Sabrient Commentary – December 2021 (as of 12/6/2021)
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 methodology**, and expertise in financial statement analysis.
2. The past several years have brought rancorous politics, social unrest, trade wars, a deadly pandemic, and a reliance on Fed monetary policy, which led to **historic performance divergences** in *Growth over Value* factors and *Large over Small* caps. This created market imbalances, with high valuation multiples in the mega-cap Tech leaders and the major, broad-market, cap-weighted indexes. However, these divergences have shown some notable mean reversion over the past couple of years.
3. Looking ahead, we expect **continued economic expansion** (despite a global slowdown from unrelenting supply chain issues and financial issues in China) as well as continued strong corporate earnings, productivity, and margins, plus ongoing fiscal and monetary policy support, and moderating inflation in 2022 (as supply chain disruptions, temporary bottlenecks, and labor shortages eventually resolve and disinflationary long-term structural trends resume).
4. But for now, investors must grapple with a combination of lofty equity valuations, new COVID variants, China's myriad issues, slower-than-expected recovery in supply chains, and ongoing labor shortages, all of which have combined to create stickier inflationary pressures than expected and unfamiliar uncertainty in Fed monetary policy. So, **elevated volatility should linger.**
5. So, **we suggest staying long *but hedged***, with a balance between 1) value/cyclicals and 2) high-quality secular growers & dividend payers. In addition, we suggest a greater *focus on quality* as the economy moves past the exuberant speculative recovery phase. (Of note: we have created a ***Sabrient Quality Index Series*** comprising 5 broad-market and 5 sector-specific, rules-based, strategic beta and thematic indexes for ETF licensing, which we are pitching to various ETF issuers.)
6. Moreover, we expect broadening leadership and share price *reliance on earnings growth rather than multiple expansion*. 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, and Dividend portfolios.**
7. The **Q4 2020 *Baker's Dozen*** Model Portfolio terminates on 1/20/2022 after 15 months of life. So far, it has outperformed the S&P 500 +40.9% versus +33.9% (gross return as of 12/3/2021), led by a diverse group of 8 positions that have outperformed the benchmark. It launched on 10/20/20 with equal position weights and a bias toward non-cyclical sectors, small caps, and the growth factor, in accordance with our enhanced model.

Market observations:

I have been predicting elevated volatility, and it surely arrived. Given lofty valuations that are based upon ongoing economic recovery and corporate earnings exceeding expectations, any hint of new obstacles – like onerous COVID variants, renewed lockdowns, persistent supply chain disruptions, anemic jobs growth, and unyielding inflationary pressures naturally send fidgety investors to the sell button on their keyboards. And now the Fed has joined the legions of nervous observers by removing the word "transitory" from its inflation description while hastening its timetable for QE tapering and interest rate hikes.

Investors are going to have to regain conviction for the market to achieve new highs. Looking at the SPDR S&P 500 ETF (SPY) chart, technicals suggest a bottoming process at the 450 level, coinciding with the uptrend line and rising 100-day simple moving average (SMA). The 100-day has provided reliable support since the pandemic recovery began, but a long overdue test of support at the 200-day SMA – which hasn't happened in 17 months – might be necessary before a concerted surge in bullish conviction can happen. So, with the next FOMC meeting and policy announcement coming on December 15, stocks may simply remain in a trading range – or even fall a bit further – until the Fed provides a bit more clarity on its intentions.

Despite the recent volatility, stocks are on-track for another stellar year (+22.1% through 12/3/2021), which would be the third year in a row for the S&P 500, following returns of +31.2% in 2019 and +18.4% in 2020. In fact, since the Financial Crisis recovery began in 2009, there has been only one slightly negative year for the S&P 500, which was in 2018 (-4.4%) when sentiment turned defensive primarily due to the trade war with China, leading to the nasty Q4 selloff. But price action since the speculative pandemic recovery launched in March 2020 has been essentially vertical – which of course simply cannot go on forever at such a rate.

Looking ahead, equity valuations remain lofty even after the latest spike in volatility, although they are bolstered by robust corporate earnings growth, massive global liquidity, negative real interest rates, and a lack of good alternatives (aka "TINA") – which should persist unless the Federal Reserve turns overly hawkish to squash the persistent (but still temporary, in my view) inflationary pressures and raise interest rates too aggressively (the classic policy mistake by which all recessions are born). I still expect inflation is on course to moderate in 2022 as supply chains recover, temporary bottlenecks and labor shortages resolve, and disinflationary structural trends resume, e.g., aging demographics, slowing global population growth, accelerating disruptive innovation, automation, rising productivity, and re-globalization of supply chains (albeit with some onshoring of manufacturing to reduce dependency on adversarial countries).

But for now, investors must grapple with a distressing combination of high valuations, new COVID variants, slower-than-expected recovery in supply chains, ongoing labor shortages, and China's growth slowdown, deleveraging of its real estate sector and cracking down on what President Xi sees as "excesses" of free market economics – all of which have combined to create stickier inflationary pressures than expected – and, as a result, unfamiliar uncertainty in what had long been a sure bet, i.e., Fed monetary policy.

So, elevated volatility is likely to linger because, historically, a hawkish Fed has led to lower growth in money supply, tighter financial conditions, slower economic growth, and lower equity multiples. Thus, growth stocks have taken a hit – witness the incredible 42% single-day haircut in powerhouse DocuSign (DOCU) last Friday, as an example. Although I do not see DOCU as the proverbial *canary in the coal mine*, it does serve to reinforce our view that investors should stay long *but hedged*, with a balance between 1) value/cyclicals and 2) high-quality secular growers & dividend payers, and with a greater *focus on quality* as we move past the exuberant speculative recovery phase. Hedges might be found in inverse ETFs, out-of-the-money index put options, gold, and cryptocurrencies. (I am personally holding all these hedges.)

Update on the Q4 2020 *Baker's Dozen* portfolio, which terminates next month:

The **Q4 2020 *Baker's Dozen*** launched on 10/20/2020 and terminates on 1/20/2022, at which time the new Q1 2022 *Baker's Dozen* will launch. Like all our portfolios, the Q4 2020 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. However, unlike most of our prior portfolios that were typically overweight value and cyclical stocks, it launched with a heavily *underweight* allocation (15% vs. 24% in the benchmark) to attractively valued "deep cyclical" sectors (Financial, Industrial, Materials, and Energy), i.e., 2 positions out of 13. This was because companies in these sectors still had relatively poor forward visibility when the portfolio was selected, even though investors were buying them on recovery speculation (rather than sound fundamentals). Instead, the initial portfolio approximately matched (31% vs. 27%) the benchmark weighting in the Information Technology sector and was overweight both Healthcare (23% vs. 13%) and Communications Services (15 vs. 11%). As for value vs. growth exposure, the portfolio launched with a 69% allocation (9 of the 13 positions) to the *growth* factor, which approximately matches the benchmark's 60%. Lastly, it had a small-cap bias relative to the S&P 500 large cap benchmark, with 4 large, 2 mid, and 7 small caps.

Despite challenges arising from the pandemic, most of the holdings have lived up to expectations, with 10 of the 13 beating or coming close to EPS estimates. Over the full life of the portfolio so far (10/20/2020-12/3/2021), **the gross average return of the Model Portfolio's equal-weighted holdings is +40.9% versus +33.9% for the S&P 500 cap-weighted index**. The table on the left shows each holding in the Model Portfolio. Of course, in a concentrated 13-stock portfolio, a few breakout winners can help offset several laggards, and indeed, you can see that the portfolio has 8 positions that have outperformed the benchmark, led by a highly diverse group: **Veeco Instruments (VECO)**, a maker of thin film process equipment for semiconductors and electronic devices (including for data storage and 5G), **Tempur Sealy International (TPX)**, a manufacturer of bedding products (like the Tempur-Pedic brand), **Boise Cascade (BCC)**, which provides lumber and building products for home construction, **Advanced Micro Devices (AMD)**, which makes semiconductors primarily for computing and graphics devices, and **Gray Television (GTN)**, which owns and operates TV stations.

Q4 2020 Baker's Dozen Model Portfolio

Ticker	Company Name	Return	Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
VECO	Veeco Instruments Inc.	107.1%	13.8	17.8	88.8%	97.0%
TPX	Tempur Sealy International, Inc.	91.9%	14.1	12.1	38.8%	88.3%
BCC	Boise Cascade Company	87.3%	10.3	8.9	61.7%	218.9%
AMD	Advanced Micro Devices, Inc.	76.6%	58.0	46.0	64.3%	120.2%
GTN	Gray Television, Inc.	69.0%	4.9	9.6	43.9%	15.2%
OMI	Owens & Minor, Inc.	57.9%	9.4	13.0	295.7%	249.6%
ABBV	AbbVie Inc.	47.8%	7.4	8.7	22.7%	25.6%
APPS	Digital Turbine, Inc.	35.3%	78.1	27.9	66.7%	226.3%
MDC	M.D.C. Holdings, Inc.	13.6%	8.6	5.5	39.7%	75.1%
CHTR	Charter Communications, Inc.	11.7%	37.1	22.7	53.0%	64.8%
GDDY	GoDaddy Inc.	-11.1%	18.6	21.5	32.3%	-15.3%
FDX	FedEx Corporation	-15.3%	18.3	11.7	36.5%	56.2%
QDEL	Quidel Corporation	-40.7%	10.2	16.3	426.6%	118.7%
	Average	**40.9%**	**22.2**	**17.1**	**97.7%**	**103.1%**
SPY	SPDR S&P 500 ETF Trust	33.9%				

The biggest laggard by far has been healthcare diagnostics firm **Quidel Corp (QDEL)**, which not only missed EPS estimates by a country mile but also is expected to show significantly lower earnings over the next 12 months. Other underperformers are air freight & logistics powerhouse **FedEx Corp (FDX)**, web services firm **GoDaddy (GDDY)**, cable operator **Charter Communications (CHTR)**, and homebuilder **M.D.C. Holdings (MDC)**. The three worst performers suffered seemingly unwarranted weakness given that they all beat earnings estimates; however, each are projected to have lower earnings over the next 12 months.

The Q4 2021 *Baker's Dozen* portfolio:

The latest **[Q4 2021 *Baker's Dozen*]** launched on 10/20/2021. 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).

The portfolio comprises a diverse mix across market caps, with 5 large caps, 6 mid-caps, and 2 small caps; and essentially even Value/Growth mix with 7 value and 6 growth stocks. It also has a slightly higher bias toward cyclical sectors Consumer, Financial, Industrial, Materials, and Energy.

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	16.6	38.8%	12.4	0.32	0.0%	5	10
AMAT	Applied Materials	Information Technology	Semiconductor Equipment	121.5	29.6%	16.8	0.57	0.7%	5	10
BLD	TopBuild	Consumer Discretionary	Homebuilding	7.2	31.6%	18.7	0.59	0.0%	5	10
DVN	Devon Energy	Energy	Oil and Gas Exploration and Production	27.3	321.3%	9.8	0.03	1.1%	5	7
FANG	Diamondback Energy	Energy	Oil and Gas Exploration and Production	20.1	120.1%	8.2	0.07	1.6%	3	6
HRI	Herc Holdings	Industrials	Trading Companies and Distributors	5.4	63.2%	20.7	0.33	1.1%	3	10
KLAC	KLA Corp	Information Technology	Semiconductor Equipment	50.5	33.7%	17.1	0.51	1.3%	4	10
MRNA	Moderna	Health Care	Biotechnology	134.7	452.6%	7.5	0.02	0.0%	5	7
NTR	Nutrien	Materials	Fertilizers and Agricultural Chemicals	41.0	140.0%	13.0	0.09	2.6%	4	7
TJX	The TJX Companies	Consumer Discretionary	Apparel Retail	76.8	41.5%	20.2	0.49	1.6%	4	8
TMHC	Taylor Morrison Home	Consumer Discretionary	Homebuilding	3.4	64.0%	4.6	0.07	0.0%	3	9
WLK	Westlake Chemical	Materials	Commodity Chemicals	12.9	75.7%	7.7	0.10	1.2%	5	8
WRK	WestRock	Materials	Paper Packaging	12.9	74.9%	9.6	0.13	2.0%	5	6
			Average:	40.8	114.4%	12.8	0.11	1.0%	4.3	8.3

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 what each company is doing that makes it 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 reduce volatility relative to the benchmark and allow 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.* In addition, Sabrient continues to have the forensic accounting team from subsidiary Gradient Analytics review every candidate for each portfolio.

Thus, we believe Sabrient's portfolios – including the **Q4 2021 *Baker's Dozen* that launched on 10/20/2021, the new Small Cap Growth 32 portfolio that launched on 12/6/2021 (today!), Sabrient Dividend 37 that launched on 9/20/2021, and the upcoming Sabrient Dividend 38 that will launch on 12/20/2021** – are positioned for any growth scenario.

I continue to expect global economic expansion (even if it slows a bit), strong corporate earnings growth, robust capex and share buybacks, ongoing fiscal and monetary policy support, low interest rates, and receding inflationary pressures in 2022. Regardless, keep in mind that inflation doesn't kill economic growth on its own; rather it is rising interest rates (aka borrowing costs), which should not be an issue unless the Fed fumbles the ball.

Market maven Alexander Green made a compelling observation when he wrote, *"The greatest threat to this long-running bull market is not a tightening Fed, higher valuations or moderating corporate profits. It's the growing clamor for regulatory and redistributive policies that will reduce innovation, lessen productivity and undermine the economy."* For my part, I still believe we are in the early stages of a "Roaring '20s redux" from 100 years ago, with only modest inflation and an extended expansionary economic cycle – so long as our political leaders don't screw it up.

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.