KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
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Bifurcation: (noun) the division of something into two branches or parts.

The word of the day is bifurcation. As things currently stand, many aspects of the investment and economic landscape have been separated into distinct "haves" and "have-nots." The two most apparent of these distinctions are between the economic growth in the United States and the rest of the world and between U.S. growth stocks and U.S. value stocks.

In the U.S., the economy appears to be firing on all cylinders. For the second quarter of this year, U.S. GDP posted an annualized 4.2% increase over the first quarter, which was a level achieved only four other times in the ten or so years since the 2008 Financial Crisis. Expectations are for another strong quarter in the third quarter. Unemployment has continued its decade-long decline and dipped to 3.7% as of the most recent reading, which is a level not seen since the 1960s. Meanwhile, consumer confidence[1] is clocking in at levels not seen since right before the Internet bubble popped in early 2000.

On the other side of the pond, the Eurozone is barely eking out positive GDP growth and there is further consternation over the form and effect of the quickly approaching Brexit. China's growth rates, while still north of 6%, are slowing amid government actions to slow the growth of consumer credit and the real and psychological effects of the protectionist tit-for-tat with the U.S.

Perhaps most telling is the difference in stock market returns inside and outside of the U.S. Year-to-date, U.S. equity markets[2] have returned 10.6%, while international developed markets[3] and emerging markets[4] have *lost* 1.4% and 7.7%, respectively. While there are few signs that the trajectory for either location will change in the near-term – there never are beforehand – this does not seem to be a sustainable long-term state of affairs for the global economy.

The divergence between U.S. Growth and U.S. Value has been discussed on these pages before, but both the persistence and magnitude of this phenomenon continue to surprise us. Year-to-date, U.S. Growth[5] has returned 17%, while U.S. Value[6] has returned only 4%. Even more striking is that the outperformance of growth has mainly come from what was already the most richly valued corner of

[1] *University of Michigan Consumer Sentiment Index*
[2] *As represented by the S&P 500 Index*
[3] *As represented by the MSCI EAFE Index*
[4] *As represented by the MSCI Emerging Markets Index*
[5] *As represented by the Russell 1000 Growth Index*
[6] *As represented by the Russell 1000 Value Index*

the market at the beginning of the year. The Information Technology sector[7], plus Amazon and Netflix, which made up about a quarter of the overall market at the beginning of the year, returned nearly 27%, while the other three-quarters of the market logged a sub-5% return. While the latter return compares favorably to the poor returns in international markets quoted above, it lags the overall U.S. market by nearly 6%. Going back to the beginning of 2017, this same segment of the market returned a whopping 78% against a 22% return for the other three-quarters of the market and a 35% return for the overall market.

Rarely in history has the most successful investing strategy been to buy the most expensive stocks and sell the cheapest, and such a strategy has never worked over meaningfully long periods of time. There is little reason to believe this time will be any different.

Moving over to the bond markets, interest rates continued their slow and steady rise during the quarter. As was widely expected, the Federal Reserve raised the fed funds target rate another quarter of a percent in late September. This contributed to an increase in the yield on longer-dated bonds, which pushed the yield on 10-year Treasuries up to 3.05% at quarter-end from 2.85% at the beginning of July. The sell-off in bonds (and resulting increase in yields) has continued into the early days of the current quarter as the yield on the 10-year stands at 3.15% at the time of this writing. This marks a more than 30% increase since the beginning of the year when the 10-year changed hands at 2.40%.

The speed of the general rise in interest rates has led many fixed income benchmarks to turn negative on the year. The broadest indicator of the investment grade bond market, the Bloomberg Barclays Aggregate Bond Index, has posted a 1.6% decline in value, including income, thus far into the year. Conversely, we are satisfied with our clients' bond portfolios, considering their shorter average maturity in this low interest rate environment, and, for some clients, the contribution of increasing coupon payments on floating-rate non-agency mortgage-backed securities. Please see the accompanying Fixed Income commentary for additional thoughts on the state of the bond market.

Across asset classes, our client portfolios are currently positioned as follows:

1. Equities: Our typical client portfolio is close to fully invested in a collection of companies that we believe are priced, in aggregate, at levels that offer a high probability of upside relative to the overall market. Earnings and revenues have by and large met our expectations and, in many cases, portfolio companies that we already considered significantly undervalued became even cheaper. Please see the accompanying Core Equity Commentary for additional details.
2. Fixed Income: Much the same as always, client portfolios remain focused on capital preservation. Our bond laddering strategy that balances the impact of rising interest rates between stability of principal and opportunity for reinvestment at higher yields has weathered the current environment well. Additionally, the increase in short-term rates continues to benefit clients who hold non-agency mortgage-backed securities backed by

[7] *The Global Industry Classification System (GICS) was reorganized as of 9/28/18. This reference refers to what is now the former Information Technology sector.*

adjustable-rate loans. Please see the accompanying Fixed Income Commentary for additional discussion of the interest rate environment and how Kovitz is responding to it.

3. Hedged Equity: Kovitz' hedged equity strategy remains positioned defensively with significant downside hedges in place – much as it has been for the past several years. We are satisfied with the performance of the strategy's downside and upside hedges, considering the increased volatility in the first half of the year.

Best Regards,

Kovitz Investment Group

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