Sabrient Commentary – October 2019 (as of 10/15/2019)
Scott Martindale, President, Sabrient Systems, LLC

The early weeks of September (actually, starting on August 28) were looking quite promising as a brief but impressive surge gave hope of a revival in the long-neglected risk-on market segments. This sustained risk-on rotation seemed to be marking a bullish change of market character from the risk-off defensive sentiment that I have been writing about extensively for the past 18 months (ever since the China trade war escalated in June of last year), specifically the massive divergence favoring the low-volatility, growth, and momentum factors, "bond-proxy" (solid dividend-paying) defensive sectors, and large caps over the value and high-beta factors, cyclical sectors, and small-mid caps. But then, for the next few weeks, those risk-on market segments were once again lagging, as fickle investors have kept returning to stocks displaying stronger balance sheets, high dividend yields, and/or secular growth stories – in spite of high valuations – rather than the more speculative cyclical growth stocks selling at attractive valuations that typically lead an upside breakout. It appeared that the fledgling bullish rotation was caput – or then again, perhaps not. Over the past several days, there were positive developments in the China trade negotiations and in the Brexit saga, bringing renewed signs of a pent-up desire to take the market higher. A better-than-expected Q3 earnings season may be the final catalyst needed.

Although YTD returns in US stocks are impressive, if you look back over the past year to when the major indexes peaked in 3Q2018, stocks really have made very little headway. As of the close on Tuesday 10/15, the S&P 500 is +21.3% YTD but only +1.7% since its 2018 high on 9/20/18, while the more speculative Russell 2000 small cap index is still more than -12% below its all-time high from over a year ago – way back on 8/31/18. The biggest difference this year versus the 9/20/18 high for the S&P 500 is that Treasury yields have fallen (from around 3.1% to about 1.8% on the 10-year), which has allowed for P/E multiple expansion (from 16.8x last year to 17.2x today) despite the earnings recession of the past three quarters.

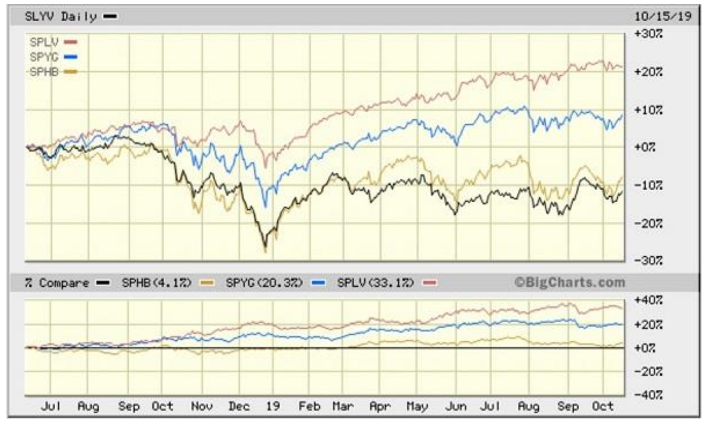
I suppose one can hardly blame investors for their trepidation given the overabundance of extremely negative news, which only expanded during Q3. We have an intractable trade war with the world's second largest economy, intensifying protectionist rhetoric, North Korean missiles, rising tensions with Iran, a brewing war in northern Syria, drone attacks in Saudi Arabia, riots in Hong Kong, China's feud with the NBA (and the animated TV show South Park!), a slowing global economy, a US corporate earnings recession, flattish yield curve, surging US dollar, low-yield/high-volatility Treasury bonds, falling consumer sentiment, Business Roundtable's CEO Economic Outlook Index down six consecutive quarters (as hiring is strong but capital investment and sales expectations lag), the steepest contraction in the manufacturing sector since June 2009, UAW strike against General Motors (GM), looming Hard Brexit, top-polling Democratic candidates espousing Modern Monetary Theory (MMT) and business-unfriendly policies, and yet another frantic attempt to impeach the President before the next election. Need I go on?

But somehow stocks have held their ground given a persistent economic expansion, supported by a dovish Federal Reserve and a rock-solid US consumer. Indeed, the very fact that stocks have held up amid such a negative macro environment suggests to me that investors are just itching for a reason to rotate cash and pricey bonds into stocks – perhaps in a big way. And from a technical standpoint, such a long sideways consolidation over the past several months suggests that an upside breakout may be imminent – and likely led by those risk-on market segments, in my view. *Notably, every such bullish rotation this year has helped many of Sabrient's various growth-at-a-reasonable-price (GARP) portfolios gain ground against their benchmarks.*

As Q3 corporate earnings season is now underway, investors will be closely watching for clues on margin compression, capital spending, and forward guidance. But unless we start to see companies cutting jobs (such as due to surging wages and falling margins), the US consumer appears to be in fine shape, serving as a sound foundation for economic growth. Moreover, the highly cyclical semiconductor and homebuilding industries are on fire, with iShares PHLX Semiconductor ETF (SOXX) setting a new high, and Treasury yields are creeping up.

I have been talking a lot about the huge performance divergence that has been building since 6/11/18 (when the trade war escalated big-league) between the low-volatility, growth, and momentum factors, defensive sectors, and large caps over the value and high-beta factors, cyclical sectors, and small-mid caps. Historically, because value stocks tend to be cyclical and capital intensive (e.g., airlines, semiconductors, homebuilders, industrial equipment makers, and the banks that support those industries), the value factor has tended to outperform during risk-on recovery periods but also tends to lag during economic slowdowns. As such, value companies typically perform better when the economy is growing and the yield curve is steepening. But because of the pervasive uncertainty, investors have preferred to play the momentum and growth factors focused on *secular* growth stories in the Technology sector (rather than *cyclical* growth), as well as solid dividend-paying "bond proxies" like Utilities and Consumer Staples stocks with robust balance sheets.

As shown in the chart on the right, SPDR S&P 600 Small Cap Value (SLYV) is down -11% since 6/11/18 through 10/15/19, versus Invesco S&P 500 Low Volatility (SPLV) up about +21%, which is approximately -32 percentage points (pps) underperformance of small cap value, with a handful of risk-on rally attempts ever since the Christmas Eve capitulation day. Also shown for comparison are SPDR S&P 500 Growth (SPYG) and the more-speculative Invesco S&P 500 High Beta (SPHB).

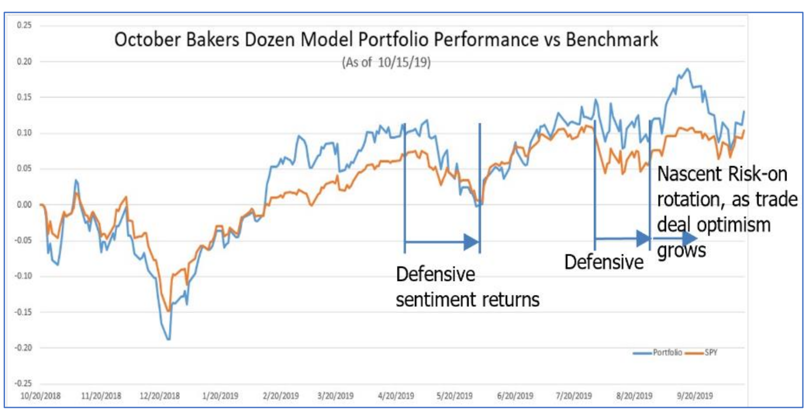


But the next chart focuses on recent price action since 8/27/19. You can see that SLYV and SPHB led the charge, greatly outperforming SPYG and SPLV by as much as 13 pps through mid-September. Although they gave some back, the past several days have again seen them making a strong attempt to pull away to the upside, primarily at the expense of low-volatility SPLV.

Indeed, despite all the doom-and-gloom propagating the airwaves, which seems bound-and-determined (whether intentional or not) into creating a US recession through self-fulfilling prophesy, I think investors should cheer up. The US economy remains solid, as the weak manufacturing segment is only about 10% of the overall economy, while the consumer remains quite strong, interest rates and debt carrying costs are low, credit spreads are tight, and the sell-side analyst community still forecasts rising corporate revenues and positive earnings growth resuming in Q4 and beyond.

And despite low yields and a flattish yield curve (distorted by massive global capital inflows), both of which historically indicate impending recession, the reality is that recessions are usually preceded by widening credit spreads, spiking oil prices, rising interest rates from a hawkish Fed (to suppress inflation and an overheated economy), none of which are in play right now – or even in the foreseeable future. I still believe we have at least a few years left in this cycle. And with plenty of idle cash on the sidelines, additional capital rotating out of pricey bonds, and with hedge funds and individual investors under-allocated to equities, I believe there is plenty of fuel for an upside breakout in Q4.

As for the **October 2018 *Baker's Dozen*** portfolio, which is coming up on one year since launch, it has outperformed the S&P 500 through 10/15/19, and in early September during that nascent risk-on rotation, it really started to pull away to the upside, before giving it all back. But now it seems to be trying again to break out, as shown in the chart.



The portfolio launched with an overweight 31% allocation (versus only 17% in the benchmark S&P 500) to three highly cyclical sectors of Energy (15.4% vs. 5.3%), Industrials (7.7% vs. 9.2%), and Materials (7.7% vs. 2.7%); an overweight in value/cyclical Financial sector (30.8% vs. 13.3%) and an underweight in Technology (15.4% vs. 24.0%). 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 most of our portfolios, 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.

The portfolio launched just several weeks after the S&P 500 peaked and before the big 4Q18 selloff. Although it made up significant ground against the benchmark during the post-Christmas Eve recovery rally through 3/1/19, gaining +35.1% 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 promising.

Looking at the individual holdings through 10/15/19, the portfolio has benefited from one breakaway position in Lattice Semiconductor (LSCC) at +158%. Other top performers so far are biopharma Horizon Therapeutics (HZNP) at +48%, private mortgage insurer NMI Holdings (NMIH), +45%, which has benefited from the resurgence in housing, and TV station operator Nexstar Media (NXST), +24%, which benefits from political advertising. All four have topped earnings estimates, and three of them have seen their forward P/E multiples expand considerably. The actual aggregate earnings growth of the overall portfolio so far has hit pretty close to the combined estimate upon launch, and the aggregate forward P/E has been rewarded with about 40% expansion.

Ticker	Company Name	Return	Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
LSCC	Lattice Semiconductor Corporation	158.2%	17.7	31.0	121.0%	125.0%
HZNP	Horizon Therapeutics Public Limited	47.9%	9.7	15.0	85.8%	99.1%
NMIH	NMI Holdings, Inc.	45.5%	10.4	10.1	64.0%	78.4%
NXST	Nexstar Media Group, Inc.	24.2%	9.5	69.4	53.3%	59.8%
TRV	The Travelers Companies, Inc.	13.7%	11.7	12.8	43.9%	27.6%
LTXB	LegacyTexas Financial Group, Inc.	8.2%	12.4	13.6	26.6%	6.9%
POST	Post Holdings, Inc.	4.8%	18.2	20.7	34.2%	20.1%
AIR	AAR Corp.	-6.5%	16.0	15.3	45.5%	34.9%
HFC	HollyFrontier Corporation	-13.4%	9.9	11.1	69.1%	71.2%
IIVI	II-VI Incorporated	-16.8%	16.2	12.1	64.2%	70.7%
SIVB	SVB Financial Group	-26.6%	15.0	10.5	39.5%	56.3%
MOS	The Mosaic Company	-39.2%	14.6	16.9	64.3%	38.0%
EOG	EOG Resources, Inc.	-41.1%	17.8	13.8	93.9%	59.6%
	Average	**12.2%**	**13.8**	**19.4**	**62.0%**	**57.5%**
SPY	SPDR S&P 500 ETF Trust	10.5%				

Nevertheless, several of the names now have lowered (or even negative) EPS growth expectations for the next 12 months, which has held back performance. While the best performers are from Technology, Healthcare, and Consumer sectors (including consumer finance, media, and insurance), the worst performers are from cyclical industries in Energy, Materials, Industrial, and Banking. Those laggards include oil & gas firm EOG Resources (EOG), -43%, fertilizer maker Mosaic (MOS), -41%, regional bank SVB Financial (SIVB), -27%, and refiner/marketer HollyFrontier (HFC), -13%, along with scientific device maker II-VI (IIVI), -17%. *Note that all five made up a lot of ground against the SPY benchmark during the first couple of weeks of the risk-on rally into the cyclicals sectors that started on 8/27,* although more recently EOG and IIVI have pulled back again. Also worth noting, the three best performers (LSCC, HZNP, NMIH) happen to be the only ones classified (by First Trust's definition) as *Growth* stocks, while the other ten are all considered *Value* stocks.

Many of our portfolios over the past 18 months 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 October 2018 portfolio, SIVB has fallen 27% and its forward P/E has compressed 29% even though it is on target to achieve 56% EPS growth versus initial expectations of 40%, as guidance has been reduced significantly. Nevertheless, some of the names in this portfolio continue to display sufficiently attractive GARP properties to make them eligible for new portfolios, including LSCC, NMIH, and TRV.

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.

Disclaimer: The information contained herein is based on sources believed to be reliable, but no warranty or representation of any kind, expressed or implied, is made as to its accuracy, completeness, or correctness. This document is for information purposes only and should not be used as the basis for any investment decision. Sabrient disclaims liability for damages of any sort (including lost profits) arising out of the use of or inability to use this document. This information is neither a solicitation to buy nor an offer to sell securities, and it is not intended as personalized investment advice. Information contained herein reflects our judgment or interpretation at the time of publication and is subject to change without notice. Past performance is no guarantee of future results. Investment returns will fluctuate, and principal value may either rise or fall.