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INVESTMENT MANAGEMENT

Monthly Commentary

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Two Key Conclusions as detailed below:

1. ***Many of the extreme divergences in equity market performance discussed last month have started to converge, albeit more on the downside for the market overall than we expected.***
2. ***Despite the market pullback, there does appear to be seasonal consistency.***

Markets are invariably unpredictable, but a couple of things remain constant in my opinion: Investor sentiment is prone to wild swings, and—barring significant changes in secular trends, economic growth or company fundamentals—reversion to the mean is inevitable.

With that in mind, one need not be a contrarian to appreciate the extreme divergences in the market today.

As we addressed in last month's commentary, we believe multiple factors had swung near their historic highs and lows, suggesting that it was time for investors to consider whether there are opportunities to invest before the rubber band snaps back and these divergences revert to the mean.

So let's review the six divergences that we wrote about on **September 12th**, and then let's discuss what we see happening from here:

1. ***US Momentum stocks (the year-to-date winners) are very expensive relative to the market. They certainly reached more expensive levels in 1999-2000 but generally speaking, this level is a warning sign that the winners are far outpacing the losers and reversion to the mean is a distinct possibility. (September 12th)***

As anyone who owns the tech winners of 2018 knows, US Momentum stocks have been on a yo-yo since then, underperforming the S&P 500.[1] Clearly, they were vulnerable as we predicted in September.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See definition section at end of commentary for index definitions.

However, November and December can be seasonally good months for momentum stocks. And since the momentum bucket is mostly technology, consumer discretionary and healthcare, it is defacto growth. Not to mention, once Q3 earnings season is behind us, many of the companies in the momentum bucket that have big buyback programs will likely return to supporting their stocks.

Our conclusion:

A pure growth portfolio is very vulnerable to sharp selloffs, as we have experienced in the past 30 days, which could happen again. Therefore moderation is appropriate, although a big reduction into year-end is unwarranted.

2. ***Year-to-date, US Internet stocks have outperformed the Chinese Internet stocks by 47%[2]. What are we doing about it? We have increased our exposure to Chinese Internet stocks.***

Clearly a tariff stalemate is not good for these Chinese exposure stocks. And this has been a big source of pain for our global strategies.

But even with concerns about tariffs and China in general, the extreme difference in multiples seems unjustified and unsustainable. In fact, while "this time might be different", *the 12-month returns from the depressed valuations for this group of Chinese names have historically been very attractive.*[3]

Since September 12th, the spread has widened by another 172 basis points[4], so this is one convergence that has not happened yet. What could cause a convergence?

1) The G20 meeting.

2) A more positive position in front of the midterms.

Our conclusion:

Short-term timing is so tricky, but it's our belief that by the time it's clear that there is some resolution with China (whenever that may be), these stocks will be significantly higher, given the substantial PE discounts to growth rates where these stocks currently sell.

3. ***Investors' distaste for value has only worsened, as value is now cheap versus history.***

Value has begun to outperform growth.[5]

Our conclusion:

As much as we are not against growth, we need to be mindful of what we said before. Growth is very crowded, and value is not. Therefore, it's worthwhile to maintain some exposure to value, especially to financial and energy names.

4. ***Investors' love affair with technology/consumer discretionary has left the staid consumer staple stocks in the dust this year. The net result is they are cheap.***

Consumer Staples have begun to outperform.[6]

We think this is a "fat pitch". While we do not believe the secular bull market is over, we are clearly in the later innings. And if these defensives are cheap relative to their history, we think it offers a pretty good chance to begin to build up the relatively safer portion of an equity portfolio.

5. ***The relative performance of the US versus the Rest of the World (ROW) is nearly as extreme as we have seen in the past 20 years. Can it continue?***

MSCI World ex US has outperformed the S&P 500.[7]

MSCI World ex US has more volatility than the S&P 500. Therefore, in market selloffs, typically the US is a safer haven, and the rest of the world goes down harder. Not this time. ROW has not underperformed.

We suspect that this has to do with the magnitude of the US differential year-to-date as we have outlined.

Our conclusion:

While we would not bet against the US into year-end, this suggests the reversion has begun and therefore we should not be giving up on the ROW.

6. ***Relative performance of European Banks versus MSCI Europe. Over the past 30 years, banks have always outperformed MSCI Europe over the subsequent 12 months when at current valuations or lower.***

European Financials have outperformed the broader European Index.[8]

Hard to believe this is the case given all the political noise.

Our conclusion:

This divergence is compelling enough to include in a portfolio of global equities, although emotionally, we can't think of a bigger widow maker than European Banks. *Weak endorsement!*

The final point of last month's commentary sent September 12th was that we felt the market would resolve these convergences not necessarily because *"the unloved go down less but rather because we envision convergence on the upside".*

Since that commentary on September 12th, the S&P 500 is down 4%. Not up.[9]

As much as we are starting to feel a touch better about relative performance since mid-September, given we have positioned for all of these convergences, they have occurred as the market dropped, not rallied.

HERE ARE OUR MARKET CONCLUSIONS:

1. Historically the equity market has struggled leading into the midterms with an average drawdown of just over -1% for the three months leading up to the midterms. The midterms are November 6th. On August 6th the S&P 500 (SPX) was at 2850[10].

So far….check this one off, as we are in that range.

2. In our experience, selloffs usually see a retest and "W" bottoms seem consistent with investor behavior. "V" corrections don't clear out the weak holders like "W" bottoms do. And that is almost always healthy. Our belief: don't bet against near-term weakness.

3. Since earnings season really commences in earnest towards the later part of the week of October 22nd, the biggest buyers of stocks (companies themselves, by a factor of 2x the second largest buyers of stock[11]) won't be back in earnest until November. Likely bad news near-term, good news later in Q4.

4. Historically, the market rallies after the midterms regardless of the outcome. We highly suspect another push higher for the market into year-end.[12]

5. In years when the market, as defined by the S&P 500 (SPX), is up over 5% going into November, momentum stocks have tended to rally into year-end. Intuitively, in strong years for the market, everyone wants to hold on to the big winners. But in anemic or negative years, investors do not have that same love affair and there is considerably more rotation into year-end.[13]

With the S&P 500 up 5.1% year to date as of this writing, it's a toss-up.

Therefore we will maintain:

a. moderation to growth but cognizant of the valuation risks here

b. some value

c. some defensive Consumer Staples

d. an international allocation that is skewed to Asia.

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[1] From September 12th through October 18th, comparing the Dow Jones Momentum Index (DJTLMO) -7.89% versus the SPX down -3.98%.

[2] Factset as of September 5, 2018. Chinese Internet stocks as defined by KWEB; US Internet stocks as defined by FDN.

[3] Source: Factset. KWEB index since inception 2013.

[4] From September 12th through October 18th, comparing the Chinese Internet Index (KWEB) -11.90% versus the US Internet Index (FDN) -10.18%

[5] From September 12th through October 18th, comparing the Russell Large Value (RLV) -3.35% to the Russell Large Growth (RLG) -5.49%.

[6] From September 12th through October 18th, comparing the Consumer Staples (XLP) –2.08 % to the SPX -3.98%.

[7] From September 12th through October 18th, comparing MSCI World ex US (MXWOU) -3.40% to the SPX -4.07%.

[8] From September 12th through October 18th, comparing European financials (EUFN) -3.77% to the MSCI Europe (MXEU) -3.97%.

[9] From September 12th through October 12th, the S&P 500 (SPX) is down -3.98% total return.

[10] Source: Bloomberg as of August 6, 2018

[11] NYTimes. October 12th, 2018

[12] Source: Sam Stoval Market Wrap , June 3 *: Post the last 18 mid-terms, the market has generated an average return of +16.5% over the next 12 months. And the "hit ratio" is 100%, meaning the market has been positive all 18 times. The market is defined by the S&P 500 (SPX)*

[13] AEA/Factset study 2016