CLS's WEEKLY 3

What You Need To Know About the Markets

JANUARY 15, 2019

1. How have stocks historically reacted to government shutdowns?
2. Global factors provided tools to manage risk and enhance returns in 2018
3. Where we're finding value in fixed income

Market Performance

Equities	LAST WEEK	QTD	YTD '19
Global Equity Market[1]	+2.99%	+3.92%	+3.92%
Total U.S. Market[2]	+2.93%	+4.06%	+4.06%
Domestic Large-Cap Equity[3]	+2.34%	+3.37%	+3.37%
Domestic Small-Cap Equity[4]	+5.21%	+7.45%	+7.45%
International Equity[5]	+3.24%	+4.06%	+4.06%
Developed International Equity[6]	+3.14%	+4.25%	+4.25%
Emerging Market Equity[7]	+3.52%	+3.47%	+3.47%
Diversifiers	**LAST WEEK**	**QTD**	**YTD '19**
U.S. Investment Grade Bonds[8]	-0.01%	+0.18%	+0.18%
Cash Equivalent[9]	+0.04%	+0.08%	+0.08%
Commodity[10]	+3.00%	+5.94%	+5.94%
Diversified Alternatives[11]	+0.83%	+1.27%	+1.27%

[1]Morningstar GblMkt Large-Mid Index [2]Morningstar U.S. Market Index [3]Morningstar U.S. Large Cap Index [4]Morningstar U.S. Small Cap Index [5]Morningstar Gbl xU.S. Large-Mid Index [6]Morningstar DM xUS Large-Mid Index [7]Morningstar EM Large-Mid Index [8]Morningstar U.S. Core Bd Index [9]Morningstar Cash Index [10]Morningstar Gbl Lng-Only Cmdty Index [11]Morningstar Diversd Alt Index As of 1/11/2019

Week in Review

Global stocks continued their year-to-date rebound last week, the third week in a row of returns north of 2%. Domestic small-cap stocks and international stocks led the way for a week of gains, which were chalked up to the potential for a trade deal with China in the near future. The ongoing government shutdown didn't seem to bother stocks much. But, as we will see later in this piece, stocks have historically gone nowhere during shutdowns and have had higher-than-average returns once shutdowns are resolved.

The U.S. dollar fell on the week, leading to gains in commodities and helping foreign stocks. Treasuries closed the week slightly lower; however, corporate bonds and inflation-protected securities managed positive returns. There was a decent amount of economic data on the week, but much of the focus was on the U.S. Federal Reserve (Fed) minutes released Wednesday and several different Fed speeches throughout the week, which generally noted patience may be warranted for further rate hikes.

Do Stocks Care About Shutdowns?

As of this writing, we are in the midst of a partial government shutdown. There has been some commentary on the effects of shutdowns on stocks, and for the most part, it all must be taken with a healthy grain of salt. This is the 19th or 20th partial government shutdown (depending on how the data is reviewed) since the 1970s (when current budget processes started) – hardly a statistically significant sample. There have also been a variety of macroeconomic forces that likely have nothing to do with politics that affected stocks in other ways during each shutdown. Nonetheless, I reviewed a few stats on stock performance during and after shutdowns and found some surprises.

First, the average shutdown has lasted just over eight days, but shutdowns have typically been shorter as the government is often partially unfunded for only a couple of days (the median is six days). During shutdowns, markets on average go pretty much nowhere – the S&P 500 Index has been a coinflip for positive returns, and the average return has been right at 0% (this includes the current shutdown). Global markets* have tended to be positive more often and with a slightly higher return during shutdowns.

Looking forward, returns after the government reopens its doors tend to be positive more than two-thirds of the time, during the time periods covered in the chart below. In fact, a year after a government shutdown, average returns are nearly double that of their historical averages and positive 94% of the time! The easy counter to that is that stocks must be falling before the shutdowns occur, but that simply isn't the case either. Returns are positive an average of 2% during the month before a shutdown and almost 5% during the prior six-months.

	Return During Shutdown			Forward Returns – S&P 500			Forward Returns – MSCI World		
	Days	S&P 500	MSCI World	2 Mo	6 Mo	1 Year	2 Mo	6 Mo	1 Year
Average	8.6	0.0%	0.3%	2.3%	6.1%	17.8%	1.6%	5.4%	15.2%
% Positive		53%	63%	72%	67%	94%	78%	72%	94%

Source: CLS Investments, Ned Davis Research, Bloomberg. Shutdown data from 1976 to present.
Note: Average number of days and average return during the shutdown include the current shutdown through January 11, 2019.

We definitely aren't saying that government shutdowns are buy signals, but stocks don't seem to mind them a whole lot. You could even make a case that stocks don't seem to care about shutdowns at all, as the last five have seen positive returns during the shutdowns themselves.

The current shutdown is just another event for the media to cover extensively and investors to unnecessarily worry about. Don't fall for the trap, especially when recent market jitters have opened up a time to buy.

Grant Engelbart, CFA, CAIA

Director of Research, Senior Portfolio Manager

Grant Engelbart manages CLS's aggressive mutual funds and several ETF and mutual fund separate account strategies, including CLS's American Funds portfolios. He also leads the alternative broad asset class team and serves on several committees across CLS's parent company, NorthStar Financial Services Group, LLC.

Mr. Engelbart first joined CLS as an intern in 2007. He returned in 2009 and held several roles in trading and investment research prior to accepting the role of Portfolio Manager in 2013. He previously held positions at TD Ameritrade and State Street Corporation.

Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln. He holds the Chartered Financial Analyst (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

Mr. Engelbart was named one of the Top Ten Money Managers to Watch by Money Management Executive in 2018.

Did you know? Grant invested in his first fund at age 13.

**As measured by the MSCI World Index, which includes developed markets around the world*

2018 in Factors

Performance reviews and articles have highlighted the return of various asset classes and major indices last year. One area that is very important to how we manage portfolios at CLS is factor investing. Factors could be thought of as the building blocks of smart beta ETFs, of which we are a major user. And, of course, "Be Smart," i.e., focusing on smart beta ETFs to construct portfolios, is a continued theme of ours. Understanding and viewing factor performance can help determine why and how we use factors in portfolios.

Last year, we saw two large (and quick) declines in equity markets, first in February and then in the fourth quarter. All factors outperformed the global index in February, and minimum volatility shined in the fourth quarter. Quality, generally considered a defensive factor, did well in February (less so in the fourth quarter) but finished the year ahead of the global index by more than 2%.

Momentum and small-caps, two of the most volatile factors, showed that trait in 2018, bouncing around my quilt chart month-to-month. Momentum ended up faring relatively well to end the year, as large gains in early 2018 helped buoy returns despite a tough October and December.

That leads to our beloved value factor. Value started the year strong, but it struggled over the summer and into the fall as interest rates fell and the yield curve inverted at certain maturities, hurting bank stocks that make up a large part of the index. The fall in oil prices undoubtedly weighed on value stocks, too.

Minimum volatility, momentum, and quality all outperformed the global index last year, which was good to see, especially in a down year. Utilizing factors and smart beta ETFs will continue to be important building blocks of CLS portfolios due to their impressive track records of providing both risk reduction and return enhancement. Track records we see playing out even as factors have gone from academia to practice.

January	February	March	April	May	June	July	August	September	October	November	December	2018
Momentum 7.9%	Momentum -2.2%	Min Vol 0.0%	Value 2.0%	Momentum 2.4%	Min Vol 0.3%	Quality 3.1%	Momentum 3.8%	Value 1.3%	Min Vol -4.7%	Min Vol 3.1%	Min Vol -5.0%	Min Vol -1.6%
Value 6.0%	Quality -3.3%	Small Cap -0.1%	ACWI 1.0%	Small Cap 2.1%	Quality -0.5%	Min Vol 3.1%	Quality 2.7%	Min Vol 1.1%	Value -7.1%	Momentum 2.0%	Value -6.7%	Momentum -4.9%
ACWI 5.6%	Min Vol -3.9%	Quality -1.7%	Small Cap 0.8%	Quality 2.1%	ACWI -0.5%	ACWI 3.0%	Small Cap 1.8%	Momentum 0.8%	ACWI -7.5%	ACWI 1.5%	Quality -6.9%	Quality -7.4%
Quality 5.3%	Small Cap -4.0%	Value -1.9%	Momentum 0.8%	ACWI 0.1%	Momentum -0.8%	Value 3.0%	Min Vol 1.5%	ACWI 0.4%	Quality -7.6%	Small Cap 1.1%	ACWI -7.0%	ACWI -9.4%
Small Cap 3.8%	Value -4.2%	ACWI -2.1%	Min Vol 0.0%	Min Vol 0.1%	Small Cap -1.0%	Momentum 1.7%	ACWI 0.8%	Quality -0.2%	Momentum -10.0%	Quality 0.8%	Momentum -7.2%	Small Cap -14.4%
Min Vol 3.3%	ACWI -4.2%	Momentum -2.9%	Quality -0.7%	Value -3.2%	Value -3.6%	Small Cap 1.2%	Value -1.3%	Small Cap -1.6%	Small Cap -10.0%	Value 0.6%	Small Cap -8.5%	Value -14.8%

Source: Morningstar, MSCI. As of 12/31/18.

Where to Go in Fixed Income

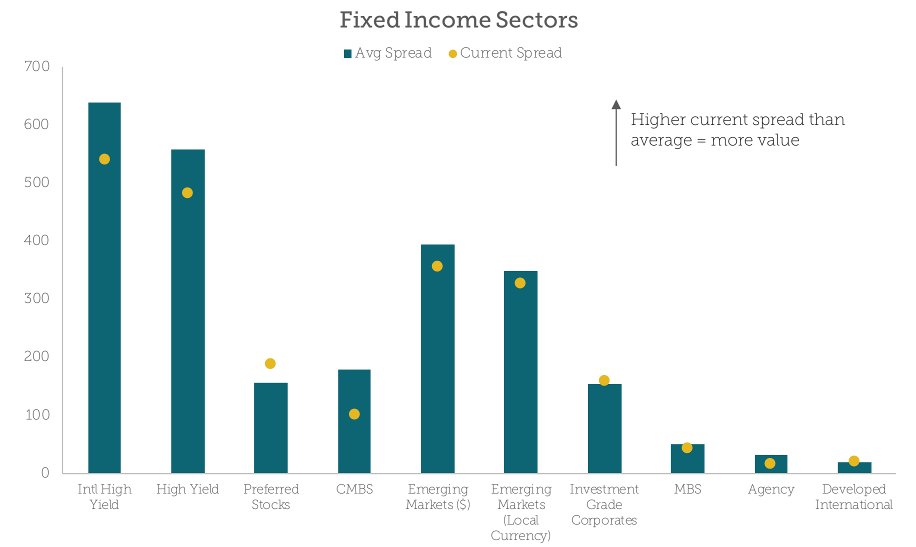
The recent volatility in stock prices has opened up a slew of opportunities across equity markets. But what about fixed income? Where is the value? Bonds managed an ever-so-slight positive gain in 2018, as measured by the Bloomberg Barclay's U.S. Aggregate Bond Index (say that three times fast), despite being one of the more hated asset classes to begin the year and one of the noted culprits of the February stock decline.

Credit spreads, the yield pick-up of riskier fixed income over a comparable Treasury bond (deemed risk-free), have widened as stock prices have declined. One way to measure the apparent value in these spread sectors is to look at their credit spread relative to history. When that spread is higher than average, there may be an opportunity in that sector, barring further spread widening.

When we look across fixed-income markets, most spreads are still tighter than average – meaning the apparent value we look for isn't really there.

A few areas have spreads around their long-term averages. Preferred stocks have spreads wider than their long-term average (due somewhat to weakness in bank stocks). Overall, the opportunities are limited, one of the main reasons we have a high-quality fixed income stance, leaning on Treasuries and actively managed bond ETFs and funds.

Yawn, right? Boring, old Treasuries are now paying you 2.5%-3% across the maturity spectrum as the yield curve has flattened. For Risk Budgeters like ourselves, we'll happily clip that coupon and spend our risk points in attractive areas of the global equity markets that have recently come down in price.



Source: CLS Investments, Bloomberg, ICE BofAML

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