Recession? What Me, Worry?

2nd Quarter Review and Commentary

Market Performance

As of the close of trading on June 28th, 2019 the S&P 500 stood at 2941, less than 1% off it's all time high of 2964. The latest employment data put the unemployment rate at 3.6%. First quarter gross domestic product grew at over 3%. Credit spreads ranged between 107 basis points for investment grade debt, to 366 basis points for high yield, both near 10-year lows.

And yet all anyone talks about is how much the Federal Reserve would cut rates over the summer.

The reason is simple. While popular measures of economic activity look healthy, a deeper dive into the details and fundamentals of the markets raises considerable concerns.

Rates

The slope of the yield curve, long revered as a harbinger of economic fortune, has been inverted since the middle of the second quarter. Inversion, where short term rates are higher than long term, is perceived as a reliable predictor of recession. While there are many valid arguments against this relationship (small sample size, limited effectiveness in non-US markets), if it lasts too long the inversion becomes a self-fulfilling prophecy. An inverted yield curve leads to negative interest margins for banks, reduced lending and less available credit, robbing the economy of fuel for growth.

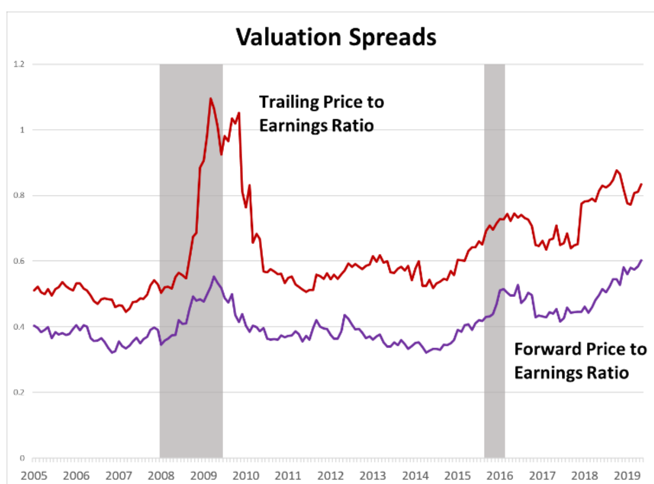
Lowering short-term rates can restore these margins if long rates remain stable, but this year, as conversations about the Fed Funds rate turned from hawkish to dovish, longer term rates fell in response. Instead of steepening, the curve simply shifted down.

Equities

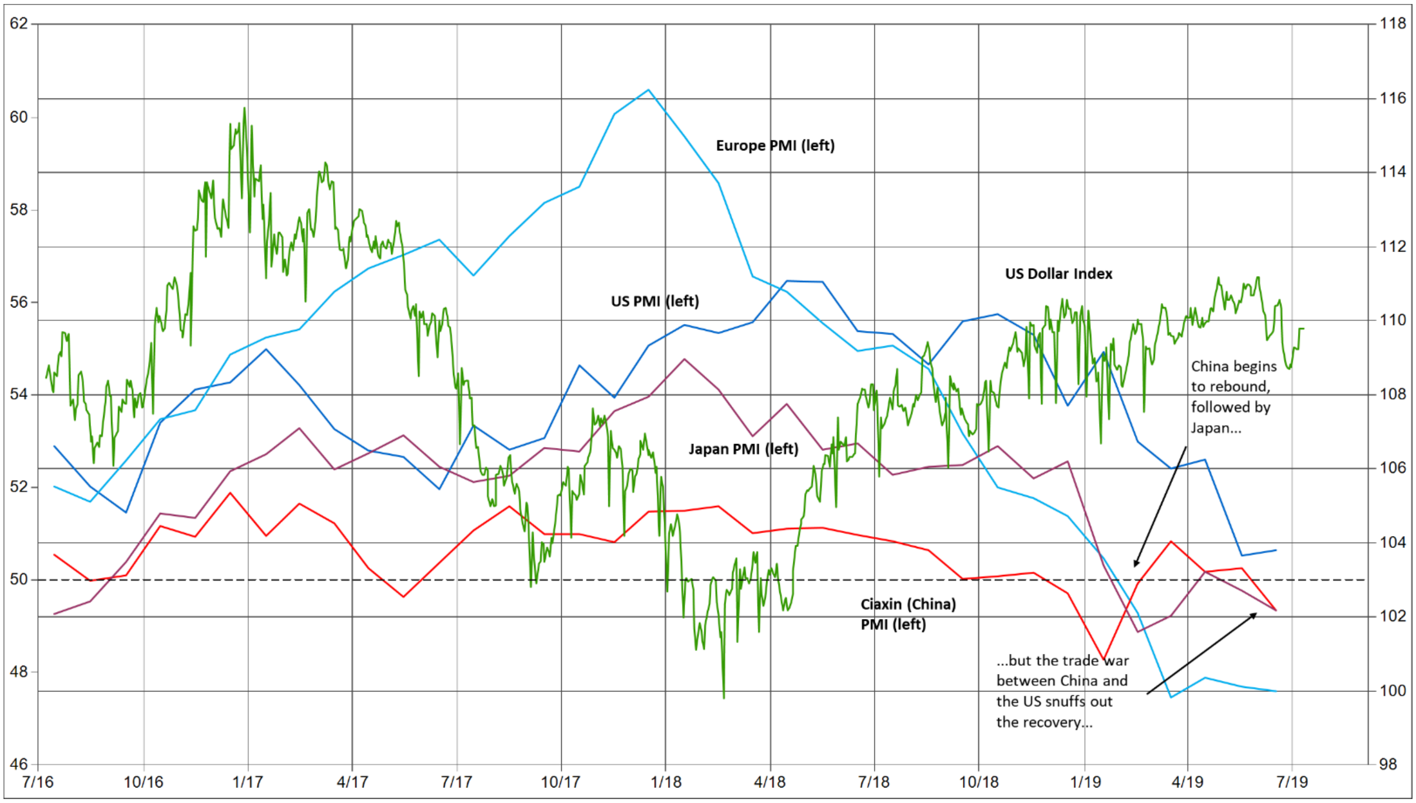
Analyzing equity market activity beyond the broad market index levels raises a long list of worries:

- The recent rally has been led by defensive stocks: a concentration of stable growth stocks, consumer staples, and bond proxies such as utilities.
- Small cap stocks have underperformed large cap stocks over the past 12 months by over 13%.
- Economically sensitive value stocks continued their now decade long underperformance relative to growth.

Healthy markets are broad markets. When investors focus on only companies with reliable growth prospects, it indicates pessimism about the economy. The difference in valuation between these stocks and the rest of the market explicitly measures this pessimism, and these spreads are as wide as they have been since the Global Financial Crisis.



Global PMIs



Economic Indicators

Global Purchasing Manager Indices (PMIs), aggregate the actions of purchasing managers in response to current business conditions. These have declined worldwide for the past 9-12 months. While there was hope that central bank stimulus in China would provide some support, these hopes were dashed by the escalation of the trade war between the US and China.

Copper vs. Gold

The copper/gold ratio compares the price of a commodity associated with economic growth (copper) with one that rises during periods of excessive central bank rate cuts (gold). The recent forecasts of economic weakness, in hand with discussion of central bank easing, has driven this measure to a three-year low. The last time the ratio saw similar levels was during the ‘industrial recession’ of 2015-16, when the global economy experienced a brief downturn that never actually reached official recession status.

Other Factors

Shipment loads for air, rail and trucking services have been falling at rates not seen since 2008.

GDP forecasting models from the Atlanta and New York branches of the Federal Reserve agree that 2nd quarter GDP growth looks to be less than 1.5%. Reviews of the 3.2% GDP growth number from the first quarter attribute that growth mostly to one-time events.

While we have been through several slowdown cycles in the last 10 years, most notably 2011 and 2015-16, neither of those were in the face of a sustained rise in the Federal Funds rate.

From a statistician's point of view, there are points to make about all this doom and gloom. While it is true that the market is presenting the largest collection of recession predictors since the beginning of the post-GFC expansion, a recession is not assured. To complete the journey to economic slowdown, some key events need to follow.

1. Federal Funds rate cuts. Only twice in the last 70 years (1967 and 1996) has a recession *not* followed a series of rate cuts Based on comments from the Federal Reserve, rate cuts this summer are fully expected by financial markets.

2. Widening credit spreads. Companies have issued a considerable amount of debt over the last several years, and smaller, less creditworthy equities have sold off, yet spreads remain firm.

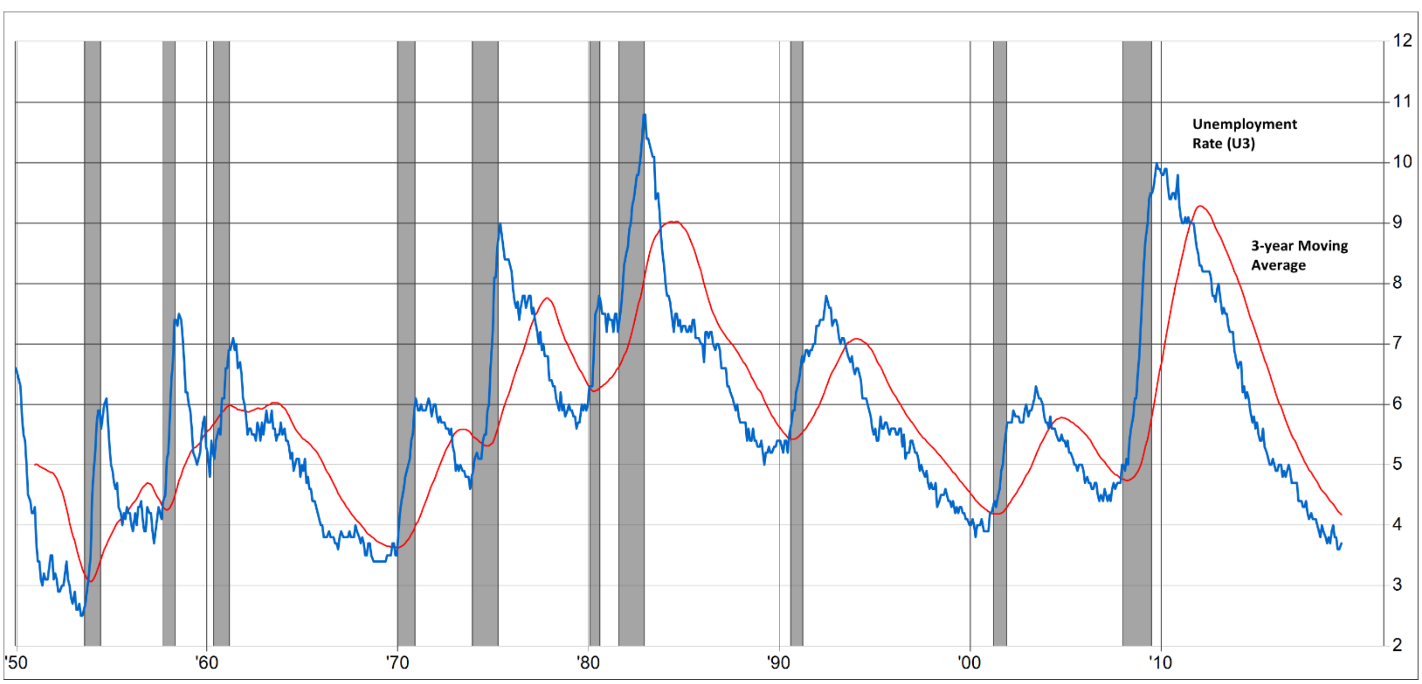
3. Equity market weakness. Eventually the stable growth stocks cannot hold up the broad market by themselves.

4. Uptick in unemployment. Employment is considered a trailing indicator, but when it breaks it's 3-year moving average, that has signaled that a recession has begun in earnest. (see chart below)

   Unemployment is the proverbial canary in the coal mine. From a timing perspective, once unemployment finds a bottom and shows signs of rising (some evidence of such a bottom can be seen in the recent reports), we are probably about 6 months away.

One pattern that has held in the past is that while timing recessions and market tops is extremely hard, once they occur, timing the bottom is a lot easier. As tales of economic doom fill the airwaves, a vigilant watch for an uptick in leading indicators can reliably indicate when to go back in and take risk.

Recessions & Unemployment



Small Cap Investing

Small cap stocks have borne the brunt of the moderating economic cycle. The slow trend of underperformance that has existed since mid-2011 accelerated in the last 12 months. The Russell 2000 index of small stocks has underperformed the Russell 1000 by over 13% over the past year.

Such underperformance is typical during the late stage of the cycle as small caps tend to be more economically sensitive. As such they represent a key area for investment once the cycle accelerates.

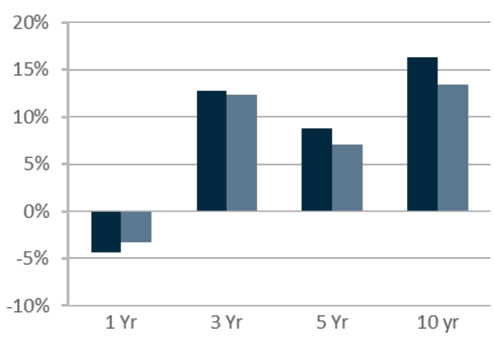
The valuation spreads described in the earlier section have manifested themselves in the size premium. The valuation premium for large cap stocks versus small, based on sales, book value or earnings, is higher than at any time in the last 15 years.

The market activity of the past 12 months and beyond has stretched the valuation spring taught, waiting for a catalyst to release it. When that catalyst emerges, small caps will be the place to be.

VCM Strategy Performance

<u>Vitruvian Small Cap Core</u>

Small Cap Core v. Russell 2000 as of 6/30/2019



	1 Yr	3 Yr	5 Yr	10 yr
Small Cap Core (Gross)	-4.40%	12.80%	8.76%	16.36%
Russell 2000 Index	-3.31%	12.30%	7.06%	13.45%
Morningstar Ranking	63	47	13	1

The Small Cap Core Strategy returned 2.49% in the 2nd quarter, outperforming the Russell 2000 Index by 0.39%. The portfolio leads the Russell 2000 by 0.20% year-to-date, placing it in the 40th percentile of the Morningstar Small Blend universe.

One note regarding long-term performance: Had the strategy remained as the advisor to the Nationwide HighMark Small Cap Core Fund after November 2017, the GIPS compliant 10-year performance record **<u>would be the #2 fund (out of 147) in the Morningstar Small Cap Blend universe for the last 10 years.</u>** The only fund with better performance is the PIMCO Stocks Plus fund, a hybrid of bond returns (well rewarded after decades of falling rates) and small cap equity derivatives.

Attribution analysis of this quarter's returns provides encouragement. Individual stock returns outperformed the benchmark by about 1.0% but were offset by the effects of industry and style positions. We strive to minimize these non-stock specific effects, and they tend to equalize over time. In this case they were a slight negative but well within what we would expect.

Some key positions:

Vonage (VG)

This provider of IP telephony services rebounded weakly in January from the December market sell-off, generating interest among informed investors, and providing a nice upside potential. The position we built in late January was rewarded in early May when the firm reported strong revenue growth from their business division.

Newmark Group (NMRK)

A solid quarter for this much maligned real estate services firm. The stock fell steadily in 2018 post their 2017 IPO, finally finding support late in the year. Management has continued to display confidence, highlighted by considerable purchases form the C-suite. With considerable upside, Newmark is finding support among informed investors, and in the second quarter began to reward our own first quarter acquisition.

World Fuel Services (INT)

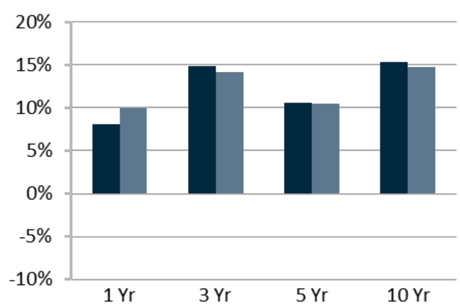
A long term holding of the fund. World Fuel Services has continued to improve their operational efficiency, and caught additional interest when they added 100 million to their stock repurchase plan in early June.

Sailpoint Technologies (SAIL)

While results for the first quarter were inline, the firm reduced guidance and the stock price fell in sympathy. Sailpoint remains the leader in identity security solutions, and while the potential for such leadership still exist, there are some doubts about their ability to realize said potential.

<u>Vitruvian Large Cap Core</u>

Large Cap Core v. Russell 1000 as of 6/30/2019



	1 Yr	3 Yr	5 Yr	10 Yr
Large Cap Core (Gross)	8.05%	14.88%	10.59%	15.32%
Russell 1000	10.02%	14.15%	10.45%	14.77%
Morningstar Ranking	62	50	31	12

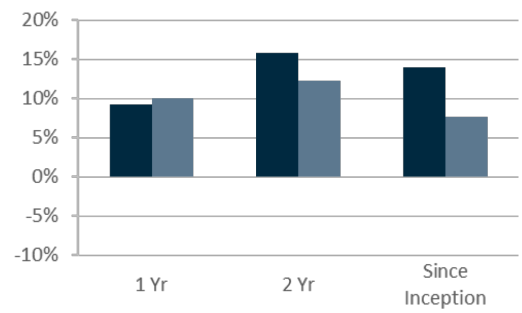
The Large Cap Core Strategy returned 3.26% in the second quarter, underperforming the Russell 1000 by 0.98% and is trailing the Russell 1000 by 0.15% year-to-date.
A tough quarter for our large cap process.

The strategy tends to have more quarter-to-quarter oscillation in returns due to the constraints of the large cap selection universe. Long-term histories are more important in this space.

Google/Alphabet was the largest detractor from performance, falling nearly 25% post their early May quarterly report. Despite the market reaction, we still believe Google is the most attractive of the so-called 'FANG' stocks.

<u>Vitruvian Large Cap Core Long Short</u>

Large Cap Core Long-Short v. Russell 1000 as of 6/30/2019



	1 Yr	2 Yr	Since Inception
Large Cap Core Long-Short (Gross)	9.16%	15.85%	13.98%
Russell 1000 Index	10.02%	12.26%	7.64%
Morningstar Ranking	46	2	2*

The Large Cap Core Long/Short Strategy returned 4.27% in the second quarter roughly in line with the Russell 1000, and now leads the benchmark year-to-date by 0.26%

The addition of small cap alpha through the long-short extension of our LCCLS strategy helped keep performance inline for the quarter, and avoided the downdraft experienced by our long-only large cap strategy.

While some of the positions from other strategies contributed such as Google/Alphabet and Sailpoint, much of the performance was derived from positions unique to this strategy such as KAR Auction

Services, and recently acquired Anadarko Petroleum.

Vitruvian Small Cap Market Neutral

The Small Cap Market Neutral Strategy returned 0.60% in the second quarter and now has returned 0.98% year-to-date

The performance of our market neutral strategy reflected that of our long-only strategy. Stock selection was strong, but the quarter to quarter vagaries of risk management worked against us this quarter and limited our outperformance.

Yours Truly,

Derek Izuel
Managing Partner
Vitruvian Capital Management