Affinity
INVESTMENT ADVISORS

LARGE CAP CORE EQUITY

QUARTERLY COMMENTARY Q3 2019

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets."
- *Peter Lynch*

2019 Q3 Market Recap

October marks the official start of pumpkin spice season. When wandering the aisles of my local grocery store, I am greeted by shelves filled with a variety of products in a range of orange hues that promise the taste of fall in every morsel. While I often wonder how I managed to feed myself during the first three quarters of the year, I have got to draw the line at pumpkin cheese spread over pumpkin bagels. That is a bit too much.

The equity markets appear to have felt similarly during September. The inexorable march higher of high-momentum, high-growth stocks ended on Aug 27. Value stocks rallied so sharply during the first two weeks of September that it right sized the performance of value managers, and many ended the quarter in the green. The pundits advanced various theories to explain value's resurgence. Some samples - the underperformance of tech unicorns after their recent IPOs, the Federal Reserve's second rate cut, the over-crowdedness in certain stocks and sectors, and the inevitability of the long bull market in growth stocks running out of steam. While we cheerfully admit to not having any insights into the mind or the mood of the market, our own belief is that September's market action reflected increased optimism by investors about a potential trade deal with China. This would result in a brighter outlook for the economy, hence interest rates and therefore banks also rebounded. Similarly, more cyclical and China-exposed industries such as Semiconductors, Automotive, Energy, and Consumer Durables rallied. This was the mirror image of the market action back in May when these same sectors sold-off owing to fears of a collapse in trade discussions with China. While we will refrain from forecasting the durability of this rally, we would venture to make the rather unoriginal comment that further improvement in prospects of a trade deal with China will likely result in value outperforming growth.

Investment Results

The Affinity Large Cap Core Non-Wrap Composite returned 2.14% compared to the 1.70% returned by the S&P 500 Index over the 3-month period ending September 30, 2019.

Investment Performance as of 9/30/19 *	Q3 2019	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception
Affinity Large Cap Core Non-Wrap Composite (%)	2.14	17.81	-1.88	9.90	7.11	11.09	11.57	10.26
S&P 500 Index (%)	1.70	20.56	4.26	13.40	10.85	13.27	13.24	9.75

** Returns longer than one year are annualized; all returns are gross of fees; Composite inception date is 6/30/92. The fee schedule can be found in Affinity's Form ADV. Returns include the reinvestment of income. Past performance is no guarantee of future results, and current performance may be lower or higher than the figures shown. All results are dollar denominated. Returns include the reinvestment of dividends and income. Individual results may vary.*

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Analysis

Since Affinity's portfolios are sector-neutral, the relative performance is primarily attributable to stock selection. The results indicate positive contribution from the Retail, Communication Services, and Energy sectors, but negative contribution from Consumer Non-Durables, Financials, and Business Services sectors. Affinity's investment philosophy emphasizes equities that trade at 'cheaper' valuations. An overweight position on equities with high dividend yields and lower price-earnings ratios helped the strategy's performance.

The following tables show the top and bottom five contributors to the portfolio's relative performance during the 3rd quarter of 2019 (source: Refinitiv). The list of top and bottom contributors can include names in the benchmark that the portfolio did not own.

Top Contributors to Relative Return**	Sector	Avg. Portfolio Weight (%)	Total Effect (%)
TARGET CORP	Retail	2.21	0.42
AMAZON.COM INC	Retail	--	0.32
FIRST DATA CORP	Business Services	0.63	0.27
CVS HEALTH CORP	Health Care	1.93	0.23
APPLE INC	Technology	5.52	0.21

Bottom Contributors to Relative Return**	Sector	Avg. Portfolio Weight (%)	Total Effect (%)
DXC TECHNOLOGY CO	Business Services	0.95	-0.57
PFIZER INC	Health Care	1.21	-0.27
PRUDENTIAL FINANCIAL INC	Financials	0.72	-0.25
RALPH LAUREN CORP	Consumer Non-Durables	1.29	-0.25
ALTRIA GROUP INC	Consumer Non-Durables	1.82	-0.21

*** Please contact Affinity Investment Advisors for calculation methodology. Note that the holdings in the tables do not represent all the securities purchased, sold, or held. Past performance does not guarantee future results.*

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Economic Commentary

In the third quarter, the stock market, as represented by the S&P 500 Index, produced a return of 1.7%. This return followed a 4.3% return for the second quarter and brought the total return for the first three quarters of the year to 20.6%. During the quarter, the VIX (a measure of market volatility) declined in the face of many challenges to the stability of the market. Corporate profits for the third quarter are expected to decline 3.8%. If this expectation comes to pass, the third quarter of 2019 will be the third consecutive quarter in which corporation profits declined on a year-over-year basis. The combination of an earnings decline and a slight rise in the stock market leaves the forward 12-month P/E ratio for the S&P 500 at approximately 17.0. This P/E ratio is above the five-year average of 16.6 and above the 10-year average of 14.8.

The decline in corporate profits mirrored the decline in real economic growth. The third revision for economic growth in the second quarter produced an estimate for real growth of 2.0%. This represented a slowdown from the 3.1% growth experienced in the first quarter. An early estimate for real growth from the Atlanta Federal Reserve indicates real GDP growth will be less than 2.0% in the third quarter. As economic growth has slowed down, market participants are acting as though they believe there will be some change in economic policies to reinvigorate growth.

Currently, investors seem to believe the Federal Reserve can stimulate real growth by further lowering interest rates. However, as the Fed has been slowly lowering rates the money supply has been declining, indicating that liquidity is being reduced. In addition, US interest rates, while low by historical standards, are much above rates in other developed countries. This interest rate differential will, all other things being equal, help strengthen the dollar versus other currencies and raise the price of American goods sold in international trade.

The Fed has kept short term rates above longer term rates. At the end of the quarter, the rate on one-month Treasury obligations was slightly above the rate on 10-year Treasury debt obligations. The short-term rate is administered by the Fed and the longer-term rate is determined by the market. The market is acting as if participants believe rates should be lower. The Fed has engineered an inverted yield curve (longer term rates are lower than short term rates.) Historically, this condition presages an economic downturn. In the last fifty years the yield curve has inverted before every recession. On the other hand, the curve has inverted on occasion and no recession has followed. The interval between inversion and a recession is variable and can be more than a year.

The ongoing tariff battles with various countries have lowered expectations for real economic growth. The primary adversary for the US is China. The on-again / off-again trade negotiations have roiled the markets on occasion. Increases in tariffs loom and with the increases a likely slowdown in international trade and overall economic activity. There seems to be little or no economic rationale for these threats of tariff increases. The increases do not provide an economic benefit to either party in the battle. The US is maintaining that there are strategic geopolitical issues beyond trade that are driving its position while negotiating trade agreements. The Chinese may be driven by the same types of issues. If this is the case,

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the rapidly approaching US elections may determine the nature and the timing of any final agreement on tariffs and trade.

The election runup in the US seems to start earlier each cycle. The 2020 elections are very much front and center. Trying to forecast the outcome is not a comfortable exercise for most market participants. Many years ago, a famous economist, Frank Knight, wrote a book titled "Risk Uncertainty, and Profits". It is thought to contain some of the most important observations on the nature of economic activity. Knight made a clear distinction between those processes that are risky and those that are uncertain. The outcomes of risky processes can be quantified while those of uncertain processes cannot. He argued that there is an economic reward that accrues to dealing with uncertain processes while there is none that accrues to managing risky processes. Risk can be measured and avoided. The process that determines the outcomes of political events is uncertain. The rewards for gaining true insights into the outcomes may be substantial. Often election results signal significant changes in economic policies and the nature of capital markets.

In the period from January 1941 through January 1982, the annualized total real, after inflation, return on 10-year Treasury bonds was -0.6%. On average, the typical investor lost purchasing power by holding these bonds, and this situation persisted for over forty years. During the period from January 1982 through September 2019, the annualized real return for 10-year Treasury bonds was 3.7%; a difference in return of over 4 percentage points. Over the period from January 1965 through January 1982, the real rate of return (including dividends) generated by the S&P 500 Index was -4.6%. On average investors lost purchasing power by holding stocks during that period. From January 1982 through September of 2019, the annualized real return produced by the S&P 500 Index was 6.1%. The difference in annualized returns for the two periods was over 10 percentage points.

What happened to reverse the earlier unfavorable tends? There is no way to be certain, but there are some clear indications that changes in economic policies brought about by changes in administration were important drivers of economic events. By 1982 there were in place new management at the Fed and a new President in the White House. In the years from 1965 to 1982, the US experienced a period of slowing economic growth, rising inflation, rising unemployment, and rising interest rates. The conventional wisdom was that these conditions could never exist simultaneously. However, a series of dysfunctional economic policies put in place by Presidents Johnson, Nixon, Ford and Carter made the seemingly impossible possible. In 1979 Paul Volker took over the reins at the Fed and by 1981 Ronald Reagan was in the White House. Volker stabilized and then reduced inflation, and Reagan cut tax rates. Prior to 1981, the iron clad rule on Wall Street was that the Dow could never rise above 1000 for any significant length of time. In December of 1981 the Dow was below 900. By December of 1988 it rose to almost 2300, and it has been on the rise on average ever since. Elections have consequences. Policy changes have consequence. The next Presidential election will be November 3, 2020. As the lady said, "Fasten your seat belts, it's going to be a bumpy night".

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