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Andrew Slimmon September 2019 Equity Market Commentary

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1. The violent selloff in growth and defensive stocks (despite the overall market level being largely unchanged) is a bad omen for what's to come for those areas when the bull market cycle truly ends. That exit could be crowded.
2. With each day that goes by with the market range-bound, the likelihood of a breakout to the upside increases. To me it's a question of when, not if.
3. I expected markets to get hit with a painful body blow in August. It was more like a papercut. I believe that speaks volumes about the limited downside risk in the market.
4. Positioning and sentiment are consistent with bear market lows, NOT bull market peaks.
5. As I have articulated in the past, I maintain that the market will be well north of 3,000 by year-end. My expectation, however, is for a later Q4 surge.
6. The inverted yield curve should not be ignored. In my opinion, it indicates problems for the economy in 2021.

1)

In my July commentary, I suggested that investors should always be wary if there were common products that asset managers were selling or were the recipients of all the inflows. In the investment business, people buy what has already gone up in price. Recency bias is a powerful concept. Inevitably, if investors chase a particular investment thesis and push prices up, momentum traders also pile in. This ultimately causes those stocks to become very crowded. As I pointed out in July, the three buzzwords I had been hearing consistently at investment conferences were "quality, defensive, growth".[1]

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If everyone is piled onto one side, eventually the boat tips over. We saw that at the end of August. From August 23rd until September 13th, top decile momentum stocks, which were ***only*** defensive or growth stocks at the time but no value stocks, declined by -9.15% relative to the S&P 500. Top secular growth stocks declined -9.21%. Value stocks outperformed the S&P 500 by 7.68% during the same period. There was no selling in this unloved group.[2]

What's incredible is the market was ***up*** during this same time. In other words, there was no overall market panic. *What would have happened to those stocks if there were a steep market selloff (i.e. panic)?* In my opinion, the carnage in these names would have been much worse. Defensive growth stocks are ***not*** defensive if they are very expensive (which they are relative to their historic valuation levels)[3] and heavily owned.

Is there a true rotation from growth to value? *Applied Equity Advisors does not think so.* Our research suggests that true rotations occur in the midst of recessionary bear markets (growth to value in 2000, value to growth in 2008, etc.). Our team is not in the recession camp. Within a bull market, there can be violent cyclical rotations, which is what we think is happening. These tend to be shorter-lived and less painful than the big secular rotations which produce far more carnage. That is why we believe the underperformance of the growth and defensive names is a **harbinger of what is to come** when the secular rotation occurs.

2) and 3)

On January 26, 2018, the S&P 500 hit 2873. On August 23rd, 2019 the market was still at that level. Zippo appreciation in 574 days.

Historically, bearish sentiment tends to build during such a long period of poor returns. The perceived risks outweigh the seemingly paltry benefits. Yet the resolution is that the market has ALWAYS broken to the upside, not the downside.[4]

Clearly the questions are:

When does the market break to the upside?

Could we have another December 2018 before that happens?

What August taught me is that perhaps the downside is limited. Here is why:

On August 5th, 14th and 23rd, the market experienced three particularly nasty down days, each with 80%-90% of stocks closing down, just as we saw last December.[4] What was different from last December was that the selling did not continue. The market rallied strongly August 6th, August 16th and August 26th. In essence, there was none of the follow-through panic selling that happened at the end of last year. With $230 billion of net liquidations from equity mutual funds and ETFs[5] as of August, there appeared to be a lack of supply left to sell to sustain a meaningful downturn. Everyone who was going to panic had already done so.

My conclusion is that eventually the market will break to the upside. This time will not be different, but while we wait there may not be a lot of downside either. This makes the risk/reward appear attractive at a juncture where the overwhelming consensus is just the opposite. As one of my favorite strategists, Jim Paulsen, said on CNBC recently, "*The only bubble out there is the fear bubble. And eventually that will pop and stocks will head higher*.[6]" (To his credit, Paulsen was bearish last year and turned bullish at the beginning of this year.)

4)

In the depths of bear markets, fear runs rampant. Fund flows are massively negative, sentiment figures are all dour, and the valuation spread between the perceived "safe" stocks and the cyclical stocks is hugely distorted (e.g. staples are trading at peak valuations and banks at historically low valuations). Does that remind you of Q1 2009? It does to me. That was just before the market had one heck of a recovery. Ultimately the market turned, because there was simply nobody left to sell those beaten down names. ***The selling was exhausted.***

Of what other time do all these indicators remind you? *How about right* ***now****?* For all the reasons I have already discussed.

What we have experienced in this slow grinding economic cycle is a series of "recession scares". Each time one has happened, safe stocks have traded to very high valuations and value stocks have traded to low valuations.

Each has been a very good time to buy the market. Recessions were avoided, and investors overpriced fear.

Take a look at the following table. We track the low volatility factor which includes the most defensive, least volatile stocks in the market. Since the current bull market started, notice how the S&P has performed over the next 3, 6 and 12 months AFTER the low volatility factor traded at 90% expensive relative to its history.

DISPLAY 1

Market performance after the low volatility factor has traded above 90% expensive relative to history:

DATE	S&P 500 NEXT 3 MONTHS	S&P 500 NEXT 6 MONTHS	S&P 500 NEXT 12 MONTHS
6/4/2010	4.26%	16.20%	24.52%
8/19/2011	8.82%	22.52%	29.07%
4/13/2012	-0.44%	5.43%	18.60%
12/18/2015	2.78%	4.44%	15.06%
8/4/2017	4.98%	12.58%	16.89%
11/3/2017	7.24%	3.91%	7.25%
2/9/2018	4.64%	9.22%	5.43%
5/31/2019	6.87%	?	?
minimum	-0.44%	3.91%	5.43%
median	4.64%	9.22%	16.89%
average	4.61%	10.61%	16.69%
maximum	8.82%	22.52%	29.07%

Source: Factset, Applied Equity Advisors

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The point is, unless you think we are having a recession now, this has been a good buy signal. We do not believe we are currently in a recession. In our opinion, the fact that value stocks have begun to rally confirms that thesis.

Unless you think this time is completely different, market behavior is consistent with a bear market low, NOT a bull market top. There is one problem with this analogy. To state the obvious, we are not in a bear market; the market is up this year. Maybe it has been the duration of stagnation that classifies this as a bear market. Who knows? It does not really matter to me. I care only that the stars are aligning consistently with a bear market low. Not a bull market peak.

5)

Notice the returns of the market the year before a Presidential election according to the Stock Trader's Almanac.[7]

DISPLAY 2

Presidential cycle in year preceding an election[1]

WHAT HAS HAPPENED HISTORICALLY	HOW HAS IT PLAYED OUT THIS YEAR?
1. Stock market peaks in July	✓
2. Selloff in August	✓
3. Further weakness in October	?
4. Strong rally into year-end	?

So far, this year has played out in line with history. Contemplating the rest of the year, the story line might continue. Trump wants to get re-elected, and what matters is how the economy is doing in Q3 2020, ***not*** how it's doing in Q3 2019. He needs good numbers next year. Not this year. That leads me to believe the US will not have a China deal in October, which would be too soon to maximize the economic impact in 2020. For this reason, I am concerned that we could see weakness in October which would be consistent with history. Plus, ***the market appears to be overbought in the short-term.***

Nevertheless, as stated above, I do think we could have a strong rally into year-end. As it has in the past, the market should anticipate an accelerating economy into an election year.

6)

The 2-10 year yield curve finally inverted just before the Federal Reserve had its August meeting in Jackson Hole. As I listened to a number of Fed officials poo-poo its recessionary signal, I found it entertaining to hear the one contrarian governor state that he was not going to ignore the signal for a third time. Smart.

The yield curve inverting now seems consistent with potential problems in 2021. It has historically inverted well in advance of a recession. If Trump gets his Fed cuts now plus a China deal later this year, then I do think the economy could run hot in the second half of 2020. That could imperil the year-over-year comps sometime in late 2021. I believe the yield curve inverting now is signalling such a timeline. Don't ignore it, but don't conclude economic problems are imminent.

Finally, I carry a notebook that I whip out anytime some fact or comment comes along that I perceive is worth remembering. The other day I heard a great quote but alas, I did not do a good job of footnoting who said it:

"It's easier to spook people than to build optimism."[8]

Does that not sum up the appetite for risk assets in 2019?

Andrew

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[1] Isn't The Stock market a Forward Predictor?

[2] Factset. Momentum stocks defined as highest top decile of the Russell 1000 based upon recent stock performance (combination of past 1 yr and 6 months). Defensive stocks defined as highest top decile of Russell 1000 based upon ranking of earnings consistency and low stock price volatility. Growth stocks defined as top decile of Russell 1000 based upon ranking of earnings growth. Secular Growth stocks as defined by the highest secular growth decile of the Russell 1000 based upon ranking of low beta, high growth, and high

momentum in terms of standard deviation. Value stocks defined as the cheapest decile of the Russell 1000 based upon ranking of price-to-book, price-to-earnings, and price-to-free cash in terms of standard deviation.

[3] Factset as of September 20, 2019

[4] Factset

[5] ICI from December 1, 2018 through August 14, 2019

[6] CNBC August 26th

[7] Stock Traders Almanac, Barrons, August 3, 2019

[8] CNBC August 22nd