BCM 2Q19 Market & Strategy Commentary: Sector Rotation

Odd, Odds and Tods: A Mid-Year Review

By the BCM Investment Team

While the stock markets love to climb a "wall of worry," it's easy to see why investors may be on edge.

While future earnings expectations had come down markedly towards the end of 2018, actual reported S&P 500 earnings have not yet had a decline. What's driving this year's earnings multiple expansion?

The trade war has already led four of the world's top five economies into a manufacturing recession, with the fifth—the U.S.—hanging on the precipice. What will it take to come to a trade truce?

According to bond market futures, more than three rate cuts have been priced into the U.S. bond markets. Are the bond markets being too optimistic?

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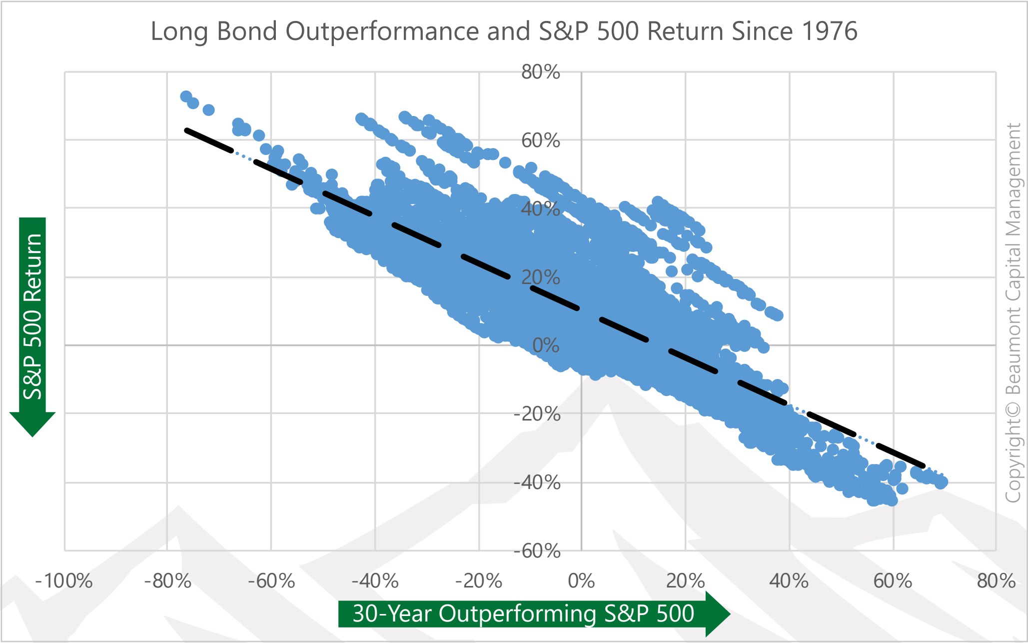
Which index has realized the highest 1-year return through June 30th, 2019?

a. S&P 500® Index
b. MSCI Emerging Markets Index
c. Russell 2000 Index (Small Cap)
d. Bloomberg Barclays U.S. Long Treasury Index

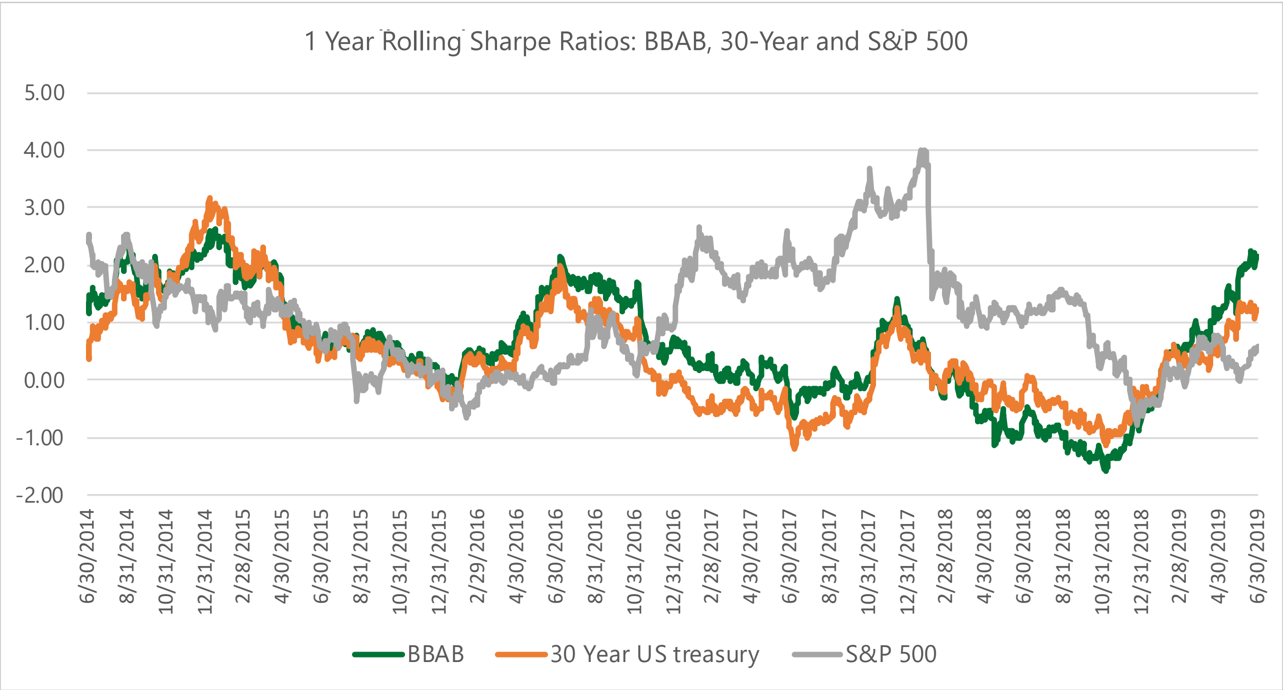
Don't overthink it! The answer is D, the Bloomberg Barclays U.S. Long Treasury Index (Long Treasuries). This is a question that we've posed to many clients over the past quarter to illustrate just how odd this market environment has been. Despite making a new all-time high just last week, the S&P 500 has underperformed Long Treasuries over the past year. What's even more interesting is that the majority of the positive performance for Long Treasuries occurred in 2019, not during the equity market drawdown in the fourth quarter of 2018.

Since the beginning of the year, the yields on U.S. 10-Year and 30-Year Treasuries have fallen by 68 and 49 basis points, respectively. Falling yields are generally associated with slowing economic activity or a risk-off appetite among investors. One would expect such an environment to be negative for equity investors but, so far, that has not been the case. In fact, when the 30-Year U.S. Treasury has outperformed the S&P 500 on a one-year basis, the average return of the S&P during these years is only 0.21%. As the chart below shows, the data supports the intuition that typically better relative long-bond performance is associated with worse (and all of THE worst) S&P 500 returns.



Source: Bloomberg, Beaumont Capital Management, Data is for the period 12/31/76 through 6/30/19

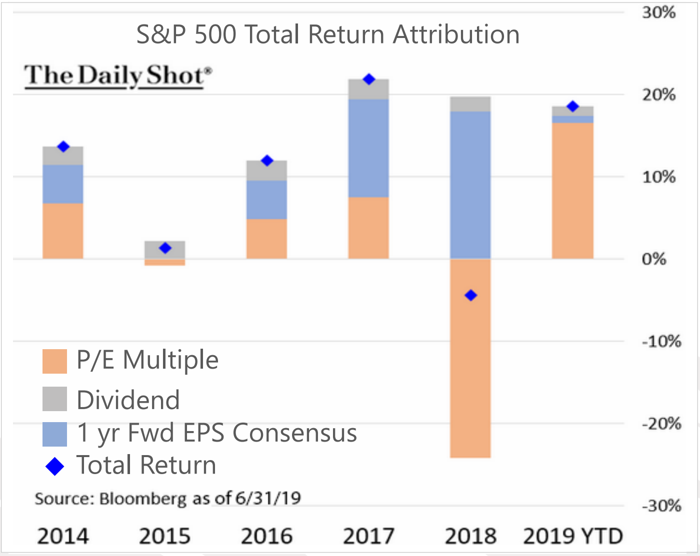
Furthermore, the second quarter's fixed income performance is in the top quartile for both U.S. and Global bonds since 1976, and since 2009, this has been the best 6 months for the Barclays Bloomberg Aggregate Bond Index (BBAB). This has all occurred despite some of the lowest starting yields on record. Remarkably, even as equity markets have recovered, fixed income has continued its outperformance on a risk-adjusted basis.



Source: Bloomberg, Beaumont Capital Management, Data is for the period 6/30/14 through 6/30/19

This information reinforces the uniqueness of the fourth quarter of 2018's near bear market (-19.7%), which now looks to be among the most speculative in recent memory. The S&P 500's movements over the past year have been driven almost entirely by rapid changes in its earnings multiple—a fancy way of saying that the prices keep changing while the earnings are not. While future earnings expectations had come down markedly towards the end of 2018, unlike the past large drawdowns in 2011 and 2016, *actual* reported S&P 500 earnings have not yet had a decline. As a result, investors seem to have quickly amended their prior bearish predictions, creating this snap back rally which has driven the multiple re-expansion we have seen in 2019. It appears the twin catalysts for the ongoing equity market rally have been the speculation that we may reach an agreement on the China trade war and a decidedly more dovish policy from the U.S. Federal Reserve Bank (Fed).

Ultimately, the market is judged by the earnings that stocks produce. Looking ahead, investors must determine if the declining growth rates we have seen in the first half of 2019 are evidence of a weakening overall economy or simply a result of challenging comparisons to 2017 and 2018. The corporate tax cut may have driven growth artificially higher in 2018 by incentivizing companies to increase their capital spending prior to 2018, knowing their profits would be taxed at a lower rate in the future. If this is true, investors may come to realize the underlying economic trends are stronger than they appear, and earnings growth may indeed re-accelerate—perhaps justifying the market's year-to-date multiple expansion.



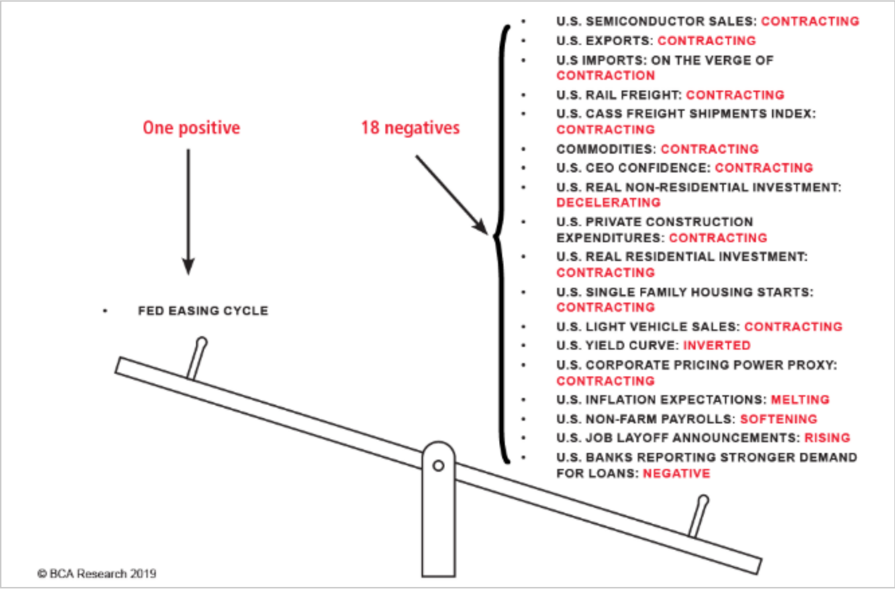
Trade War Update

Truce! No more tariffs! Hooray! Oh, wait, just no more new tariffs... for now, unless talks break down again... Tariffs are nothing more than a tax on imported goods and services that create uncertainty for corporations and consumers alike. These increased costs must be absorbed by companies and/or consumers either as reduced profits or higher prices, or a bit of both. Tariffs decrease free trade. Reduced trade leads to lower revenues. Lower revenues may eventually affect profits. There is a reason the S&P 500's 2019 and 2020 earnings estimates are being revised lower. For those of you who read our blog (blog.investbcm.com), the cause and effect of tariffs have been made clear over the past year. The trade war has already led four of the world's top five economies into a manufacturing recession with the fifth—the U.S.—hanging on the precipice.

The Federal Reserve

The FED is doing an incredible job managing its three mandates and stewarding this expansion. Yet according to bond market futures, more than three rate cuts have been priced into the U.S. bond markets. Are the bond markets being too optimistic? What about the equity markets?

We still agree with the adage of "don't fight the Fed." However, Fed easing cycles have rarely occurred in an economic expansion. If multiple rate cuts are indeed needed in the current economic environment, we believe equity investors should be careful treating that as a cause for celebration.



Source: Demetri Nikolias, BCA; WSJ Daily Shot, 6/25/19

What does this all mean?

While the stock markets love to climb a "wall of worry," it's easy to see why investors may be on edge. We've enjoyed many favorable trends in the U.S over the past decade: As of July 1st, we're now in the longest economic expansion in U.S. history, ten years and counting. U.S. equities outperformed their international brethren substantially over this period. U.S. interest rates have remained low and after this year's decline we wonder if they will revisit the 2012 and 2016 lows. Can these trends continue? Of course! But we believe it's imprudent to bet that they will last forever. With change comes opportunity.

As a predominantly quantitative investment manager, our rules-based systems use probability to try to determine the best times and asset classes to invest in. We view our models' actions as akin to a skilled blackjack player counting cards. We don't know the future, but our systems are designed to risk investor capital when the odds are in our favor. Periods like 2019 may be frustrating in hindsight, just as losing a hand when the deck is "hot," but that doesn't mean that our actions weren't the best decision at the time. At BCM, we feel the most important investment rule is "don't lose a lot of money." Adhering to this maxim may make investors uncomfortable at times as our systems assess and seek to avoid elevated and perhaps undesirable risk. No manager can always be "right," but if we're right more than we're wrong over time, investors should realize an acceptable result.

On a separate note, we welcome our new National Sales Director, Tod Perry. Tod joins us from F.U.S.E. Research Network and has enjoyed an extensive career in sales and sales management at firms such as Charles Schwab and State Street Global Advisors. We are more than excited to have Tod's experience and expertise, and you may meet him soon as he begins his introductory tour of our great country.

We thank you for your business and continued trust in BCM.

Beaumont Capital Management (BCM) Strategy Commentary

BCM Sector Strategies

BCM U.S. Sector Rotation, BCM Diversified Equity, BCM Growth and BCM Moderate Growth

The **BCM U.S. Sector Rotation Strategy (U.S. Core Equity Allocation)** began the quarter fully invested with all eleven sectors owned. In late May equity market volatility spiked and by early June we had sold five sectors: Materials, Energy, Industrials, Healthcare and Communication Services. This bout of volatility was short-lived and in mid-June we repurchased four of the five sectors that had been sold. The portfolio ended the quarter fully invested in ten of the eleven sectors, excluding only the Energy sector.

The second quarter of 2019 was more volatile than the first but still proved to be a relatively benign environment for equity investors. Despite falling for the majority of May, the S&P 500's drawdown remained within the 5-10% range that we refer to as an "ordinary pullback." In a normal market environment, we'd expect little change to the portfolio during an ordinary pullback, but in this instance we sold five sectors and were on the cusp of selling more. This quick reaction reflects the nature of the market environment that we've been in for the past year and a half. Equity returns have been strong on a year-to-date basis, but many sectors are only re-approaching all-time highs that were set in January or October of 2018. Therefore, while momentum is positive, many sectors remain on a relatively short leash.

The portfolio slightly underperformed its benchmark primarily due to underweight allocations to the Technology and Financials sectors and poor timing on the sale of the Energy sector. The portfolio returned 3.60% gross of fees (3.22% net) compared to 4.30% for the S&P 500 Index.

In the BCM U.S. Sector Rotation Strategy, we use an equal-weight portfolio construction. As a result, when the strategy is fully invested, its results will tend to differ from the S&P 500. We remind investors of this frequently in order to set proper expectations surrounding the strategy. Our goal is not to track the S&P 500 but instead to provide exposure to sectors exhibiting positive momentum and eliminate exposure to those that are not while reducing risk relative to the index. We believe that over time this strategy will produce desirable results, with the S&P 500 being the relevant benchmark, but investors in the strategy should expect a fair degree of tracking error along the way.

The **International Equity Allocation** maintained a constant exposure throughout the quarter, holding equal positions in an ACWI Ex-U.S. ETF and an Emerging Markets Excluding State-Owned Enterprises (Emerging Markets Ex-SOEs) ETF. Our investment thesis driving these portfolio allocations remains unchanged. When momentum is positive, we believe the allocation should be fully invested with an overweight allocation to emerging market equities, specifically emerging market consumers. We believe that the Emerging Markets Ex-SOEs ETF provides a better exposure to emerging market equities, and specifically emerging market consumers, than the broad emerging market indices. Removing state-owned enterprises, which are typically not run for the benefit of shareholders but rather the nations that own them, decreases the ETF's exposure to Banks and Energy companies while increasing exposure to Internet and Consumer companies.

The International Equity Allocation underperformed during the quarter, as emerging market equities underperformed developed international equities. The International Equity Allocation had an estimated return of roughly 1.6% gross of fees (roughly 1.3% net) during the quarter, compared to a return of 4.03% for the MSCI World ex-U.S. Index.

The Global-Macro Equity Allocation maintained a constant exposure throughout the quarter with 75% of the allocation in a U.S. Quality Dividend ETF and the remaining 25% in an Internet-Based Equities ETF. Our investment thesis behind these portfolio allocations remains unchanged. We believe that with the baby boomers entering retirement, there will be ample demand for high-quality, high-dividend securities, especially in a low interest rate environment. Many internet-based technology companies are legitimately dominant businesses that are benefitting from massive tailwinds as technology permeates the economy. We view the positions as complements to each other as they should realize differing performance characteristics during short-term market cycles.

The **Global Macro Allocation** slightly underperformed during the quarter, as the U.S. Quality Dividend ETF underperformed the benchmark. The Global Macro Allocation had an estimated return of roughly 2.7% gross of fees (roughly 2.3% net) during the quarter, compared to a return of 4.18% for the MSCI World Index.

The H**igh Quality Fixed Income Allocation** maintained a constant exposure throughout the quarter holding equal positions in Enhanced Yield U.S. Aggregate Bond and Total Return Tactical ETFs. Since the purpose of this allocation is to reduce risk for more conservative investors, the BCM Investment Committee intends to keep the allocation's duration about a year shorter than the Bloomberg Barclay's U.S. Aggregate Bond Index (BBAB), while roughly matching the index's yield through a mix of passive and active credit exposure.

The allocation slightly underperformed its benchmark, as the increased credit exposure didn't entirely offset the allocation's shorter duration amid falling interest rates. The allocation ended the quarter with a weighted average duration of 4.6 years compared to 6.0 years for the BBAB, and the allocation had an estimated return of roughly 2.8% gross of fees (roughly 2.4% net), compared to a return of 3.08% for the BBAB.

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As with all investments, there are associated inherent risks including loss of principal. Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Sector investments concentrate in a particular industry, and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less concentrated investment options and the market as a whole. Securities of companies with smaller market capitalizations tend to be more volatile and less liquid than larger company stocks. Foreign markets, particularly emerging markets, can be more volatile than U.S. markets due to increased political, regulatory, social or economic uncertainties. Fixed Income investments have exposure to credit, interest rate, market, and inflation risk. Diversification does not ensure a profit or guarantee against a loss.

All BCM strategies invest only in long-only ETFs. The BCM investment strategies may not be appropriate for everyone. Due to the periodic rebalancing nature of our strategies, they are not appropriate for those investors who need or desire frequent withdrawals or deposits. The portfolio manager maintains full discretion over the portfolio.

The telecommunications sector was treated differently by the indices of the underlying ETFs and within the BCM strategies from inception into Q3 2018. It may have been included as part of the technology or utilities sector, or as its own sector. Effective Q3 2018, the telecommunications sector was eliminated, and the communication services sector was created. This new sector is comprised of names from the now-defunct telecommunications sector plus names that were previously included in the technology and consumer discretionary sectors.

The BCM Decathlon Tactics strategies are predictive, algorithm driven and use pattern recognition technology (PRT) to rank a population of ~110 handpicked ETFs in which it will "invest" in the 10 most promising based on upward price movement and defined volatility levels. BCM Decathlon Growth Tactics targets volatility and maximum drawdown at 16%, BCM Decathlon Moderate Tactics targets volatility and maximum drawdown at 12% and BCM Decathlon Conservative targets volatility and maximum drawdown at 7% with an 80% maximum equity allocation. The algorithm re-evaluates the population of ETFs and 'rebalances' typically every 25 trading days.

The Standard & Poor's (S&P) 500® Index is an unmanaged index that tracks the performance of 500 widely held, large-capitalization U.S. stocks. The Bloomberg Barclay's U.S. Aggregate Bond Index, which used to be called the "Lehman Aggregate Bond Index," is a broad base index and is often used to represent investment grade bonds being traded in United States. The Morgan Stanley Capital International All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI). It is designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. The MSCI Emerging Markets Index is an index used to measure equity market performance in global emerging markets. It consists of 23 economies including Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates. The MSCI is a float-adjusted market capitalization index. The Russell 2000 index is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks. It is a market-cap weighted index. The Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint.

An Exchange Traded Fund (ETF) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold. All BCM strategies invest only in long-only ETFs. The performance of any ETFs, as contributors or detractors to the strategy, are provided on a gross basis.

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