**Sabrient Systems**

# *Baker's Dozen* Commentary – October 2023 (updated)

**October 20, 2023**

**Scott Martindale**, President & CEO

Key talking points this month:

1. Sabrient Systems and subsidiary Gradient Analytics form a **unique collaboration of engineers and forensic accountants** who leverage quantitative models, a **process-driven approach** (led by founder and former NASA engineer David Brown), and **expertise in financial statement analysis** (through subsidiary Gradient Analytics, led by Brent Miller, CFA).
2. Our portfolios displayed **consistent performance** during 2009–2014, but then the market became narrow and news-driven, dominated by mega caps and passive index investing, leading to **historic divergences** in Growth versus Value factors and Large versus Small caps, which was challenging for our value-oriented *Growth at a Reasonable Price* (aka GARP) portfolio strategies.
3. In December 2019, we implemented **process enhancements to make our GARP approach more all-weather**, including proprietary new alpha factors—Earnings Quality Rank v2 and Growth Quality Rank—*while maintaining the potential for significant outperformance*.
4. The **Q2 2022 *Baker's Dozen*** terminated on 7/20 with a gross total return of **+28.3% vs. +3.8%** for the S&P 500 (SPY). The **Q3 2022 *Baker's Dozen*** just terminated on 10/20, and it is up **+17.6% vs. +10.2%** for SPY, as of 10/19.
5. The new **Q4 2023 *Baker's Dozen*** just launched today, 10/20. It holds 13 concentrated positions, a small-mid bias relative to the SPY benchmark, and a growth bias (versus value). We believe this and our other portfolios are poised to outperform as inflation continues to fall, interest rates eventually subside, and market conditions improve. The Baker's Dozen selection process seeks to identify undervalued, explosive growth stocks that offer the *potential "rocket fuel" for outsized gains.*
6. **Forward Looking Value 11** launched on 7/24, and its primary market sales period ends on 11/4. It holds 34 stocks selected similarly to *Baker's Dozen* but with a greater value bias. Some investors prefer its greater diversification while still leveraging the *Baker's Dozen* selection approach. Notably, the prior **Forward Looking Value 10** terminates on 10/24 and has solidly outperformed SPY, **+26.5% vs. +12.9%**, as of 10/19.
7. **Small Cap Growth 39** provides an *alpha-seeking alternative* to a passive position in the Russell 2000. Many market observers expect significant mean reversion in the gaping large/small cap valuation divergence and suggest increased small cap exposure.
8. **Dividend 45** employs a GARP & Income strategy that seeks capital appreciation from quality companies with a solid growth history that distribute reliable dividends. It pays a ***current yield of 5.7%*** (as of 10/19).
9. **Core inflation remains in a downtrend** (albeit choppy)—despite stubborn energy, food, and shelter prices—as supply chains are solid, money supply growth is stagnant, interest rates continue to rise, and wage growth slows.
10. **Surging real interest rates** have impacted stock prices, despite solid earnings growth, with the 2-year Treasury yield above the critical 5% level and the 10-year approaching it as well. But the Fed's hawkish rhetoric is softening, and I think it should be done with its rate hikes. In fact, real rates are too high in my view, so as inflation falls, interest rates must come down.
11. **Elevated valuations** on the major indexes were primarily driven by a handful of mega-cap Tech names (e.g., the AI-oriented "Magnificent Seven"). Minus those stocks, **valuations across the broader market are much more reasonable**. For example, as of 10/19, the forward P/E on SPY is 18.4x, but equal-weight S&P 500 (RSP) is 14.6x and Russell 2000 small cap (IWM) is 13.6x.
12. Rather than passive positions in the broad market indexes, **investors may be better served by *active stock selection*** that seeks to exploit improving market breadth and performance dispersion among individual stocks by identifying those "under-the-radar" and undervalued gems that are primed for explosive growth. *This should continue to be **favorable for Sabrient's portfolios**,* which combine Value, Quality, and Growth factors and provide exposure to both secular and cyclical growth trends.

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## Market commentary:

Bonds continued their selloff into the start of Q4, while stocks remain volatile despite a solid outlook for corporate earnings. Investors seem to have a singular focus on a hawkish Fed and surging interest rates, even as signs point toward falling core inflation. Incredibly, long-term bonds have seen an historic selloff approaching 50% since the July 2020 highs. But perhaps a bottom is near.

The carnarge has been primarily due to the Fed's relentless "higher for longer" mantra and the impact of elevated interest rates on the economy, corporate earnings, and stock valuations, as Treasury supply outstrips demand given: 1) the Fed reducing its balance sheet (QT) of long-term Treasuries at about $95 billion per month, 2) the US Treasury rolling out massive new issuances of something like $80+ billion per month to fund deficit spending, 3) "bond vigilantes" protesting those issuances by withholding purchases, and 4) foreign buying drying up to better support their own currencies against a rising US dollar.

The ultra-strong dollar has played havoc with our trading partners, emerging markets (especially those holding dollar-denominated debt), and our own multinational companies who garner a high proportion of their revenues from overseas (e.g., over 40% of S&P 500 revenues are generated outside the US). Indeed, stocks of late have been *inversely correlated* to the dollar and the 10-year Treasury yield, i.e., as the dollar and yields surged beyond psychological thresholds (e.g., 5% on the 2-year Treasury), stocks fell.

As a result, the traditionally defensive "safe haven" of Treasuries have been a dismal failure this year. Even worse, stocks from defensive sectors haven't helped cushion the blow, either, as three of the *worst* performing sectors in the market are Consumer Staples, Real Estate, and Utilities, with Utilities down over -20% at one point, largely due to their interest rate sensitivity.

Some commentators have speculated that investors are not worried about the economy and are simply hunkering down to weather temporary volatility. Instead of buying traditional defensives in anticipation of a recession and bear market, they largely moved to cash and high-yielding money market funds while sticking with the mega-cap "Magnificent Seven" (MAG7) titans due to their "wide moats," market dominance, pricing power, customer loyalty (and high switching costs), continual innovation, history of consistent and reliable earnings growth, and strong earnings growth expecations—no matter the market conditions ahead. These companies serve as the "new defensives" as investors wait out the Fed's extreme hawkishness while remaining long-term optimistic about the economy and stocks.

As I said in my 10/2 *Sector Detector* blog post, I expect a Q4 rally to materialize despite the August-September weakness because of the plentiful tailwinds. For starters, from a technical standpoint, as the S&P 500 tested support at its 200-day moving average, nearly 90% of stocks were trading below their 50-day moving averages (i.e., extremely oversold), which is quite rare, and historically speaking, extreme September weakness typically leads to a strong Q4 rally. Indeed, the S&P 500 bounced firmly off its 200-day moving average. And from a fundamental standpoint, corporate earnings expectations are looking good for the upcoming Q3 reporting season and beyond, as analysts are calling for solid earnings growth in 2024 versus 2023.

But that still leaves us with the pesky interest rate problem and its attendant impacts on the economy, debt carrying costs, and federal debt payments, as well as valuation multiples (e.g., P/E) and the equity risk premium. My "line in the sand" for the 2-year Treasury yield has been the 5% handle, which has reached as high as 5.15%, while the 10-year rose even faster to as high as 4.80% (the highest in 15 years, which is starting to "un-invert" the inverted yield curve). After a brief flight to the safety of Treasuries on news of the large-scale terrorist attack on Israel, the 10-year yield is on the rise once again.

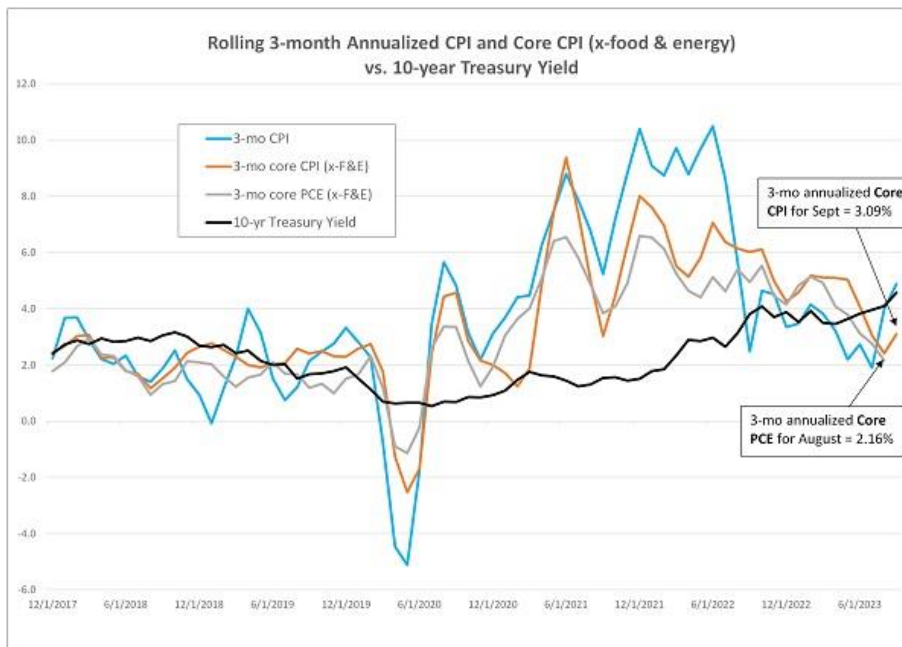
As for inflation, because the Fed can do little about energy and food prices, which have relatively inelastic demand, it is best to focus on *core* inflation (excluding food & energy). In September, core CPI (excluding food and energy) was up 4.1% year-over-year (YoY), which was an improvement from August's 4.3% print. While the focus tends to be on headline YoY numbers, I prefer to focus on *current* price trends using the month-over-month (MoM) readings rather than comparing to the price index 12 months ago. And because inflation can be volatile, computing a rolling 3-month annualized average smooths it out a bit.

The chart below compares a variety of rolling 3-month annualized inflation metrics—including CPI, *core* CPI (ex-food & energy), and the Fed's preferred core PCE (ex-food & energy)—along with the 10-year Treasury yield, starting in December 2017 through current. As shown, core inflation had been improving dramatically, showing a steep downtrend since the middle of last year.

You can see that 3-month annualized headline CPI fell to a post-pandemic-recovery low of 1.90% in July but has since resurged in August (3.98%) and September (4.88%), mainly due to a spike in gasoline prices in August (driven by a supply shortage of oil) followed by a surprising 7.2% YoY surge in shelter cost in September (which accounts for 40% of CPI). But there is a long lag between the data used in CPI calculation and current shelter prices (which includes rent, owner's equivalent rent, and hotel lodging), so actual inflation today is likely lower.

Nevertheless, the slight CPI uptick riled investors and the FOMC, leading to a surge in Treasury yields, a selloff in stocks, and a spike in the CBOE Volatility Index (VIX) to the 20 "panic threshold."

As for *core* CPI, while it did not uptick in August—instead, the 3-month annualized fell to a low of 2.41%—in September it jumped back up to 3.09%, reflecting at least a temporary reversal to its steep downtrend, primarily driven by that pesky shelter index, which accounted for over 70% of the total increase.




And as for the Fed's preferred metric, *core* PCE, we'll have to wait until 10/27 for the September data. But August showed a MoM reading of only 0.14%, which annualizes to 1.75% (well below the Fed's 2% inflation target), and *the rolling 3-month average annualized to 2.16%,* which suggested at the time that *no further rate hikes are necessary*. Although the latest CPI data suggests we might see a similar reversal in PCE, I think any uptick is simply normal volatility and only a temporary stall to the downtrend.

As for the New York Fed's Global Supply Chain Pressure Index (GSCPI), which measures the number of standard deviations from the historical average value (aka Z-score) and generally presages PPI, it plummeted from a December 2021 all-time high of +4.31 to the May 2023 reading of -1.57 (its lowest level since November 2008), mostly due to softer consumer goods demand, an easing of parts shortages, and less shipping congestion (and lower freight rates). Although GSCPI has ticked up a bit through the summer to a September reading of -0.69, it remains quite low.

So, to summarize, Treasury yields and core inflation have been moving in opposite directions (yields up, core inflation down) and creating a surge in *real* rates, with the 10-year *real* yield challenging its highest levels of the Financial Crisis. This is threatening our economy by burdening indebted corporations and households, excessively strengthening the dollar, and contributing to distress among our trading partners and emerging markets—including capital flight, destabilization, and economic migration.

For consumers, US home affordability is at a record low, home sales are crashing, household savings rates are shrinking, and wage inflation is dropping, indicating that the consumer is feeling the pinch. Excess savings from the pandemic have been used up, credit card debt is at a record high, and student loan payments have resumed.

For businesses, lending conditions are the tightest ever, and commercial credit availability is contracting for the first time since we emerged from the financial crisis. Companies will soon need to roll over trillions of dollars of existing debt at much higher rates in the next 1-2 years, which likely will squeeze profit margins and drive up corporate bankruptcies.

In addition, there is weakness in Europe and a deflationary impulse from China, including dumping finished goods and parts on the global market in a fit of desperation to maintain some semblance of GDP growth while its critical real estate market teeters on the verge of implosion.

And let's not forget our federal budget, with gross federal debt having reached about 124% of annual GDP and rising fast. The budget deficit for the past fiscal year (ended 9/29) likely hit $1.7 trillion, or about 6.3% of GDP, with interest payments on federal debt expected to hit 2.5% of GDP by year-end, up sharply from 1.85% last year (which was the highest since 2001 during a steep decline from its 1991 peak of 3.16%).

So, why is Fed Chairman Jay Powell remaining so hawkish? Evidently, he doesn't want to stop before the "job is done" on inflation. Moreover, I think he sees his tough talk as helping to drive up interest rates without having to boost the fed funds rate quite so much. But now, given all I described above, I believe the Fed must begin to lighten up on its hawkish rate policy and stagnant money supply growth—and it should it do it soon to prevent a deflationary recession in the US.

As market maven Eric Fry wrote, *"…at this stage of the game, the Fed's relentless inflation-fighting campaign is starting to look more like a bad habit than an astute, forward-looking strategy."* Even Philly Fed President Patrick Harker admitted in a speech last Friday, *"Disinflation is underway. Economic activity has been resilient. Labor markets are coming into better balance. So…I believe that we are at the point where we can hold rates where they are."*

When the Fed ultimately decides to cut rates—both to head off escalating crises in banking and housing and to mitigate growing strains on highly leveraged businesses, consumers, and governments (including our own)—it would be expected to ignite a sustained rally in both stocks and bonds…and across risk assets.

Regarding elevated stock valuations and the low equity risk premium, my observation is that they are primarily driven by a handful of mega-cap Tech names. Minus those stocks, valuations across the broader market are much more reasonable. For example, the forward P/E for the cap-weight SPY (dominated by the MAG7) is 18.4x (as of 10/19), but equal-weight RSP is only 14.6x and small cap IWM is 13.6x. However, according to The Market Ear, on a *growth-adjusted basis*, the MAG7 are priced at the *largest discount to the "median stock"* in the S&P 500 in over 6 years. Yes, you read that right—*discount*. Those titans can justify their valuations with extraordinary earnings growth.

Nevertheless, *outsized* gains in share price via multiple expansion might be more difficult going forward. So, rather than passive positions in the broad market indexes—investors may be better served by *active stock selection* that seeks to exploit improving market breadth and performance dispersion among individual stocks—not by holding positions in the so-called "median stock" or equal-weight indexes, but by identifying those under-the-radar and undervalued gems that may be primed for explosive growth.

With small caps displaying the widest under-performance gap versus large caps since the Internet Bust (22 years ago!), many market commentators expect significant mean reversion and recommend increasing small cap exposure. To that end, the **Sabrient Small Cap Growth portfolio (SCG 39)** provides an alpha-seeking alternative to the passive Russell 2000 index.

In addition, the newly launched ***Q4 2023 Baker's Dozen*** holds a small/mid-cap bias relative to the SPY benchmark (5/4/4 in large/mid/small holdings) and offers potential "rocket fuel" for outsized gains, the annual ***Forward Looking Value (FLV 11)*** portfolio is a more diversified (34 positions) version of the *Baker's Dozen* but with a slightly greater value bias, and as dividend strategies gain traction again, the ***Sabrient Dividend 45*** portfolio seems like a good bet as it seeks both capital appreciation and reliable income—offering a current yield of **5.7%** (as of 10/19).

Note that this is the *final week of sales for* ***Q3 Baker's Dozen***, and the new **Q4 2023 *Baker's Dozen*** launches on Friday, 10/20.

### Performance of the terminating Q3 2022 *Baker's Dozen*:

Last year's **Q3 2022 *Baker's Dozen*** launched on 7/20/2022 and terminates today, 10/20. As of 10/19, it has a total return of **+17.6% vs. +10.2%** for SPY, for an active return of +7.4%. Also, **Forward Looking Value 10**, which launched on 7/15/2022 and terminates on 10/24, is also well ahead of the SPY, **+26.5% vs. +12.9%**, for an active return of +13.6%.

**Q3 2022 Baker's Dozen Portfolio**

| Ticker | Company Name | Sector | Return |
|---|---|---|---|
| AVGO | Broadcom Inc. | Information Technology | 75.5% |
| TMHC | Taylor Morrison Home Corporation | Consumer Discretionary | 45.3% |
| ON | ON Semiconductor Corporation | Information Technology | 44.8% |
| PGR | The Progressive Corporation | Financials | 42.3% |
| MRO | Marathon Oil Corporation | Energy | 29.7% |
| VLO | Valero Energy Corporation | Energy | 26.1% |
| HRI | Herc Holdings Inc. | Industrials | 8.4% |
| CHDN | Churchill Downs Incorporated | Consumer Discretionary | 5.1% |
| CF | CF Industries Holdings, Inc. | Materials | 2.5% |
| LNTH | Lantheus Holdings, Inc. | Health Care | -6.7% |
| DVN | Devon Energy Corporation | Energy | -6.9% |
| PLAB | Photronics, Inc. | Information Technology | -10.0% |
| BOX | Box, Inc. | Information Technology | -11.2% |
| | | **Average =** | **17.6%** |
| SPY | SPDR S&P 500 ETF Trust | | 10.2% |
| RSP | Invesco S&P 500 Equal Weight | | 1.3% |
| MDY | SPDR S&P MidCap 400 ETF Trust | | 2.7% |
| IWM | iShares Russell 2000 ETF | | -5.1% |

Let's take a closer look at the terminating **Q3 2022 *Baker's Dozen***. Like all our portfolios, it 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 on 7/20/2022 with a diverse mix across market caps, with 5 large caps, 4 mid-caps, and 4 small caps, which gave it a small-mid bias relative to the benchmark S&P 500. It had an overweight in attractively valued "deep cyclical" sectors (Energy, Industrials, Materials), i.e., 5 positions out of 13, plus 2 from Consumer Discretionary, 1 Healthcare, and 4 Technology names. As for Value vs. Growth exposure, the portfolio launched with 54% allocation (7 positions) to the Growth factor, which was close to the benchmark's 60% weight (as the cap-weighted index is dominated by mega-cap Growth stocks).

It has been led by a diverse group including specialty semiconductor makers Broadcom (AVGO) and ON Semiconductor (ON), homebuilder Taylor Morrison Home (TMHC), and P&C insurance firm The Progressive Corp (PGR). They offset laggards like content management software firm Box Inc. (BOX), semiconductor equipment maker Photronics (PLAB), and independent oil & gas producer Devon Energy (DVN).

As shown at the bottom of the table, the portfolio has outperformed all relevant large cap, mid-cap, and small-cap benchmarks (including both cap-weight and equal-weight) by a wide margin. This illustrates my earlier point that, rather than passive positions in the broad market indexes, investors may be better served today by *active stock selection* that seeks to exploit improving market breadth and performance dispersion among individual stocks by identifying a diverse group of "under-the-radar" and/or undervalued gems (from targeted industries and across market caps) that may be primed for explosive growth.

## Overview of the new Q4 2023 *Baker's Dozen* Portfolio:

The **Q4 2023 *Baker's Dozen*** launched on 10/20. 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 has a diverse, small-mid biased mix across market caps, with 4 large caps, 5 mid-caps, and 4 small caps; a 4/9 split between value/growth stocks; and a 8/5 split between secular and cyclical growers. As for sectors, there are 3 from InfoTech, 2 Financials, 2 Energy, 2 Healthcare, 2 from Comm Services, 1 Utilities, 1 Consumer Discretionary.

| Ticker | Company Name | Sector | Industry | Mkt Cap ($B) | NTM EPS Growth | Fwd PE | Fwd PEG | Div Yield | EQR | GQR |
|---|---|---|---|---|---|---|---|---|---|---|
| ALKS | Alkermes | Health Care | Biotechnology | 4.5 | 146.8% | 15.3 | 0.10 | 0.0% | 4 | 9 |
| CHX | ChampionX | Energy | Oil & Gas Equipment and Services | 6.8 | 28.7% | 16.7 | 0.58 | 1.0% | 4 | 10 |
| COOP | Mr. Cooper Group | Financials | Mortgage Finance | 3.6 | 86.1% | 7.3 | 0.08 | 0.0% | NA | 6 |
| DTE | DTE Energy | Utilities | Multi-Utilities | 20.0 | 31.5% | 14.1 | 0.45 | 3.9% | NA | 10 |
| EXEL | Exelixis | Health Care | Biotechnology | 6.8 | 56.6% | 18.2 | 0.32 | 0.0% | 4 | 7 |
| EXTR | Extreme Networks | Information Technology | Communications Equipment | 2.9 | 42.0% | 14.3 | 0.34 | 0.0% | 5 | 9 |
| META | Meta Platforms | Communication Services | Interactive Media & Services | 815.6 | 86.2% | 19.8 | 0.23 | 0.0% | 3 | 9 |
| NFLX | Netflix | Communication Services | Movies and Entertainment | 154.2 | 48.9% | 26.9 | 0.55 | 0.0% | 4 | 8 |
| NVDA | NVIDIA Corp | Information Technology | Semiconductors | 1042.2 | 186.2% | 28.1 | 0.15 | 0.0% | 5 | 10 |
| RPD | Rapid7 | Information Technology | Systems Software | 3.2 | 106.6% | 30.3 | 0.28 | 0.0% | 5 | 10 |
| TRV | The Travelers Companies | Financials | Property and Casualty Insurance | 38.4 | 73.6% | 10.2 | 0.14 | 2.4% | 5 | 10 |
| VC | Visteon Corp | Consumer Discretionary | Automotive Parts and Equipment | 3.6 | 59.5% | 15.1 | 0.25 | 0.0% | 5 | 9 |
| WFRD | Weatherford International | Energy | Oil & Gas Equipment and Services | 6.8 | 101.1% | 18.7 | 0.19 | 0.0% | 3 | 8 |
| | | | **Average:** | 162.2 | 81.1% | 18.1 | 0.22 | 0.6% | 4.3 | 8.8 |

Some of the constituents are familiar names, like **Meta Platforms (ne: Facebook, META**), **Netflix (NFLX)**, and today's most prominent name in semiconductors for AI applications, **NVIDIA (NVDA)**. But most are relatively "under the radar" stocks, like mid-cap oil & gas services firm **ChampionX Corp (CHX)**, small-cap mortgage servicer **Mr. Cooper Group (COOP)**, and cybersecurity software firm **Rapid7 (RPD)**.

You can find more details on this portfolio 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. You also can download my latest slide deck and market commentary.

Also, the annual ***Forward Looking Value 11*** portfolio launched on 7/24 with 34 stocks, diversely mixed with a small-mid bias across market caps, with 7 large, 18 mid, and 9 small caps; a value-bias with a 20/14 split between value/growth; and 23% international exposure. Financials/Insurance lead the sector allocations at 29%, followed by InfoTech 20%, Industrials 18%, and Healthcare 15%. This portfolio takes the baton from the **Forward Looking Value 10**, which has solidly *outperformed SPY by 14.1 percentage points*.

## Final Comments:

I go into greater detail on market conditions and outlook in my periodic **Sector Detector newsletter and blog post**, which you can find (and subscribe to for free) on the **https://www.sabrientsystems.com** homepage. I also review Sabrient's latest fundamentals based SectorCast quant rankings of the ten U.S. business sectors and serve up some actionable ETF trading ideas.

As a reminder, Sabrient implemented **process enhancements** in December 2019 to our *Growth-at-a-Reasonable Price* (GARP) model and *"quantamental"* portfolio selection methodology—which uses the quantitative model as a prescreen and then uses a fundamental review and final selection approach that includes forensic accounting analysis by our Gradient Analytics subsidiary. This has made our portfolios more "all weather" (*without sacrificing the potential for significant outperformance*) by allowing companies having *consistent and reliable earnings growth* to score more competitively in our value biased GARP model, even if they display somewhat higher valuations, and provides exposure to both *cyclical* growth opportunities and *long-term secular* growth trends.

Indeed, we believe Sabrient's portfolios—including the new **Q4 2023 *Baker's Dozen*** (launched on 10/20), **Forward Looking Value 11** (launched on 7/24), **Small Cap Growth 39** (launched on 8/7), **Sabrient Dividend 45** (launched on 9/1, offering a **5.7%** dividend yield)—are each positioned to outperform their passive benchmarks.

As a reminder, you can check out Sabrient's simple new **stock and ETF screening/scoring tools** called ***SmartSheets***, which are available for *free download for a limited time*.

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