Sabrient Commentary – June 2022 (as of 6/3/2022)

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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 the market became narrow/news-driven, causing **historic divergences** in Growth/Value factors and Large/Small caps. But these divergences have shown **notable mean reversion**.
3. Sabrient implemented **process enhancements** in December 2019 to make our *Growth at a Reasonable Price* (aka GARP) model more "all-weather," including adding proprietary new alpha factors: *Earnings Quality Rank (EQRv2)* and *Growth Quality Rank (GQR)*. Thus, our newer GARP portfolios provide diversified exposure to Value & Growth, cyclical & secular growth, and across market caps. We have seen significant improvement in performance relative to the benchmarks across all Sabrient's portfolios.
4. Although the Q1 2021 *Baker's Dozen* terminated on 4/20/2022 with substantial underperformance versus the benchmark, that has proven to be an anomaly. In fact, **18 of our 19 live portfolios are outperforming** their benchmarks (gross total return as of 6/3/2022), despite the market correction and defensive sentiment. These include ***Baker's Dozen*, Dividend, Small Cap Growth, and Forward Looking Value.**
5. Our **Dividend portfolios have performed particularly well** (illustrating a prevailing value/quality/income preference). Rather than a pure income orientation, it employs a GARP + Income strategy that seeks quality stocks displaying a solid growth forecast, a history of raising dividends, a solid coverage ratio, and an aggregate dividend yield approaching 4% or more.
6. The **Q2 2021 *Baker's Dozen*** launched on 4/20/2021 and will terminate on 7/20/2022, and as of 6/3/2022 it is the only underperformer among the 19 live portfolios – albeit only slightly, -0.4% vs. +0.9% for the S&P 500. However, several of the underperforming stocks actually exceeded estimates with solid guidance and yet still endured severe P/E contraction.
7. Although volatility will likely persist, **inflation and the 10-year Treasury yield are showing signs of topping** while supply chains and labor markets recover, the US dollar remains strong, and the Fed reduces monetary accommodation, leading to some demand destruction, slower growth, and reducing the excess demand gap.
8. **Equity valuations have shrunk**, with the S&P 500 and S&P 600 small caps having fallen to a forward P/E of 17.5x and 12.6x, respectively, due to a combination of deleveraging and devaluation/repricing, as the Fed has "talked up" interest rates with hawkish rhetoric and share prices are now based more on *earnings growth rather than multiple expansion*.
9. W**e suggest staying long but hedged***,* with a heightened emphasis on quality and a balance between value/cyclicals and high-quality secular growers & dividend payers. Moreover, rather than investing in the major cap-weighted index ETFs, **stocks outside of the mega-caps may offer better opportunities** due to lower valuations and higher growth rates. Active selection, strategic beta, equal weighting, and the Quality factor should thrive, which should be favorable for Sabrient's portfolios.
10. The new **Q2 2022 *Baker's Dozen*** launched on 4/20/2022, with equal position weights and a diverse mix across market caps, Value and Growth factors, and cyclical and secular growth exposures.

Market observations:

Stocks continue to thrash about with elevated volatility, testing critical technical support levels while seeking catalysts for upside breakouts, as markets devalue/reprice (i.e., lower P/Es) and deleverage (i.e., margin calls) in response to signals from the Federal Reserve on its monetary policies – which has been mostly talk but little action so far. The CBOE Volatility Index (VIX) has not been below 20 since late April. Overall, however, recent price action has been encouraging, as has the general trend in economic data and corporate earnings. When the markets rallied in late May, it was decidedly "risk on," led by growth (both cyclical and secular) and Technology. Slowing growth in GDP, jobs, wages, home sales, and money supply – along with signs that CPI inflation has peaked – have given hope that the Fed will make a dovish pivot sooner than later.

But investors remain jumpy. When Friday's jobs report fewer in May (390,000) versus April (428,000), stocks sold off. Why? Because although the number is down, it was expected to be even lower (330,000). So, with the June FOMC policy update coming up on 6/15 and given overbought technicals following the late-May rally, traders decided to take profits. Nevertheless, I see any further weakness ahead of the FOMC announcement as a buying opportunity.

We still haven't yet seen a true market capitulation, i.e., a high-volume trading day in which selling overwhelms buying, new 52-week lows overwhelm new 52-week highs, and the VIX approaches the 40 handle. But I don't believe a capitulation is essential for the market to resume its bullish trend. Investors just need to see a meaningful decline in inflation and a dovish pivot from the Fed.

Already, both CPI and PCE decelerated YoY in April, and in a suddenly accommodative statement – particularly after “talking up” rates with a lot of hawkish language – the latest FOMC minutes indicates that the Fed may be prepared to *pause* rate hikes after July to re-assess economic conditions at that time (leading fed funds futures to adjust downward). Moreover, Fed chair Powell insists that the committee will remain “data-driven,” which is Fed-speak for retaining *flexibility to change its approach* – and I think it will end up with far fewer rate hikes than the market still expects.

There are many encouraging signs that a bottom has been put it for the major stock market indexes, potentially opening the door for a sustained rally as more bullish catalysts emerge. For example, last Thursday’s trading had signs of massive buying programs among institutional traders, and the insider buy-sell ratio recently hit its highest level since March 2020, and its behavior is consistent with historical market bottoms. Also, the AAII weekly survey of bullish investor sentiment showed a huge jump from a dismal 19.8% on 5/25 to 32.0% on 6/1. Other good news includes the ISM Manufacturing Index rising to 56.1 in May, with gains in the forward-looking new orders and production indices and improvement in supplier deliveries.

Notably, the New York Fed’s Applied Macroeconomics and Econometrics Center (AMEC) has begun monthly publication of a Global Supply Chain Pressure Index (GSCPI) to assess the intensity of global supply chain disruptions based on data from the transportation and manufacturing sectors. *This index has been showing gradual easing all year*, although the April reading ticked up slightly – solely due to conflict escalation in Ukraine and renewed lockdowns in China, despite most of the index’s components declining. Moreover, many commodity prices (other than energy, primarily due to sanctions on Russia) have been in retreat for the past few weeks, including fertilizer, steel, copper, and lumber.

Regardless, there is little the Fed can do with monetary policy other than squash demand and risk pushing the economy into recession. Unfortunately, it can’t fix supply chains or turn its money printer into a 3D printer to make oil, semiconductors, or fertilizer. Because inflationary pressure since the pandemic lockdowns has been so supply-driven, any resolution to the China lockdowns (which are already showing signs of improvement) in the near term and Putin’s war and associated sanctions in the longer term are the best bets to relieve inflationary pressures before the Fed induces too much demand destruction and an outright economic recession.

Notably, according to the St. Louis Fed as of Friday 6/3, the 5-year Breakeven Inflation Rate is 3.04%, and the 5-year/5-year Forward Inflation Expectation Rate is only 2.44%, which gives an indication of what the institutional market expects.

Longer-dated Treasury yields seem to be hitting a ceiling. For most of 2022, Treasury yields have been surging, putting downward pressure on equity valuations. But for most of May, yields were steadily dropping, and from a technical standpoint, the important 10-year Treasury yield appears to be consolidating – and perhaps forming a topping pattern – as income-hungry global investors and retirees scoop up these elevated yields, which are higher than anything seen in a sustained way since pre-financial crisis. Since that time, 10-years have consistently caught a strong bid every time yields breached the 3% level.

So, I remain optimistic that inflation is cresting and the Fed will take a dovish pivot well before year-end. I continue to believe 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.” Also, as relates to the stock market, I believe the “Fed put” is still alive, although hiding in the shadows for now, and although the Fed may well raise rates another 50 bps in June, I think the Fed will not end up raising rates nearly as much as the Dot Plot suggests (reaching a 3.5% fed funds rate by late-2023).

The Fed has been reducing monetary accommodation (by raising fed funds rate and reducing M2 money supply growth), which keeps the dollar strong. However, the dollar is the world’s primary reserve currency – which will make it hard for the Fed to outright reduce money supply. Global GDP at about $85 trillion, total global debt estimated at more than $300 trillion, around 60% of the world’s foreign exchange trading involves the US dollar, and 60% of the world’s debt is issued in dollars. Thus, foreign banks need dollars to conduct business and make interest payments such that rising interest rates put a tremendous burden on the global economy – so, it might not be long before the Fed reverses course and buys bonds to ensure a sufficient global supply of dollars.

Regarding earnings, because multinationals in the S&P 500 get a lot of revenue from overseas and then convert those sales from weaker currencies into strong dollars, current EPS estimates might be hard to achieve. Microsoft (MSFT) cut guidance by 2% the other day. Sell-side analysts have been reducing S&P 500 EPS estimates for both current Q2 as well as 2H 2022, according to FactSet. Still, Q3-Q4 estimates average about $60/share (compared to a run rate of about $54/share for the past four quarters), and the FY 2023 EPS estimate is an aggressive $251.50. The S&P 500’s trailing 12-Month (TTM) P/E ratio is below its 10-year average, and the next 12-months (NTM) forward P/E appears attractive at 17.5x for S&P 500 (which is back to pre-pandemic levels) – and a lowly 12.6x for the S&P 600 small caps. This is due to a combination of deleveraging (largely due to margin calls), as the Fed has “talked up” interest rates with hawkish rhetoric, and devaluation/repricing, as investors have moved past the speculative fervor (“animal spirits”) phase and want to see if EPS expectations actually materialize, given the onerous macro headwinds.

The Big Tech "FANGMAT" stocks that dominate the major cap-weighted indexes – namely Meta (nee Facebook), Apple, NVIDIA, Alphabet (nee Google), Microsoft, Amazon, Tesla – are all down YTD (accounting for about 40% of the S&P 500's decline), as their EPS estimates have been cut. But given that the economy is still growing and consumers are still spending, we recommend staying invested but hedged, with a focus on smaller stocks outside of those mega-cap darlings to find better opportunities for investors due to lower valuations and higher growth rates.

Performance update:

Sabrient's models combine growth, value, and quality factors while searching across all market caps to find opportunities. Our portfolio line-up comprises the quarterly Baker's Dozen, Dividend, and Small Cap Growth portfolios, and the annual Forward Looking Value portfolio. As I have explained in the past, market conditions in 2018-19 (especially due to the trade war with China) were different from anything we had seen in developing our previously high performing "growth at a reasonable price" (aka GARP) model and portfolio selection process, and our portfolio performance, as well as most other value-oriented strategies.

Baker's Dozen & FLV - Gross return thru: 6/3/2022

Portfolio	Launch	Close	Gross Return (FTP website)	SPY Return	Diff
Q2 2021 BD	4/20/21		-0.4%	0.9%	-1.3%
2021 FLV	7/7/21		-0.4%	-4.6%	4.2%
Q3 2021 BD	7/20/21		6.1%	-3.8%	9.9%
Q4 2021 BD	10/20/21		6.1%	-8.7%	14.8%
Q1 2022 BD	1/20/22		0.3%	-7.8%	8.1%
Q2 2022 BD	4/20/22		-0.8%	-7.7%	6.9%

Sabrient Dividend - Gross return thru: 6/3/2022

Portfolio	Launch	Close	Gross Return	SPY Return	Diff
Div 32	6/30/20		42.9%	36.5%	6.5%
Div 33	9/28/20		48.3%	25.4%	22.9%
Div 34	12/21/20		27.0%	13.4%	13.5%
Div 35	3/19/21		7.2%	6.8%	0.4%
Div 36	6/22/21		11.6%	-2.0%	13.6%
Div 37	9/20/21		19.3%	-4.8%	24.0%
Div 38	12/20/21		13.3%	-9.5%	22.8%
Div 39	3/18/22		2.8%	-7.6%	10.4%

Small Cap Growth - Gross return thru: 6/3/2022

Portfolio	Launch	Close	Gross Return	IWM Return	Diff
SCG 29	3/15/21		-7.4%	-19.3%	11.9%
SCG 30	6/11/21		-4.1%	-18.6%	14.5%
SCG 31	9/8/21		8.6%	-15.8%	24.3%
SCG 32	12/6/21		-4.0%	-14.2%	10.2%
SCG 33	3/4/22		-2.3%	-5.7%	3.3%

However, rather than simply wait for our model to start "working again," we created and implemented new process enhancements in December 2019 to produce portfolios displaying a better balance between cyclical and secular growth companies and across market caps, lower volatility relative to the benchmarks, and greater portfolio resiliency (i.e., "all weather"). Indeed, the enhanced process has improved relative performance across all our portfolios, as has the market's rotation from a preference for aggressive growth and speculative stocks into a preference for value and quality.

In fact, **18 of the 19 <u>live</u> UIT portfolios** are outperforming their benchmarks (SPY is the S&P 500, IWM is the Russell 2000) despite the volatile market conditions this year, as shown in the **table** on the left. The table displays gross total return through May (from the First Trust website, without transactional sales charge).

Of particular note, the **Sabrient Dividend UITs** (which seek a combination of capital appreciation and a dividend yield of around 4% or more) have been performing particularly well, as investors have favored dividend payers as a bond substitute.

Update on the terminating Q2 2021 *Baker's Dozen* portfolio:

As for the next-to-terminate **<u>Q2 2021 *Baker's Dozen*</u>**, it launched on 4/20/2021 and terminates on 7/20/2022, at which time the new Q3 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.

Q2 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
CTRA	Coterra Energy Inc.	135.9%	11.2	7.4	173.2%	235.9%
REGN	Regeneron Pharmaceuticals, Inc.	25.0%	10.8	15.0	46.8%	118.6%
ACGL	Arch Capital Group Ltd.	19.1%	14.2	10.2	106.4%	177.7%
KFY	Korn Ferry	-2.1%	19.8	10.5	69.9%	198.4%
AMAT	Applied Materials, Inc.	-9.8%	21.2	14.2	34.8%	42.2%
DBX	Dropbox, Inc.	-11.3%	20.7	14.3	36.0%	40.5%
TOL	Toll Brothers, Inc.	-13.3%	11.0	4.2	45.7%	89.1%
AXTA	Axalta Coating Systems Ltd.	-13.3%	16.8	14.0	42.0%	-2.6%
VSH	Vishay Intertechnology, Inc.	-17.6%	14.3	8.3	96.4%	119.7%
XPO/GXO	XPO Logistics / GXO Logistics	-18.6%				
SEM	Select Medical Holdings Corporation	-27.3%	15.7	10.1	22.9%	8.6%
nyse:MGA	Magna International Inc.	-28.7%	12.5	11.8	91.4%	-7.9%
MBUU	Malibu Boats, Inc.	-28.8%	13.2	6.8	63.7%	60.2%
	Average	**0.7%**	**15.1**	**10.6**	**69.1%**	**90.0%**
SPY	SPDR S&P 500 ETF Trust	0.9%				
RSP	S&P 500 Equal-Weight	3.3%				
EWMC	S&P 400 MidCap Equal-Weight	-3.4%				
EWSC	S&P 600 SmallCap Equal-Weight	-3.9%				

It launched with an overweight allocation (46% vs. 24% in the benchmark) to attractively valued "deep cyclical" sectors (Financials, Industrials, Materials, and Energy), i.e., 6 positions out of 13. Also, it approximately matched the benchmark (38% vs. 40%) for secular growth Technology and Healthcare sectors (5 positions). As for Value vs. Growth exposure, the portfolio launched with a 54% allocation (7 positions) to the Growth factor, versus the benchmark's 60% weight (as the cap-weighted index is dominated by mega-cap Growth stocks).

Lastly, it had a small bias relative to the S&P 500 large cap benchmark, with 3 large, 5 mid, and 5 small caps. Unfortunately, small caps in general have lagged large and mega caps, as shown in the performance **table** to the left (note the equal-weight large, mid, and small index returns). Indeed, the top two performers are both large caps.

Nevertheless, most of the holdings have lived up to expectations, with 9 of the 13 having exceeded EPS estimates – and yet they still were subjected to significant P/E multiple contraction. Over the life of the portfolio so far (4/20/2021-6/3/2022), the gross average return of the Model Portfolio's equal-weighted holdings is **+0.7% versus +0.9%** for the S&P 500 cap-weighted index. (Note: This is somewhat different from the actual UIT performance in the previous table above, which tracks daily NAV as shares are accumulated during the sales period.) The **table** above shows each of the holdings. Top performers include oil & gas firm **Coterra Energy (CTRA)**; biopharma **Regeneron Pharmaceuticals (REGN)**; and insurer/reinsurer **Arch Capital Group (ACGL)**.

Of course, in a concentrated 13-stock portfolio, one or two breakout winners can offset a few laggards, but only CTRA has provided a big return. Worst among the laggards is recreational power-boat maker **Malibu Boats (MBUU)**, OEM auto parts maker **Magna International (MGA)** and **Select Medical Holdings (SEM)**, which operates critical care and rehabilitation hospitals and clinics. Notably, although MGA and SEM both badly missed EPS estimates, MBUU actually came quite lose to meeting estimates and yet saw its P/E multiple cut in half. As you can see, other losers like **Toll Brothers (TOL)** and **Vishay Intertechnology (VSH)** also handily beat estimates but were not rewarded.

Overview of the Q2 2022 *Baker's Dozen* portfolio:

The latest **Q2 2022 *Baker's Dozen*** launched on 4/20/2022. 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
AA	Alcoa	Materials	Aluminum	16.0	86.5%	6.8	0.08	0.4%	3	8
ACLS	Axcelis Technologies	Information Technology	Semiconductor Equipment	1.9	44.6%	13.9	0.31	0.0%	4	10
AVGO	Broadcom	Information Technology	Semiconductors	244.0	23.8%	16.2	0.68	2.8%	4	9
BOX	Box, Inc.	Information Technology	Application Software	4.6	33.6%	28.5	0.85	0.0%	5	10
CF	CF Industries Holdings	Materials	Fertilizers and Agricultural Chemicals	22.4	171.0%	6.5	0.04	1.1%	5	9
COP	ConocoPhillips	Energy	Oil and Gas Exploration and Production	131.6	123.2%	7.6	0.06	1.8%	3	10
DVN	Devon Energy	Energy	Oil and Gas Exploration and Production	41.8	108.0%	8.6	0.08	6.3%	5	9
MRC	MRC Global	Industrials	Trading Companies and Distributors	1.1	214.2%	15.4	0.07	0.0%	5	4
ON	ON Semiconductor	Information Technology	Semiconductors	24.4	41.4%	13.6	0.33	0.0%	5	10
PFE	Pfizer	Health Care	Pharmaceuticals	282.2	60.4%	7.1	0.12	3.1%	3	10
PHM	PulteGroup	Consumer Discretionary	Homebuilding	10.5	41.4%	4.2	0.10	1.4%	4	7
SAIA	Saia, Inc.	Industrials	Trucking	5.4	32.6%	16.7	0.51	0.0%	5	10
VLO	Valero Energy	Energy	Oil and Gas Refining and Marketing	44.1	278.4%	11.7	0.04	3.6%	5	8
			Average:	63.9	96.8%	12.1	0.12	1.6%	4.3	8.8

The portfolio comprises a diverse mix across market caps, with 5 large caps, 5 mid-caps, and 3 small caps; a Value/Growth mix of 6 value and 7 growth stocks; and a 8/5 split between cyclical and secular growth companies. As for sectors, holdings are quite diversified, including 4 Technology names, 3 Energy, 2 Materials, 2 Industrials, 1 Healthcare, and 1 from Consumer Discretionary. Some like **ConocoPhillips (COP)** and **Broadcom (AVGO)** are familiar names to most investors, while others like semiconductor equipment maker **Axcelis Technologies (ACLS)** and oil & gas equipment maker **MRC Global (MRC)** are more "under the radar."

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 persistent market conditions characterized by narrow market leadership and performance divergences in Growth/Value factors and Large/Small capitalizations, 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.*

Regardless, we believe Sabrient's portfolios – including the **Q2 2022 *Baker's Dozen*** (launched on 4/20), **Sabrient Dividend 39** (launched on 3/18), **Small Cap Growth 34** (launched on 6/1), and the upcoming **Dividend 40** (launches on 6/15) and **Q3 2022 *Baker's Dozen*** (launches on 7/20) – 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*** – which we believe it is.

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.