IRONBRIDGE INSIGHTS

Meaningful Analysis on a Predictable Schedule

July 28, 2017

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Twice-per-Month Newsletter

July 28, 2017

Welcome to IronBridge Insights, our flagship twice-per-month newsletter.

Here we provide an overview and context around the content, format and history on why and how we developed this newsletter.

First, we developed IronBridge Insights as a response to feedback from our clients. They told us a few important things:

1. Our clients are interested in meaningful analysis on various markets
2. Provide a report that was concise, but had further information if clients wanted more.
3. Information should be relevant to their specific portfolio.
4. Help differentiate important issues from news-cycle noise.
5. Prepare a one-page executive summary at the beginning of the report that highlights the key points.
6. Deliver information on a predictable schedule.

We took this advice, and it became one of the many reasons we founded IronBridge.

This report is divided into three sections, with a one-page OVERVIEW section at the beginning:

1. MACRO Insights (Broad Themes)
2. PORTFOLIO Insights (Portfolio Specific)
3. MARKET Microscope (Detailed Analysis)

The Macro Insights section covers one-to-two topics relevant in today's environment. We will cover a wide range of topics, including markets, the Fed, geopolitics and economic issues. Our goal is to provide a timely update of topics relevant to your portfolio.

Portfolio Insights focuses on specific investments within our clients' portfolios. We provide general information on the investment, why we own it, and what we see going forward.

Then we move to the more detailed Market Microscope. This is a report that Chad Karnes has been generating for many years, and touches on various markets and trends. This is where we get more specific as to what we expect to occur going forward and what exactly we are watching.

In addition, we are developing a proprietary market indicator we call the FIT Model, which is a combination of more than 20 separate Fundamental, Investor Sentiment and Technical market measurements. The FIT Model results are covered in the Executive Summary.

We welcome feedback on how we can improve this report, as well as any topics you'd like discussed.

Thank you for your trust and confidence, and we look forward to serving your wealth management needs with the integrity and professionalism you expect and deserve.

Best Regards,

Jim Denholm
Founder & Managing Director

Insights Overview

Executive Summary

In This Issue

Macro Insights (page 4)

Sector performance can give us excellent information about the underlying health of the stock market.

Portfolio Insights (page 5)

Over the next two weeks we will be introducing into client portfolios our sector rotation strategy. We are very pleased with how this strategy has back-tested.

Market Microscope (page 6)

New highs have been made as the market recently broke out of its consolidation. This is bullish as we start to roll out a sector rotation strategy to help bring alpha to the portfolio.

On Our Radar

Fed - The July FOMC meeting occurred this week. No change in interest rates, but the Fed did say that normalization of the balance sheet would occur soon

GDP: 2Q GDP released on 7/28 was lower than estimates at 2.6%. Previous years were revised lower as well.

Earnings - We are right in earnings season, and although earnings have been strong, a few companies have been subject to "selling of the news"

F I T Model

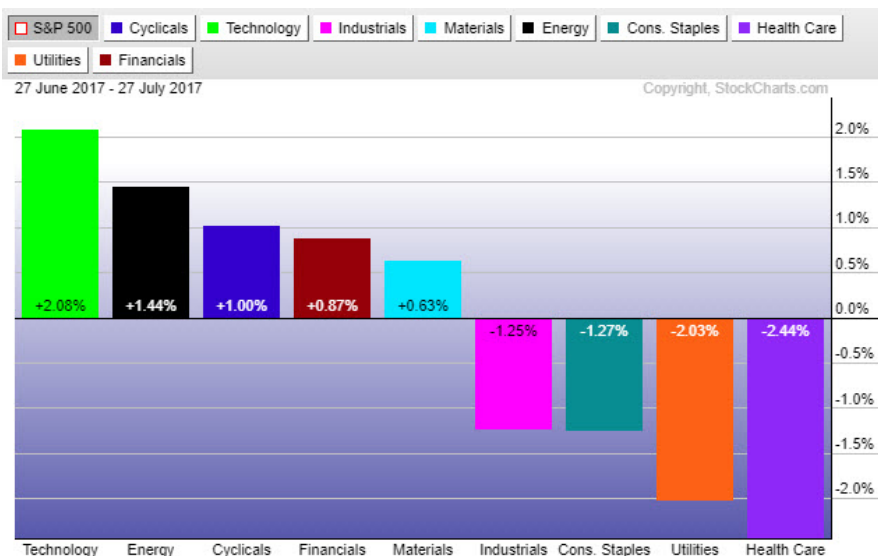
Fundamental Overview: Earnings continue to be largely positive, but earnings aren't all that control share prices. Some stocks have seen some profit taking on the good news. Overall the economy and fundamentals continue to move forward in a positive way.

Investor Sentiment Overview: The latest record to be reached on the sentiment front concerns derivatives. The amount of put options purchased (options purchased to anticipate a decline in price) versus the amount of call options purchased (options purchased to anticipate a move higher in price) recently on the VIX Index set a low not seen for almost 3 years. This reveals market complacency remains very prevalent, and complacency often coincides with market tops.

Technical Overview: On most indices the market has broken out to new all time highs. This moves the technical needle back into bullish territory (from the former consolidation). We remain fully invested to take advantage of any further upside.

Our proprietary FIT Model is a combination of over 20 various market measurements designed to provide an independent, unbiased and non-emotional snapshot of the current state of the market. This includes a reading of the current expected position in a given market cycle.

Focus Chart



Sector rotation can be a powerful tool to:

1. Stay ahead of key macro trends
2. Outperform relative benchmarks.

The chart to the left ranks all the sectors over the last month.

Currently, the sectors that are leading are Financials, Materials and Technology, which are more economically sensitive. At the same time, the defensive sectors are lagging, such as Utilities and Staples.

This reveals an overall bullish posture.

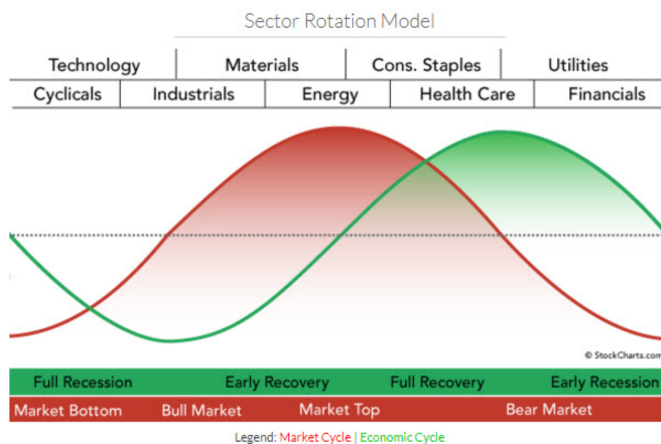
We go more in-depth in our Market Microscope to look at what sector performance told us during previous cycles.

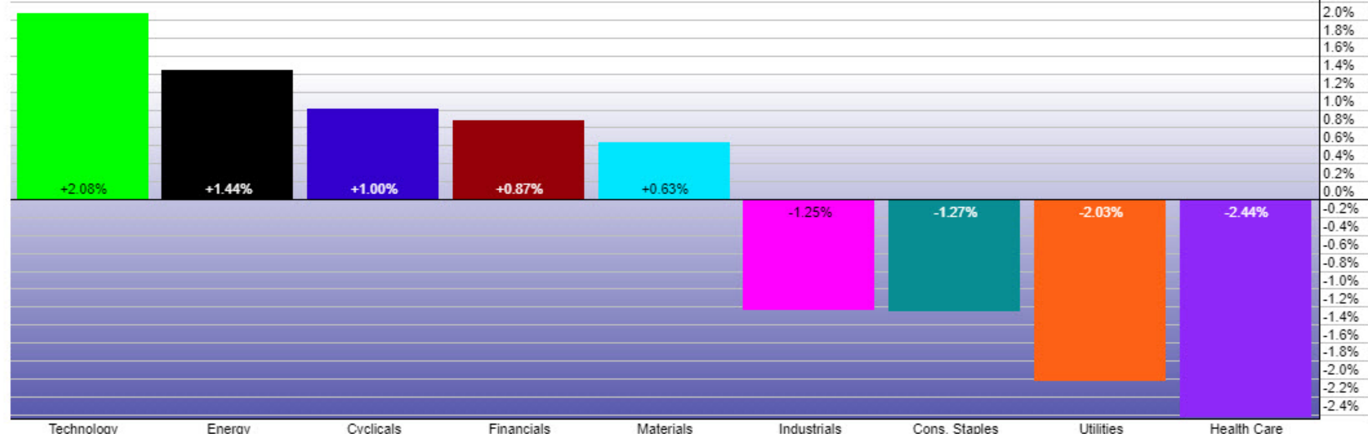
FIT Model Conclusion: Bull Market

Using Sectors to Identify Cycles

The S&P 500 is a diversified group of 500 different companies. Each of those companies is associated with one of nine sectors, and keeping an eye on which sectors are doing better than others has historically allowed a glimpse into where the market is within its cycle.

There is a little known relationship in finance surrounding sector rotation. Sector rotation is the concept of money moving from sector to sector looking for returns. Generally, safer stocks such as those of utility companies and household goods (consumer staples) tend to perform better, relative to their peers, during times of recession or market stress and more consumer & tech focused and industrial companies tend to perform better during times of growth. The chart to the right reveals the sector breakdown across the top along with the business cycle along the bottom (in green) and stock market cycle along the bottom (in red). Depending on which sectors are leading the markets, we can get a better glimpse into where we are within the market's overall cycle.





The chart above provides the relative performance of each S&P 500 sector (there are nine sectors total) over the last month. The numbers on the chart are the returns during that 50 day period either above (or below) the S&P 500's return.

So, where does the market stand today?

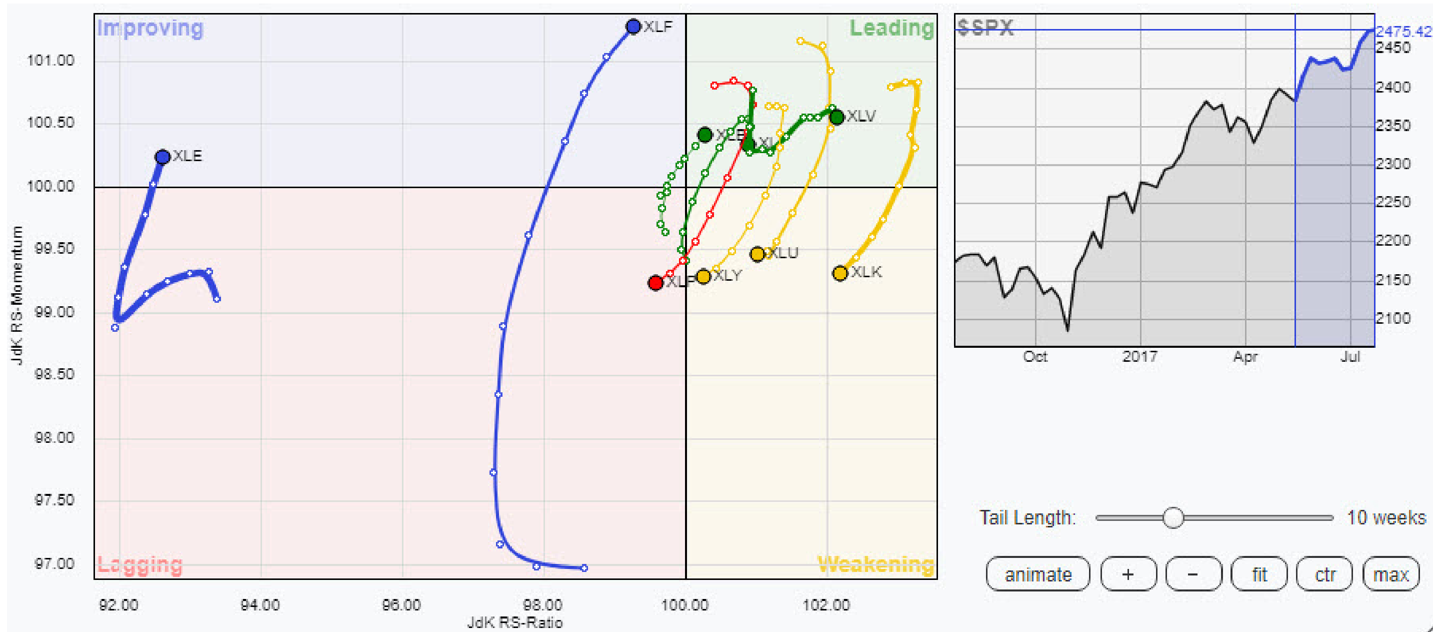
Shown on the left side of the chart, we see Technology, Energy, Cyclicals and Financials as the large leaders during the last month. But, more importantly, we see the safer Utilities and Consumer Staples as two of the laggards. This let's us know that the market is generally looking for more upside, and is not taking a defensive stance.

In the Market Microscope section I reveal some real time ways to use this information to our advantage. Not only do the "safer" sectors typically outperform their broader index during times of stress, there are times when that rotation is occurring <u>before</u> that stress, providing a generally good warning system that warns when to get positioned for a potential pullback in the markets.

Sector Rotation Strategy

In each of our client portfolios, we are beginning to implement a strategy where we rotate into sectors as they begin to outperform the market, and out of sectors when they begin to underperform.

Portfolio Strategy



The chart above courtesy of StockCharts.com is a visual of how sectors perform relative to the S&P 500 over time.

Exposure: Sector-specific ETFs

Investment Thesis: By continually owning the sectors that are outperforming the S&P 500 Index, we can attempt to generate returns in excess of the index within this portion of an equity allocation.

Commentary: The S&P 500 Index is an average. As individual stocks rise and fall, this average moves up and down. Since this is an average, there are many companies on a given day or week that perform better than average, and many that perform worse.

This approach focuses on getting broad exposure to specific sectors within the S&P 500. We will not pick individual stocks in this system, we are only concerned with gaining exposure to the sector as a whole.

We have developed a strict buy and sell discipline that allows us to rigorously back-test how our approach would have performed in various market cycles and over various timeframes. We are very pleased with the results, and believe our clients will be pleased as well.

We view there to be many benefits to our sector rotation strategy:

1. It removes emotion.
2. We do not try to predict which sector will outperform.
3. Sector rankings give us information on the overall health of the market.
4. Back-testing of this strategy shows excellent risk/reward metrics.
5. This strategy promotes prudent, focused diversification.

Our clients will have varying degrees of exposure to this strategy depending on each client's individual goals and risk preferences. It replaces a portion of the equity exposure currently target allocations.

Stocks Break to New Highs

This bull market continues to push higher. New highs are bullish and derserve respect. Lagging small caps and mid caps are now both breaking to new highs. There is always the chance for a head-fake, where markets quickly break below support, but the long sideways correction in small caps appears over.

US Equities:

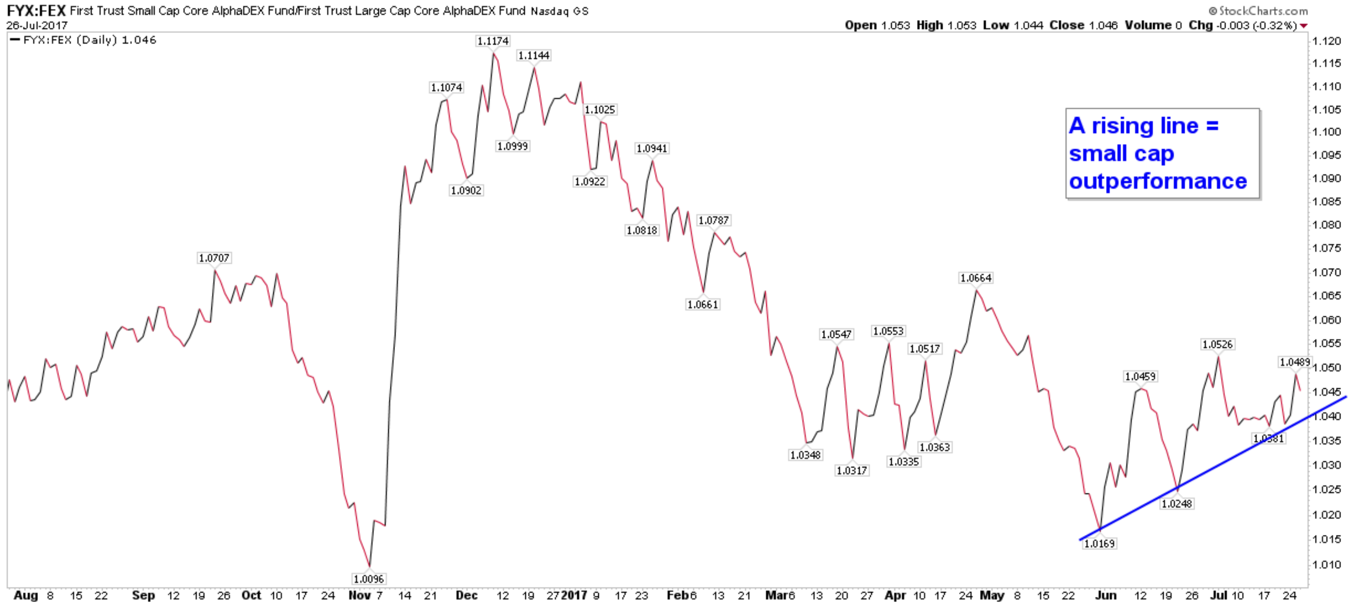
The biggest news on the technical front this week is the breakout in price that is occurring across most domestic markets. In particular, the breakout by small caps seems to be more relevant, given that it has been underperforming and consolidating since late 2016. In other words, small cap stocks hadn't really done much for over 6 months as the chart below reveals, but that looks to be changing.

The rally in Novemeber and December took price into the mid $50s for FYX, one exchange traded product that focuses on small cap stocks. Since then the ETP moved net sideways, which is consistent with other small cap focused funds. Notice as the calendar moved from June to July, its price was below $55, the level reached in early December. Small cap stocks went nowhere for eight months, but that now seems to have ended with the technical breakout.

Small caps have broken higher, but investing has as much to do with tradeoffs and opportunity costs as it does with just buying something that is moving up and to the right. You may have "chosen wisely", but that doesn't mean you couldn't have "chosen wiser". There's an infinite amount of investment opportunities out there, so one way we whittle down the universe of potential investments is by looking at things not just in absolute terms, but also in relative terms.

Relative strength analysis is a technique we like to use to help us make our investment decisions. One such example is shown next.

Small caps have broken out to new all time highs, but so have the other major domestic markets. So should we be invested in small caps right now, or is there a better option?



The chart above compares the performance of the small cap index to one of the large cap index funds. If the chart is moving higher, it means small caps are outperforming. If it is moving lower then large caps are outperforming. Right now the difference between the two is negligible.

Since early June, small caps have been outperforming large caps, but since December, large caps have been outperforming. One could also say that the two have performed equally over the last year, since the ratio today is the same as it was one year ago.

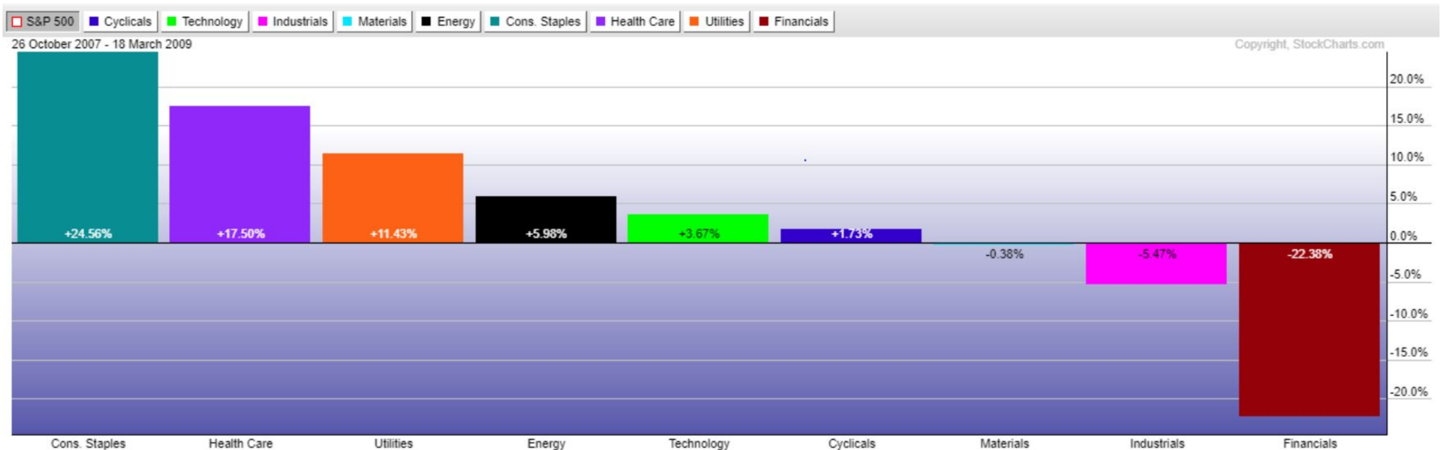
The chart above suggests that both large and small caps are performing similarly. Have large cap stocks also broken out to new all time highs, just like small caps? Indeed they have as the next graphic reveals.

Right now both large cap and small caps are rising and making new all time highs, leaving us interested in both large and small caps right now. What this analysis helps prove is our indifference right now between large caps and small caps. They both are good choices, performing similarly over the last year.

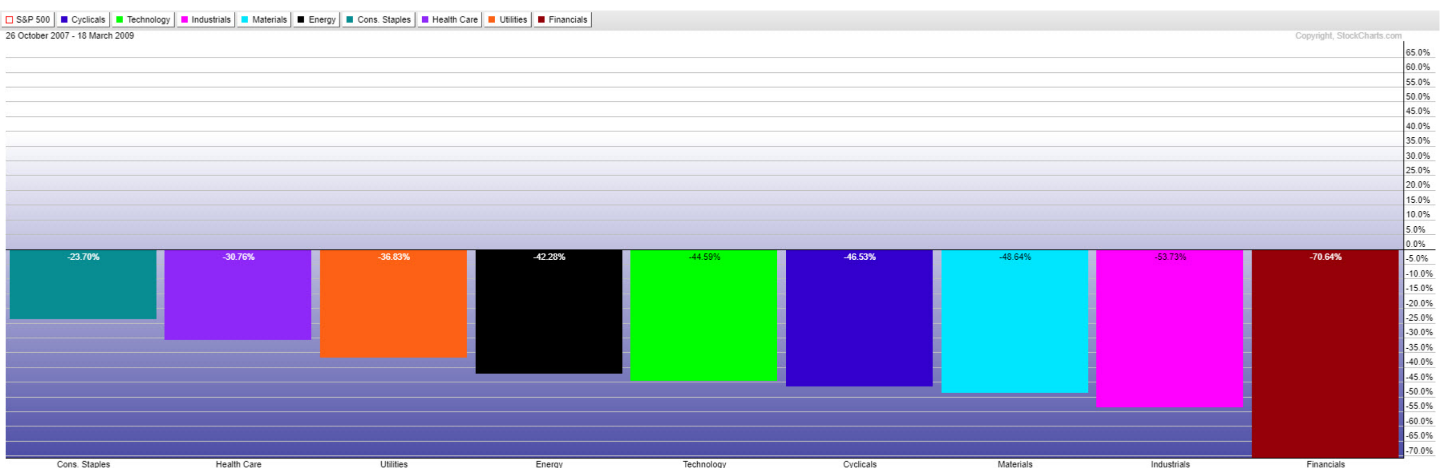
Sector Rotation:

We have already seen in the 'Macro Insights' section of this newsletter how key defensive sectors are lagging the market currently. This suggests any large downside risk is likely not yet upon us. Let's review some history to support such claims.

The first chart I want to dive into shows the sector performance during the financial crisis. The stock market peaked in October 2007 and bottomed in March 2009, which is shown below. The leading sectors were the consumer staples (XLP), Health Care (XLV), and Utilities (XLU), two of which are considered the safest of the sectors. Keep in mind this chart reveals sector performance relative to the S&P 500.



The next chart reveals the same time period, just with absolute returns. It's important to recognize that although the consumer staples, health care, and utility sectors all outperformed the S&P, they still declined in absolute value. Being in these sectors didn't help you avoid the crisis all together, but it did help you not feel as much pain during the decline.

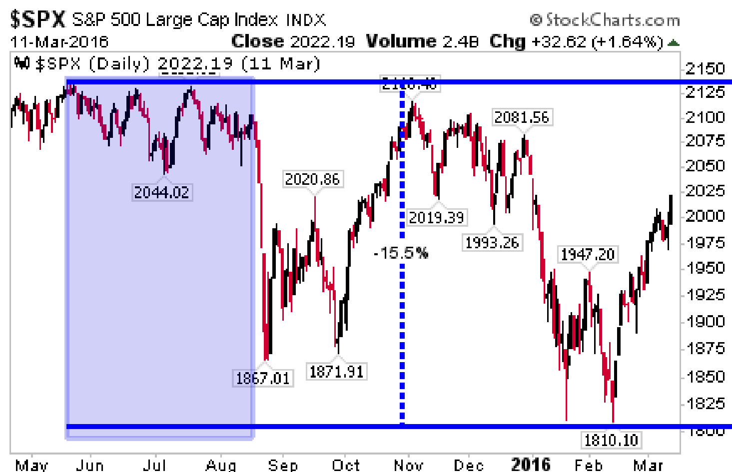


Savvy readers will recognize, however, that this out performance by the defensive sectors occurred during the financial crisis. In other words, the crisis was already happening, and pain was already being felt. The key question is, do these defensive sectors start to outperform prior to the start of market down turns?

Ah ha! They do!

The first chart on the next page reveals the most recent sizeable market pullback, the one that occurred in late 2015/early 2016, which took the S&P from a peak to trough decline of over 15%.

On the left hand side I have shaded a large area where the market moved sideways to slightly down, but generally didn't really do much. This period, however, was just before a very swift 200+ point S&P drop.

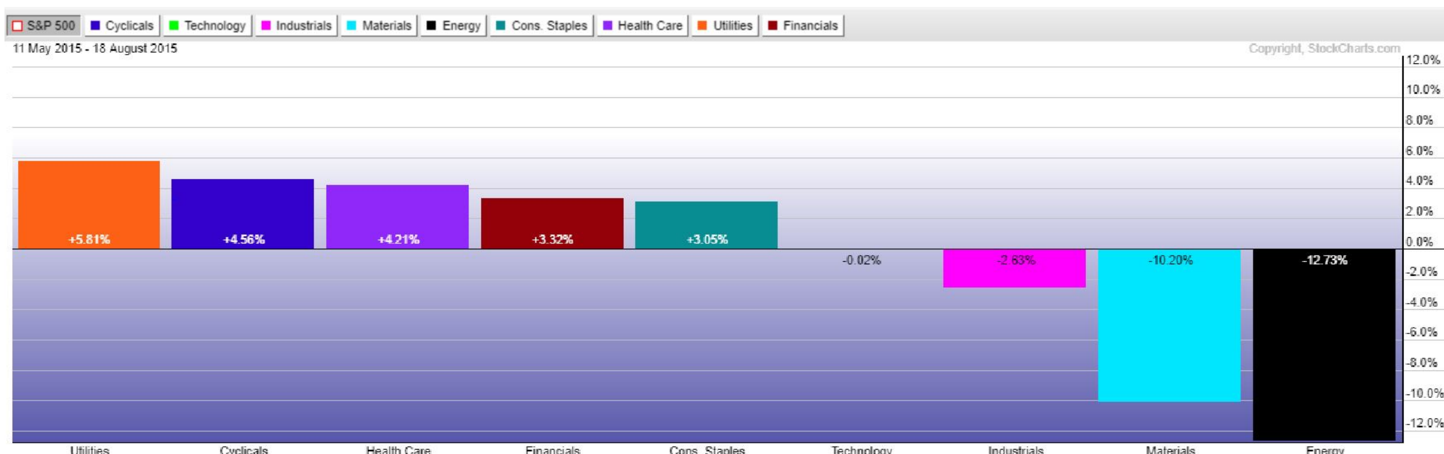


Wouldn't it be nice, if during this three month long period of sideways market action we were warned that something big could be brewing around the corner?

Sector rotation happens to be one such warning sign we can look to for that signal of increased risk.

The chart immediately below shows the relative sector performance during this time. Notice anything familar?

The utility, health care, and staple sectors were in the group of outperformers, with utilities leading the way.



If we think of the S&P like a house, then the sectors would be the foundation, walls, and roof of that house. The utility and consumer staples, being generally the least volatile and most reliable of the sectors would be the foundation. The consumer cyclical, industrial, technology, and energy sectors would be the roof, with the financials, materials, and health care sectors the walls connecting the two. Typically a house can survive with some wall damage and even some roof damage, however, if the foundation on the house goes, the entire home becomes unstable.

This is how we like to look at the different sectors, and looking at the past helps prove to us that if the utility and/or staples sectors start to become the market outperformers, we should probably be looking to start protecting our holdings and moving to safer areas of the markets.

The good news is we are not seeing the utilities or staples lead this market, quite the contrary actually as the staples and utilities have been lagging over the last 50 days.

One of our proprietary techniques keeps us abreast of which sectors are leading and which are lagging, offering insight into the market's broader cyclical position. Until the utilities and staples start moving into the outperforming column, we remain fully vested in equities.

Disclosures

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