J2 CAPITAL MANAGEMENT MARKET UPDATE

J2 Capital Management October 2018 3rd Quarter 2018 Update

## Please increase my risk. On second thought, forget it.

| Selected Benchmarks | 3rd Qtr | Trailing 1 Yr |
|---|---|---|
| S&P 500 TR | 7.71% | 17.91% |
| Russell Mid Cap Growth | 13.38% | 21.10% |
| Russell 2000 Index | 11.50% | 15.20% |
| MSCI All Country World Index **Ex–US** | 0.71% | 1.76% |
| 60% MSCI ACWI/40% Agg Bond | 2.64% | 5.70% |
| MSCI Emerging Mkts Index | -7.68% | -0.81% |
| ***Barclays Aggregate Bond** | 0.02% | -1.22% |
| *Tactical Allocation | 2.57% | 5.60% |

*S&P and MSCI data provided by S&P and MSCI. Russell Index data provided by FTSE-Russell Inc. *Other data provided by Morningstar.com.*

*Please refer to strategy disclosures/fact sheets for more information.*

It's a lot of fun writing these quarterly updates at times. What you plan to discuss can all be tossed out in a matter of days. For instance, I had planned to discuss how well momentum and growth stocks were continuing to do compared to just about every other asset class investment option. This market has been a J2 RS Leaders story since August 2016. All other strategies, like most asset allocation strategies, have had a tough go due to how narrow the market has been.

As an RIA, I understand what is going through clients' minds. I also have the advantage of talking to the many advisors we do work for. The conversations at the end of September were all very similar. That dreaded disease of **FOMO (fear of missing out)** had officially plagued the average investor. Like a world event, this disease seemed to hit everyone almost the same week.

Ending the third quarter, the typical asset allocation portfolio was up less than 5% for the year, and closer to low single digits. With two-thirds of client investment selections flat to down for the year, clients wondered if they were missing out. Even financial sites were helping you navigate this conversation. Take for example a classic diversified 60/40 fund, such as the Fidelity 2025 retirement fund. As of the end of

September, this fund was up only 2.52%. Positive for sure, but nowhere near the 10% to 15% year to date return that most growth indexes were up. The S&P 500, as noted above, was up close to 8% year to date at September's end. Many of us understand that clients cannot be 100% invested in one area (index) of the market for the simple fact that they cannot handle the risk once the tide turns. A diversified account allows you to better steady your clients and reduce volatility to allow them a chance to see their investment plan through. Unfortunately, since we are human, we are always plagued with either fear or greed. Blame it on our caveman relatives, I guess.

With the likes of the **(Facebook, Amazon, Apple, Netflix, Microsoft, Google)** stocks hitting all-time highs—well, minus Facebook—which we wrote about in our 1st quarter 2018 update where we argued it would be a lousy investment going forward due to future earnings destruction. These stocks were the engine that drove those dreaded career-killing indexes like the S&P 500 and the Nasdaq higher. Clients wanted a piece of the action, which almost always seems to hit a fever pitch at the end of the cycle.

What those clients were missing is exactly how those indexes were hitting all-time highs. If they had looked under the hood, they would have seen a market that was in real trouble. The average value-oriented dividend-paying stock was up just 3%. Many sectors were flat to negative. Heading into October the average stock in the S&P 500 was below its 50-day moving average, and many were even below their 200-day. How can that be? Easy: it's the math behind the index construction, being either market cap or price weighted. In short, the largest companies drive the bus here, with many of those companies being the technology FAANMG-type stocks.

**…Fast forward to October 11:** My, how fast things change. Let's go back to the selected benchmark table and see where we stand now, just two trading weeks into the fourth quarter.

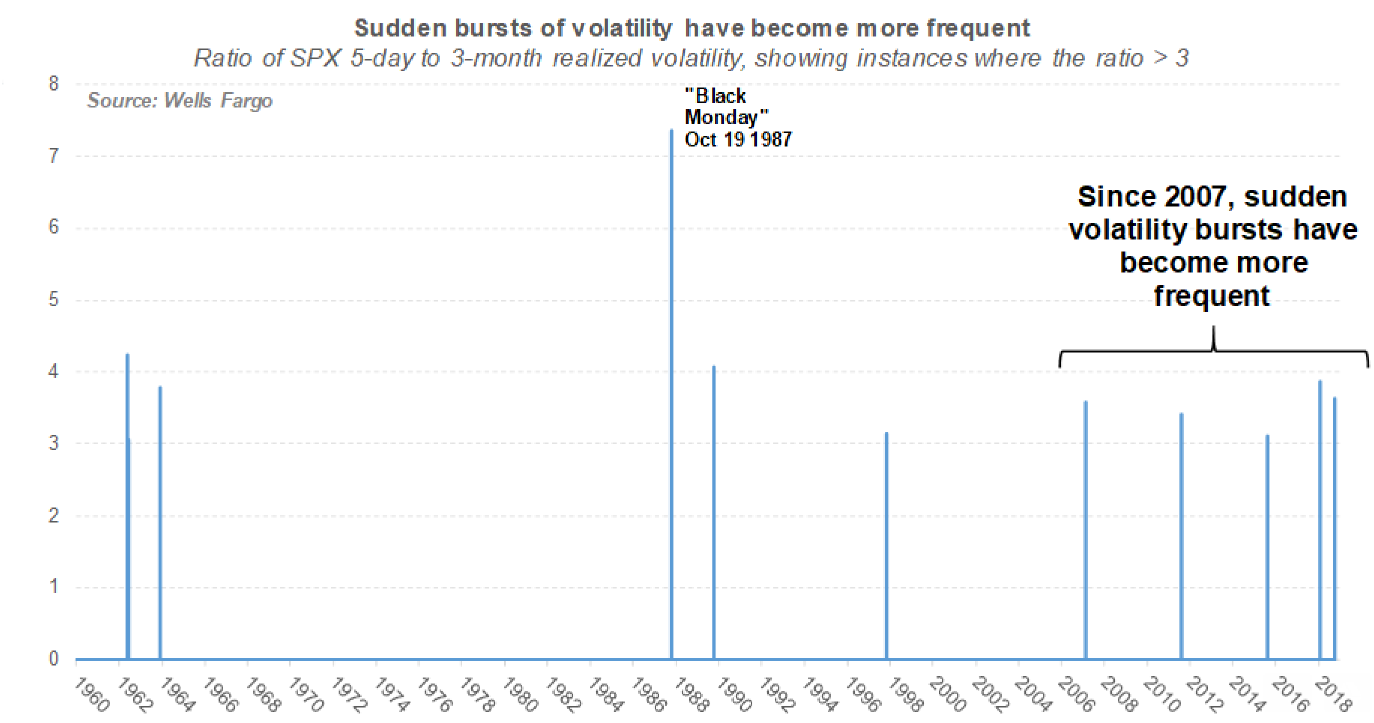
| Selected Benchmarks | Oct 1–11 | Year to Date Thru Oct 10 |
|---|---|---|
| S&P 500 TR | -6.31% | 3.58% |
| Russell Mid Cap Growth | -10.06% | 1.98% |
| Russell 2000 Index | -8.89% | 1.60% |
| MSCI All Country World Index **Ex–US** | -6.79% | -9.29% |
| 60% MSCI ACWI/40% Agg Bond | -4.14% | -2.25% |
| MSCI Emerging Mkts Index | -8.89% | -16.12% |
| ***Barclays Aggregate Bond | -0.46% | -2.05% |

…**And** just like that, all the calls and FOMO stop. It appears that the antibiotic for FOMO is simply its opposite, which really means the fear of losing money.

As shown above, the market has given back almost all year to date gains and in many cases went into a major correction. Just 11 days in, and everything has been lost in market indexes.

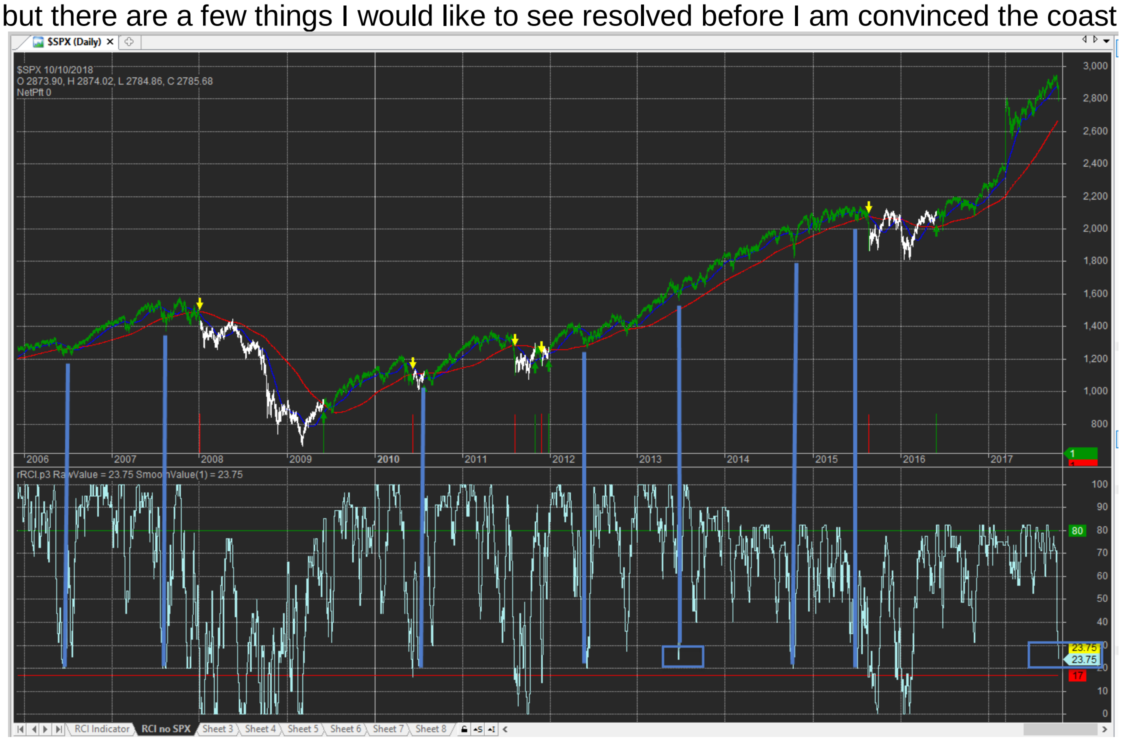
### Where to from here? Our current market thoughts

Volatility this year compared to recent years has picked up. The volatility ramp and subsequent large quick market drops are on the rise.

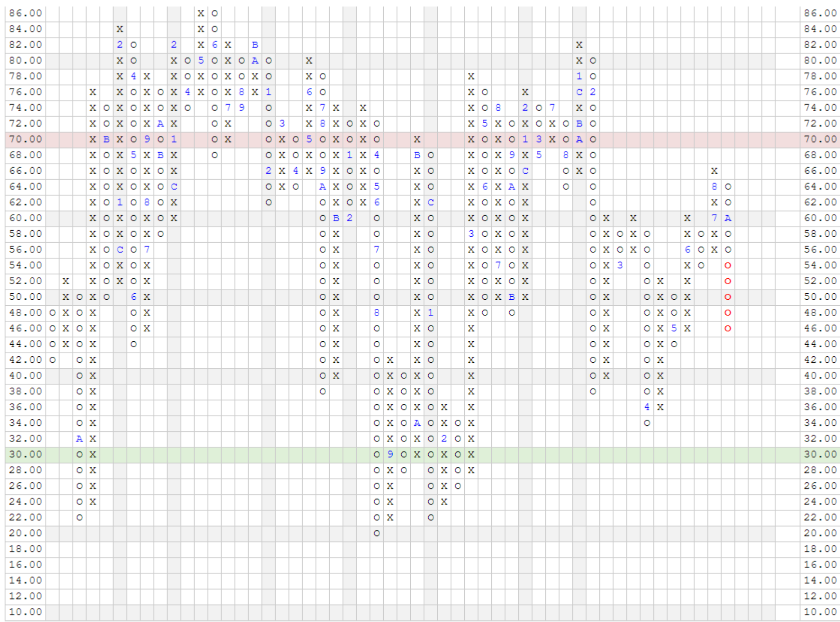



https://www.marketwatch.com/story/heres-proof-sudden-stock-market-plunges-have-become-much-more-frequent-2018-10-15

As of this writing, on October 16, we do not view the recent drop as providing a good entry point yet. This very well could be a buyable low, but I am not viewing it as a durable low that is of low risk. Our RCI Indicator, which gauges the general market (S&P 500), dipped down 23.75, very close to our bear market warning level of 17. I drew a blue line (see below) for every other instance of the indicator dropping this low but not signaling a bear market. As you can see, almost every instance was a great buyable low, except in 2015 when the rally rolled over and headed lower. That should be enough to convince me to add risk here, but there are a few things I would like to see resolved before I am convinced the coast is clear.

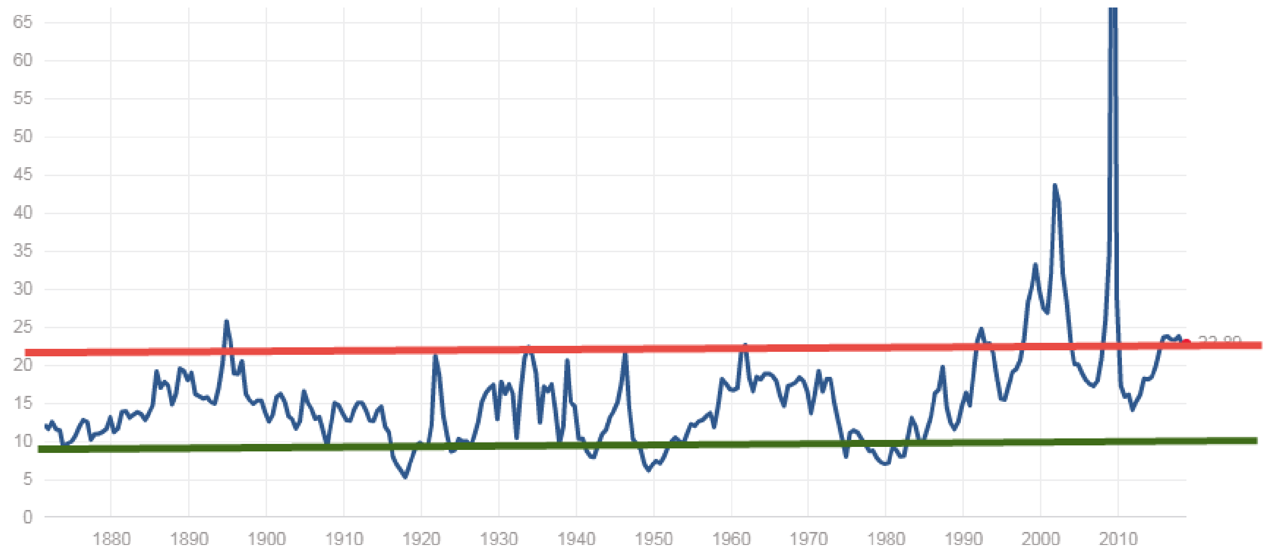


For starters, there were many stats and discussions online of how oversold the market had become on the recent drop. I think it's important to separate out stats meant for day traders and those for longer-term investors. Below is a chart of the percentage of S&P 500 stocks that are on a buy signal. Note that the current reading is 44%. What's interesting is that this is higher than the February drop that took place. Great long-term buy signals come when the market gets washed out below 30. We have a negative divergence here until we see market strength that is followed up on.



S&P 500 Bullish Percentages, DorseyWright and Associates

There also seems to be a great debate over how cheap or expensive the market currently is. The most basic and common method of determining that is the standby P/E ratio, or price to earnings ratio. That ratio now stands at 22.5x—historically a little rich, though those who have read my past missives know that I have long argued for a higher-than-historical P/E ratio due to disruptive tech forces and the earnings being derived from them. But this assumes that economic growth continues unabated, which I now have serious doubts about. More on that in the next section.




**S&P 500 P/E ratio, trailing 12 months: www.mutpl.com**

The current price to sales of the S&P 500 also seems to be fully valued here.

Data provided by S&P

**Earnings on deck:** Likely, what will make or break this market will be earnings coming out over the next couple of weeks. The guidance will be watched especially closely. It is my belief that we saw peak earnings in the second quarter of 2018. Should that be true, then the whole game changes. We are already seeing some early negative comments about future growth prospects. A few of the financials reported last Friday mentioned slowing loan growth. We also heard a litany of reasons from PPG industries on why they are lowering guidance. Should earnings guidance be lowered, that would be a negative, as the delta will have changed. I keep wondering, how we can be in such a wonderful economy with auto and home sales in the tank? Yes, this is an interest rate story, as they have moved up, but these two sectors are still a large portion of the economy, and housing is where the average American has all their net worth!

In my estimation, it's highly likely that the combination of the Trump tax cuts along with deregulation and corporate buybacks stimulated (juiced) earnings and thus the economy in the short term. Just how exactly is the U.S. getting along so well, while every other global economy is turning down? A true miracle, I must say. It is for these reasons that I theorize that the economy will slow down a little. Again, it's about trajectory here and not good versus great. It's slower, and that's all that needs to happen for risk to be brought in.

On that note, should I be correct, then we should see interest rates back down a little, or at least stop rising sharply. We would also come to see a more dovish fed that starts walking back the number of rate increases it sees happening. I'll be watching earnings and the economic data to either confirm or disprove this thesis.

**Summary:** We believe that for the market to be back in an up- trend and out of a high-risk environment, we need to see a couple strong days in the market that put the RCI Indicator above 80. That would suggest to us that institutions feel comfortable enough with the market to be engaged again. Good earnings guidance will give cover to the risk-on trade being back in style. I believe we will find out by the end of October what kind of market we are in. For now, J2 Capital is holding higher-than-normal levels of cash across our models, waiting to see what the market's next move is.

## Selected J2 Capital Management Strategies Review

- RS Leaders with its mid-cap growth portfolio continued its strong performance and stayed ahead of its benchmark, the Russell Mid Cap Growth Index, in the third quarter.
- Our RCI Tactical ETF Strategies struggled in the third quarter. We had two positions go against us, and two for us. Performance has stagnated the past 15 months but is still within range of our benchmarks. We should outperform if the market continues to correct.

## J2 Risk-Managed RS Leaders

J2 Risk Managed RS Leaders had another huge quarter, posting high single digit returns for the quarter and now up double digits for the year. RS Leaders is our mid-cap growth stock strategy. Mid cap growth stocks are the leaders of this recent market run since 2015. Returns in our strategy were led by our exposure to technology, medical technology, industrials, and consumer discretionary. Stock selection was key in each of these sectors, as we have been able to locate and ride the leaders.

### Current positioning

Coming into October we have been selling our largest winners and those not performing. We took our cash allocation from 10% at the end of September to almost 30% by mid-October.

We have reduced our weightings in technology, consumer discretionary, and industrials—the winners of this bull market cycle. We now have significant under-weights in these areas, as we wait for third quarter earnings and growth stocks to firm up before we buy back in.

**RS Leaders selected top holdings**

| Description | Symbol | Sector | Industry | Weight |
|---|---|---|---|---|
| **USD Cash** | **CASH** | **Cash** | **Cash** | **38.5%** |
| Total System Services | TSS | Financial | Financial Tech | 3.5% |
| Graco Inc | GGG | Industrial | Manufacturing | 3.4% |
| Cintas | CTAS | Consumer Discr | Business Services | 3.2% |
| Roper Technologies | ROP | Industrial | Industrial Tech | 3.2% |
| DollarTree | DLTR | Consumer DIscr | Discount Stores | 3.0% |
| HDS Supply | HDS | Consumer Discr | Industrial-Retail | 2.9% |
| Molina Healthcare | MOH | Healthcare | HMOs | 2.6% |
| Evercore | EVR | Financial | Asset Manager | 2.5% |
| Grand Canyon Education | LOPE | Consumer Discr | Education Svcs | 2.5% |
| Spirit Aerosystems | SPR | Industrial | Aerospace/Defense | 2.4% |
| ICON PLC | ICLR | Healthcare | Biotech services | 2.4% |
| | | | **Total:** | **70%** |

## J2 RCI Tactical ETF Strategies (Aggressive, Growth, Moderate)

In our RCI Tactical ETF strategies, we started off the year strong. We believed we were in a good position to best our benchmarks with less risk by holding a little higher cash weighting along with a modest amount of emerging market ETFs, namely Russia (RSX/ERUS) and Latin America (ILF/FLN). At the time, Russia and Latin America appeared to be ready to exert relative strength against US growth and momentum stocks. Made sense, given the dramatic underperformance of emerging markets (compared to the US) the past few years. That thesis fell apart fairly quickly, and we were left selling out of those emerging positions at a loss.

On the other end, we timed a great entry into both REITs and high-yielding dividend ETFs at the bottom in February. These two asset classes went on to outperform the S&P 500 over the next few months, which helped negate our losses in emerging markets. We continued to hold a higher cash allocation throughout the summer and did not have exposure to the technology sector, which led the market higher. For these reasons we trailed our benchmarks by a couple of percentage points this past quarter.

**Current positioning**

| | Equity | Alternative | Bonds | Cash | TOTAL |
|---|---|---|---|---|---|
| **RCI Tactical Aggressive** | 61% | 0% | 0% | **39%** | 100% |
| **RCI Tactical Growth** | 49% | 0% | 33% | **18%** | 100% |
| **RCI Tactical Moderate** | 37% | 0% | 45% | **18%** | 100% |

As noted previously, our concerns on this market run deep at present moment. We are currently positioned defensively, holding more than usual cash. Our RCI strategies are currently allocated to capture two-thirds of the upside and about half of the downside of our benchmark. So far in October, we have quickly caught up to our benchmarks and are now outperforming.

We believe the current environment has higher risk than reward at present. We are awaiting a new strong buy signal on the S&P 500 as our cue to add more risk.

***—John Benedict***
***CIO and Portfolio Manager for J2 Strategies***

## J2 tactical strategies available*

*Certain strategies may be available only to direct clients of J2 Capital Management RIA. Please check with your broker dealer.

**Tactical Stock**

**RS Leaders:** Momentum, low-vol factor growth stock strategy

**$85,000 minimum**

**Tactical ETF**

**RCI Tactical Models:** Broad-Based Equity & Fixed Income

**Sector Rotation:** Sector Tactical ETF

**Global Rotation:** Country-International ETF

**Tactical Annuity**

J2 is a TPIA on Jefferson National platform
**Monument Advisor Fee-Based Annuity**

RCI Models/Sector Rotation/Tactical Income options

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**Disclosures:**

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J2 Capital Management claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with those standards. J2 Capital Management has been independently verified for the period of July 1, 2008, through December 31, 2016. The verification report is available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS. Verification does not ensure the accuracy of any specific composite presentation.

**Fees:** Strategy returns presented here in this quarterly/year-end review are composited gross and net of our maximum model–based 0.50% bps fee. For full disclosure of fees, please see disclosure presentations. The US dollar is the currency used to express performance.

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