Strategy Quarterly

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Massimo Santicchia
Co-Founder and Chief Investment Officer
Alpha Quant Advisors, LLC
Massimo.Santicchia@AlphaQuantAdvisors.com

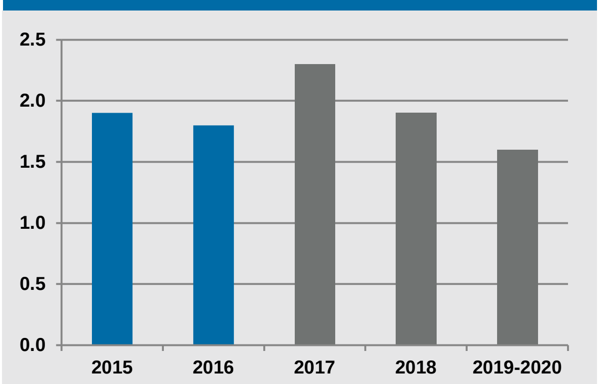
Executive Summary

- Right after the U.S. presidential elections, stock prices rose significantly on optimistic expectations of pro-growth economic policies from the new government. Last week's surprising setback for health-care reform brought investors back to reality by acknowledging that the path to enacting new policies will be less smooth than anticipated.
- Despite the health-care stumbling block, we believe that positive global economic trends support the equity markets. Output and activity gauges point to a resurgence in manufacturing, consumption indicators point to high consumer confidence, business investment is rebounding and the labor market continues to improve.
- An analysis of the business cycle indicates that the U.S. economic expansion remains on track. Economic growth should continue to outpace growth in potential GDP and, thus, reduce the amount of slack in the economy. The result may include increases in hiring, employment and wages, along with gradual upward pressure on inflation and interest rates.
- One risk is that pro-growth policies enacted by the new government could, in the short term, overheat the economy. Given the current low level of slack, such a growth boost could trigger a spike in inflation and prompt the Federal Reserve ("the Fed") to hasten the pace of interest rate hikes. In turn, the economy could be pushed into the recession phase.
- Alpha Quant Advisors offers an array of equity strategies with differing sensitivities to economic conditions, which may appeal to distinct risk profiles. Historically, this phase of the business cycle has favored economic-sensitive, cyclical sectors. Investors with a long-term investment horizon and an aggressive risk profile could potentially benefit from exposure to our Cyclical Growth and Cyclical Value Equity Strategies. Risk-averse investors should consider a more conservative approach like our Dividend and Defensive Equity strategies.

Economic Outlook

According to the Congressional Budget Office (“CBO”), GDP in real terms will expand at an average annual pace of about 2% from the fourth quarter of 2016 to the fourth quarter of 2018, after having risen at an annual rate of 1.8% last year (Figure 1). Most of the growth in output during the coming years should be driven by consumer spending, business investment and residential construction, the CBO anticipates. The activity data for January and February suggest that the economy is growing in line with the CBO’s projections.

Figure 1: Real GDP Growth (%)



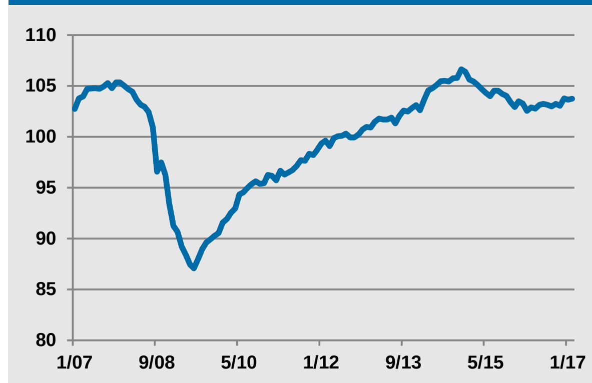
Source: Congressional Budget Office (Actual vs. Estimates)

According to Capital Economics, first-quarter GDP growth will be a modest 2% annualized. Consumption growth could be less than 1.5%, as the unseasonably warm winter reduced demand for utilities and motor vehicle sales fell back from a 17-year high. But the recent strength of monthly employment gains and the marked improvement in the activity surveys suggest that GDP growth will rebound in the second quarter.

Figure 2: ISM Index

Source: Capital Economics

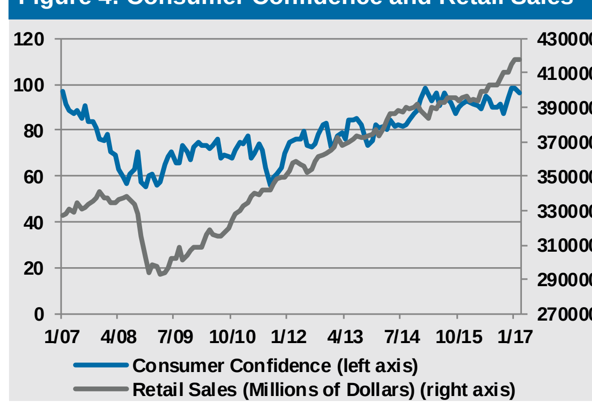
Figure 3: Industrial Production Index



Source: Federal Reserve

The recovery in the manufacturing activity surveys has been particularly strong. The ISM manufacturing index has surged to a two-year high, while the latest regional surveys suggest that the ISM index may have risen even further in March, to its highest level since 2011 (Figure 2). This is now feeding through into a resurgence in manufacturing output and industrial production (Figure 3). The outlook for consumer spending for 2017 is encouraging. Underlying retail sales started the year on a fairly solid footing, with the three-month annualized growth rate rising to a six-month high in February. Moreover, consumer confidence has remained close to the highs reached in the aftermath of November’s presidential election (Figure 4). According to the Conference Board, consumers are much more optimistic regarding the short-term outlook for business, jobs and personal-income prospects. Thus, consumers’ renewed optimism suggests the possibility of some upside to the prospects for economic growth in the coming months.

Figure 4: Consumer Confidence and Retail Sales



Source: Federal Reserve

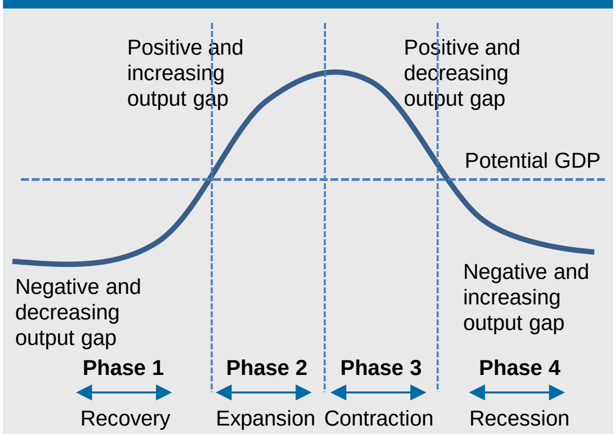
Business-Cycle Analysis

The departure point for assessing the dynamics of the business cycle is the long-run sustainable real growth rate of the economy – or potential real GDP. The availability and growth of capital and labor determine the long-term potential growth rate of the economy. Thus, the output gap deviation in GDP growth from potential indicates disequilibrium within the economy and it can be either unsustainable (positive output gap is inflationary) or suboptimal (negative output gap is deflationary).

Given that rising demand has been met with existing capacity, corporate margins have expanded driving strong earnings growth. Monetary policy has remained very accommodative as underutilized capacity has kept inflation muted. The stock market has reflected this economic rebound by advancing by 250% since the 2009 market bottom through the end of March 2017.

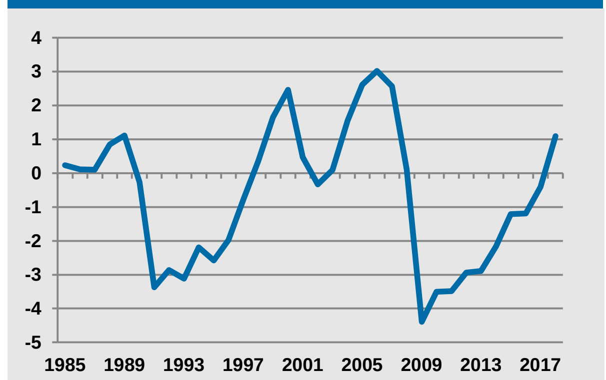
The duration of this recovery phase has been uncommonly lengthy compared to past cycles, as the aftermath of the financial crisis was

Figure 5: Stylization of Output Gap Cycle



Source: Adapted from Taylor (1998)

Figure 6: U.S. Output Gap



Source: OECD

The magnitude of the output gap and its direction (increasing or decreasing) has implications for inflation, monetary policy and overall direction of the economy. The output gap's magnitude and direction also define the four phases of the economic growth cycle:

- Phase 1: Recovery
- Phase 2: Expansion
- Phase 3: Contraction
- Phase 4: Recession

Each phase is characterized by distinct trends in the corporate earnings cycle, inflation, credit cycle and monetary policy. More importantly, the four phases of the cycle affect the relative performance of various asset classes and economic sectors.

Where are we now in the cycle? Based on the actual output gap (Figure 6), the U.S. economy has slowly moved from the bottom of the 2009 cyclical trough and is forecasted to close the gap in 2018. These eight years have been characterized by a resurgence of growth led by inventory accumulation, business investment and recovery in housing.

characterized by a prolonged corporate and consumer deleveraging period. Nonetheless, the economy, albeit slowly, kept growing with the support of the most accommodative monetary policy in U.S. history.

The length of this cycle and the corresponding advance of the equity market has led some investors to question its ability to continue to rise. Although the stock market advance may "feel" long in the tooth, it may still have legs based on the typical evolution of the business cycle and its underlying drivers.

First, economic growth is expected to continue for the next couple of years at the modest but still significant rate of about 2% on a resurgence of manufacturing output, resilient consumer spending and a rebound of corporate capital investments.

Second, monetary conditions remain very accommodative. The Fed is not in a hurry to increase rates and we would not expect more than three hikes in 2017, unless inflation moves up sharply from current trend.

Third, the new presidential government's pro-growth policies such as corporate tax reform and infrastructure investment could boost economic growth above the current forecasted levels.

We see potential risks to our outlook. One risk is that pro-growth policies enacted by the new government could, in the short term, overheat the economy. Given the current low level of slack, such a growth boost could trigger a spike in inflation and prompt the Fed to hasten the pace of interest rate hikes. In turn, the economy could be pushed into the contraction phase.

In addition, although cyclical considerations may be more relevant at this stage of the cycle, investors should always be aware of market valuations, as high, relative valuations have been consistently associated with lower future long-term returns. More recently, the S&P 500 was trading at about 18 times projected 2017 operating earnings. While such valuation levels do not signal a frothy market, they are still above historical averages and may make the market vulnerable to corrections should economic and corporate fundamentals turn out to be less favorable than currently projected.

Finally, should pro-growth policies be further delayed by political discord, investors could become more anxious or less confident about the prospects for pro-growth legislation and trigger a sell-off.

We maintain a constructive outlook on equities based on a combination of positive global economic trends, high consumer confidence and accommodative monetary policy. If our assessment of the business cycle is correct, we believe that we are just entering the true expansion phase of the cycle. During this phase, the economy moves above its sustainable noninflationary growth path. Capacity constraints and labor shortages drive inflationary pressure. The emergence of capacity constraints drive investment in capital equipment as corporations try to keep up with demand. In this phase, stocks have historically continued to do well even as the Fed starts tightening, at least initially, on business momentum and positive sentiment. In the commodity markets, the supply is constrained by existing capacity limits while demand accelerates along with economic growth.

In terms of asset classes, stocks tend to outperform bonds and international stocks have historically outperformed U.S. stocks.

Within economic sectors, this phase favors economically sensitive sectors such as discretionary, materials, industrials and energy. Commodities tend to do well due to positive demand/supply dynamics.

The relationship between investment "styles," such as growth and value and the business cycle, has been historically inconsistent. We would expect that, as corporate earnings build momentum and inflation rises, growth-oriented strategies would perform better than value or high dividend-oriented strategies. We found that during this phase of the cycle, strategies driven by growth-oriented factors like earnings revisions and earnings quality generally perform well.

Alpha Quant Strategies

Alpha Quant Advisors offers an array of equity strategies with different sensitivity to economic conditions and appropriate for distinct risk profiles.

The next page depicts the range of Alpha Quant Equity Strategies – what we call the Equity Strategy Spectrum.

The strategies on the far left are built to be less sensitive to economic conditions (or "defensive"). As you move to the right, both volatility and sensitivity to market conditions increases.

Each strategy has a well-defined sector composition driven by a distinct set of "alpha factors" – fundamentals and valuation metrics that have historically been associated with future excess returns.

Investors with a long-term investment horizon and an aggressive risk profile could benefit from exposure to our Cyclical Growth and Cyclical Value Equity strategies. Risk-averse investors should consider more conservative equity strategies, such as our Dividend and Defensive Equity strategies. For investors seeking a solid core allocation that can be maintained throughout various market conditions, we believe our Core Equity Strategy is appropriate.

Less Sensitive ← **Equity Market Sensitivity** → ***More Sensitive***

Defensive Value	Defensive Growth	Dividend	Quality	Core	Value	Cyclical Growth	Cyclical Value
Focused strategy of 30 non-cyclical stocks with attractive valuations	Focused strategy of 30 non-cyclical stocks with above-average earnings momentum	Focused portfolio of 30 stocks with strong dividend persistence, broadly diversified across sectors	Focused portfolio of 30 high-quality large- to mid-cap stocks with strong profitability and lower leverage at reasonable valuations	Diversified portfolio of 50 to 60 stocks across Quality and Value strategies	Focused portfolio of 30 attractively valued large- and mid-cap stocks with high free cash flow, lower leverage and lower valuations	Focused strategy of 30 cyclical stocks with above-average earnings momentum	Focused strategy of 30 cyclical stocks with attractive valuations
Aims to outperform the market during periods of economic contraction and recession		Aims for high risk-adjusted returns by emphasizing dividend growth potential	Aims to outperform over a full market cycle	Aims for a more consistent return pattern	Aims to exploit investors' short-term biases and under-appreciation of cash flow trends	Aims to outperform the market during periods of economic recovery and expansion	
Composite Inception Date							
8/1/2013	8/1/2013	1/1/2012	1/1/2012	1/1/2012	1/1/2012	2/1/2015	2/1/2015
SmartALPHA® Index Start Date*							
7/1/2012	7/1/2012	—	—	—	—	7/1/2012	7/1/2012

Massimo Santicchia is a co-founder and chief investment officer of Alpha Quant Advisors, LLC. Mr. Santicchia develops and manages equity strategies and funds and oversees all aspects of Alpha Quant's investment process. Previously, he also served as chief investment officer of Cypress Capital Group and Cypress Trust Co. He has more than 18 years of investment experience, including at S&P Investment Advisory Services LLC as developer and portfolio manager of the four JNL/S&P funds. He also co-managed the JNL/S&P Managed and Disciplined funds. Prior positions include: consultant with the investment banking divisions of Goldman Sachs and Credit Suisse First Boston and international equity analyst at Nicholas-Applegate Capital Management. Mr. Santicchia holds a B.A. in Economics and Political Science from the University of Perugia, Italy; an MBA from the U.S. International University, San Diego; and an M.S., Investment Management, from Pace University, New York.