LCM
LEE CAPITAL MANAGEMENT

Lee Adaptive Strategies Update

Monthly Commentary

March 2019

Uncommon Events

It is not every day that a bull market has a tenth birthday. In fact, in the US it has happened just once, this past March 9. On a total return basis, the S&P 500 gained almost exactly 400% in ten years. Celebrations were muted. Indeed, several media outlets pointed out that if the market fails to regain its high from last September and falls into a bear market, the bull market will be considered to have ended last year.

What did get attention this month was the about-face at the Fed. In last month's commentary we confidently wrote that the pause in rate rises was just that, a pause. The climb upward was inexorable and inevitable, even if the markets were allowed the occasional break to catch their breath.

It seems we were mistaken. Apparently, the current halt in tightening is not a temporary reprieve but a full pardon. And, as evidenced by the fixed income markets, not only are no further increases foreseen, but decreases in rates are anticipated for next year. Such changes in Fed direction are more common than ten-year bull markets, but are still rare. If it happens, this one will be just the fourth since 2000.

Of course, a revelation that rates have stopped rising and will soon start falling is, or should be, very good news for capital markets. It is not quite equivalent to an announcement that stock and bond prices will now start rising, but it does suggest that a strong headwind will now become a tailwind. And the impact on markets should be even more pronounced if the change in direction was not broadly anticipated.

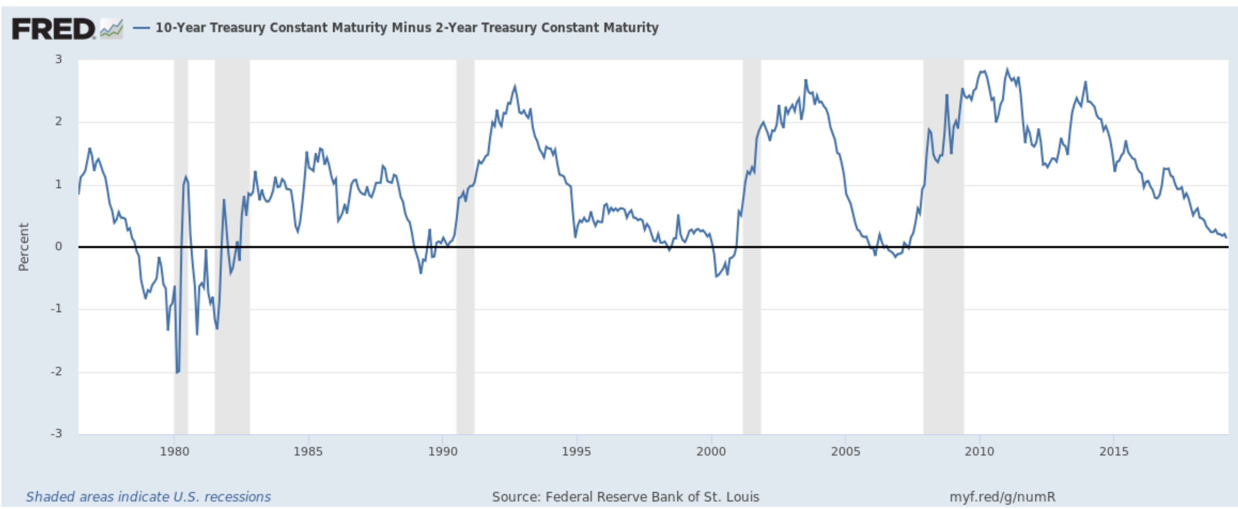
But on March 20, the day of the release of the Fed minutes that indicated no further rises for 2019, the S&P 500 lost -0.29%. Through the end of the month, it gained just 0.11%. That hardly sounds like the product of good news. What could have caused such a non-reaction?

The first possibility that comes to mind is that the markets do not, in fact, believe that the Fed has reversed course. As it involves cynical skepticism, we are instinctively drawn to this explanation. However, the bond market, presumably the place where the consensus on the Fed is definitively revealed, did react positively. The benchmark 10-year Treasury went from yielding 2.61% on March 19 to end the month at 2.39%.

There are only two plausible justifications for the stock market going nowhere on such positive Fed news. The first is that the market is fundamentally random and cannot be relied on to act in a certain way in any given situation. Again, we are instinctively sympathetic, but this goes a bit too far. We believe the market is much less rational than is often assumed, but it is not merely a random number generator.

The other plausible explanation is that the good news from the Fed was bundled with offsetting bad news for equities. And a person does not need much imagination to find offsetting bad news. After all, it is safe to assume that the Fed did not reverse course merely as a gift to the markets. It is worried, and not unreasonably, about a possible recession.

Much of the recent recession talk has focused on another uncommon event, an inverted yield curve, in which longer dated bonds yield less than shorter dated ones. It is a signal of almost mythic status, a revered bit of wisdom that defies simple explanation or understanding. And from a purely empirical point of view, the inverted yield curve seems to be a grave augur. Since 1979 there have been five recessions, each following an inverted yield curve and five inverted yield curves, each followed by a recession.



Depending on your definition of the yield curve, it has either already inverted in the past few weeks or is very close to doing so. (We favor the 10-year constant maturity yield less the 2-year constant maturity yield, which has not, quite, crossed over into negative territory. Yet.)

It is probably worth noting that in each of the five previous inversions the proximate cause could be appropriately described as 2-year yields increasing above the 10-year rate, rather than the 10-year yield falling below the two. Would an inverted yield curve caused by a rally in longer dated bonds still be a sign of recession? The honest answer is that nobody knows.

And what would an inverted yield curve mean for the stock market? Surely an oncoming recession is a bad environment for equity? That is not clear. The average (price only) return for the S&P 500 in the year following the five yield curve inversions is +7.21%, not far below the average annual return since 1978 of 8.45%.

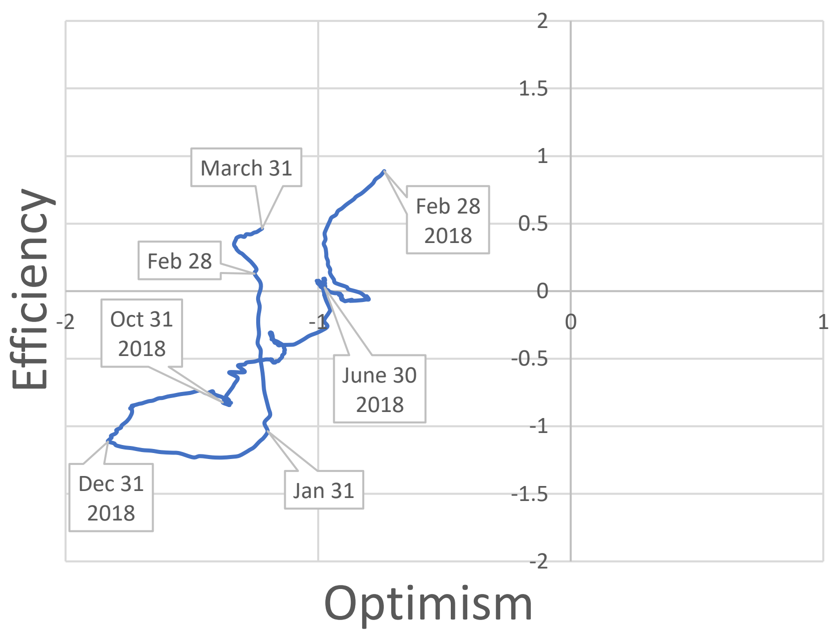
Of course, there is a bit of a lag between the yield curve inversion and the predicted recession, so a year after the inversion is often before the recession starts. And as experienced investors know all too well, recessions are bad for stocks, at least in the short term. So bad, in fact, that with the benefit of hindsight it is clear that many recessions generate once-in-a-generation buying opportunities. They are, almost by definition, bouts of irrational pessimism in which the lessons of the past are ignored.

March 9, 2019 was not an occasion of any significance. March 9, 2009, on the other hand, was the sort of uncommon event worth looking out for.

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 trend of February, in March Optimism held fairly steady while Efficiency rose.



Although it suffered a brief mid-month decline, Optimism ended March at -1.22, not meaningfully far from where it began at -1.25.

Although still low in absolute terms, Optimism is much improved from levels of last December, having now returned to the region it last inhabited in early fall 2018.

Efficiency made a marked improvement during February and added to it in March, rising from 0.13 to 0.46. This is a strong two month improvement which goes counter to a downward trend in Efficiency that had lasted more than a year. Efficiency has now nearly retraced itself to levels of a year ago. While the change in Efficiency is an indication of healing markets that are increasing in orderliness, the absolute level is still comparatively low by historical standards.

Middling levels of Efficiency, as we currently have, are neither good nor bad news for value and momentum investors, suggesting that some opportunities exist for both.

The current positioning of the Sentiment Framework implies a market that is functioning well but is less efficient than it could be, with moderate opportunities for relative gains from stock picking as well as from momentum. Optimism, although not exceptionally low in absolute terms, and despite a strongly positive first quarter, is still at a level that would suggest caution.

Performance

Lee Adaptive Large Cap Sector (LALCS)

For the month of March 2019, the LALCS composite, on a net of fee basis, was up an estimated +2.29%, ahead of the S&P 500, which was up +1.94% on a total return basis.

The strategy ended February fully invested in equity, holding six sectors, Healthcare, Consumer Staples, Utilities, Real Estate, Financials, and Technology. Four of the remaining five sectors were added to the portfolio during the month. Materials was purchased March 6th, Both Consumer Discretionary and Industrials came in on the 19th, and finally Energy entered the portfolio on the last day of the month. As of March 31, the only sector absent was Communications Services.

Lee Adaptive US Equity – Broad Market (LAUSE)

For the month of March 2019, the Lee Adaptive Large Cap Sector Strategy composite, on a net of fee basis, was up an estimated +2.13%, ahead of the S&P 500, which was up +1.94% on a total return basis.

The strategy ended February fully invested in equity, holding six sectors, Healthcare, Consumer Staples, Utilities, Real Estate, Financials, and Technology. Five of the remaining six sectors were added to the portfolio during the month. Materials was purchased March 6th, Both Consumer Discretionary and Industrials came in on the 19th, Small Cap was added on March 21st and finally Energy entered the portfolio on the last day of the month. As of March 31, the only sector absent was Communications Services.

Lee Adaptive Global Equity (LAGE)

For the month of March 2019, the LAGE composite gained an estimated +0.72%. This was behind the MSCI All Country World Index, which was up +1.32% on a total return basis.

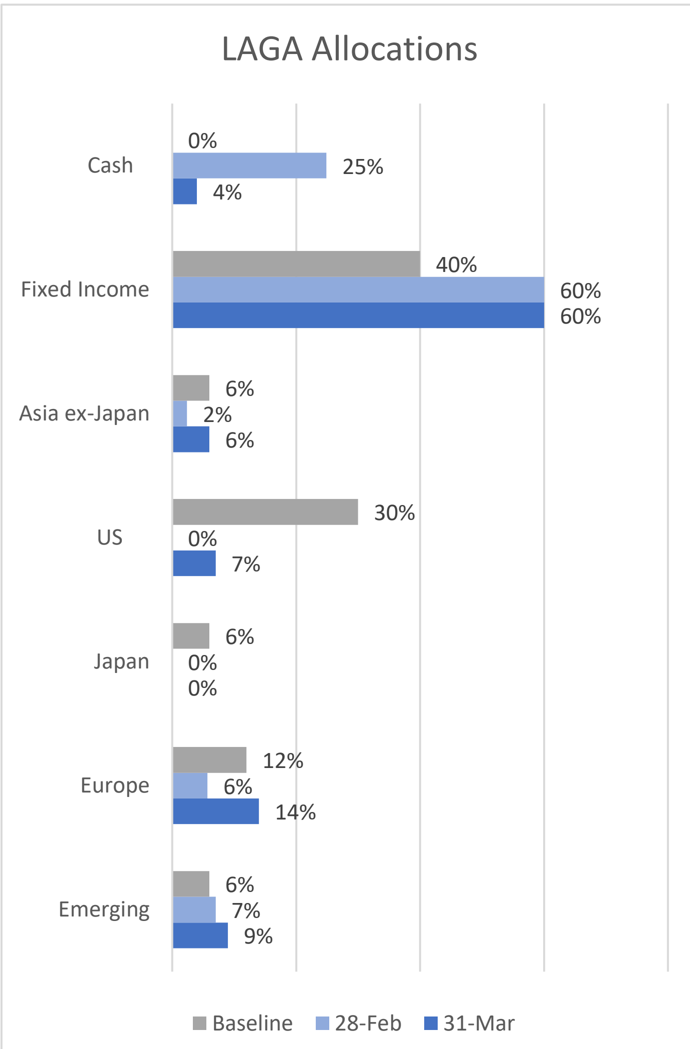
The portfolio began the month with a strongly defensive positioning, holding 67% cash. As the month progressed, cash was reduced in favor of equity.

Emerging Markets began and ended the month at its maximum holding, 15%. US equity started March at 5% of the portfolio and was built up to 15% by the end. Europe went from 19% to 29%, while Asia ex-Japan grew from 5% to 10%. Japan remained unowned. Cash ended the month at 31%. This is still a moderately defensive positioning.

Lee Adaptive Global Allocation (LAGA)

For the month of March 2019, the LAGA composite, on a net of fee basis, was up an estimated +1.10%, behind our blended benchmark, which was up +1.56% on a total return basis.

The portfolio began the month with 60% cash and 25% in fixed income. During March the fixed income allocation held steady at its maximum position, while cash was reduced to just 4%. With the exception of Japan, the equity allocations were all increased.



Since the start of the year, the porfolio has been shifting progressively less defensive. Cash began the quarter at 95% of the portfolio and ended it at 4%, while equity exposure grew from nothing to 36%.

Although much less defensive than it was just a few month ago, with 60% in fixed income the portfolio is still considerably less aggressive than it could be.

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 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.
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Lee Adaptive US Equity Composite ("LAUSE Composite"). A capital weighted performance composite of an investment strategy known as the Lee Adaptive US Equity Strategy (the "LAUSE Strategy") that holds some combination of the U.S. large cap sector ETFs, a small cap ETF and/or cash, as determined by a proprietary quantitative model. The LAUSE Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.55%. Actual expenses of operating the LAUSE 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 LAUSE Composite. Such expenses may detract materially from the performance of the LAUSE Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LAUSE Strategy.

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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.

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Blended Benchmark. Is a hypothetical index comprised of 60% MSCI AC World Index and 40% the Bloomberg BarCap US Aggregate Bond Index. You cannot invest directly in this index.

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