firm Domtar (UFS), -33.6%, manufactured steel products maker Steel Dynamics (STLD), -31.4%, refiner/marketer HollyFrontier (HFC), -18.4%, and vertically integrated oil & gas firm ConocoPhillips (COP), -17.0% – *although all five have made up a lot of ground against the SPY benchmark during September's risk-on rally into the cyclicals sectors*.

Many of our portfolios over the past year have seen their holdings from these sectors meet or exceed expectations and yet still sell off (guilt by association with their respective industries). For example, in the September 2018 portfolio, UFS has fallen nearly 34% even though it is on target to achieve 60% EPS growth versus initial expectations of 49%, and ARCB has also greatly exceeded its estimates for the past 12 months and yet its share price has fallen nearly 34% while its forward P/E has compressed by 26%, although admittedly both companies have seen EPS estimates for the next 12 months lowered significantly. Nevertheless, some of the names in this portfolio continue to display sufficiently attractive GARP properties to make them eligible for new portfolios.

In summary, my view is that the economy remains solid, with expectations of strengthening corporate earnings growth, and it appears China is absorbing the brunt of the trade war fallout. Despite a distorted yield curve caused by massive capital flows into the strength and safety of the US, the reality is that recessions are usually preceded by a hawkish Fed or surging oil prices, neither of which are in play. We enjoy low interest rates and low inflation (in all developed markets), a strong US dollar, and a preference among global investors for US assets. Corporate insiders recognize the attractive valuations, particularly among the neglected market segments, and are buying up shares with their own money. Buyback and IPO activity has been robust. Bonds are pricey and starting to see capital rotate into equities. And cash hordes are plentiful, while both hedge funds and individual investors are under-allocated to equities.

A persistent investor preference for defensive sectors and mega-cap Tech (at the expense of cyclical sectors and small-mid caps) as well as for US Treasuries (which caused yields to plunge and flattened the yield curve) has been driven mostly by geopolitical uncertainty and a desperate desire among global investors for yield, which has pushed up valuation multiples in defensive stocks and created a historically large relative valuation divergence between Low-volatility/Defensives and Value/Cyclicals. It seems appropriate that the market is finally ready to look to the neglected market segments like value, cyclicals, and small-mid caps, and indeed, a re-convergence of this historic divergence may have just commenced this month. And when you also consider the high cash balances and sky-high bond valuations that appear ripe for capital rotation (which, again, may have already commenced), it just might be the start of a powerful and sustainable risk-on rally.

Note that we post on our public website my commentaries and presentation slide deck. You can find them all on the Marketing Materials tab on **http://bakersdozen.sabrient.com**, which also includes performance information on all of our current and historical *Baker's Dozen* portfolios. In addition, I go into greater detail on market conditions and outlook in my monthly Sector Detector newsletter and blog post, which you can find (and subscribe to for free) on the **Sabrient.com** homepage. As a reminder, I am always happy to take time for individual conversations with financial advisors about market conditions, outlook, and Sabrient's portfolios.