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INVESTMENT MANAGEMENT

Applied Equity Advisors Monthly Commentary

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I would like to use this commentary to address several questions and topics that have come up with some frequency lately:

1. When will the market rotate from Growth to Value?

In the April commentary, we discussed what has historically worked (Growth) and what has not (Bond proxies/Defensives) ***leading up to*** a yield curve inversion.[1]

Since then:

1. The yield curve has flattened further with the 2-10 year spread dropping from 50 basis points (May 16th) to 37 today (June 18th).
2. The Russell Large-Cap Growth Index has continued its outperformance, adding another 200 basis points of relative performance versus the S&P 500 year-to-date, while the defensives continue to lag by over 300 year-to-date.[2]

My simple take is that this time is lining up pretty consistently with what we have seen in the past: growth works and defensives do not.

Going back to the question of if and when value will work, I think the answer surrounds what happens *post* the yield curve inversion. Based on the past four inversions, here is what has worked and what has not *after* the flattened yield curve:

What Has Worked After the Yield Curve Inverts?[1]

- **Defensives**
  - Dividend Yield
  - Bond Proxies
  - Low Volatility
- **Value**
- **Momentum (Defensive)**

What Has Not?

- **Growth**

Will growth run out of steam after its monstrous outperformance? Time will tell if history repeats itself.

So how are our strategies positioned?

We have a modest growth over value bias in all our strategies. That's what our quantitative factor models are telling us, and that does seem to be consistent with history.

But we are in the process of reducing our growth bias. From a value perspective, we have increased our energy exposure and remained overweight to financials. But more significantly, *we have begun to increase our exposure to defensives.*

My long-held belief that the low volatility bubble would unwind is occurring, as groups like staples have massively underperformed the markets. But as the table above highlights, *post* yield curve inversions, the defensives' period of underperformance should end. Therefore, it's still early, but we have started to increase our exposure to defensives, primarily in *consumer staples*, but in time we would expect to add health care as well.

2). Checking on our three 2018 Reversion to the Mean themes:

Our view has been that there are three key reversion to the mean moves occurring in 2018:

1. An increase in volatility
2. Anemic equity returns
3. The value of financial advice

I really don't think I need to discuss much on #1 except to say that if the market continues at this current level of volatility for the rest of the year, it will completely offset last year's lack of volatility. In essence, a classic reversion to the mean. And what better way to create that volatility than *trade war fears!*

Another catalyst for volatility is the mid-term elections. Leading up to these November elections the market tends to get the jitters. In Q2 and Q3 of mid-term years, volatility increases substantially, and the market as represented by the S&P 500 has averaged a -1.1% return. However, *in the last 18 mid-terms, the market has generated an average return of +16.5% over the next 12 months following the elections. And the "hit ratio" is 100%, meaning the market has been positive all 18 times.*[3]

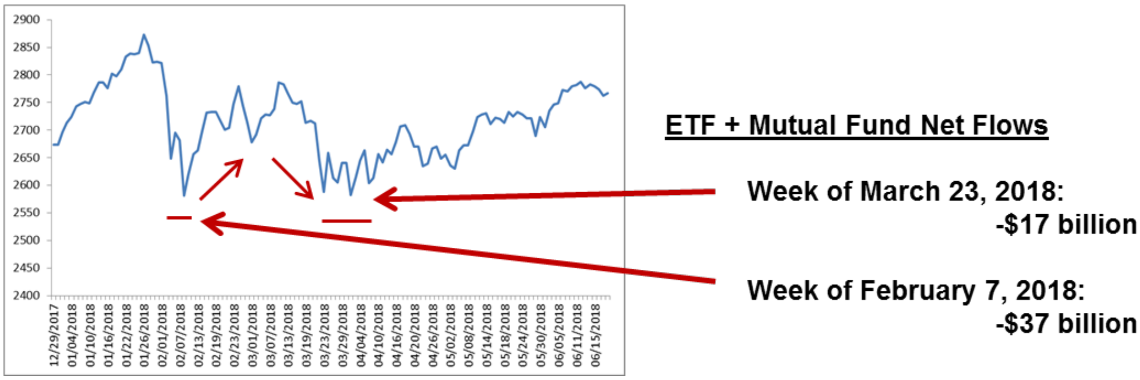
So it's entirely possible that ALL the positive return for 2018 may come late in Q4. Hence, I think we'll see anemic returns until then.

Finally, as volatility increases, so does the investor behavioral gap. In essence, the higher the volatility, the wider the difference between how the market does in any one year and how the average investor does.

An analysis of the market year-to-date overlayed with weekly net fund flows suggests that the behavioral gap is widening once again. The intra-year low (so far) was on February 8th at 2581 as per Display 1. As of June 18th, the S&P 500 is 7.5% higher, but look at the net flows the week of February 7th. So far this year, it's the biggest week of outflows. The second worst week of net outflows was the week of March 23rd, just as the market was retesting the February lows.[4]

DISPLAY 1

S&P 500
12/31/2017 – 6/18/2018



Bloomberg, ICI
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In my mind, this points to the importance of financial advice. Cumulatively, investors have NOT made the best timing calls year-to-date. And while I have no proof yet, I have seen enough historical data about the poor timing of self-directed trading to be confident that professional financial advice could have prevented investors from jumping at the wrong time.

3). Do I remain confident the "euphoric" stage is still out there?

I have detailed pretty consistently that the market historically does not run out of steam once the yield curve flattens. The last time the spread was at its current level was in June 2005. The yield curve spread ultimately hit zero in December 2005, but the *market did not peak* until October 2007.

I am no bond expert, but I thought this comment from yesterday was pretty interesting:

> *USTs are somehow unable to sell-off, despite 4+% Q2 "tracking" GDP growth; a 3.5 Stan Dev "beat" in last week's Retail Sales; six year highs in CPI ;seven year highs in PPI; and a hawkish Fed indicating 5 more hikes over the next year and a half.*[5]

We are seeing stronger economic growth, higher inflation, a more hawkish Fed, and yet the long-end of the curve does not budge. And that confirms the bond market is screaming late cycle. In my opinion, this sends another message that we are nearing the final stage of an equity bull market.

Ultimately however, what ***could*** extend the duration of the bull market and push this final stage further out, would be if the economy cooled a bit and the Fed were to back off, thereby pushing the short-end of the yield curve lower. What could do that? *A tariff war.* How ironic.

4). When will international outperform the US?

A popular investment justification for Europe and Japan is that they are cheaper than the US. That drives me nuts, because they *should* be. Sectorally, Europe and Japan are more cyclically oriented indices than the S&P 500.[6] Hence, they should be cheaper because they have heavier weightings in value names.

Given the global economy has limped along at a sub-par level since the 2008 recession, it should therefore be no surprise that Europe and Japan have lagged the US.

On the one hand, with faster global growth and greater cyclicality, international should accelerate and outperform the US. On the other, non-US markets are simply more volatile. *And in a volatile year, the drawdowns in more volatile areas of the market are likely to be bigger and more painful.* My conclusion: I would not bet on international outperforming the US in 2018. But maybe in 2019.

5). Long-term Investment Cycles

I will close with an update on bull/bear cycles. In late 2016, I started to use the chart below to argue that we were not at the end of a bull market but potentially at the end of a long-term bear market cycle. And better returns were ahead rather than behind us. My thesis was that long bear market cycles end with fiscal policy reform or the anticipation of reduced taxes. This is what happened in 1982, and I felt this is what could be happening with the election of our latest President.

Well that got a ton of skeptical comments and backlash (including being almost jeered off the stage in London…..tough crowd)!

Many of you have requested an update of this slide so here you go:

DISPLAY 2

Fiscal Policy Reform Has Often Contributed to the End of Long-Term Bear Market Cycles

Annualized S&P 500 Total Returns

Inception of S&P 500 March 4, 1957

BEAR CYCLES				BULL CYCLES			
START	END	YEARS	ANNUALIZED RETURN	START	END	YEARS	ANNUALIZED RETURN
1/19/1906	8/24/1921	15.6	1.97%	8/24/1921	9/3/1929	8.0	29.78%
9/3/1929	6/13/1949	19.8	1.00%	6/13/1949	2/9/1966	16.7	17.21%
2/9/1966	8/12/1982	16.5	4.26%	8/12/1982	3/23/2000	17.6	20.22%
3/23/2000	11/4/2016	16.6	3.88%	Average		14.1	**22.40%**
Average		17.1	**2.78%**	? **11/7/2016**	**Today**	**1.6**	**19.55%**

Source: Bloomberg / Robert Schiller as of May 30, 2018

1. The data prior to the inception of the S &P 500 (3/4/1957) date constitutes backtested data based upon Robert Schiller's work. Backtested results have inherent limitations, such as decisions were made with the benefit of hindsight and not under actual market conditions. Therefore, results cannot completely account for the impact of financial risk in actual trading. No representation is being made that any investment strategy or portfolio will or is likely to achieve similar results to those being shown.

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Could the fiscal policy reform we have just experienced cause another long-term bull market cycle? We'll see, but one and a half years in and I would conclude, so far so good.

Andrew

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[1] Based upon Factset data looking at 2005 and 1998 inversions, and Fama/French CRSP data for last four Yield Curve Inversions, 6 months prior to an inversion.

[2] As measured by the RLG, S&P 500 and DEF (Invesco Defensive ETF). Bloomberg as of June 18, 2018.

[3] Sam Stovall. "Market Wrap". June 3rd.

[4] MS Research. ICI mutual fund and ETF net flows reported on Wednesdays.

[5] Charlie McElligott: Nomura Cross-Asset: DOWNSHIFT ESCALATES = GET TACTICAL

[6] Energy + Financials + Industrials + Materials comprise 32% of the S&P 500 versus 40% of MSCI Japan and 50% of EAFE ex Japan (Europe)