EQUITY STRATEGY FOCUS

October, 2019

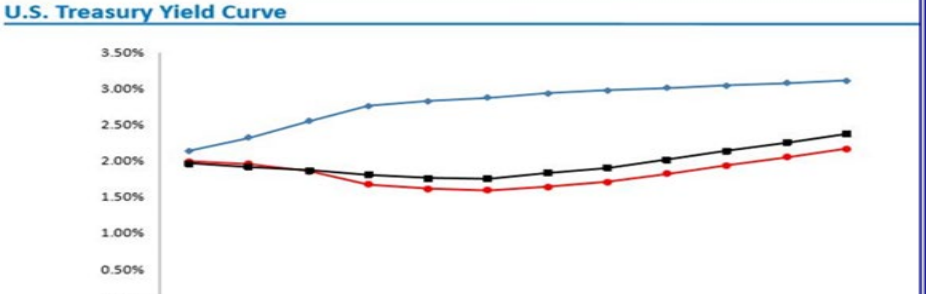
IN VIEW: The Economic Landscape

GDP grew at a rate of 1.9% in Q3, down from the previous quarter of 2% growth, but beat expectations by 0.3%. The consumer continues to be the main support of growth as personal consumption expenditures climbed 2.9%, although this number is decelerating. After dipping in September, retail sales will be key to watch throughout the upcoming holiday season to better gauge consumer strength heading into the new year. Government spending was also additive, particularly in federal non-defense spending and on the state/local level. Residential investment was a plus to GDP growth but was partially offset by a surge in imports. Weaker business investment detracted from growth, as evidenced by declining spending on structures and equipment. Corporate managerial spending plans along with factory orders are constrained by the uncertainties surrounding the longevity and severity of the ongoing trade war with China.

In September, the Institute of Supply Management (ISM) Manufacturing Index contracted for the second consecutive month to 47.8, down 1.3 from August. This is the lowest rate in 3 years in which the average manufacturing PMI registered at 56.5. Trade was cited as the largest issue contributing to lower confidence by manufacturers, resulting in lower export orders. Although the index dipped below a significant threshold of 50, it remains well above the 42.9 floor the ISM sets for expansionary economies. The ISM reports the 47.8 figure corresponds to a 1.5% increase in real GDP on an annualized basis. It is our conclusion that this latest reading is not yet enough cause for concern as we are entering a period of slowdown, not a recession.

The Federal Reserve cut interest rates for the second time this year, a preemptive move to support the economy amidst slowing global growth. The Fed also modestly increased their GDP growth expectations to 2.2% for this year. While not forecasting a recession, officials are anticipating growth to dip to 2% in 2020 and 1.9% in 2021. The key to the next Fed meeting is whether or not consumer strength and job growth are enough to offset weakening business spending and manufacturing as trade tensions escalate.

In our Q2 2019 commentary, when the short term 3-month Treasury curve inverted against the 10 year, we wrote about some impacting factors. A weakening economic landscape in conjunction with lower European yields are pushing U.S. yields lower. Since early this year, trade tensions have escalated, uncertainties surrounding Brexit are mounting, and the Fed lowered interest rates 2x after 9 consecutive rate hikes since 2015. The Fed cited slowing global growth, trade uncertainties, and low inflation for the reduction. Lowering the short end of the curve was not enough however to prevent the 10-year/2-year treasury spread from inverting.



	3M	6M	1Y	2Y	3Y	5Y	7Y	10Y	15Y	20Y	25Y	30Y
09/13/18	2.13%	2.32%	2.55%	2.76%	2.82%	2.87%	2.93%	2.97%	3.00%	3.04%	3.07%	3.11%
08/13/19	1.99%	1.95%	1.85%	1.67%	1.61%	1.58%	1.64%	1.70%	1.82%	1.93%	2.05%	2.16%
09/13/19	1.96%	1.91%	1.87%	1.80%	1.76%	1.75%	1.83%	1.90%	2.01%	2.13%	2.25%	2.37%

Source: Bloomberg Finance L.P. 2019
The U.S. Treasury Yield Curve plots the interest rates, at the indicated point in time, of bonds having equal credit quality but differing maturity dates, as listed in the table above.

The U.S jobs report for September was soft tempering sentiment as 136,000 non-farm payroll jobs were created, down from 157,000 in August. The recent data brought the 2019 monthly average down to 161,000 compared to the 2018 average of 223,000. For the month, healthcare, professional and business services, government, and transportation and warehousing, were some of the positive sectors contributing to growth. Manufacturing jobs weakened reflecting weaker ISM figures. Jobs in retail also came in lighter. Average hourly earnings fell by -$0.01 and the 12-month average gain stands at 2.9%. Unemployment dropped to 3.2%. Fed Chairman Powell still believes that although the economy faces some risks it is "in a good place". That is somewhat consistent with his optimistic remarks from the prior month citing moderate growth and a healthy overall jobs market. The Fed lowered rates another ¼ point in October. After acknowledging strong household spending, job gains, and moderate inflation, they cited weakening business fixed investment and exports as reasoning for reducing rates.

CLOSE-UP: Equity Investment Overview

Market Performance Overview:

The S&P 500 index was up 20.6% in the first 3 quarters of the year this compares to 6.3% for the Merrill Lynch Domestic Master Index. In September, value stocks took the helm and outperformed growth by 356 basis points. The outperformance of value stocks generally correlates with higher interest rates as growth stocks rely on lower rates to secure lending. This recent fast break by value stocks may be anticipating a higher interest rate environment or could simply be an overreaction to the back up in interest rates that began in September.

Stock strength was broad-based year to date, with 7 of the 11 sectors outperforming the overall market. Technology, Real Estate, and Utilities led the market with total returns of 31.4%, 29.7% and 25.5% respectively. Energy and Financial stocks lagged the market with total returns of 6% and 5.7%. For the quarter, defensive sectors moved to the forefront led by Utilities, Real Estate, and Consumer Staples. One explanation could be that volatility spiked in late July as the economy began showing signs of a highly anticipated slowdown, and thus led to a repositioning in the marketplace.

There has been a growing debate about whether or not we are in a bond bubble, as U.S. bond yields revisit lows (down from 3.2% last fall) and some European bond yields turned negative. Since the last financial crisis, both U.S. and European nations have been providing liquidity by purchasing bonds. Some analysts point to the build-up of cheap money as a sign of a bubble. But there are other factors to consider as well.

Global debt has increased over 50% in the last decade, when you consolidate the sectors of government, corporate and household debt, according to CNBC. What's different about this debt accumulation as compared to the one that led up to the financial crisis, though, is that the recent increase in debt is not so much coming from the private sector as it is the government side. Additionally, a larger portion of the debt increase comes from China who has been borrowing domestically - limiting any potential contagion effect should they default. Household debt in China has significantly outpaced growth in the U.S. by approximately 70% per year, indicating U.S. households have demonstrated some restraint.

Additionally, data from the St. Louis Fed shows U.S. Household debt to GDP declining from 100% to 76% since the financial crisis. The strength in the economy has aided in reducing credit default risks.

<u>The Risk of Credit Default Risks Remain Low</u>

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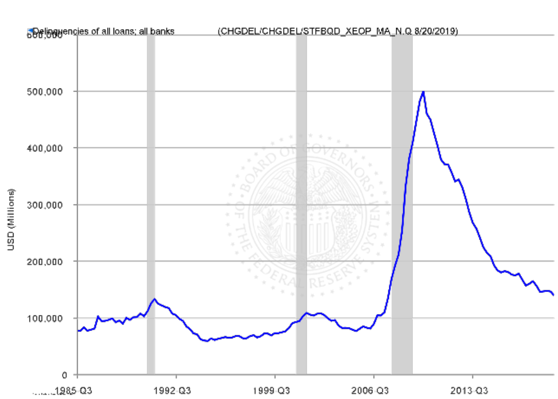
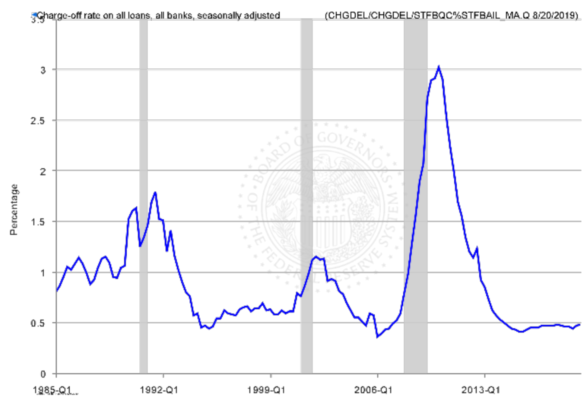


Charge off Rate on Loans at all Banks



There is still a relatively upbeat expectation for S&P 500 revenues and earnings: Undoubtedly, industry analysts may be too optimistic about the outlook for earnings, as they often have been in the past. They are currently forecasting earnings growth for the quarter of 2.0%, 10.1% next year, and 10.3% in 2021. That implies that the profit margins, which are at record highs, could continue to move higher. Once the euphoria dissipates, an earnings hook like last year with growth in the low single digits (closer to 4.0%) this year is more likely and better than 2016 (which came in at only 0.5%). Industry analysts are currently projecting that 2019 annual earnings will be just 1.1% this year, while we are a bit more optimistic still above 4.0%. In terms of next year, analysts are still at 11.2%, while we have dropped our expectations to 7.5%.

In addition to earnings, market strength is dependent upon global growth, interest rates, and trade negotiations. We will be closely watching how the Fed manages interest rates in the months ahead. The 10-year treasury yield is once again above the 3-month treasury yield, which is a good sign. As global growth continues to slow, it is unclear exactly how the Fed will respond. There is wide expectation for two more rate cuts next year. Should this not materialize and disappoint investors, the market could sell off. Brexit - and of course China trade negotiations - remain wild cards as well. The market currently reacts to daily headlines, but progress is uncertain and specific terms have yet to materialize, therefore any long-term implications are still unknown.

In terms of the AIM composite, Industrials and Financials were most additive to performance. Energy and Materials detracted the most from performance.

- Top performing stocks year to date in the portfolio were Keysight Technologies, Northrop Grumman, Applied Materials, Johnson Controls, and Conagra. These stocks gained over 50% year to date with the exception of Conagra which gained 47%.
- The worst performers year to date were Halliburton, Occidental Petroleum, Cigna, Pfizer, and Marathon Oil. Stock performance amongst these names ranged between -13% and -27%.

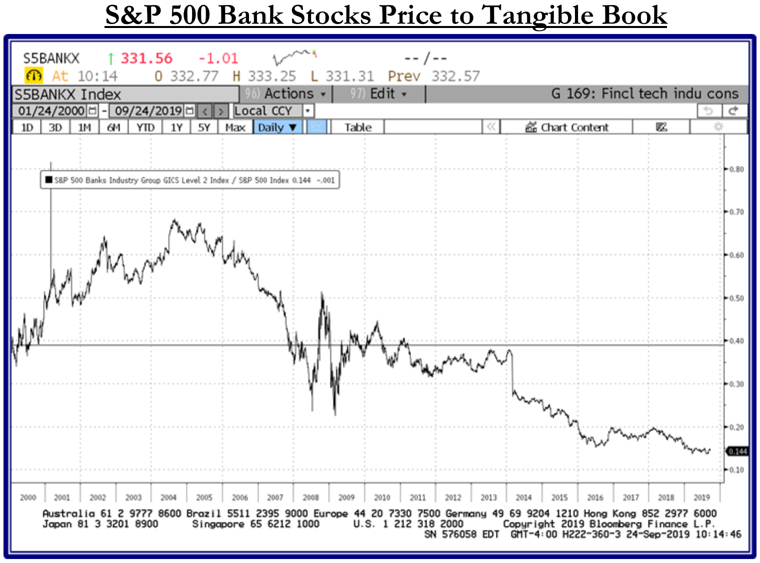
Looking to the most recent quarter, the AIM composite was pretty much on par with the benchmark index as value stocks surged ahead of growth stocks in September. The value stocks 350 basis point lead over growth during the month helped to narrow the gap in year to date performance. Our stock selection in the Industrial and Consumer Discretionary sectors was most additive to relative performance, as Northrop Grumman, Lowe's, Johnson Controls, and Dollar Tree posted significant gains.

Portfolio Strategy:

❖ *Financials: Rationale for Banking Industry Exposure*

Bank stocks are trading at an 85% discount to the S&P 500 Index on a price to tangible book value basis. This compares to a low of 77% in the aftermath of the financial crisis and is well below its average over the past two decades. We believe that banks stocks are already pricing in a longer-term lower interest rate environment or perhaps even pricing in a recession. As we have written about in prior commentaries, we are not predicting a recession based on a moderate growth, a resilient consumer, a healthy jobs market, and benign inflation. Therefore, the current discount in the banking sector makes these stocks all the more attractive at current levels.

S&P 500 Bank Stocks Price to Tangible Book



Source: Bloomberg

Bank of America produced record profits this past quarter reporting, an 8% increase in the second quarter. After two interest rate hikes this year, management now anticipates net interest income to rise by 1% down from an earlier estimate of 3% during 2019. The strong consumer helped deposit and loan growth while global business banking also improved in the same areas. Head winds were evident in global markets segment as lower volatility weighed on activity. The inverted yield curve is particularly negative for banks, because the spread they make over borrowing costs is narrowing.

Wells Fargo's reported profit up 20% for Q2, with the help of increased share buybacks and cost cutting. Management's forecasts for net interest income for the year were reduced to -6% against analyst expectations of -3.8%. The company has a relatively large variable mortgage business which has been under pressure as a result of lower rates and cost that are declining but are still at the high end of their target range. This month Wells Fargo finally appointed Charlie Scharf CEO after the absence of a permanent appointee since March. Mr. Scharf was previously CEO of The Bank of New York (BK) and has the banking expertise to help develop strategic initiatives through product/service enhancements and cost cutting initiatives. The stock traded up 3% on the news.

On the other side, BK's Todd Gibbons was appointed interim CEO to replace Charlie Scharf. The stock initially traded down on the abrupt news, due to the uncertainty of a more permanent CEO. Mr. Gibbons was previously Vice Chairman and CEO of Clearing, Markets, and Client Management and should his status become permanent we believe he is more than qualified to move the company forward. With regards to earnings, in September BK reported that lower expenses and higher asset yields helped offset declining revenues in Q2. Revenue weakness can be attributed to lower net interest revenues and fee pressures across a majority of their businesses. Looking ahead, BK stands to benefit from continued cost cutting and a strong custody business.

Regions Financial (RF) reported 3rd quarter earnings of $0.39, pretty much in line with expectations. Top line sales came in 1.04% ahead of expectations. Management has been successful in stabilizing expenses over the last few years, as they navigate the low interest rate environment. RF is shifting to a larger percentage of fixed-rate loans which should help stabilize margins in the coming months should interest rates remain low. EPS is anticipated to slow somewhat in 2020 if the Fed continues to cut rates, so continued management of expenses is crucial. Additionally, the current Simplify and Grow program is still in the early stages with nearly 75% left until completion providing further room for improvements.

❖ *Consumer Staples: Valuation Disparity Triggers Purchase*

As we are in the midst of the 10th year of the economic cycle, adding to our consumer staple exposure seems consistent with our view that the overall market is no longer undervalued – rather, trading at an average market multiple of 17 times our 175/share estimate for the S&P 500 in 2020. Taking a more cautious market outlook; the defensive nature of Consumer Staples stocks and the emergence of relative attractive valuations historically in the industry provides greater appeal.

Conagra Brands is a leading food company encompassing a broad array of well-known brands such as Birds Eye, Chef Boyardee, Healthy Choice, Hunt's, Reddi-Wip, Slim Jim and Marie Callender's. Pro-forma sales for the company in 2018 were spread across the following categories: Frozen & Refrigerated (37%), Condiments & Enhancers (19%), Snacks & Sweet Treats (16%) and Shelf-Stable Meals & Sides (11%). The remainder was in the International and Food Service segments.

The company is gaining market share benefiting from a demographic tailwind, growth in health and wellness and a shifting consumer preference for convenience foods - key pillars of Conagra's long term strategy. The acquisition of Pinnacle Foods late last year, emphasizing frozen foods (including Birds Eye, Wish Bone and Duncan Hines), snacks, refrigerated, and shelf-stable products, for $10.7 billion put pressure on the shares as the businesses underperformed market expectations. This resulted in a 40% drop in Conagra's share price and a five-point drop in the stock's P/E ratio. Not keeping up with market innovations resulted in the loss of shelf space at major retailers. Over the years, we have gained greater confidence in management's ability to address these issues. While Conagra's shares recovered about half of its losses prior to rounding out our portfolio position, we are now encouraged that the company is out of the woods allowing us to expand our position at current levels. Conagra's P/E ratio is below its five-year and peer group averages.

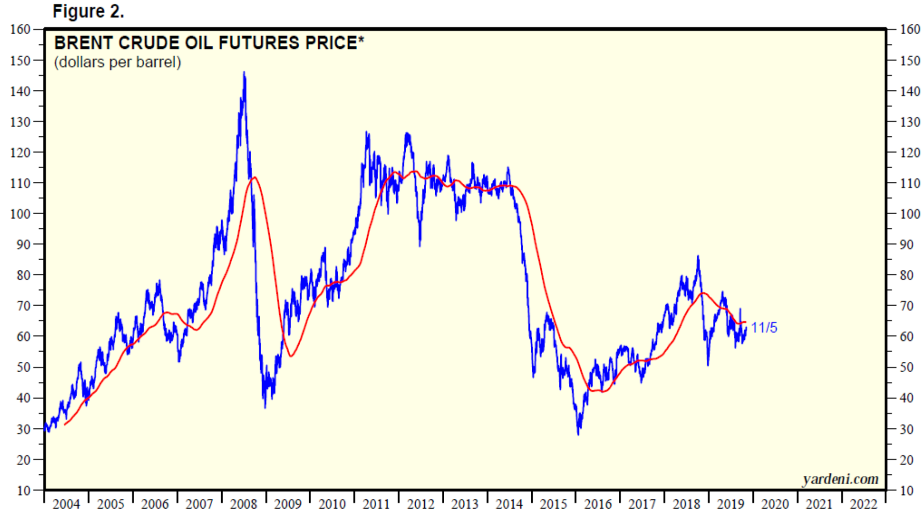
The shares also appeared undervalued on multiples of sales, cash flow and earnings before interest, tax, depreciation, and amortization (EBITDA), and scores in the third-cheapest decile in our investment model. The balance sheet is improving and, relative to peers, the fundamentals such as organic sales and cost of goods sold look decisively better than the peer group. Due to their ongoing deleveraging efforts, the majority of synergies from Pinnacle should fall to the bottom line in 2020. In addition, the stock offers an above market yield of 3.0%.

❖ *Energy: The Case for Overweighting Sector*

There are few times when problematic issues can be boiled down to one simple explanation. For the market in crude oil, the current problem is simply too much supply and not enough demand. U.S. crude production has soared, and a sluggish world economy has led to below trend consumption.

If the U.S. and China can strike a trade deal, there's a chance that the worst has passed for the energy markets for a while. A deal should cause consumers and businesses to use more oil, at the same time as U.S. fracking production growth may be slowing down. With those caveats, for long-only investors, the S&P 500 Energy sector seems to be bottoming and we would expect at least for the rest of the year that the group could take center stage as investors start thinking about a global economic rebound in 2020. This would be a welcome change of pace, given that the Energy sector has been the worst-performing sector year to date and over the past year.

Figure 2.

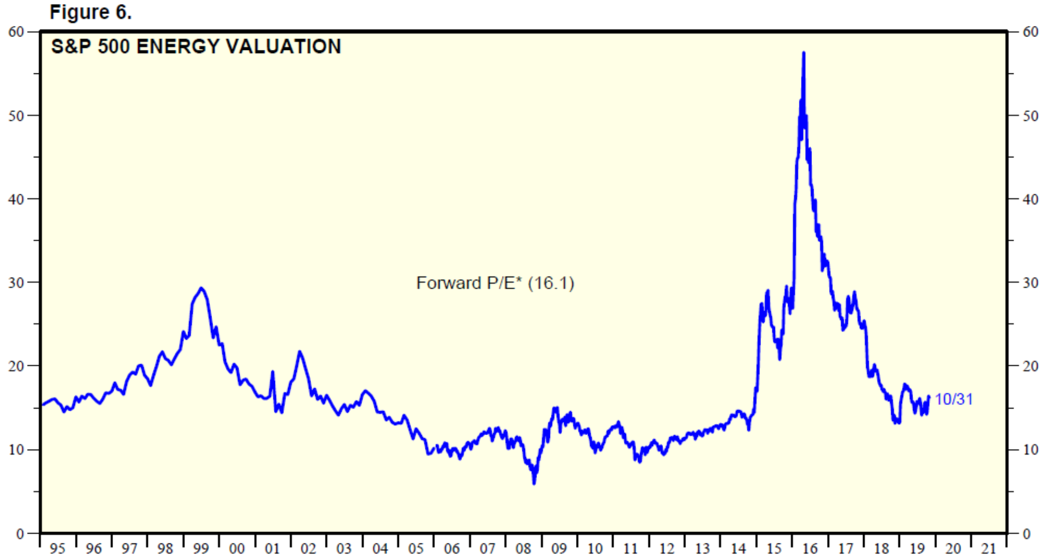


200-day moving average
* Nearby futures price.
Source: Haver Analytics.

The consensus of industry analysts is optimistic that the Energy business has solid fundamentals ahead. The Energy sector's earnings are expected to drop 25.7% this year, but are expected to experience a solid rebound next year. Estimates are as high as 24.7%. Additionally, sales are expected to reverse from a 3.1% decline this year to an increase of as much as 4.0% in 2020. However, we are also cognizant that energy analysts' forecasts are notoriously poor in the Energy sector and can change quickly along with the price of crude.

The sector has been struggling ever since peaking in 2014, and at long last it may be bottoming. Its forward P/E has declined to 16.1, and it represents only 4.3% of the S&P 500's market capitalization, down from a peak of 16.1% in July 2008.

Figure 6.



* Price divided by 12-month forward consensus expected operating earnings per share.
Source: Thomson Reuters I/B/E/S.

❖ *Silver Linings in the Oil Patch:*

For the first time in quite some time, the supply and demand fundamentals are giving investors some hope for the first time in a while:

(1) ***U.S. Production forces OPEC and Russia to cut output.*** U.S. oil and gas production has continued to surge this year even as the rig count has fallen. U.S. oil rigs have fallen by 22% to 691 since mid-November 2018; yet over that time, crude production has jumped 8%. Crude production has surged to 12.9 million barrels per day (mbd) this year from the 8.7 production level in 2016. This U.S. oil production phenomenon means the country no longer depends on imported oil to meet its needs. OPEC and Russia have responded by cutting production to deal with the global oil glut and falling prices. Their production cuts helped keep world oil production flat this year, but supply is set to rise again next year, according to the Energy Information Administration's (EIA's) Short Term Energy Outlook.

(2) ***Dwindling Demand.*** OPEC's and Russia's efforts to support the market have been thwarted by the global economic slowdown in the wake of the trade war between the U.S. and China. The world produced more oil in 2018 (100.81 mbd) than it consumed (99.98 mbd). This year, the market dropped back in balance, with production roughly equal to consumption. However, the EIA forecasts that production will rise by close to 2.0 million barrels a day and possibly surpassing world consumption again. The agency assumes world real GDP (weighted by oil consumption) picks up to 2.4% growth in 2020 compared to 2.0% this year. However, it is forecasting that the average price of Brent crude oil per barrel will decline to $59.93 next year down from $63.37 this year.

(3) ***What could go Right for Oil?*** If the U.S. and China manage to repair their trade relationship - something that's in both parties' interests - it's possible that global economic growth will rebound more than the EIA expects. Global growth was 3.0% in 2018, down from 3.2% in 2017. It should be at least as good as 2017 if a deal is struck, in which case energy demand might surpass the forecast.

There is some concern that U.S. oil production growth could slow more than expected as fracking wells age and as the price of oil remains subdued. U.S. oil production increased by less than 1% during the first six months of 2019, down from the 7% growth in the same period of 2018, according to the Wall Street Journal.

Well productivity may be falling off more quickly than expected. A recent Wall Street Journal article, based on research by Morgan Stanley, reported that last December "drilling rigs helped extract 25% more oil than they had a year prior. In August, they were producing about 14% more than last year, according to the [EIA]. Meanwhile, production in the first 90 days of an average shale well, its most productive period, declined by 10% in the first half of the year compared to the 2018 average". A better supply/demand balance could support the energy market over the next 12 months, and the price of crude oil could rise modestly.

A longer recovery or major spike in the price of oil looks more unlikely, however. There's just too much oil available at the right price. If oil prices spiked to $70 or $80 a barrel, OPEC and Russia would probably reverse their production cuts and U.S. companies would find a way to pump more oil out of existing wells or find more wells to drill. Oil prices then would fall back down. Likewise, technological developments in renewable energy and batteries are coming along rapidly and may dampen crude oil consumption within the next few years. But over the next 12 months or so, oil production and consumption appear to be more in balance than they have for a while, and that could help the downtrodden sector.

- ***Geopolitical Stress - Provides a Bullish Case on Oil:***

Our overweight position on oil is also bolstered by ever increasing stress in the Middle East stability described by an article published in The Atlantic in late spring titled, "The Coming Middle East Conflagration." The author Michael Oren, the Israeli ambassador to the U.S. from 2009-2013, was also a member of the Knesset and Deputy Minister in the Prime Minister's Office from 2015-2019. The article describes the tempest brewing between Iran and Syria and that a similar assault could be mounted against Israel from Iraq. As Israel builds up its missile defense capacity, this suggests fighting could break out at any time. While the U.S. is embroiled in an impeachment much like 1973, Israel could be vulnerable and suffer even worse casualties according to Oren.

- ***Disruptive Technologies have weighed heavily on the Oil Stocks:***

We recognize that investors have been obsessed with the technological advances in battery technologies – potentially providing the key to making solar power, wind power, and electric cars widely economical. If the cost of energy storage drops enough, then all of the above becomes economical for the masses. Of course, China too has been focused on batteries and has gone to great lengths to nurture and protect CATL so it could grow to be the world's biggest maker of electric vehicle batteries. But there are others who believe the key to energy storage lies beyond the battery.

Researchers at Sweden's Chalmers University of Technology have harnessed a molecule made of carbon, hydrogen, and nitrogen to absorb sunlight. It is purported to hold the energy for days or decades "until a catalyst triggers its release as heat," It's called "MOST," or "molecular solar thermal storage." According to Bloomberg, with MOST the scientists have developed a storage unit that they claim can outlast the 10-year span of a lithium-ion battery. They've also created a transparent coating that uses the energy-trapping molecules. This technology can be applied to home windows, vehicles, and clothing. It absorbs the daytime sun's heat, keeping rooms cool during daylight hours, and when the sun sets, it releases heat and keeps rooms warm. The good news is that the coating doesn't require the silicon used in solar panels or the rare metals used in lithium-ion batteries. The jury is still out as to whether the molecules can produce electricity. We believe the impact of these technologies are overdone on their overall impact on the oil sector in the shorter term, and provide an opportunity to buy into a cyclical rally in the sector.

IN SUMMARY:

To date, the consumer continues to show resilience. The Fed remains optimistic citing moderate growth and a healthy overall jobs market. We believe interest rates will remain low, at least for now. Inflation remains subdued which perhaps the Fed may view as a reason to continue lowering rates in 2020. Lower oil prices are reflecting a more benign inflationary environment as well. Overall, lower interest rates are a positive for stocks as investors seek higher returns on their investments. Also, foreign investors find both our stock and bond markets attractive on a yield basis relative to their domestic markets.

We believe that moderate, albeit slowing global growth, a strong consumer, and low interest rates will support our preference for stocks over bonds. Noise from trade negotiations could add to volatility but should be transitory. The costs to the consumer as a result of tariffs imposed can be offset by lower oil prices, lower borrowing costs, and a stronger currency.
