Sabrient Commentary – August 2019 (as of 8/8/2019)
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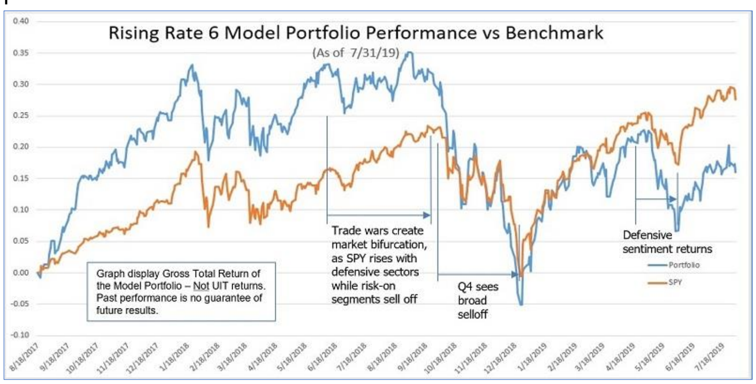
For the past 18 months (essentially starting with the February 2018 correction), investor caution has been driven by escalating trade wars and tariffs, rising global protectionism, a "race to the bottom" in currency wars, and our highly dysfunctional political climate. However, this cautious sentiment has been coupled with an apparent *fear of missing out* (aka FOMO) on a major market melt-up that together have kept global capital in US stocks but pushed up valuations in low-volatility and defensive market segments to historically high valuations relative to GARP (growth at a reasonable price), value, and cyclical market segments. Until the past few days, rather than selling their stocks, investor have preferred to simply rotate into defensive names when the news was distressing (which has been most of the time) and then going a little more risk-on when the news was more encouraging (which has been less of the time).

The market's gains this year have *not* been based on excesses (aka "irrational exuberance") but instead stocks have climbed a proverbial *wall of worry* – largely on the backs of defensive sectors and mega-caps and fueled by persistently low interest rates, and mostly through multiple expansion rather than earnings growth. In addition, the recent BAML Global Fund Manager Survey indicated the largest jump in cash balances since the debt ceiling crisis in 2011 and the lowest allocation ratio of equities to bonds since May 2009, which tells me that deployment of this idle cash and some rotation out of bonds could really juice this market. It just needs that elusive catalyst to ignite a resurgence in business capital spending and manufacturing activity, raised guidance, and upward revisions to estimates from the analyst community, leading to a sustained risk-on rotation.

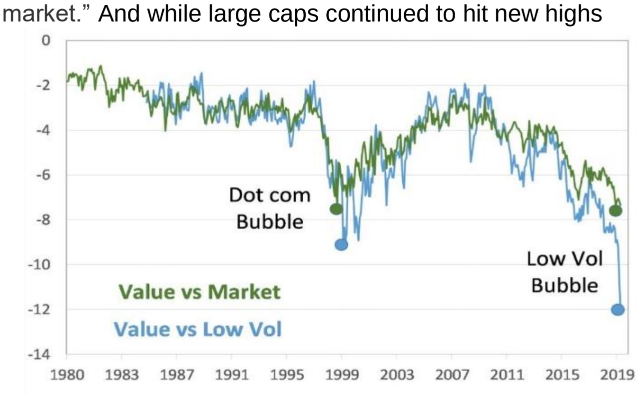
Market Conditions:

The dramatic defensive rotation last summer out of cyclical sectors and small caps – driven by a sudden escalation in the trade war with China and an "autopilot" Federal Reserve – was painful for all of Sabrient's portfolios and many other fundamentals-driven portfolios that seek attractive forward valuations. This market "bifurcation" is easily observable in a chart. To the left is a representative example, using our August 2017 Rising Rate portfolio, since it is a 2-year product that illustrates the market impacts starting with the favorable climate in 2017, followed by the sudden bifurcation in June 2018 when the SPY continued to rise despite a risk-off defensive rotation as risk-on segments weakened, culminating in an ugly Q4 market selloff (rather than a risk-on rotation to fuel more upside), and then this year's schizoid flip-flopping between risk-on and risk-off. Before the recent surge in volatility, stocks had been buoyed by those powerful market forces FOMO and TINA – i.e., *"fear of missing out"* and "*there is no alternative."* And right on script, last week brought the Fed's widely expected 25-bps rate cut and the US trade delegation's visit to Shanghai. However, although stocks have managed to scale a proverbial *wall of worry* from all the unsettling macro and political news and unresolved trade wars, it seems clear that investors have not overlooked those issues at all, as the market segments that would normally lead the charge to new highs (e.g., cyclical sectors and small caps) have been lagging. Moreover, through last Friday, nearly 20% of the S&P 500's stellar YTD performance was attributable to its four largest holdings: Microsoft (MSFT), Apple (AAPL), Amazon (AMZN), and Facebook (FB), so narrow mega-cap Tech leadership has been a key aspect of the market strength, as well.



I have been writing and speaking about this unsettling market divergence since last summer, as have other valuation-driven quants (like Cliff Asness of AQR Capital, among many others). *Over the past 18 months (ever since the February 2018 correction commenced), there were really only about 3 months* in which cyclicals have been the clear leaders, as all eyes await a resolution to the trade war. This has led to the unlikely result that defensive sectors like Utilities and Staples have been the leaders (due primarily to their reliable dividends in a low interest-rate environment). S&P Global has termed it a "low conviction rally" led by Minimum Volatility and Low Volatility (i.e., risk-off) factors, opining that the significant outperformance of the S&P 500 Low Volatility Index (SPLV) versus the S&P 500 Index is "unusually strong performance for a defensive index in a rising market." And while large caps continued to hit new highs this year, the Russell 2000 small cap index has remained at least 10% below its high on 8/31/2018. *None of this describes the type of behavior you expect to see in a solid economy and rising stock market.* Typically, the broad market indexes rise to new highs in a *risk-on* climate led by cyclicals and with strong market breadth that includes mid and small cap stocks.

Well, to lend further support to these observations, JP Morgan recently discussed the historically large *relative valuation gap* between Value/Cyclicals and Low Volatility/Defensives that has characterized the market since at least June 2018. It essentially reinforces everything I have been talking about regarding market conditions over the past 15 months. The chart to the right says it all.



Source: JPMorgan

JP Morgan's quant strategist Marko Kolanovic sees this as *"…a once in a decade opportunity to position for convergence…[of the] record divergence between value/cyclical stocks on one side and low volatility/defensive stocks on the other side....The bubble of low volatility stocks vs. value stocks is now more significant than any relative valuation bubble the equity market experienced in modern history."* He sees the biggest beneficiaries of a re-convergence to be, *"…small caps, oil and gas, materials, and more broadly stocks with low P/E and P/B ratios."* Those market segments happen to be some of the biggest components of Sabrient's various portfolios over the past year – as you would expect to see from a valuation-driven GARP strategy in a growing economy.

This supports our own observations and reinforces our optimism that we may see significant outperformance once investor preferences re-rationalize. And ever since the Fed reverted to a dovish stance and optimism rose about trade negotiations, investors have shown periodic signs of readiness for a risk-on rotation. Of course, the recent turn of events with China may have halted that sentiment, but it may well be only temporary, given China's increasingly tenuous situation.

As a reminder, we don't *force* cyclicals and small caps to be in our GARP portfolios, but rather the model identifies stocks that are expected to achieve solid earnings growth while still selling at an attractive price – and most of those tend to come from the cyclical sectors *when we are enjoying a growing economy*. (If on the other hand the economic and earnings outlook was weak, we would expect the model to prefer defensive companies with stable earnings streams over those with falling earnings.) Our model-driven approach historically has worked pretty well *when fundamentals matter to investors*. But we can't predict irrational investor behavior (such as allowing many companies with solid earnings expectations to fall to mid-single-digit forward P/E ratios), which has been more common over the past 4 years – ever since mid-2015 when the last presidential campaign began and which also coincided with the Fed signaling intentions to tighten. However, the Fed recently moved firmly back in the dovish camp, and whenever there has been any encouraging news about trade negotiations, investors have displayed signs of readiness for a risk-on rotation.

Observations on terminating July and August 2018 Baker's Dozen portfolios:

The **July 2018 Baker's Dozen** is nearing termination in late August, while the **August Baker's Dozen** terminates in late September. The July portfolio launched with a <u>92% allocation to cyclical sectors</u> Industrials (23%), Financials (15%), Energy (15%), Materials (15.4%), Consumer Discretionary (15%), and Technology (8%) and with a <u>92% allocation to small-mid caps</u> (vs. the S&P 500 benchmark being 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), but the market's Value factor has greatly underperformed the Growth factor, and the July portfolio carried only a <u>28% allocation to the Growth factor</u> (vs. the benchmark's 59%). Similarly, the August portfolio launched with <u>92% allocation to cyclical sectors</u> Industrials (30%), Energy (23%), Materials (15%), Technology (15%), and Financials (8%), a <u>77% allocation to small-mid caps</u>, and a <u>23% allocation to the Growth factor</u>. Although the specific holdings might vary, all these numbers are generally representative of the allocations in all of our portfolios since last summer, as cyclicals tend to show the strongest growth in a strong economy, and large caps are largely "bid up," according to our model.

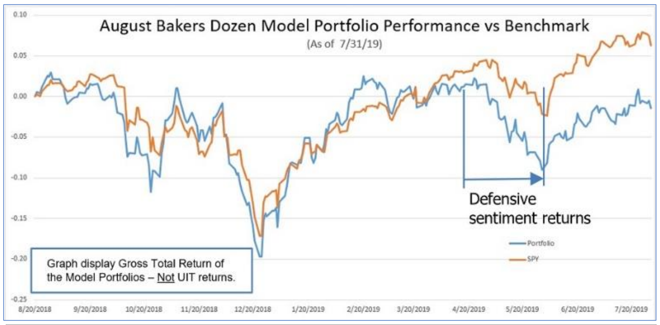
However, every single one of these allocation "tilts" is essentially the opposite of the cap-weighted S&P 500 benchmark's composition (sectors, market caps, value/growth ratio), and they have hurt our relative performance during this historic relative-valuation divergence for approximately 15 of the past 18 months. However, we believe (like JP Morgan) that all these tilts represent areas in which an investor should want to be positioned for a convergence or mean reversion, i.e., when the relative valuation bubble eventually corrects.

The performance chart to the right for the **July 2018 Baker's Dozen** shows that the portfolio could never quite get traction after a bad start into the teeth of the summer 2018 market bifurcation, although it came close to matching the benchmark return by the end of February – at the tail end of the risk-on recovery rally off the Christmas Eve "capitulation" day – until investor caution returned.

Looking at the individual holdings, not surprisingly, the worst performers were from industrial segments like oil & gas, steel, trucking and construction equipment, while the best performers were from pharma, mortgage, semiconductors, comm services, and homebuilding, as shown in the table. Although many of our portfolios have seen holdings meet or exceed expectations and yet still sell off (guilt by association with their respective industries), that was not so much the case with this portfolio as all the underperforming names missed their earnings estimates, largely due to a slowing in the global economy as a result of the trade war. An example is Steel Dynamics (STLD), which is down 37% in share price. It was expected to achieve 105% EPS growth over the past year but so far is on target to achieve only 30% EPS growth, and looking forward, it is expected to have 39% *lower* earnings from trade war impacts. (But I thought domestic steel companies were supposed to benefit from tariffs on imported steel!)

Ticker	Company Name	Return since Launch	Fwd P/E at Launch	Current Fwd P/E	Next 12 months (NTM) Expected EPS Growth at Launch	Combination of Actuals + Remaining Expected EPS Growth Since Launch
HZNP	Horizon Therapeutics Public Limited	58.0%	9.8	14.9	78.9%	99.1%
NMIH	NMI Holdings, Inc.	39.5%	11.6	10.0	95.5%	78.4%
MLNX	Mellanox Technologies, Ltd.	30.5%	16.5	16.4	33.3%	55.9%
NXST	Nexstar Media Group, Inc.	27.2%	9.5	13.8	82.2%	59.8%
PHM	PulteGroup, Inc.	4.5%	9.3	9.3	34.4%	21.8%
COP	ConocoPhillips	-21.3%	14.8	13.3	176.2%	69.2%
WNC	Wabash National Corporation	-22.3%	9.4	9.3	59.2%	2.0%
VBTX	Veritex Holdings, Inc.	-25.9%	17.0	9.7	69.7%	61.7%
HFC	HollyFrontier Corporation	-28.1%	11.6	10.6	89.2%	71.2%
MRC	MRC Global Inc.	-35.4%	21.8	14.0	297.0%	51.2%
STLD	Steel Dynamics, Inc.	-37.6%	8.2	10.0	104.8%	29.5%
TEX	Terex Corporation	-38.0%	13.9	7.8	66.9%	38.6%
CLR	Continental Resources, Inc.	-49.2%	17.9	12.5	191.7%	36.6%
	Average	**-7.5%**	**13.2**	**11.7**	**106.1%**	**51.9%**
SPY	SPDR S&P 500 ETF Trust	7.1%				

The portfolio's four top performers are biopharma Horizon Therapeutics (HZNP), private mortgage insurer NMI Holdings (NMIH), and Nexstar Media Group (NXST), Mellanox (MLNX), which specializes in Ethernet adaptors and is being acquired by NVIDIA Corp, and Nexstar Media (NXST), an operator of TV stations around the country and benefiting from political advertising. Most of them have come close to or topped earnings estimates, and two of them (HZNP and NXST) have seen their forward P/E multiple expand considerably. Although the aggregate forward P/E is even lower (more attractive) today, the aggregate earnings growth fell far short of estimates.



Ticker	Company Name	Return since Launch	Fwd P/E at Launch	Current Fwd P/E	Next 12 months (NTM) Expected EPS Growth at Launch	Combination of Actuals + Remaining Expected EPS Growth Since Launch
MLNX	Mellanox Technologies, Ltd.	37.5%	15.9	16.4	33.3%	55.9%
TRV	The Travelers Companies, Inc.	12.8%	11.9	13.2	46.4%	27.6%
KNX	Knight-Swift Transportation Holdings	6.8%	13.4	15.2	39.2%	53.1%
CVX	Chevron Corporation	4.7%	13.5	15.4	66.8%	45.3%
POST	Post Holdings, Inc.	0.4%	18.8	20.3	34.6%	20.1%
PWR	Quanta Services, Inc.	-1.3%	11.3	9.8	46.0%	50.2%
ALSN	Allison Transmission Holdings, Inc.	-9.0%	8.7	8.2	43.4%	51.4%
SPR	Spirit AeroSystems Holdings, Inc.	-13.8%	12.1	10.3	34.4%	30.7%
KEM	KEMET Corporation	-16.0%	8.9	7.2	31.7%	93.4%
MOS	The Mosaic Company	-22.5%	15.3	14.1	41.0%	38.0%
HFC	HollyFrontier Corporation	-27.8%	10.3	10.6	63.6%	71.2%
UFS	Domtar Corporation	-26.8%	10.7	13.6	48.3%	59.9%
CNQ	Canadian Natural Resources Limited	-27.7%	11.3	11.6	64.6%	2.9%
	Average	**-6.4%**	**12.5**	**12.8**	**45.6%**	**46.1%**
SPY	SPDR S&P 500 ETF Trust	4.8%				

Moving to the **August 2018 Baker's Dozen**, the performance chart to the left shows that the portfolio started late enough in the summer to avoid much of the market bifurcation and was starting to break away from the benchmark by the end of February during the risk-on recovery rally, until the defensive sentiment returned.

Looking at the individual holdings, once again the worst performers were mostly energy, materials, and industrials companies. Although we indeed had some names that badly missed their projected earnings estimates, some of them met or exceeded expectations and yet still sold off. For example, Domtar Corp (UFS), a paper & packaging company from Materials sector, has fallen 27% even though it is on target to achieve 60% EPS growth versus initial expectations of 48%. But its estimates for the next 12 months are significantly lower, which has hurt the share price. On the other hand, Spirit AeroSystems (SPR) has fallen 14% in price and its forward P/E is down 15% even though it came close to hitting expectations and is projected to grow EPS further over the next 12 months.

The top performers are Mellanox (MLNX), which again is being acquired by NVIDIA, and The Travelers (TRV), a property & casualty insurer.

Overall, the aggregate forward P/E multiples of the July and August portfolios are as good or better today than they were at launch, with several of the holdings displaying a single-digit forward P/E as cautious investors avoid them. Our model-driven approach simply seeks quality companies with strong growth expectations selling at a reasonable price, but it can't predict investor behavior. Many of the names continue to display sufficiently attractive GARP properties to make them eligible for new portfolios.

Reasons for Optimism:

In summary, US economic and employment data remains solid, consumer confidence is near record highs, the Fed has followed through on its dovish stance, Q2 corporate profits have been coming in better than expected, and it appears China is destined to absorb the brunt of the trade war fallout as it resists any pressure to renounce its longstanding but wholly unethical business practices. We enjoy low interest rates with nary a whiff of inflation (in any developed market), a strong US dollar, and a preference among global investors for US assets. In addition, there is plenty of global liquidity with all central banks dovish once again, plus stockpiles of cash and an overbought bond market, all of which can fuel quite an equity rally if much of it rotates into US equities.

My view is that, much like the May pullback, the early-August volatility provided yet another buy-the-dip opportunity for new highs ahead. The persistent investor preference for defensive sectors and mega-caps – at the expense of cyclical sectors and small-mid caps – as well as US Treasuries, which has caused yields to plunge (and a 3-mo/10-yr yield curve inversion), has been driven by geopolitical uncertainty rather than hard data and a desperate desire among global investors for yield – which they have found in US Treasuries and in solid dividend-paying defensive stocks. This has driven up valuation multiples in defensive stocks and created a historically large relative-valuation divergence between low-volatility/defensives and value/cyclicals, setting up a potentially strong risk-on rally – given a strong catalyst like a resolution to the trade war – led by small-mid caps and cyclical sectors.

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.