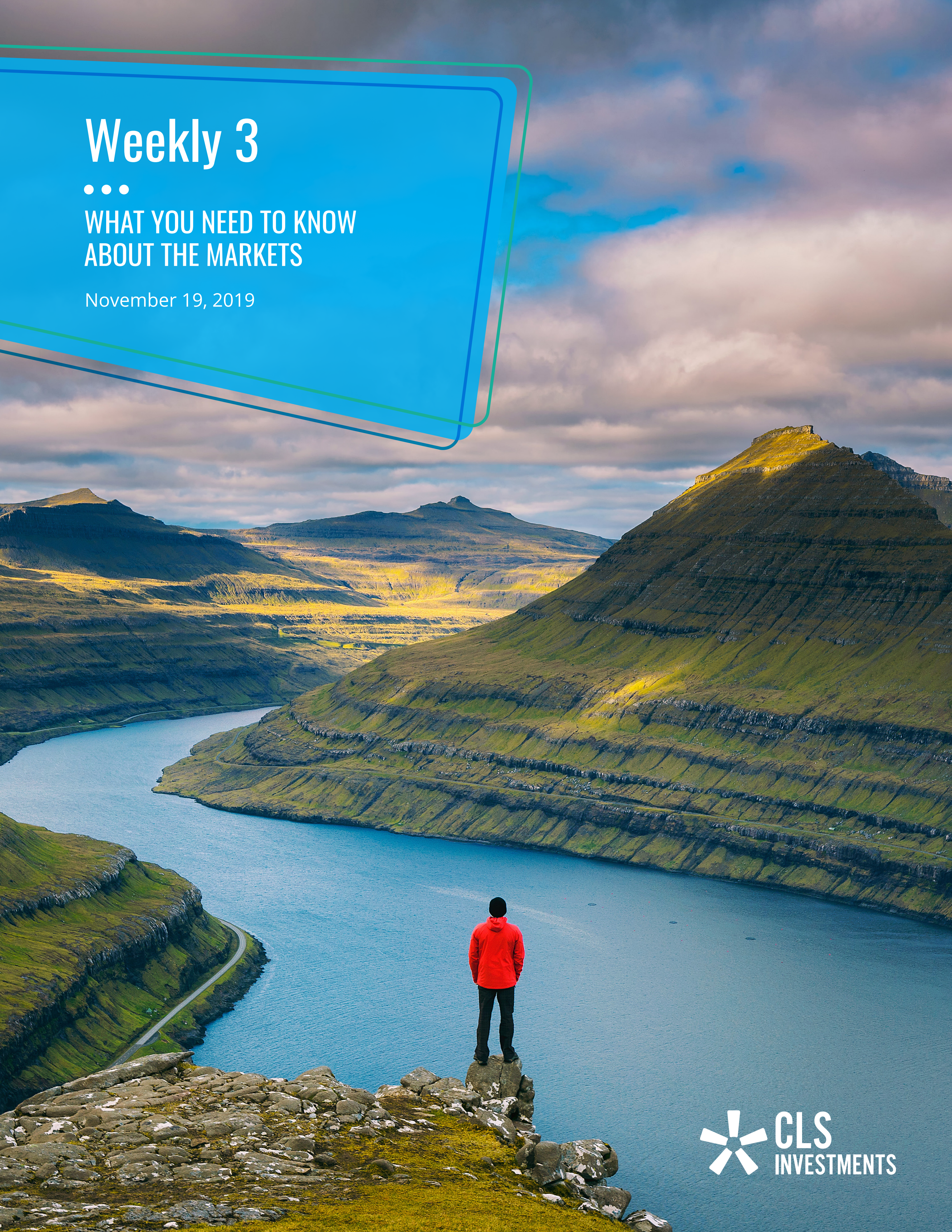
Weekly 3

WHAT YOU NEED TO KNOW ABOUT THE MARKETS

November 19, 2019



CLS INVESTMENTS

Week in Review

Global stocks and bonds gained last week, led by domestic, large-cap stocks. In particular, Wall Street and Main Street intersected on the debut of Disney+ on Wednesday, which propelled Disney stock (and the price-weighted Dow Jones Industrial Average) higher for the week. Earnings season is winding down in the U.S. with more than 90% of the S&P 500 index reporting. Three quarters of companies beat expectations, 60% beat sales, and overall earnings declined 2% or so as companies came down off elevated numbers from the corporate tax cut.

International companies gave back a little of their recent outperformance. The eurozone and major economies, such as Germany and the U.K., all reported positive, albeit slower, economic growth. Emerging market stocks fell on Chinese data, and the continuing sagas in Chile and Turkey weighed on sentiment. Bonds recovered from recent losses, too, with the closely followed 10-year Treasury closing at 1.83%, down 0.10%.

1 *Has Disney always been a momentum stock? We take a look at the current factor environment.*

2 *What if most economists are wrong and the current economic expansions lasts a lot longer?*

3 *Inflation seems to be missing. But there are signs that it's moving up in important areas.*

Market Performance

as of 11/15/2019

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.53%	+0.99%	+1.57%	+2.26%	+1.96%	+0.23%	+0.02%
U.S. Investment Grade Bonds[2]	+3.65%	+3.12%	+3.78%	+10.79%	+8.31%	-0.19%	+0.54%
EQUITIES	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+8.72%	+7.54%	+12.18%	+14.39%	+21.83%	+4.93%	+0.43%
Total U.S. Market[4]	+13.41%	+10.84%	+14.54%	+16.22%	+26.50%	+5.06%	+0.94%
Domestic Large-Cap Equity[5]	+13.35%	+11.44%	+15.71%	+17.08%	+26.78%	+5.46%	+0.96%
Domestic Small-Cap Equity[6]	+12.35%	+7.51%	+8.53%	+8.33%	+21.70%	+4.99%	+0.32%
International Equity[7]	+5.00%	+4.49%	+9.83%	+12.50%	+17.04%	+4.86%	-0.19%
Developed International Equity[8]	+5.30%	+4.58%	+9.67%	+13.01%	+18.94%	+4.77%	+0.21%
Emerging Market Equity[9]	+4.01%	+4.19%	+10.57%	+11.33%	+11.54%	+5.13%	-1.37%
DIVERSIFIERS	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+3.08%	+0.84%	+2.19%	+2.99%	+5.43%	+0.63%	+0.05%
Commodity[11]	-4.43%	-6.54%	-0.08%	-2.40%	+5.09%	+1.90%	-0.99%

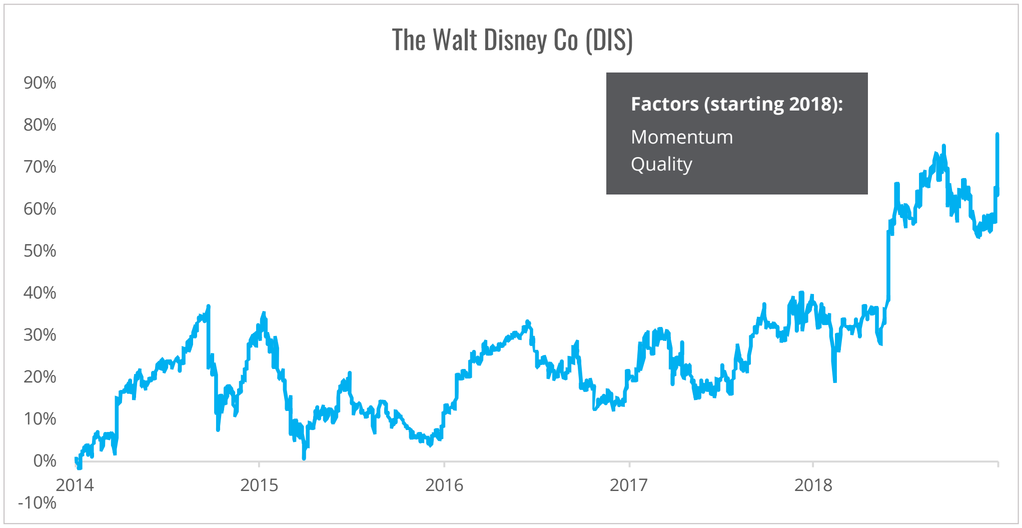
[1]Morningstar Cash Index [2]Bloomberg Barclay's Capital U.S. Aggregate Bond Index [3]Morningstar Global Market Large-Mid Index [4]Morningstar U.S. Market Index [5]Morningstar U.S. Large Cap Index [6]Morningstar U.S. Small Cap Index [7]Morningstar Gbl xU.S. Large-Mid Index [8]Morningstar DM xUS Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversified Alternatives Index [11]Bloomberg Commodity Index.

Disney (Factors) Through Time

1

Disney stock surged last week as investors realized Disney+ might actually live up to its expectations. As I watched The Mandolorian (a Star Wars series exclusive to the streaming service), I was also watching Disney's stock price. I naturally assumed that Disney might be a momentum stock. If not now, I believe it definitely will be soon. But what factors has Disney exhibited in the past?

Interestingly, Disney has been absent from several factor indices until recently (except some small allocations in minimum volatility). Disney was apparently too expensive for value, not high enough quality for quality, lacking momentum, and obviously too large for small-caps. However, an improving balance sheet and rocketing stock price has moved Disney firmly into momentum and quality indices.



Source: Morningstar, iShares

While my own take on Disney+ might not be all that interesting, many high-quality and sometimes lower-volatility (safer) names have moved into momentum indices. It's possible that investors fear we are late-cycle (see next section). While these momentum stocks are generally great companies, there is an increasing risk that large, high-quality companies are getting expensive. Momentum, quality, and minimum volatility indices in the U.S. all trade over 20x earnings. If you're looking for quality, you should account for value.

What's not expensive? Usually IBM! Despite being at the forefront of machine learning and innovation, IBM has struggled to captivate the investment community for years. Just ask Warren Buffett. IBM has bounced around many factor indices from minimum volatility to quality and, most recently, to both quality and value.

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, Orion Advisor Solutions, 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.

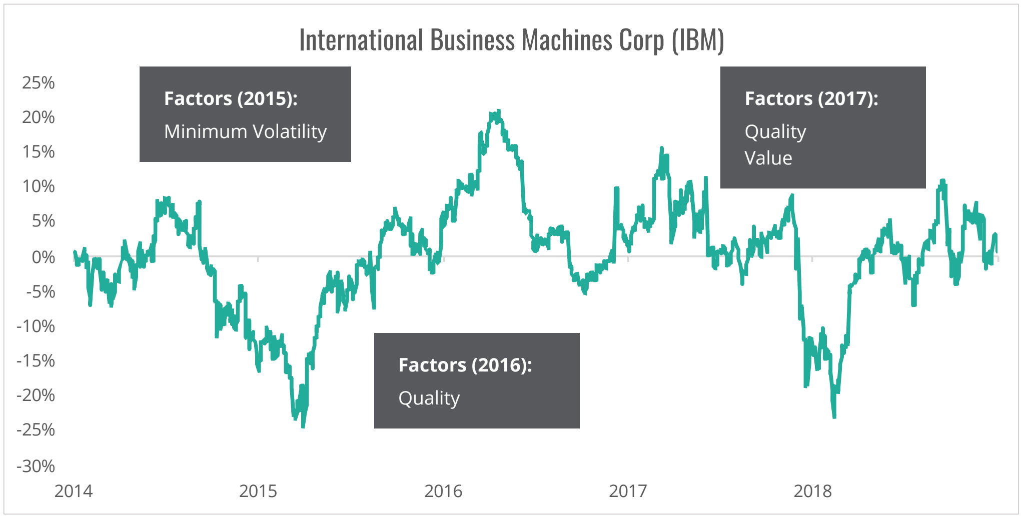
Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln. He holds the Chartered Financial Analyst® (CFA) designation, Chartered Alternative Investment Analyst® (CAIA) designation, and Series 65 license. He is a member of the CFA Society of Nebraska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

Disney (Factors) Through Time (cont.)

1



Source: Morningstar, iShares

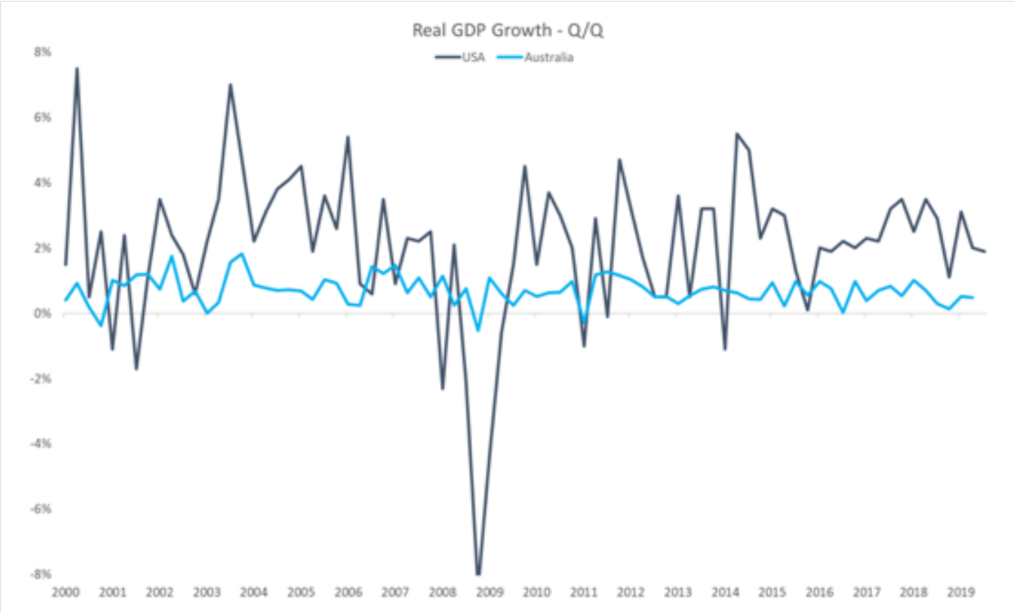
This brings up an interesting point. A recent paper pointed out that the fundamentals of value stocks haven't lagged like their prices have. While all value stocks haven't moved into the exact definition of quality (IBM an exception), there are several terrific companies trading at attractive prices that have been overlooked in recent years. It won't be long before many value names will also be in the momentum index.

What if Economists are Wrong?

2

There seems to be a consensus out there that a U.S. recession is just around the corner or at least likely to occur within the next couple of years. That has probably been the prediction for the last several years, but the length of the current cycle has many assuming it's bound to come to an end. It's true that we are seeing some late-cycle behavior. Yield curve inversions, non-cyclical stocks outperforming, and the Federal Reserve (Fed) cutting rates all seem to point in that direction. But with any prediction, you must always think about the risks. What if the consensus doesn't come to fruition and the cycle continues? How prepared are investors for that possibility?

The length of economic cycles in the United States has increased as the Fed has become much more involved in controlling inflation and managing interest rates. Since 1945, economic expansions in the U.S. have averaged just under five years (58 months). The three previous expansions have averaged nearly eight years (95 months), and we are currently more than 10 years into the current cycle. I think it's fair to say that expansions don't die of old age. As the adage goes, the Fed usually "kills them" by hiking rates. Well, the Fed just finished cutting rates in what it called a "mid-cycle adjustment." Interesting language choice.



Source: Factset

Has any country or region around the world seen expansions last this long? Absolutely. Australia is currently 28 years into its economic expansion! The pace of growth hasn't been spectacular, but it has been stable. Australia's economy has changed over this expansion, and it really isn't all that different from ours. Services make up the majority of the economy, and household consumption is by far the biggest end use. One difference may be Australia's large supply of natural resources, but the shale oil growth in the U.S. offers a comparison. To be fair, much of the sustainability of GDP growth in Australia has come from expanded population and immigration. Something for other developed economies (U.S. included) to keep in mind if they want to sustain long-term growth.

I'm certainly not saying that we are Australia and this cycle will never end. But as long as business and consumer confidence remains supportive, and you and I keep buying stuff, the cycle can last longer than people think. That's why it's always so important to evaluate and revaluate your Risk Budget. Take on the risk you are comfortable with, regardless of where you think we are in the cycle. Doing this will keep you from missing gains in strong years like this one.

CLS INVESTMENTS

Should Stocks be in the CPI?

3

I'm mostly joking. But keeping my economist hat on, stocks do represent an increasingly higher proportion of household assets. Inflation, or the lack thereof, has been quite the headscratcher. The Federal Reserve engaged in quantitative easing and cut interest rates in part to propel prices. That has worked — but mostly for stock and bond prices! It is interesting to think that if the Fed is also concerned about creating asset bubbles, having a component of the Consumer Price Index (CPI), or personal consumption expenditures (PCE) as the Fed prefers, including stock prices could alleviate concern. Hiking rates as inflation rises (stock prices included) would theoretically slow it all down and vice versa. Maybe it's a bad idea, but a good headline!

Will inflation ever return? Absent major financial stress, it seems unlikely that runaway inflation, such as occurred in the 70s and 80s, is coming back any time soon. Especially with such an active Federal Reserve. Technology has undoubtedly contributed to sluggish price pressures. It's partly the "Amazon Effect," but it also involves the technological advancements relating to oil and gas. Shale oil, and the speed at which it can essentially be "turned on and off," has become a global price regulator. I heard one of the more interesting, and somewhat controversial, reasons for lower inflation recently from JP Morgan. They posit that income inequality has kept inflation at bay. Low-earners tend to spend all (or slightly more) of their income. High-earners tend to spend a lot less (around 70%). As the high-earners increase in number, overall spending declines.

There are signs, however, that inflation is strengthening somewhat. Although tariff pressures seem (fingers crossed) to be waning, tariffs add to price increases as producers pass the cost on to consumers. Core CPI, which strips out the more volatile components, in August and September hit the highest levels since the financial crisis! At full employment, wage growth has been consistently stronger this year, which should theoretically lead to inflation on the margin.

Why do we even want/need inflation? Many believe that inflation is important for value stocks and, of course, commodities. There is truth to that, and it makes sense if you think about it. Traditional value sectors, such as energy, need higher energy prices, and financials stocks need higher interest rates — there are signs that both of these are actually occurring. But the nature of value has also changed. Healthcare companies benefit from higher healthcare costs. Those have definitely been rising! Technology companies, like IBM, that make their way into the value indices now, benefit from higher costs for their services but not in the same way as traditional value sectors.

The Morningstar Global Market Large-Mid Index is an index that measures the performance of the global market's equity markets targeting the top 90% of stocks by market capitalization. The Morningstar U.S. Market Index is an index that measures the performance of U.S. securities and targets 97% market capitalization coverage of the investable universe. It is a diversified broad market index. The Morningstar U.S. Large Cap Index is an index that measures the performance of U.S. large-cap stocks. These stocks represent the largest 70% capitalization of the investable universe. The Morningstar U.S. Small Cap Index is an index that measures the performance of U.S. small-cap stocks. These stocks fall between the 90th and 97th percentile in market capitalization of the investable universe. In aggregate, the Small Cap Index represents 7% of the investable universe. Morningstar Global ex U.S. Large-Mid Index is an index that measures the performance of Global Markets (ex-U.S.) equity markets targeting the top 90% of stocks by market capitalization. The Morningstar DM ex U.S. Large-Mid Index is an index that measures the performance of developed markets ex-U.S. equity markets targeting the top 90% of stocks by market capitalization. The Morningstar EM Large-Mid Index is an index that measures the performance of emerging markets targeting the top 90% of stocks by market capitalization. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Morningstar Cash Index is an index that measures the performance of a Treasury Bill with six to eight weeks until maturity in the U.S. market. The Morningstar Diversified Alternatives Index allocates among a comprehensive set of alternative underlying ETFs that employ alternative and non-traditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure or inflation-related investments. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. This index provides investors with a means of understanding the performance of commodity futures markets and serves as a benchmark for investment performance of commodities as an asset class. The volatility of the indexes may be materially different from the individual performance attained by a specific investor. In addition, portfolio holdings of investors may differ significantly from the securities that comprise the indexes. You cannot invest directly in an index.

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*CLS Investment, LLC ("CLS") Senior Portfolio Manager & Co-Director of Research, Grant Engelbart, CFA, CAIA, was selected as a "Top 10 Fund Managers to Watch" in 2018 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 12, 2018. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.

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