Sabrient Commentary – April 2022 (as of 4/13/2022)
Scott Martindale, President & CEO, Sabrient Systems, LLC

Key talking points this month include:

1. Sabrient Systems and subsidiary Gradient Analytics form a **unique collaboration of engineers and forensic accountants** who leverage quantitative models, a **process-driven approach**, and expertise in financial statement analysis.
2. Our portfolios displayed consistently strong performance in 2009–2014, but then market became narrow/news-driven, causing **historic divergences in Growth/Value and Large/Small caps.** But the divergences have shown **notable mean reversion** recently.
3. Sabrient continually implements **process enhancements** to make our *Growth at a Reasonable Price* (aka GARP) model more all-weather, including adding proprietary new alpha factors: *Earnings Quality Rank (EQR)* and *Growth Quality Rank (GQR)*. Thus, our newer GARP portfolios provide diversified exposure to Value & Growth, cyclical & secular growth, and across market caps.
4. Although **volatility will likely persist, inflation should begin to moderate** later in the year as supply chains and labor markets gradually recover (reducing the excess demand-versus-supply gap), the US dollar remains strong, the Fed reduces monetary accommodation, and disinflationary structural trends resume. War in Ukraine and lockdowns in China have stunted supply chain recovery, and all the Fed can do is depress demand by raising rates and removing liquidity, which is potentially recessionary.
5. **Interest rates should remain low**. Although the 10-year US Treasury yield has spiked above 2.7% due to a "taper tantrum," it is likely to pull back as bond investors add duration. So, the Fed might be at risk of inverting the yield curve with an aggressive tightening policy. I foresee far fewer rate hikes than indicated by the Fed's Dot Plot, and I think the "Fed put" is still alive.
6. **Equity valuations have shrunk**, with forward P/E of S&P 500 at 18.8x and S&P 600 small caps at 13.0x, as prices have fallen while EPS has surged. Strong EPS growth, high profit margins, and low interest rates serve to justify these multiples.
7. Given asset inflation and "malinvestments" from massive global liquidity and pandemic-recovery speculation, we expect **broader market leadership, re-emergence of the Quality factor, performance reversion** in Value/Growth and Small/Large, and *greater share price reliance on earnings growth rather than multiple expansion*.
8. Thus, ***we suggest staying long but hedged,*** with a heightened emphasis on quality and a balance between: 1) value/cyclicals and 2) high-quality secular growers & dividend payers.
9. Stocks outside of Big Tech may offer **better opportunities for investors** due to lower valuations and higher growth rates. Active selection, strategic beta, equal weighting, and the **Quality factor should thrive**, which also should be favorable for Sabrient's ***Baker's Dozen*, Small Cap Growth, Dividend, and Forward Looking Value** portfolios.
10. The **Q4 2020 *Baker's Dozen*** terminated on 1/20/2022 after launching on 10/20/20, and the model portfolio *outperformed* the benchmark by +5.3% (+37.7% vs. +32.4% for the S&P 500). On the other hand, the **Q1 2021 *Baker's Dozen*** will terminate on 4/20/2022, and as of 4/12/2022 the model portfolio is *underperforming* the S&P 500 by -18.6% (-2.5% vs. +16.1%) – although several of the underperforming stocks exceeded estimates with solid guidance and yet still endured severe P/E contraction.
11. Since the process enhancements were implemented in December 2019, **6 of 12** *Baker's Dozen*, **7 of 9** Dividend, and **7 of 8** Small Cap Growth model portfolios have outperformed or stayed even with their benchmarks – despite recent defensive sentiment.
12. Notably, our **Dividend portfolios have held up best** (further illustrating the prevailing value/quality/defensive sentiment). It employs a GARP + Income strategy that seeks quality stocks with a history of raising dividends, a solid coverage ratio, and an aggregate dividend yield approaching 4% or more.
13. The new **Q1 2022 *Baker's Dozen*** launched on 1/20/2022, with equal position weights and a diverse mix of market caps, Value and Growth stocks, and cyclical and secular growth companies. The **Q2 2022 *Baker's Dozen*** launches on 4/20/2022.

Market observations:

Volatility remains elevated, as would be expected given the first war in Europe since WWII, the highest inflation in 40 years, a suddenly hawkish Federal Reserve, and fears of at least one quarter of flat or negative economic growth. On the other hand, Q4 2021 corporate earnings reports were quite strong, and Q1 looks to be solid as well, with FactSet reporting that S&P 500 companies are likely to report EPS growth of more than 10%, which would be the fifth consecutive quarter of YoY earnings growth over 10%. Of course, that's all backward looking, so all ears will be on forward guidance.

Inflation has proven quite persistent as the latest PPI came in at 11.2% and CPI at 8.5% YoY. Surging food and energy prices were the main culprit as supply chains struggle to recover, with the latest obstacles being China's new COVID lockdowns in key manufacturing cities (like Shanghai) and, of course, Russia's vicious annihilation of Ukraine, which is exacerbated by Ukraine's heroic resistance that unfortunately has prolonged the misery and destruction such that there won't be much infrastructure or production left.

Although it would have been better for the global economy in the short run if Ukraine had just surrendered immediately, few people in Ukraine and around the world wanted to see that happen. They valiantly preferred to adopt Patrick Henry's rallying cry, *"Give me liberty, or give me death!"* So, Russian President Putin has decided to oblige the latter – both to save face and to perpetuate his own expansionary ambitions of resurrecting the old USSR – although he has sacrificed many thousands of his own soldiers and turned Russian into a global pariah in the process. Moreover, the destruction of Ukraine and sanctions on Russia will have long-lasting impacts on food and energy supplies for the global economy, as they are major exporters in these categories.

So, as I have been harping, we are enduring *supply-driven* inflation (or "scarcity inflation," as BlackRock calls it). Rather than increasing supply to match demand, all the Fed can do with its monetary policies is depress demand to match supply, and overly aggressive action surely will lead to recession. The Fed has transitioned rather quickly from a complacent view of inflation ("transitory") to an almost panicky stance – and the threat of overly hawkish Fed actions are a bigger worry to me than the sluggish recovery of supply chains at this stage.

Historically, the Federal Reserve simply *not* expanding its balance sheet brought down inflation. Today, we all realize that money supply is bloated, so there has been a great push for the Fed to unwind its balance sheet. But keep in mind, money supply has risen for 25 years even while inflation was *falling* due to a commensurate fall in the *velocity* of money supply – and velocity remains at historic lows today, which dramatically mutes the inflationary impact of the bloated balance sheet. Removing liquidity (particularly US dollars) from the global market is a dicey proposition with wide-ranging (and potentially recessionary) impacts.

So, the Fed has been focusing on yield-curve control and has successfully "talked up" rates without actually having to do much yet. My prediction that 10-year Treasury yields wouldn't rise much above 2.0% for long has proven wrong, at least for the moment, as an investor "taper tantrum" has sold off bonds and pushed the 10-year yield to above 2.7%. I was convinced that global investors would find safe US Treasury yields too juicy to pass up as it rose above 2.0%, and indeed I still think these elevated yields will soon entice investors to add duration to their bond portfolios, and thus bring rates back down.

A flat or inverted yield curve is the bond market's way of signaling that the Fed in fact may be at the terminal fed funds rate and near the *end* of the tightening cycle, not the beginning. And the 10-2 Treasury spread did indeed invert briefly, but now it has steepened back up to around +34 bps as of 4/12/2022. Also, keep an eye on BBB US corporate bond spreads. DataTrek examined them going back to 1997 and found that only when BBB spreads were "consistently below 200 bps does the Fed even consider raising rates." The spread briefly spiked to a worrisome 185 bps in March but has since pulled back to around 152 bps.

Regardless, my view is that the global economy is too leveraged or "financialized" to absorb higher rates – despite the Fed's assertion that it is strong enough to "flourish in the face of less accommodative monetary policy." As relates to the stock market, I believe the "Fed put" is still alive, although hiding in the shadows for now, which means I think the Fed will not end up raising rates nearly as much as the Dot Plot suggests (9 quarter-point hikes this year and 14 by September 2023, or 3.5%).

In fact, all this overarching negativity may suggest from a contrarian perspective that *it is time to go long once again*. Indeed, I believe the major market indexes bottomed in March and are just awaiting an upside catalyst, albeit with ongoing volatility.

Update on the terminating Q1 2021 *Baker's Dozen* portfolio:

The **Q1 2021 *Baker's Dozen*** launched on 1/20/2021 and terminates on 4/20/2022, at which time the new Q2 2022 *Baker's Dozen* will launch. Like all our portfolios, the Q1 2021 portfolio was selected based on Sabrient's *forward-looking* GARP selection approach that relies upon the consensus EPS growth estimates of the sell-side analyst community.

It launched with an overweight allocation (38% vs. 24% in the benchmark) to attractively valued "deep cyclical" sectors (Financial, Industrial, Materials, and Energy), i.e., 5 positions out of 13. Notably, 4 of those 5 positions are the top performers in the portfolio. Also, it approximately matched (38% vs. 40% for the S&P 500) the benchmark weighting for secular growth Technology and Healthcare sectors.

As for Value vs. Growth exposure, the portfolio launched with a 69% allocation (9 of the 13 positions) to the Value factor, versus the benchmark's 40% weight (as the cap-weighted index is dominated by mega-cap Growth stocks).

Lastly, it had a small-cap bias relative to the S&P 500 large cap benchmark, with 3 large, 5 mid, and 5 small caps. Unfortunately, the small caps have been predominantly the worst performers, as small caps in general have badly lagged large and mega caps.

Most of the holdings have lived up to expectations, with 8 of the 13 having exceeded EPS estimates. Nevertheless, most of the names have experienced significant P/E multiple contraction. Over the life of the portfolio so far (1/20/2021-4/12/2022), the gross average return of the Model Portfolio's equal-weighted holdings is **-2.5% versus +16.1%** for the S&P 500 cap-weighted index. The table on the left shows each of the holdings. Top performers include **Louisiana-Pacific (LPX)**, which provides building products for home construction & remodeling; farm and heavy equipment maker **Deere & Company (DE)**; goldminer **Newmont Corp (NEM)**, and reinsurer **Everest Re Group (RE)**.

Q1 2021 Baker's Dozen Portfolio						
Ticker	**Company Name**	**Return**	**Fwd P/E at Launch**	**Current Fwd P/E**	**Est. NTM EPS Growth at Launch**	**Actual EPS Growth**
LPX	Louisiana-Pacific Corporation	57.9%	7.9	4.9	103.1%	219.4%
DE	Deere & Company	41.4%	22.5	17.6	50.8%	64.9%
NEM	Newmont Corporation	35.7%	15.2	25.9	95.2%	11.7%
RE	Everest Re Group, Ltd.	26.2%	11.1	8.7	78.1%	290.5%
DGX	Quest Diagnostics Incorporated	10.3%	10.5	15.1	44.4%	27.6%
KNX	Knight-Swift Transportation Holdings Inc.	5.1%	13.2	8.8	41.2%	72.3%
PHM	PulteGroup, Inc.	-9.2%	8.0	4.1	24.2%	53.1%
CHTR	Charter Communications, Inc.	-14.6%	33.0	17.9	44.7%	56.6%
MTSI	MACOM Technology Solutions Holdings, Inc.	-17.1%	38.4	18.6	69.0%	71.3%
WGO	Winnebago Industries, Inc.	-19.2%	11.8	5.0	64.0%	127.6%
NTGR	NETGEAR, Inc.	-41.3%	12.9	15.5	36.9%	-15.7%
COHU	Cohu, Inc.	-46.8%	18.4	9.5	505.3%	173.5%
EBS	Emergent BioSolutions Inc.	-61.2%	9.8	19.6	89.1%	-23.6%
	Average	**-2.5%**	**16.4**	**13.2**	**95.8%**	**86.9%**
SPY	SPDR S&P 500 ETF Trust	16.1%				

Of course, in a concentrated 13-stock portfolio, one or two breakout winners can offset a few laggards, but in this case, three losers that have badly missed estimates are dragging down the overall return. Worst among them is **Emergent BioSolutions (EBS)**, which provides vaccines and other response products for public health threats. Other underperformers include semiconductor testing equipment maker **Cohu (COHU)** and networking equipment maker **NETGEAR (NTGR)**.

Notably, cable operator **Charter Communications (CHTR)**, RV manufacturer **Winnebago (WGO)**, and analog chipmaker **MACOM Technology Solutions (MTSI)** also underperformed and endured severe P/E contraction, which *seems unwarranted given they exceeded earnings estimates* and display solid forward estimates for this year.

Overview of the Q1 2022 *Baker's Dozen* portfolio:

The latest ***Q1 2022 Baker's Dozen*** launched on 1/20/2022. Its 13 holdings are shown in table below, along with statistics on forward valuation, consensus next-12-months (NTM) EPS growth expectations, forward PEG ratio (P/E divided by EPS growth) and two key scores: Earnings Quality Rank (EQR, 1-5 scale, with 5 the best) and Growth Quality Rank (GQR, 1-10 scale, with 10 the best).

Ticker	Company Name	Sector	Industry	Mkt Cap ($B)	NTM EPS Growth	Fwd PE	Fwd PEG	Div Yield	EQR	GQR
ACGL	Arch Capital Group	Financials	Property and Casualty Insurance	17.7	45.1%	11.0	0.24	0.0%	3	10
ACLS	Axcelis Technologies	Information Technology	Semiconductor Equipment	2.1	64.7%	16.8	0.26	0.0%	5	10
AEL	American Equity Investment Life	Financials	Life and Health Insurance	4.2	51.0%	9.2	0.18	0.8%	3	8
ARCB	ArcBest	Industrials	Trucking	2.3	36.0%	10.2	0.28	0.3%	5	9
CHTR	Charter Communications	Communication Services	Cable and Satellite	104.2	37.3%	19.4	0.52	0.0%	4	7
DAR	Darling Ingredients	Consumer Staples	Agricultural Products	10.8	50.9%	13.0	0.26	0.0%	4	8
DVN	Devon Energy	Energy	Oil & Gas Exploration and Production	33.1	146.2%	9.3	0.06	6.7%	5	9
HRI	Herc Holdings	Industrials	Trading Companies and Distributors	4.7	61.4%	15.3	0.25	1.3%	3	10
KLAC	KLA Corp	Information Technology	Semiconductor Equipment	59.6	35.5%	18.0	0.51	1.0%	4	10
PFE	Pfizer	Health Care	Pharmaceuticals	300.5	56.2%	9.1	0.16	3.0%	4	9
TEX	Terex	Industrials	Construction Machinery and Heavy Trucks	3.0	31.2%	12.0	0.39	1.0%	3	10
TOL	Toll Brothers	Consumer Discretionary	Homebuilding	7.3	53.2%	5.9	0.11	1.1%	4	10
WDC	Western Digital	Information Technology	Technology Hardware, Storage, Peripherals	19.3	32.2%	7.4	0.23	0.0%	3	7
			Average:	43.8	53.9%	12.0	0.22	1.2%	3.8	9.0

The portfolio comprises a diverse mix across market caps, with 4 large caps, 4 mid-caps, and 5 small caps; a Value/Growth mix of 8 value and 5 growth stocks; and a 7/6 split between cyclical and secular growth companies. As for sectors, holdings are quite diversified, including 3 Information Technology names, 3 Industrials, 2 Financials, 1 from Healthcare, 1 Energy, 1 from Consumer Staples, 1 from Consumer Discretionary, and 1 from Communications Services. Some – like Charter Communications (CHTR) and KLC Corp (KLAC) – are familiar names that have appeared in several previous Baker's Dozen portfolios, while others – like semiconductor equipment maker Axcelis Technologies (ACLS) and insurer American Equity Investment Life (AEL) – are new faces.

You can find more detail by downloading the full Holdings report on the *Baker's Dozen* website: https://bakersdozen.sabrient.com/bakers-dozen-marketing-materials. The report describes each of the 13 stock picks in greater detail, including a brief description of each company and what makes them attractive.

Final thoughts:

As a reminder, in response to the "new normal" market conditions characterized by persistently narrow market leadership and Growth/Value and Large/Small performance divergences, Sabrient developed and implemented (in mid-December 2019) **process enhancements** that seek to make our portfolios more "all weather" by reducing volatility relative to the benchmark and allowing companies that display *consistent and reliable earnings growth* to score more competitively in our GARP model, even if they display somewhat higher valuations. The enhanced process allows for exposure to both the *longer-term secular* growth trends and the *shorter-term cyclical* growth opportunities *without sacrificing strong performance potential.*

Up until this latest April pullback in stocks, 22 of Sabrient's 27 model portfolios created since the process enhancements were implemented in December 2019 – and 15 of the 18 live portfolios – were either outperforming or staying even (within 1%) with their benchmark. But with the Consumer Sentiment Index below the 60 threshold and bearish investor sentiment pervasive, market conditions have become challenging for risk assets – particularly growth stocks, small caps, and our growth-at-a-reasonable-price (GARP) portfolios. So, today we see 11 of the 18 live portfolios outperforming or staying even (as of 4/12/22) – with our *Dividend portfolios holding up best*, which further illustrates the prevailing value/quality/defensive sentiment.

The **Sabrient Dividend portfolio** is a GARP + Income strategy that seeks quality stocks with a history of raising dividends, a solid coverage ratio, and an aggregate dividend yield approaching 4% or more. Moreover, it has shown consistently strong performance versus the S&P 500 since our process improvements were implemented in December 2019.

Regardless, we believe Sabrient's portfolios – including the **Q1 2022 *Baker's Dozen*** that launched on 1/20/2022, **Small Cap Growth 33** that launched on 3/4/2022, **Sabrient Dividend 39** that launched on 3/18/2022, and **Q2 2022 *Baker's Dozen*** that will launch on 4/20/2022 – are positioned for any growth scenario.

If indeed the market has put in a bottom – and the Fed refrains from a recessionary policy mistake – ***this may be a great buying opportunity for our portfolios***.

Please be sure to download my accompanying slide deck as well, which is available on the *Baker's Dozen website:* **https://bakersdozen.sabrient.com/bakers-dozen-marketing-materials**. 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 **http://Sabrient.com** homepage.