LCM
LEE CAPITAL MANAGEMENT

Lee Adaptive Large Cap Sector Update

Monthly Commentary

September 2018

Dangerous Curves

September was what passes for normal in this venerable bull market. The S&P set new highs and gained 0.60%. MSCI EAFE was up 0.91%. The news of the month included US-China trade talks going badly, and Brexit negotiations not doing any better. Elon Musk was, briefly, sued by the SEC. And the Fed raised rates.

None of those items were particularly unexpected, rising interest rates included. That the Fed would tighten was not merely the subject of a broad consensus and numerous warnings from the Fed itself, it was (and is) thought to be a practical inevitability. And yet when the Fed made its announcement on the 26th the market retreated. As unsurprising as the increase in rates was, there was still a palpable sense of disappointment.

The situation reminds us of a story that the illusionist/comedian Penn Gillette tells about a mathematician friend who spends weekends counting cards at the blackjack tables. The friend has worked out that if he plays for 20 hours the range of likely outcomes is narrow and that he will almost certainly make money. Yes, Gillette responds, but based on your calculations you expect to make just $25 an hour. Surely a man of your talents could find a more lucrative part time job? To which the mathematician shrugs and admits “Well, I guess I hope that one weekend I will get lucky and win big.”

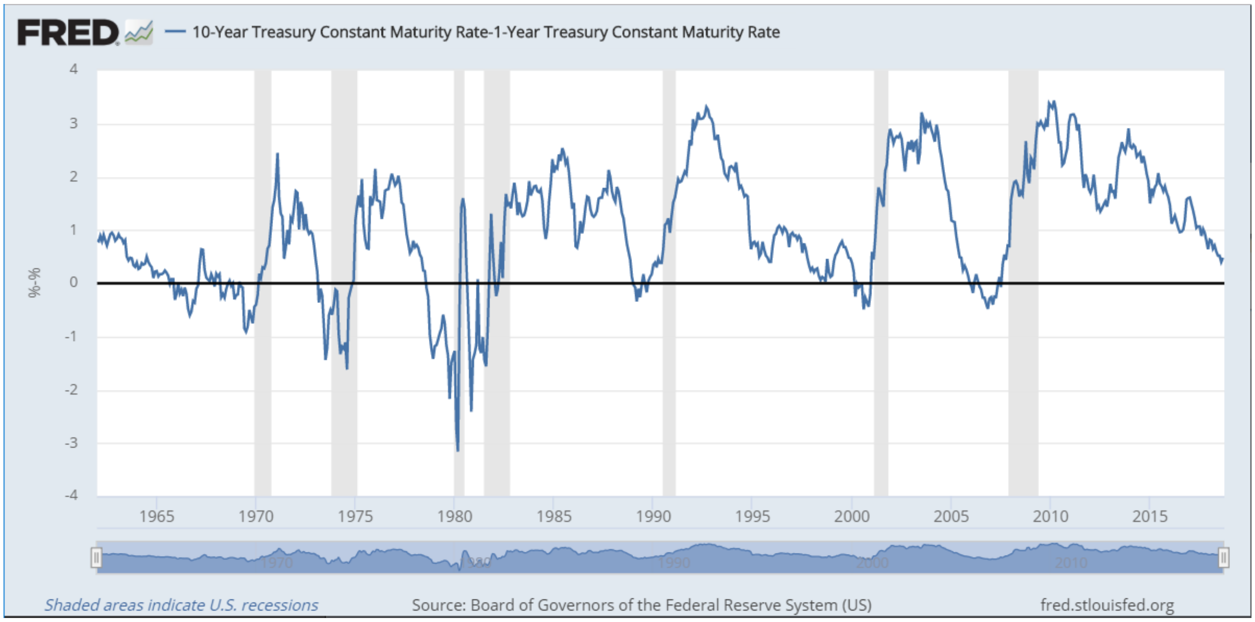
And so it is with the Fed. Everybody expects them to raise rates. Most even agree with the policy and would themselves vote to raise rates if asked. But deep in the recesses of its heart, the market has a secret hope that somehow rates will not go up.

Lately, a focus of interest rate anxiety has been on a typical result of increasing short-term rates, a flattening yield curve. Particularly worrisome is the prospect of an inverted curve, the situation in which short-term rates are above long-term ones. This is thought to foretell an imminent recession.

Being cynical quants with an instinctive distrust of conventional wisdom, our first thought is to wonder if this is true, if an inverted yield curve really is a grim economic omen. But this turns out to be a case where our skepticism is misplaced. With several significant caveats, conventional wisdom seems to be right on target here.

Below is a chart from the ever-useful St. Louis Federal Reserve Bank site, showing the spread between 10-year and 1-year Treasury yields for the past sixty years, with recessions shaded. (Yield curves are generally measured using the two-year rate, but that data series goes back only to 1976.)

Sure enough, each of the seven recessions in the chart is preceded by a yield curve inversion, that is, a negative spread. And in only one case, back in the mid-1960s, was an inversion not soon followed by a recession.



But there are caveats, beginning with sample size. The problem is not just that seven examples is not a large pool, but that five of the seven were more than 25 years ago. It is just possible that capital markets and the economy have evolved in some way since then that makes 20th Century evidence less valid.

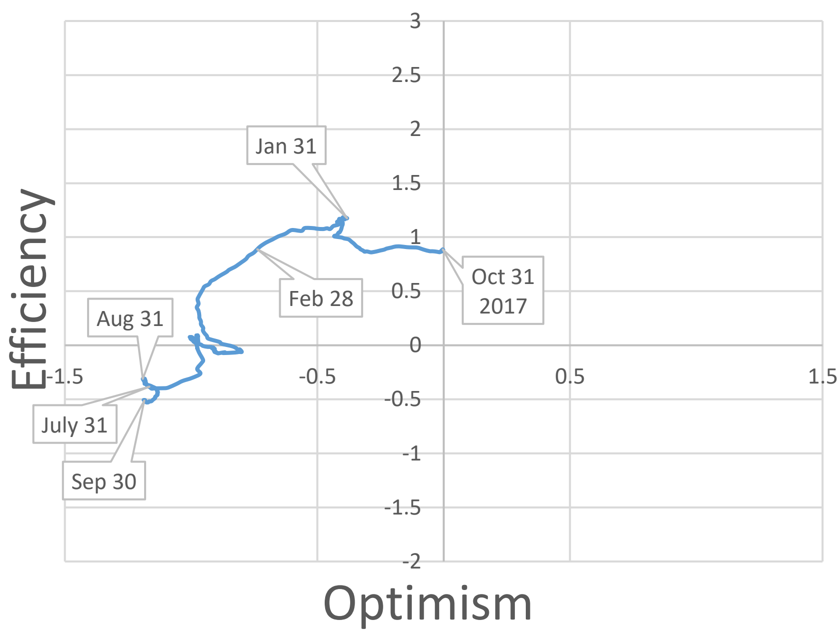
More significantly, there is the issue of causation. Conventional wisdom is silent on why an inverted curve indicates a recession. Does it cause the recession? Perhaps oncoming recessions cause inverted yield curves? Or are inversions and recessions both the result of some third thing? Without a good causative theory, if the yield curve inverts in 2019, how will we know if it is a typical recession-predicting inversion or an anomaly caused by years of exceptional monetary policy?

A larger and even more significant issue is that predicting that a recession will begin in the next 6-12 months is not, when you get down to it, all that impressive. GDP numbers move slowly. Generally, by the time statistical confirmation arrives the fact of a recession is universally acknowledged.

What would be impressive, and useful, would be if yield curve inversions predicted moves in the equity market. And there is some indication that they do, although weakly. 1-year rates were above 10-year rates on 125 of 678 month-ends since 1961. The average return for the S&P 500 during the following month for those 125 was -0.11%, as against 0.84% for the 553 non-inverted months. That suggests a reasonably useful buy/sell signal. But it must be noted that much of the effect happened long ago. The 25 inversion months since 1995 were followed by an average gain in the S&P of 0.45%, while the 246 non-inverted months were followed by a gain of 0.73%. That is still a meaningful difference between inversion and not, but instead of going down after inversions, in the 21st Century the market has merely gone up a bit more slowly.

The Market Sentiment Framework

We use our Market Sentiment Framework to adapt the mechanics and weightings of our full quantitative models to changing market conditions. The Sentiment Framework gauges the current state of market psychology on two dimensions. Efficiency measures the crowdedness of the market, the volume of participants seeking investment opportunities. Lower levels of efficiency imply more market mispricing. Optimism measures the willingness of investors to take on risk in exchange for distant and uncertain rewards. Higher levels of optimism imply a better outlook for risky asset classes.



Continuing the pattern of August, September saw almost no change in either Optimism or Efficiency.

Optimism is now -1.18. Although not an extreme reading, it was -2.00 as recently as Q1 2016, both the absolute level and the longer term trend are clearly negative.

After staying close to zero for most of the second quarter, Efficiency made a more decisive movement downwards to end July at -0.38 and ended September at -0.51. Having crossed over into negative territory in mid-April for the first time since September 2012, this measure remains at a low level when compared to recent history. This suggests a market that is coming under continuing stress and that is becoming less crowded.

Lower Efficiency is good news for value investors who are now more likely to find bargains produced by a less well-functioning marketplace. But it is bad news for momentum investors who now have a smaller crowd to get in front of. Moreover, it raises the danger that in a crisis there would be fewer calmer heads ready to provide liquidity.

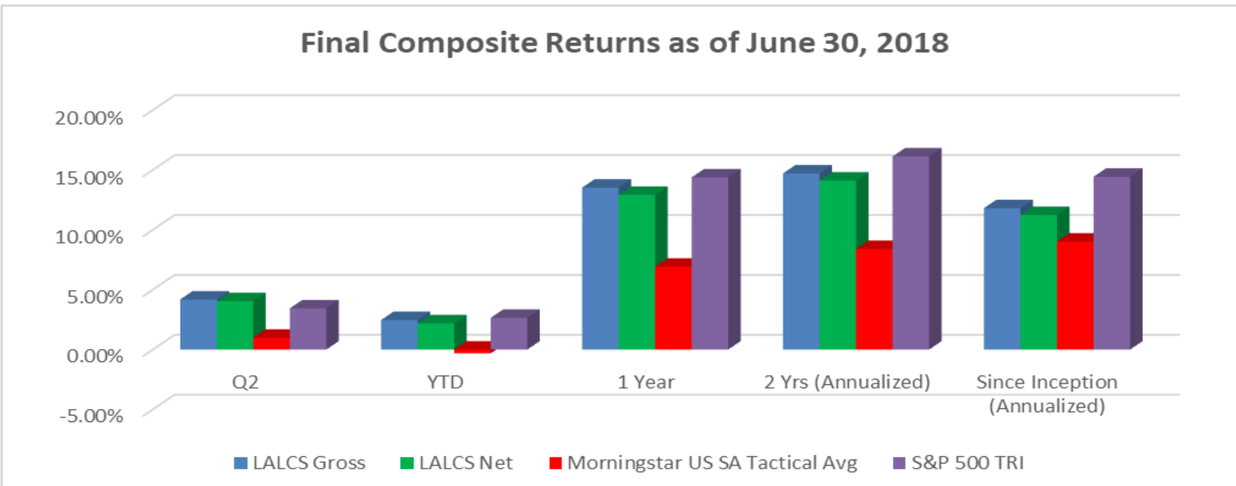
The current positioning of the Sentiment Framework implies a market that tends to the inefficient, with moderate opportunities for relative gains from stock picking. Optimism, although not exceptionally low in absolute terms, has been showing a downward trend and is at a level that would suggest muted, if not negative, market returns.

Performance

Lee Adaptive Large Cap Sector (LALCS)

For the month of September 2018, the LALCS composite, on a net of fee basis, was up an estimated +0.06%, vs the S&P 500, which was up +0.60% on a total return basis. For the first eight months of 2018, LALCS is up +7.33%, trailing the S&P 500, which is up +10.56%.

The strategy began and ended September invested in all sectors other than Healthcare.



Period Returns as of June 30, 2018	Q2	YTD	1 Year	2 Yrs (Annualized)	Since Inception (Annualized)
LALCS Gross	4.18%	2.47%	13.52%	14.71%	11.81%
LALCS Net	4.04%	2.19%	12.92%	14.12%	11.24%
Morningstar US SA Tactical Avg	0.99%	-0.31%	6.92%	8.40%	9.02%
S&P 500 TRI	3.44%	2.65%	14.38%	16.13%	14.43%

Inception Date: December 31, 2015

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILITY

Definitions:

Lee Adaptive Large Cap Sector Composite ("LALCS Composite"). A capital weighted performance composite of an investment strategy known as the Lee Adaptive Large Cap Sector strategy (the "LALCS Strategy") that holds some combination of the U.S. large cap sector ETFs and/or cash, as determined by a proprietary quantitative model. The LALCS Strategy is currently offered by LCM to (A.) certain qualified investors through (i) a single account which is a component of the overall strategy offered through a managed account Lee Diversified Opportunities Fund LP ("LDOF"), during the period commencing on December 18, 2015 through July 1, 2016 and (ii) the private fund Lee Adaptive Strategies LP ("LAS"), during the period commencing on June 1, 2016 through November 30, 2017 and (B.) certain accounts managed by LCM on a discretionary basis ("LALCS Managed Accounts"). LAS, LDOMF and the LALCS Managed Accounts all use the same investment program as the LALCS Strategy. The LALCS Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.55%. Actual expenses of operating the LALCS Strategy may vary, depending on the investment structure in which the Strategy is used, which could result in lower returns than those stated for the LALCS Composite. Such expenses may detract materially from the performance of the LALCS Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LALCS Strategy.

The LALCS Composite is being shown for illustration purposes only and should not be relied upon. No representations or assurance is made that any investor will or is likely to achieve results comparable to those shown above or will make any profit or will be able to avoid incurring substantial losses. PAST PERFORMANCE OF THE STRATEGY AND THE LALCS COMPOSITE ARE NOT INDICATIVE, OR A GUARANTEE, OF FUTURE RESULTS.

S&P 500 Total Returns Index. The returns for the S&P 500 index on a total return basis, that is, with dividends included and does not reflect the deduction of fees and expenses. You cannot invest directly in this index. The returns for the S&P 500 Index are provided for comparison purposes only to show how the LALCS Composite compares to a broad-based index of securities. The S&P 500 is comprised of a representative sample of 500 large-cap companies. The index is an unmanaged, float-weighted index with each stock's weight in the index in proportion to its float, as determined by Standard & Poors. The index is one of the most widely used benchmarks of U.S. equity performance. The index is not subject to any of the fees or expenses to which the LALCS Composite is subject. It is not possible to invest in this index. The index is used for comparison purposes only. It should not be assumed that the LALCS Strategy will invest in any specific securities that comprise the index or that the investment program of the LALCS Strategy will track the index. Consequently, the returns of the LALCS Composite may or may not be highly correlated with those of the index.

Morningstar US SA Tactical Average: Is the average return of a universe of Tactical Allocation portfolios that seek to provide capital appreciation and income by actively shifting allocations across investments. These portfolios have material shifts across equity regions, and bond sectors on a frequent basis. To qualify for the tactical allocation category, the fund must have minimum exposures of 10% in bonds and 20% in equity.

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