Sabrient *Baker's Dozen* – June 2019 Commentary (as of 6/10/2019)
Scott Martindale, President, Sabrient Systems, LLC

It was exactly one year ago that President Trump escalated the trade war with China from simple threats of tariffs to actual numbers and dates, which ignited a risk-off rotation and a starkly bifurcated market, as the S&P 500 large-cap index continued to rise on the backs of defensive sectors and a handful of mega-cap Tech names while risk-on cyclical sectors and small-mid caps sold off. The big oversold risk-on recovery following a fear-driven Q4 selloff (culminating in a Christmas Eve "capitulation day") leveled off in March as global uncertainty started to set in once again. And then a full-on defensive rotation commenced on 4/16/19, as global capital rotated into US Treasuries and "bond proxies" (like low-but-stable-growth defensive sectors Utilities, Staples, and REITs) at the expense of growth-oriented cyclicals and small caps (despite their highly attractive forward valuations and strong growth outlooks). Although the S&P 500 was able to rise a bit further and achieve a new all-time high despite the defensive rotation, the complete breakdown in trade negotiations last month created another risk-off market bifurcation reminiscent of last summer.

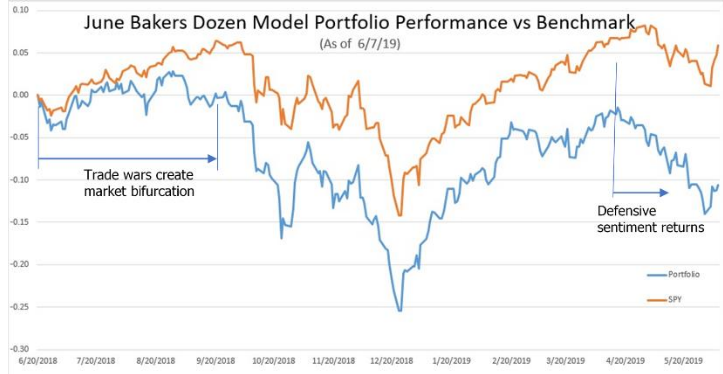
The problem of China flouting accepted international trade practices that are incumbent upon a member of the WTO (China has been a member since 2001) has been festering for a long time, and to his credit, President Trump decided he wasn't going to continue the usual practice of kicking the can down the road to a future administration. China clearly (and dangerously) is intent on challenging the US for global dominance – economically, technologically, and militarily – with its powerful brand of state-sponsored capitalism. I personally support the cause against China's unfair practices, given the enormous importance for our nation's future – even though the persistent risk-off sentiment the trade war has created (essentially 9 of the past 12 months) has been challenging for Sabrient's growth-and-valuation-driven portfolios (which are dominated by the neglected cyclical sectors and smaller caps), as the negative news stream creates a disconnect between investor preferences and analyst consensus earnings estimates (which reflect an implicit assumption that the trade wars would be solved by now as its in no one's interest to escalate it. Fund flows instead suggest strong demand for low-volatility and momentum strategies as well as fixed income (tilted to shorter maturities and higher credit quality), and the 10-year TIPS breakeven inflation rate has fallen to 1.73% (as worries of *deflation* have set in). It's as if investors are expecting analysts to begin slashing estimates at any moment as the economy spirals into recession.

History suggests that although valuations can become disconnected from fundamentals for stretches of time (whether too exuberant or too pessimistic), share prices *eventually* do reflect fundamentals. And despite periods of fear-driven market behavior over the past 10+ years that Sabrient has been publishing a Baker's Dozen top picks list, like mid-2011 (European sovereign debt crisis), 2H2015 (China weakness and currency devaluation leading to narrow breadth and "FAANG" or nothing), and 2H2018 (trade wars and Fed "autopilot" tightening leading to risk-off defensive rotation), we at Sabrient continue to stick to our belief that active selection based on a disciplined growth-at-a-reasonable-price (GARP) investing approach is timeless and tends to outperform passive market benchmarks *when fundamentals matter to investors*, i.e., when investor preferences are aligned with analyst estimates and the most attractive valuations (which happens most of the time). But in this extended period of global and domestic uncertainty, all eyes remain on the trade negotiations, as well as the Fed's reactions to it, rather than the still-solid fundamentals, due to the far-reaching global impacts. I thought domestic steel companies were supposed to benefit from the tariffs on imported steel, but instead, those stocks at the end of May had sunk nearly to the December lows and single-digit forward P/E ratios – witness the SLX steel ETF, *down about -20%* since the beginning of 2018 (and at an 8.6x forward P/E today, versus 14.2x at the start of 2018 in anticipation of surging corporate capex and infrastructure spending) despite solid financial results and little change in forward estimates, versus the S&P 500, which is *up +10%* over the same timeframe (30 pps differential!).

In response to the recession fears and rampant defensive sentiment, the FOMC felt compelled to issue a highly accommodative statement that essentially said, *we got your back*, which turned around the fading stock market. Fed chairman Jay Powell asserted that the trade war is on the list of the committee's concerns and that the central bank would "act as appropriate to sustain the expansion," i.e., cut interest rates if necessary. This explicitly reestablished the proverbial "Fed put" as a market backstop, and investors liked it. We already are seeing a somewhat weaker dollar, which could be a further boost to US equities (especially those that sell internationally).

Today, China faces a difficult Catch-22. On the one hand, with its economy weakening materially, forcing it to reinstitute stimulus (and debt, which was already sky-high), it can ill-afford to absorb the pain of fighting this trade war much longer, no matter what the bluster from their official press seems to suggest. But on the other hand, giving up its long-standing unfair advantages may be nearly as destructive, given its reliance on forced (contractual) technology transfer, cyber espionage, physical theft, counterfeiting, piracy, and the blatant disregard of IP rights (not to mention massive state subsidies) to power its incredible growth (e.g., Huawei). A White House whitepaper last year put estimates of the cost to the US from IP theft alone at as much as $540 billion per year. But ultimately, I think the writing is on the wall for China, and it will soon need to make some commitments – although enforcement will be difficult.

After a promising start to the year when investors snapped up bargains in cyclical sectors and small-mid caps, the biggest laggards recently (at least until the big rally during the first week of June) were those risk-on market segments like steel, semiconductors, transports, materials, and energy, as a trade deal became less of a sure thing. Notably, small caps trailed the pack even during the rally to start June. The general risk-off rotation has driven capital into the relative safety of US Treasuries, defensive sectors, and reliable dividend payers like Utilities and REITs, leading to sky-high valuations in low-growth risk-off market segments and head-scratchingly low valuations in those risk-on segments. Typically, holding small-mid caps and cyclicals displaying strong growth forecasts, solid earnings quality, and attractive forward valuations is a profitable approach, especially in a growing economy with low interest rates. But, except for a few months of an oversold rally in Q1, it sure hasn't worked very well for most of the past 12 months, ever since the escalation in the trade war.



For example, the **June 2018 *Baker's Dozen* portfolio**, which is nearing termination next month, launched just days after the start of the defensive rotation and resulting 6/11/18-9/20/18 period of market bifurcation, as illustrated in the accompanying chart. But after nicely outperforming during the risk-on recovery rally from Christmas Eve through February, global uncertainty started to set in once again, and then a full-on defensive rotation commenced on 4/16/19, as described earlier. The top performers are from Financial and Communications Services sectors, including private mortgage insurer NMI Holdings (NMIH), television broadcaster Nexstar Media (NXST), and insurance carrier The Travelers Companies (TRV). On the other hand, the worst performers are small and mid-cap stocks from the cyclical Industrials and Materials sectors, plus one large cap Semiconductor company. They include small trucking company ArcBest (ARCB), steel products companies Steel Dynamics (STLD) and Commercial Metals (CMC), and renowned semiconductor memory manufacturer Micron Technology (MU).

Ticker	Company Name	Original Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
ARCB	ArcBest Corporation	16.7	7.8	52.2%	100.0%
CMA	Comerica Incorporated	13.4	8.5	35.1%	48.7%
CMC	Commercial Metals	12.2	6.4	96.5%	55.2%
COG	Cabot Oil & Gas	18.8	13.0	103.8%	167.7%
COP	ConocoPhillips	15.9	12.8	145.1%	167.8%
MRC	MRC Global Inc.	20.0	16.1	292.2%	128.9%
MU	Micron Technology	4.9	9.3	33.9%	27.5%
NGHC	National General	11.8	8.9	86.2%	80.8%
NMIH	NMI Holdings, Inc.	10.6	11.8	90.7%	118.6%
NXST	Nexstar Media Group	9.4	15.3	82.2%	104.2%
OLN	Olin Corporation	12.7	11.8	157.4%	119.9%
STLD	Steel Dynamics	8.6	7.7	98.2%	95.0%
TRV	The Travelers Companies	11.6	13.1	44.9%	23.0%
	Average	**12.8**	**11.0**	**101.4%**	**95.2%**

Let's examine the fundamental expectations of the portfolio holdings upon launch one year ago versus how things actually played out. The accompanying table shows the improved forward valuations and actual earnings growth achieved versus the projections. Although some fell short, others handily beat expectations. Overall, the aggregate forward P/E of the portfolio *fell* -14% even though EPS came in within 6% of expectations. Notably, ARCB has been one of the worst performers, with price down more than -40% and forward P/E falling -53%. But if you look at its actual EPS performance, it almost doubled its expectations at +100%. How to make sense of that? On the other hand, TRV is one of the better performers, and yet it fell far short of its expected EPS growth. As we have often seen over the past year, performance can have much more to do with a stock's sector than its actual performance and outlook. Witness the lofty valuations in defensive dividend-paying sectors like Utilities and Consumer Staples. Homebuilders are one cyclical market segment that has bucked the negative trend. In general it struggled last year (after strong performance in 2017) as rising interest rates and higher material prices made investors cautious, but we saw no demand problem with housing, only a lack of affordable supply, which seems to be correcting as mortgage rates retreat while wages rise and millennials come into the market. Although the June 2018 portfolio does not have a homebuilder, many others do, including the terminating May 2018 Baker's Dozen, which holds PulteGroup (PHM).

Overall, the aggregate forward valuation of the June portfolio is even more attractive today, with many of the holdings now displaying a single-digit forward P/E as fearful investors ignore them. Our model-driven approach simply seeks quality companies with strong growth expectations selling at a reasonable price, but it can't predict irrational investor behavior. Many of the names continue to display sufficiently attractive forward GARP properties to make them eligible for new portfolios.

In closing, the strong bounce to kick off June was quite impressive, posting the best week (+4.5%) since November (led by the highly cyclical Materials sector, +9%), and providing a powerful technical signal. Nevertheless, it seems to me that equity investors have been fearful of both the consequences of a prolonged trade war as well as missing a rally (aka FOMO) on a sudden trade deal, as there has been a strong preference for large and mega caps (except those with the heaviest international revenue exposure), defensive sectors, and reliable dividend payers/growers, over small-mid caps and cyclical sectors – much like the summer of 2018, right after the trade war had escalated from tariff threats to actual numbers and dates. As an example, Utilities (e.g., the XLU) and REITs (e.g., the XLRE) are at all-time highs, having been bought up for their stable and stout dividend yields in a low interest rate environment.

My view is that the May pullback was another buy-the-dip opportunity for new highs ahead, as the latest defensive rotation, including shunning of cyclical sectors, relative weakness in small caps, and global capital flight into Treasuries causing plunging yields (and a 3-mo/10-yr yield curve inversion), has been driven by uncertainty rather than hard data. A healthy economy helps corporate earnings, while a dovish Fed keeps rates low and supports equity valuations, and an end to the trade war would provide a more predictable environment for corporate investment and steady earnings growth. Thus, I believe stocks are poised for a major risk-on rotation – led by small-mid caps and cyclical sectors – once the fog has lifted and investor preferences again align with the solid fundamentals.