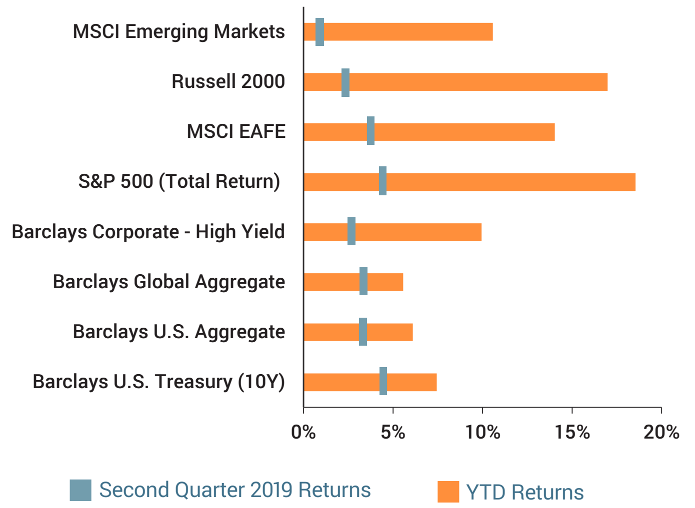
Market review:
Second Quarter 2019

Investor sentiment was pulled between the yin and yang of conflicting U.S. equity and bond market data. While equities continued to suggest strength and potential for a further rally, Treasuries provided pause that the U.S. economy may be inching closer to a recession. This divergence has been accompanied by equity and bond markets trading near all-time highs and growth stocks notably outperforming value stocks. For investors considering de-risking from high beta equity or fixed income exposure, a complementary allocation is discussed.



Sources: Glenmede Investment Management L.P. and FactSet   Data through 6/30/2019

The Yin and the Yang of Equities and Bonds This Quarter

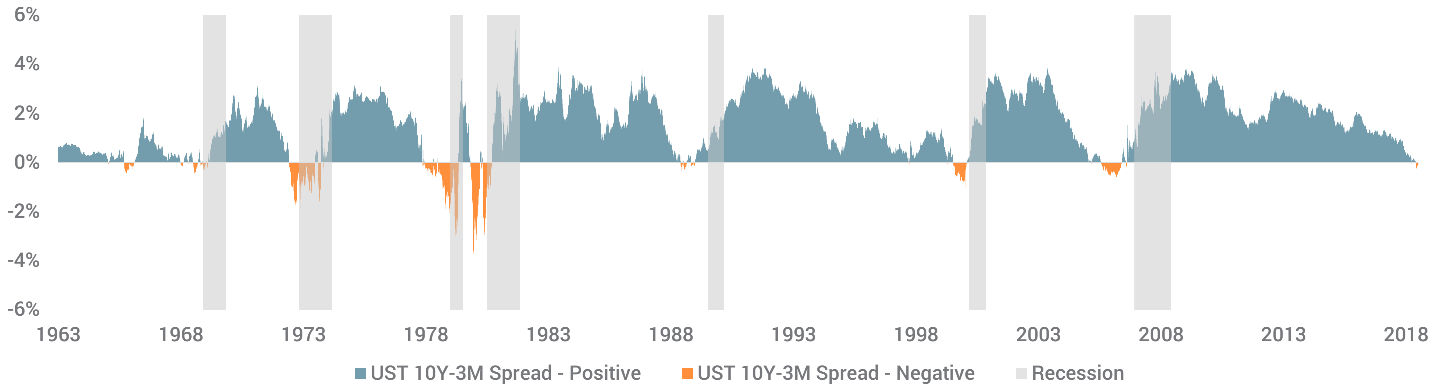
Equity markets' bullish outlook led the S&P 500 index to a new all-time closing high on June 20, almost two months after the previous high on April 30. Since 1962, all-time closing highs in the S&P 500 index tend to be clustered within six weeks or less of one another, suggesting that the June 20 high could be followed by others. True to the pattern, the S&P 500 index started the third quarter with six new all-time highs and even closed above the psychological $3,000 price level for the first time on July 12.

Conversely, the U.S. Treasury market suggested a more ominous forward-looking perspective as the 10Y/3M yield curve spent 26 consecutive trading days of the quarter inverted – the most since Q2 2007. Historically speaking, U.S. Treasury yield curve inversion is a negative sign for the broader economy and has preceded every recession since 1962, as seen in Exhibit 1. Importantly, every curve inversion was not followed by a recession. When filtering for periods of inversion at least as long as we experienced in Q2 2019, however, there is only one period that did not result in a recession in the following 18 months (Q4 1966 into Q1 1967).

This time could be different. The 10-year U.S. Treasury yield's lower starting range (2-2.5%) versus previous periods of anywhere between 5-15%, could make this signal less relevant. Additionally, the 10Y/2Y Treasury spread has not yet inverted. Because this spread has historically been the first of the two to invert, there may be other factors contributing to the current 10Y/3M inversion.

EXHIBIT 1

U.S. Treasury 10Y-3M Spread vs. U.S. Recessions



Sources: Bloomberg, NBER *Data as of June 30, 2019*

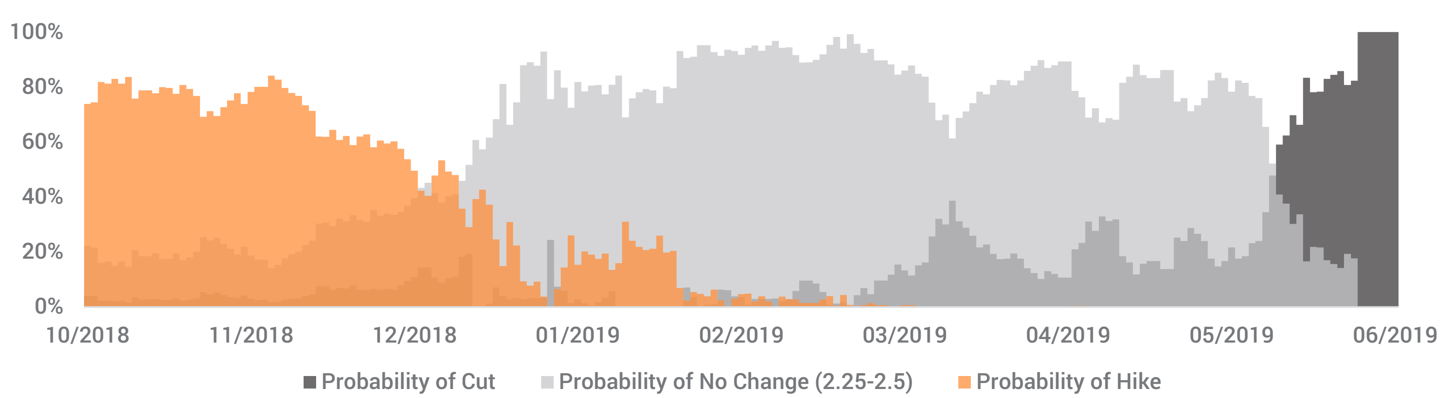
Since 1962, there have been four periods during which S&P 500 index all-time price highs occurred on the same day as a yield curve inversion – early January 1966, November 1980, July-August 1989 and this quarter on June 20, 2019. Two of these instances were followed by a recession in the following 12 months (1980 and 1989). All three historical instances were shortly followed by more all-time closing index price highs, consistent with what we have seen in the current period. However, within a year of each historical period's first observation of price highs and inversion, the index price fell 5% in 1989, 19% in 1980, and 28% in 1966.

HOW DID WE GET HERE?

The most notable driver of the U.S. Treasury market in Q2 was the market's shifting perception of the Federal Reserve's rate narrative. As seen in Exhibit 2, expectations of rate movements changed dramatically. In late 2018, markets implied an 84% probability of a rate hike of at least 25 bps for the July 2019 meeting. By the end of Q2 2019, sentiment had shifted to a 100% probability of a rate cut of at least 25 bps. Just two trading days after the S&P 500 index closed at a new all-time high, dovish sentiment prevailed and the implied probability of a larger 50 bps cut stood at 38%.

EXHIBIT 2

Market Implied Probability of Fed Rate Changes at the Upcoming July Meeting

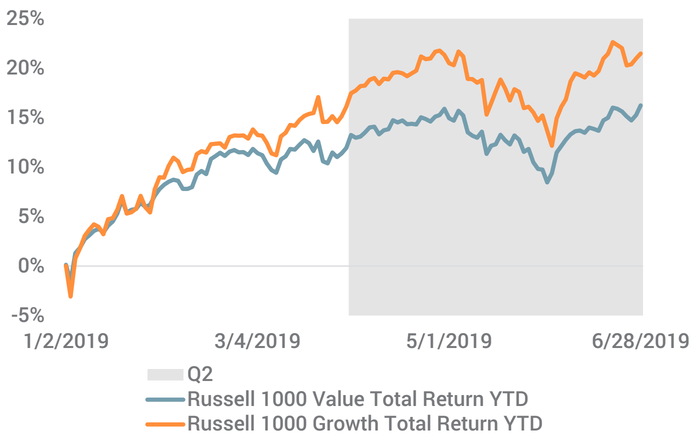


Source: Bloomberg, World Interest Rate Probability (WIRP) Data *Data as of June 30, 2019*

As the curve flattened the decline in the discount rate likely contributed to the continued outperformance of growth stocks versus value, as noted in Exhibit 3. More interestingly, companies with negative free cash flow, often growth oriented companies, continued to see price increases YTD but historical data shows these companies tend to underperform over three and five year cycles (Exhibit 4).

EXHIBIT 3

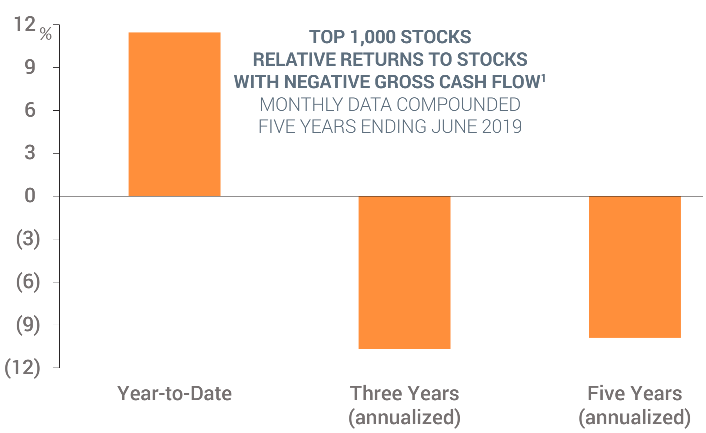
Russell 1000 Growth vs. Value Index Total Return Performance YTD



Source: Bloomberg
Past performance is not indicative of future results. *Data as of June 30, 2019*

EXHIBIT 4

Relative Returns of Negative Free Cash Flow Stocks



Source: Empirical Research
[1] *Equally-weighted returns* *Data as of June 30, 2019*

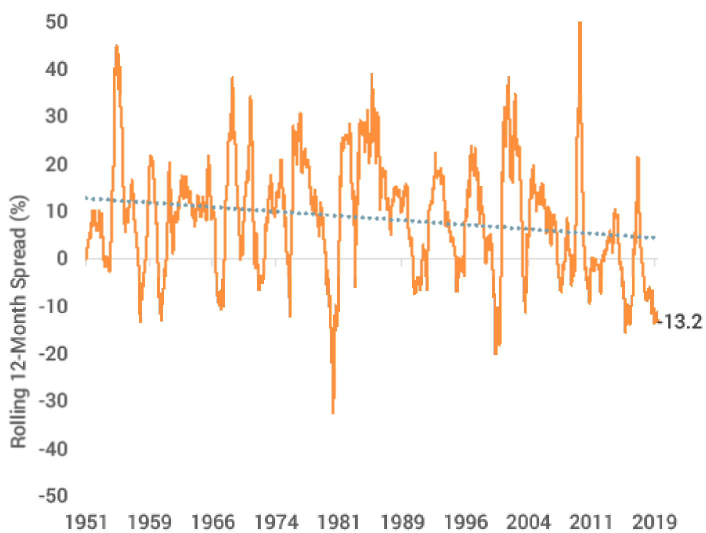
IS THIS NORMAL?

With the dramatic shift in the rates narrative, equity markets are responding by rewarding growth stocks more than value. This trend has led to a historic divergence between the investing styles.

We have previously debated the right metric for evaluating value versus growth (please see our piece "Redefining Value"). Using a cash flow-to-price measurement, style performance tends to be cyclical and mean reverting (Exhibit 5).

EXHIBIT 5

Cash Flow/Price: Performance Since 1951
(Top versus Bottom Quintile, Equal-Weight)*



Source: French, Kenneth R. (2019, June 21). Portfolios Formed on Cashflow/Price. Retrieved from https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
**Relative Cash Flow/Price Performance based on Top versus Bottom Quintile Returns of stocks on NYSE, AMEX or NASDAQ (CF to Price, equal weight)* *Data as of May 31, 2019*

As of May 31, growth has outperformed value +13.2% on a rolling one-year basis. This relationship reflects a reversal of the long-term trend — since 1951, value has had an annualized +8.7% edge over growth — a nearly 22% swing. During this entire historical period, there have been 34 observations where value has underperformed growth by at least 10%. Value then outperformed growth over the next year every time (100% hit rate). The average return differential of the two styles over the next year has been +20.3% (value averaging a +25.7% return versus growth's +5.4%), suggesting that the market could be setting up for an attractive tilt to value.

Furthermore, when this data is filtered for periods of curve flattening of at least 100 bps and underperformance of value of at least 10% over the same time frame (5 observations), value's snapback is even more pronounced. In those circumstances, the average return differential of the two styles over the next year has been +30.4% with a 100% hit rate (value averaging a +14.0% return versus growth -16.4%), suggesting that a long/short position could be optimal, as seen in Exhibit 6.

EXHIBIT 6

Cash Flow/Price: Performance Since 1951
(Top versus Bottom Quintile, Equal-Weight)*

Source: French, Kenneth R. (2019, June 21). Portfolios Formed on Cashflow/Price. Retrieved from https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
**Curve flattening by at least 100 bps and underperformance of value vs. growth by 10% over the previous year. Relative Cash Flow/Price Performance based on Top versus Bottom Quintile Returns of stocks on NYSE, AMEX or NASDAQ (CF to Price, equal weight) Data as of May 31, 2019*

While the current negative differential between value and growth could persist or intensify, over time this dynamic may be more likely to revert. Although there are multiple factors that could be driving the divergence between growth and value stocks, the analysis contained in Exhibits 5 and 6 may provide insight for further discussion about current asset allocations.

So Now What?

Given the current magnitude of the value vs. growth spread, a flattening curve, and "hot" equity markets, investors with high beta exposure may find de-risking part of the portfolio attractive. Within equity, beginning a shift from growth to value could be attractive to gain exposure to the potential reversal of performance trends. Alternatively, a complementary strategy to a high beta portfolio could be a low beta, long/short equity strategy with a value focus. These strategies could lower risk and be phased in over time until the expected snapback of value is realized.

We are not making a rates call and recognize that the rates market could continue on a path that is more rewarding to growth, but we believe that slowly implementing a tilt of this nature could be attractive for the following reasons:

1 | The potential asymmetry of the growth/value equity distribution coupled with the historical magnitude and speed of recovery suggest timing a snapback to value could be difficult, but missing the potential return is suboptimal.

2 | The market is implying a 100% probability that the Fed will cut rates. Any unexpected Fed policy changes could reverse the outperformance of growth to value.

We believe the current environment offers a risk/reward similar to a rubber band, with the possibility of continued stretching against the shift but eventual mean reversion. For investors contemplating current allocations and seeking potential de-risking opportunities, shifting part of an allocation to a value equity strategy could be warranted to gain exposure to this potential snapback.

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