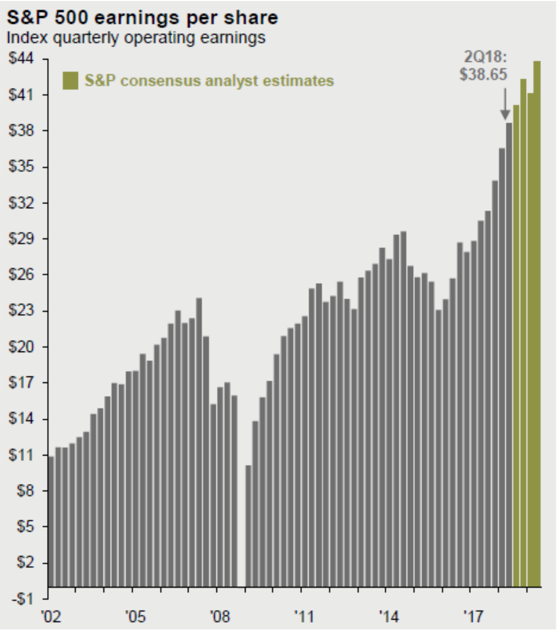
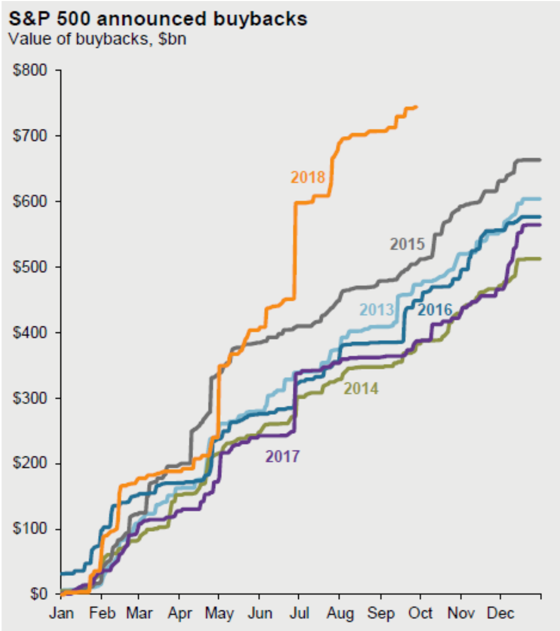
BCM 3Q 18 Market Commentary

By: The BCM Investment Team

"These rose colored glasses
That I'm looking through
Show only the beauty
'Cause they hide all the truth"
-John W Conlee

Over the past year we've started to wonder whether U.S. investors are beginning to view the world through a pair of rose colored glasses. If one doesn't look too critically and restricts their gaze to the U.S. alone, they'd certainly see a "rosy" picture. Strong revenue growth, and continued margin expansion combined to fuel great earnings across the board in the second quarter for U.S. companies. Following the Tax Cuts and Jobs Act, U.S. corporations have authorized a record amount of share buybacks. The U.S. Bureau of Economic Analysis (BEA) revised the second quarter's GDP estimate to 4.1% annualized, the highest in years. The fundamentals are strong, consumers are confident, and the market is rising. What is there to worry about?



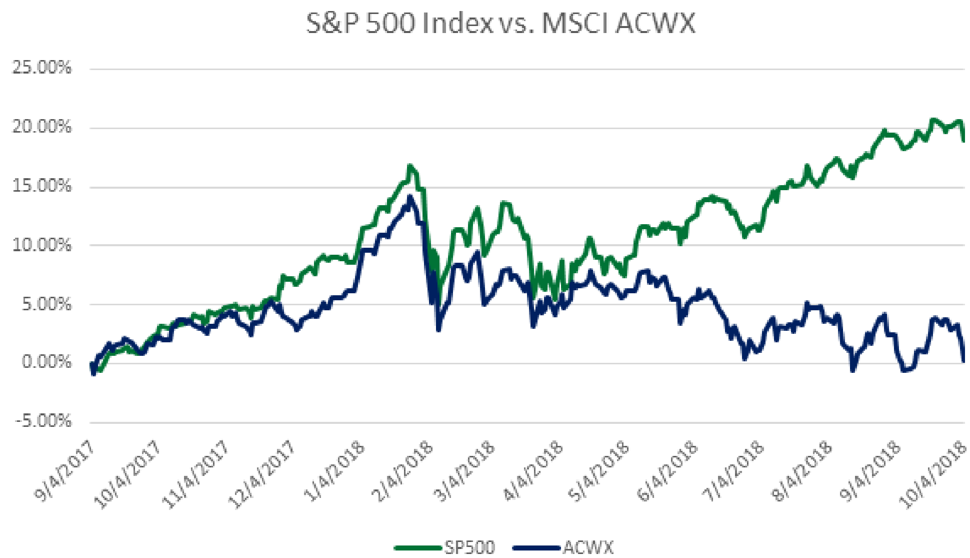


Source: Bloomberg, Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management
EPS levels are based on operating earnings per share. Earnings estimates are Standard & Poor's consensus analyst expectations.
Buybacks are based on company announcements year to date. Guide to the Markets – U.S. Data are as of September 30, 2018.

Plenty, in our opinion. We believe the current environment is not nearly as rosy as it seems. If you take a critical look and have a global perspective, there are a few thorns to contend with: namely an escalating trade war with China (and others) as well as quietly rising U.S. interest rates.

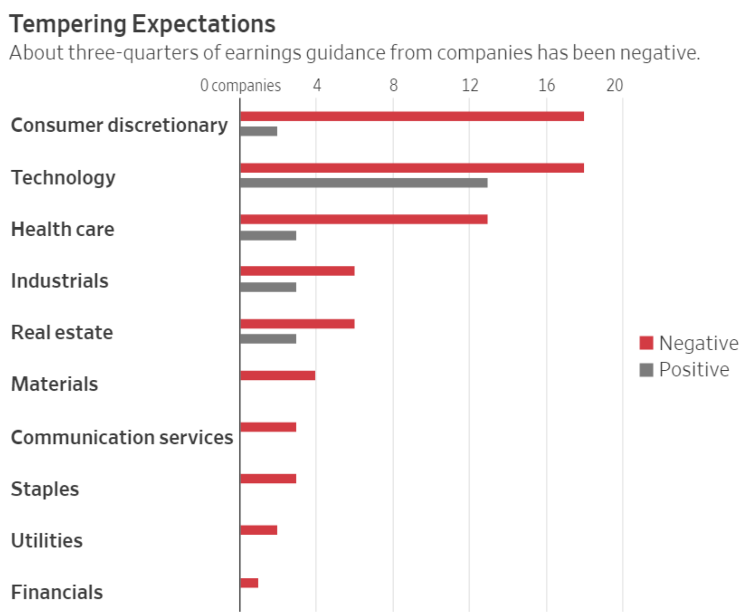
While we have written and blogged extensively on tariffs and the trade war, this is not the forum to continue my anti-tariff rants. However, it is worth pointing out that the trade war appears to be having a profound impact on the global economy. When the year began, the leading economic indicators for all 35 of the Organization for Economic Co-operation and Development (OECD) countries were in positive territory and on an improving trend. Today, many of these trends have turned negative including the U.K., Germany, Italy, France (Europe as a whole), Brazil and Russia. China's Purchasing Managers' Index (PMI) has fallen to 50… the dividing line between growth and contraction.

Subsequently we have seen an extraordinarily bifurcated global equity market. U.S. equities have realized strong performance, and then there is everyone else. The divergence has been especially acute in the emerging markets. If trade uncertainty continues, we believe it is more likely that the U.S. equity market closes the gap with the rest of the world than vice versa.



Source: Bloomberg as of 10/4/18

While equity analysts are forecasting continued earnings growth, of the 98 companies who have issued Q3 earnings guidance, ~76% revised them *downward*.[1] Negative guidance would be a shock if one only considered the U.S. economy, but S&P 500 companies conduct a material portion of their business outside of the U.S. We live in a global economy and we are not on an island! We don't know whether this is a simple reset of expectations or the beginning of a trend, but if it continues, something will have to give.



Note: No companies in the energy sector provided third-quarter guidance.
Source: FactSet, WSJ, 9/29/18

Another trend that has been quietly forming is rising interest rates. The 10-year U.S. Treasury yield broke through the 3% barrier yet again as the Federal Reserve (FED) continues to raise the Federal Funds rate. With further rate increases telegraphed, we shall see if this trend continues. Put simply, it is likely that the 35-year macro bond cycle has now ended. Certainly, the massive financing needs of our Government, together with the FED's rate increases and Quantitative Easing (QE) reversal lend credence to this argument. What we would like to point out next are the potential consequences.

Source: Bloomberg as of 10/5/18

Investors and advisors generally consider bonds a "safe" investment. This is largely true when considering investment grade bonds with short to intermediate durations, but those who have searched for yield due to low interest rates may have ventured outside of the realm of what may be considered safety. A 1% rise in interest rates for a 30-year U.S. Treasury bond could cause the bond's price to fall as much as 17%! This year, trade war fears and a rising U.S. Dollar caused many emerging market bond funds to fall well over 10%. High yield, formerly known as junk bonds, have produced high returns during the largely favorable equity market conditions of the past few years. Not surprisingly, they also correlate with equities during times of duress. Even the Bloomberg Barclay's U.S. Aggregate Bond Index has seen its exposure to interest rate and credit risk increase. According to Bloomberg, the index's weighted average duration has risen from ~3.7 years in 2009 to 6.0 years today, and the weighting of the lowest quality investment grade bonds has nearly doubled from 8% in 2007 to 14% in 2017. How will retirees react when the perceived "safe" elements of their portfolios produce low or even negative returns?

Despite our misgivings, the market has continued to climb higher. We agree that bull markets don't die of old age, but there is more than enough market, economic and geopolitical turmoil that we believe it's worth being vigilant. It is not our desire to predict how long this bull market, now the longest in history, is going to last. We certainly don't know the answer to that question and express deep skepticism towards anyone who claims to. Instead, our goal is to point out the major economic events that we have our eyes on and provide you with enough information to understand our point of view.

Periodically, we like to make sure everyone understands our mission. It is worth a quick revisit to the proper expectations of Tactical Management. In our opinion, tactical managers are trying to do two jobs: provide growth during the good times and to preserve the majority (not all) of client capital when markets correct or worse. It is difficult for any active manager to beat a broad, market-cap weighted equity index during a run-away bull market. But these bull markets always end, and usually do so in a rather shocking manner. This is when we can add the most value.

As always, we are grateful for your business and please let us know how we can help you navigate these interesting times.

We thank you for your business and trust in BCM.

BCM Strategy Commentary – Sector Strategies

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

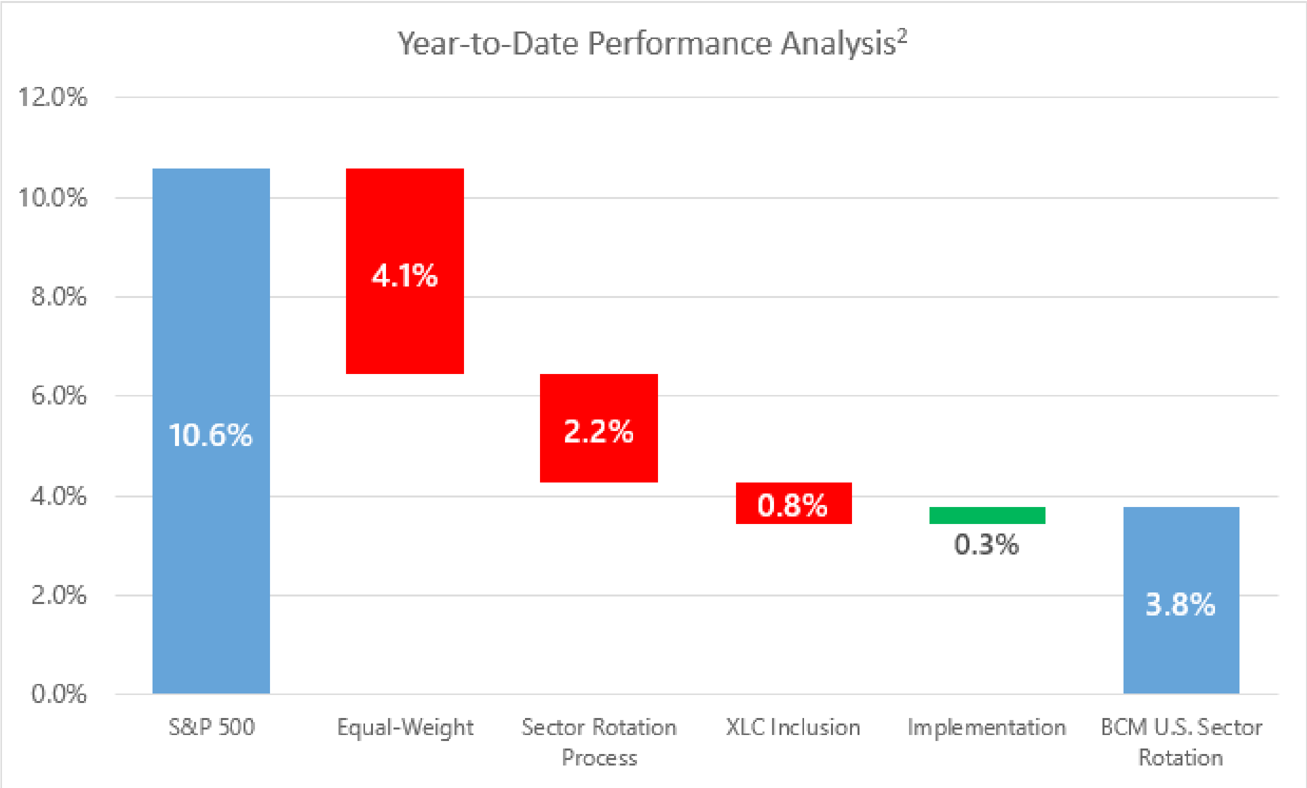
To remind our readers, in June S&P Dow Jones and MSCI, the creators of Global Industry Classification Standards (GICS), announced a re-alignment of the sectors of the S&P 500. These changes resulted in a 6% reduction in the size of the Technology Sector and a 3% reduction in the size of the Consumer Discretionary Sector. These constituents moved into the new

Communications Services Sector, along with the vestiges of the now defunct Telecom Sector, which has become about 10% of the S&P 500's market cap. State Street was the first ETF sponsor to launch a Communications Services Sector ETF, XLC, which we purchased in our Sector Rotation strategies in June, and many of the other ETF sponsors have either followed or made similar changes.

The **BCM U.S. Sector Rotation Strategy (U.S. Core Equity Allocation)** began the quarter fully invested in seven of the eleven sectors: Energy, Financials, Real Estate, Technology, Healthcare, Consumer Discretionary, and Communication Services. In late July, we purchased the remaining sectors not owned in the portfolio: Materials, Industrials, Consumer Staples, and Utilities. The portfolio ended the quarter fully invested in all eleven sectors.

This year has proved to be an unsatisfactory period for investors in a U.S. Equity limit-loss strategy with equal-weight construction. In light of this, we would like to take some time to walk through our performance for two purposes; to clarify the source of any deviations between our strategy and the S&P 500 and to ensure that correct expectations are set for the strategy going forward.

There are two reoccurring sources of deviation between our strategy and the S&P 500. The first is our equal-weight sector construct. We selected an equal-weight construction because it is more efficient to implement our strategy in this manner, reflects the active bets our strategy is making, and provides greater portfolio diversification. In this current bull market, the relatively more concentrated S&P 500 has outperformed our equal-weight construct by over 400 basis points (first red bar in chart below) as its largest sectors have outperformed. There is no structural reason why the larger sectors should outperform indefinitely and we expect that there will be many periods where the opposite is true.



Red bars illustrate detractors from performance and the green bar illustrates a contribution to performance meant to delineate the sources of variance between the performance relative to the benchmark.

The second is normal slippage due to the nature of our process (the second red bar in the chart above). The goal of our sector rotation strategy is to limit large losses and this protection has a cost. We believe that tail risk, or large loss, prevention will produce a favorable outcome over time (a full market cycle including a bull and a bear market) but preserving the ability to avoid large losses in bad times has a cost associated with it in good times. Our goal is to keep the cost of these premiums as low as possible.

A third source of deviation this year, which we would refer to as non-reoccurring, is due to the recent inclusion of the new Communication Services sector (third red bar in chart above). We believe that the inclusion of the Communication Services sector will help to mitigate some of the current imbalances between our equal-weight portfolio and the S&P 500, and add value to our process over time. Unfortunately, the timing of our purchase was less than ideal. Within one month of including the new sector, Facebook missed earnings estimates and revised their future guidance lower, causing the sector to fall nearly four percent in one day. While we believe having access to the new sector for the entire year would have been a positive for portfolio performance, the sector has detracted around 80 basis points from performance since being added to the strategy. Now that the reconstitution noted above is complete, this issue will not occur again.

Now that we have laid out the sources of deviation, what does this mean for the future? As long as the bull market continues, our defensive design will extract a cost from the portfolio. We expect to recoup some, or all, of this cost during the next bear market. The larger recent deviation, caused by equal-weight's underperformance, may or may not continue. We don't know which construct will outperform in any given year but over a full market cycle we don't expect equal-weight to realize performance that is materially different from capitalization-weighting (although it's likely equal-weight will realize lower standard deviation or volatility). Additionally, the sector reconstitution should help to somewhat mitigate performance deviations going forward as it resulted in a reduction of the technology sector's weighting. Thus, the magnitude of equal-weight's underweight exposure to the technology sector has declined as a result.

The third quarter of 2018 was a continuation of the adverse environment that has plagued our equal-weight portfolio construction for over a year. The two best performing sectors, healthcare and technology, are the third and first largest sectors respectively. Additionally, the portfolio missed the majority of the third best performing sector's positive performance, Industrials, as the system cautiously waited for the sector to confirm its positive momentum. The portfolio underperformed the S&P 500 Index during the quarter returning 4.20% gross of fees (4.07% net) compared to 7.71% for the 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 a full market cycle (including a bull and a bear market) 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** entered the quarter with a 75% allocation to an ACWI ex-U.S. ETF and the remaining 25% allocated to a China Internet ETF. In early August, we sold the China Internet ETF and purchased an All-World ex-U.S. ETF. The threat of a trade war has continued to linger and, despite the sector's primarily domestic revenue base, the Chinese Internet ETF succumbed to selling pressure as well. In keeping with our strong sell discipline, informed by our quantitative models, we removed the position for the time being. This change will leave the International Equity Allocations underexposed, as perceived by the BCM Investment Committee, to both China and the international technology sector. As long as the trade war continues, the BCM Investment Committee expects this underweight exposure to be a positive for performance, although the committee would like to revisit this underexposure in a less hostile market environment.

The trade war continued to hurt the portfolio during the quarter, hitting emerging market equities particularly hard. The International Equity Allocation had an estimated return of roughly -1.5% gross of fees (roughly -1.6% net) for the quarter compared to a return of -0.80% 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. Roles reversed this quarter as the U.S. Quality Dividend ETF outperformed the benchmark while the Internet ETF realized weak, but still positive, performance. The BCM Investment Committee remains confident in these themes for the foreseeable future. The Global Macro Allocation had an estimated return of roughly 6.3% gross of fees (roughly 6.2% net) during the quarter, compared to a return of 5.10% for the MSCI World Index.

The **High 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. The allocation slightly outperformed its benchmark due to outperformance by the Enhanced Yield U.S. Aggregate Bond ETF. This outperformance occurred as credit spreads tightened, offsetting the negative effects of widening spreads, which took place over the prior two quarters.

The BCM Investment Committee expects to keep the allocation's duration about a year shorter than the Bloomberg Barclay's U.S. Aggregate Bond Index (BCAB) for the foreseeable future.

The allocation ended the quarter with a weighted average duration of 5.56 years compared to 6.35 years for the BCAB, and the allocation had an estimated return of roughly 0.3% gross of fees (roughly 0.2% net), compared to a return of 0.02% for the BCAB.

For more insights on market highlights, economics or educational topics, check out BCM's blog at blog.investbcm.com

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Sources and Disclosures

[1] "Greenback Weighs On Corporate Profits". Wall Street Journal, September 29th, 2018, by Michael Wursthorn.

[2] The SPDR Communication Services ETF (XLC) became available in June 2018 but the actual GICS reconstitution was not implemented until September 2018. All numbers are YTD through 9/30/18 and are gross of fees. "S&P 500" is the year-to-date total return of the S&P 500 Index. "Equal-Weight" is the difference between the year-to-date performance of the S&P 500 Index and the ALPS Equal Sector Weight ETF (EQL), which holds the State Street Sector SPDRs in equal-weight allocations. "Sector Rotation Process" is the difference between the year-to-date performance between EQL and the hypothetical model allocations of the BCM U.S. Sector Rotation strategy with any allocations to the Communication Services Select Sector SPDR ETF (XLC) spread equally across the other positions in the portfolio. "XLC Inclusion" is the difference between the hypothetical year-to-date performance of the "Sector Rotation Process" absent XLC, and the hypothetical performance calculated using model allocations of the BCM U.S. Sector Rotation strategy. "Implementation" is the difference between the hypothetical year-to-date performance of the model allocations of the BCM U.S. Sector Rotation strategy and the actual gross of fees GIPS Composite representing the BCM U.S. Sector Rotation strategy.

Past performance is no guarantee of future results. Index performance is shown on a gross basis and an investment cannot be made directly in an index.

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Sources and Disclosures (continued)

The Purchasing Managers' Index (PMI) is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers. In the United States, the Federal Funds Rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight, on an uncollateralized basis. The U.S. 10-Year Treasury Rate measures the yield on Treasury nominal securities at "constant maturity" of 10 years for non-inflation-indexed Treasury securities.

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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.