**Enhanced Equity Income**
Q2 2019 Commentary

## Market Review:

US equities had a volatile second quarter, but the S&P 500 finished up 4.3% and the Russell 1000 Value returned 3.8% to end the month of June at near record price levels. The S&P 500 also posted its best first half in 22 years (1997), up 18.5%. The quarter saw an extension of the major themes that sparked volatility over the past three quarters, namely the US-China trade dispute and the Federal Reserve's shifting interest rate policy. Stocks were up significantly in April, extending the rally that began at the end of December when the Fed began shifting to a more accommodative stance on interest rates. However, the market retreated sharply in the month of May when trade negotiations deteriorated and concerns grew over a lengthened dispute. Stocks recovered quickly with the best month of June for the S&P 500 since 1955, largely on hopes of interest rate cuts by the Fed.

Returns in the quarter were broadly distributed, with 10 of the 11 sectors finishing in positive territory. Financials (+8.0%) was the best-performing sector, driven by optimism for a global cyclical recovery in back half of the year and finished the quarter strong with the Fed's approval of large capital return plans for most of the largest banks. Materials (+6.3%) was the next best performing sector, as gold stocks soared on increasing Fed rate cut expectations. Information Technology was up +6.1%, with software and IT services companies outperforming. Energy was the only sector that posted a negative return (-2.8%), as the WTI oil benchmark declined on concerns of reduced demand from slowing global growth. Health Care (+1.4%) was also a laggard, impacted by increasing political rhetoric on health care reform and various drug pricing initiatives.

Concerns grew on US-China trade when Treasury Secretary Steven Mnuchin announced that talks had gone "substantially backward," and the Trump Administration soon levied a new 25% of tariffs on $200B of Chinese imports while threatening additional measures. China President Xi Jinping retaliated with tariffs on $60B of US imports; furthermore, the Xi administration appeared to take a much harder long-term stance on trade, indicating through several statements and other actions that the country is prepared to negotiate for an extended period if necessary. Concurrently, President Trump threatened to levy tariffs on Mexico unless the Mexican government took action to deter the flow of Central American migrants passing through its borders. Ultimately, The Trump administration reached an agreement with Mexico, and on the final day of the quarter Trump and Xi reached some concessions and an agreement to restart talks.

Yields on US government bonds continued to decline, reflecting concerns over slowing global growth and increased demand for safe haven assets. Although the US economy surprised with 3.1% GDP growth for the 1st quarter, the IMF lowered its projection for global growth to 3.3% in 2019, down from 3.6% in 2018. The 10-year US Treasury yield dipped below 2% and has fallen by more than a full percentage point over the past three quarters. Notably, the 10-year yield also dipped below the yield on short-term Treasurys, resulting in an inverted yield curve; however, most economists dismissed the likelihood of an impending recession.

## Income and Options Summary:

Only 43 positions were written during the quarter, due to call premium strength. Of the 264 contracts sold in the representative account, 40% (105) were assigned. During the year-to-date strong equity market, the assignment rate ended the quarter at 47% on fewer positions written, and calls were written at an average of 2.6% out-of-the-money.

Income generation remained well above targets, annualizing 7.6% at quarter end. Dividends and options premiums each contributed 3.8% to that sum. Dividend growth continued; six increases were declared during the second quarter, averaging an increase of 5.0%. Year-to-date, 20 portfolio companies have raised their dividends with an average increase of 5.2%.

## Performance Analysis:

In continuation of a long-term broad market uptrend than began in late December, Growth-style equities continued to outperform, primarily in the Information Technology and Consumer Discretionary sectors. Value-style equites showed strength in Financials. The Russell 1000 Growth Index outpaced its Value counterpart by 0.8% (4.64% vs. 3.84%).

In contrast with its first-quarter performance, the Enhanced Equity Income strategy lagged its benchmarks during the quarter, returning 0.4% net of fees, compared with 3.3% from the CBOE S&P 500 Buy/Write Index (BXM) and 2.5% from the SPDR Barclays High Yield Bond ETF (JNK). In addition to its expected underperformance versus the S&P 500 in Information Technology and Consumer Discretionary, it lagged significantly in the Consumer Staples and Materials sectors. It outperformed in Real Estate, Industrials, and Health Care.

**Figure 1: Enhanced Equity Income Returns vs. Benchmark**

| | Q2 | YTD | 1 Yr | 3 Yr | 5 Yr | Since Incept* |
|---|---|---|---|---|---|---|
| **SCCM Enhanced Equity Composite (gross)** | **0.7** | **10.8** | **10.4** | **7.5** | **5.9** | **9.2** |
| **SCCM Enhanced Equity Composite (net)** | **0.4** | **10.2** | **9.2** | **6.3** | **4.7** | **8.1** |
| S&P 500 Buy-Write Index (BXM) | 3.3 | 10.3 | 3.2 | 7.4 | 6.0 | 7.0 |
| SPDR Barclays High Yield Bond ETF (JNK) | 2.5 | 10.6 | 7.8 | 6.8 | 3.1 | 5.4 |

**12/31/2010. Performance for periods greater than 1 year is annualized. Past performance is no guarantee of future results.*

## Portfolio Changes:

*Purchases*

A new position in **Bank of America (BAC)** was established in the quarter. Bank of America, one of the largest US banks by assets and branch network, offers consumer banking, credit cards, mortgage lending, corporate and investment banking and asset management services through its Merrill Lynch and US Trust platforms. The company is one of the most diversified, high quality banks with strong long-term growth prospects; BAC has built significant scale in each of its businesses, focusing on driving new areas of top-line growth while improving underwriting, efficiency and strengthening its balance sheet. The Consumer banking business is experiencing solid loan growth with a strong funding base, holding the highest deposit market share in the country, and maintaining high credit quality (with an average FICO score of 770). The bank's Investment Banking division has invested heavily in technology to grow its Trading business and focused on gaining market share in M&A/Advisory. The Wealth and Investment management business, the company's crown jewel, consists of Merrill Lynch and US Trust, continues to increase its fee-based model and deliver peer leading margins. Management, led by Brian Moynihan, has been focused on making significant investments in technology and operational efficiency to lower operating costs, improve the customer experience and gain market share. The annual Fed stress test results (DFAST), which evaluates capital levels under various economic downturn scenarios, were recently released and Bank of America's projected capital levels came in significantly above minimum requirements for all five capital ratio requirements. As a result of its positive outcomes, the company announced a 2019 CCAR cycle capital plan with $30.9B in gross share repurchases, roughly 11.5% of its market capitalization, and a 20% increase in its quarterly dividend.

Banks have underperformed the market over the past 2.5 years and are one of the more attractively-valued segments of the market; however, considering the group's higher beta nature and historical underperformance in downturns, they generally trade at a discount to the market. In late 2016, the prospect of corporate tax reform, the loosening of financial regulations and a steeper yield curve propelled bank stocks higher. Since then, large banks have faced the headwind of a flatter yield curve pressuring net interest margins (NIM) and no significant regulatory relief is in sight. Despite the flattening/inverted yield curve, banks stocks have begun to stabilize and are already pricing in Fed rate cuts over the next several quarters. Bank of America trades at 9x forward earnings, 1.0x book value with a 2.7% dividend yield at purchase.

*Sales*

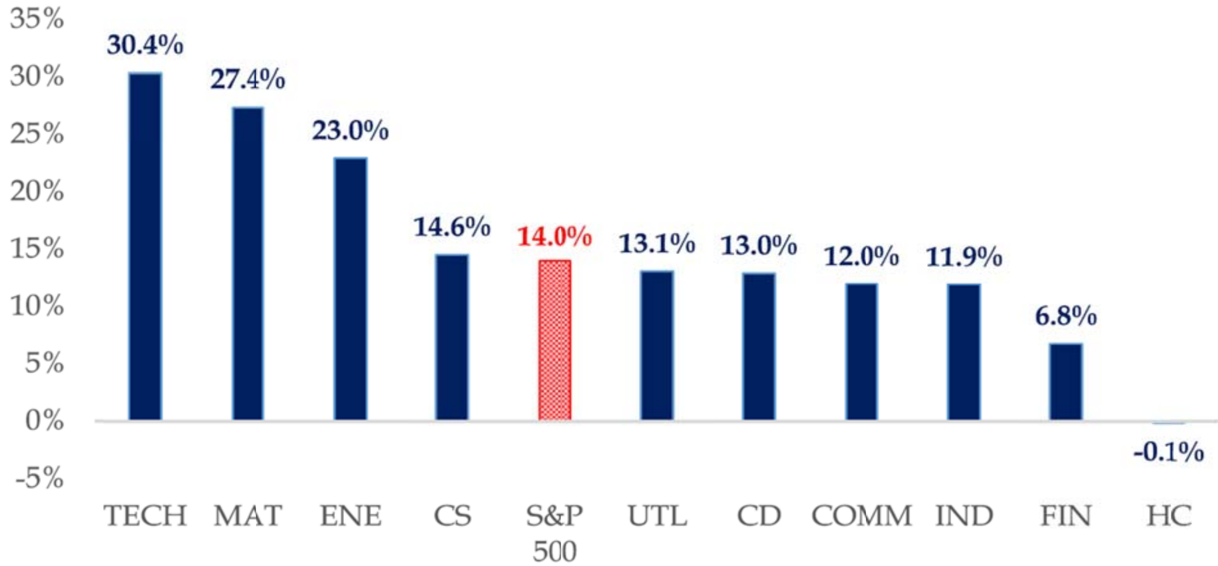
**Siemens (SIEGY)** was sold in June, primarily due to its share price, the absence of an options chain and a reduction in portfolio positions.

**HSBC (HSBC)** was sold in June as a source of funds for the Bank of America purchase.

## Market Outlook:

The equity market rally to record highs by the end of the second quarter was driven by a significant turn in global central banking policy with the Federal Reserve now expected to cut interest rates this year, as a result of weakening US economic data and macro uncertainties including the outcome of the US-China trade war and the impact of the tariffs on the economy. The current state of "bad news is good news" for the market is evidenced by the flattening yield curve alongside peak equity levels. Valuation expansion has accounted for nearly all of the rally year-to-date as earnings expectations have continued to decline throughout the year.

**Figure 3: S&P 500 Change in Price/Earnings Ratio (1/1/2019 - 7/1/2019)**

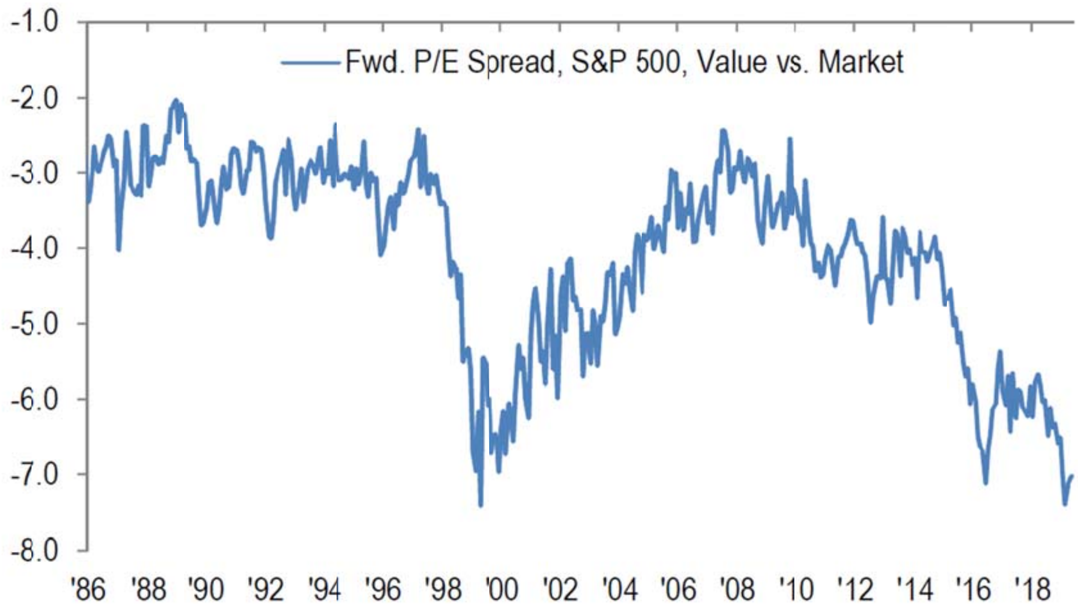



Source: Strategas, Quarterly Review in Charts, 7/1/2019. The graph is for illustrative purposes only and does not reflect information about any fund or other account managed or serviced by Schafer Cullen Capital Management.

At this juncture, the global slowdown may simply be a "soft patch" or a deeper mid-cycle slowdown. This uncertainty caused US yields to fall precipitously in the quarter and the S&P equity risk premium (Earnings Yield less 10-year Treasury Yield) rose to 320 basis points, 1 standard deviation above the long-term average. However, with overall growth expectations declining, the current increase in the ERP may be justified. Since January 2019, S&P 500 consensus earnings estimates for 2019 have declined nearly 6% to +8% year-over-year (Ned Davis Research, June 2019). Meanwhile, equity markets have been relatively range-bound over the past 18 months as "risk off" (Growth and Defensive) outperforms on the slowdown narrative while "risk on" (Financials and Cyclicals) outperforms on a recovery narrative. With markets now pricing in an imminent recovery, the question is whether renewed monetary easing will be enough to offset broadly slowing global growth.

A key feature of this record bull market is the persistent outperformance of Growth over Value. By almost any measure, Growth is trading at a historic valuation premium to Value and fund flows into Growth and Technology funds are at extreme levels. Value is trading at its largest discount to the market and offers the largest premium over the last 30 years. The median P/E of the cheapest portfolio relative to the S&P 500 is trading at a 7x discount (99% percentile) (JPM, The Value Conundrum, 6/7/19). Flows into the SPDR Technology ETF reached 95% percentile levels by the end of Q2 (Strategas, Technical Strategy, 6/26/19).

**Figure 4: Forward Price/Earnings Spread – Value vs. Market**

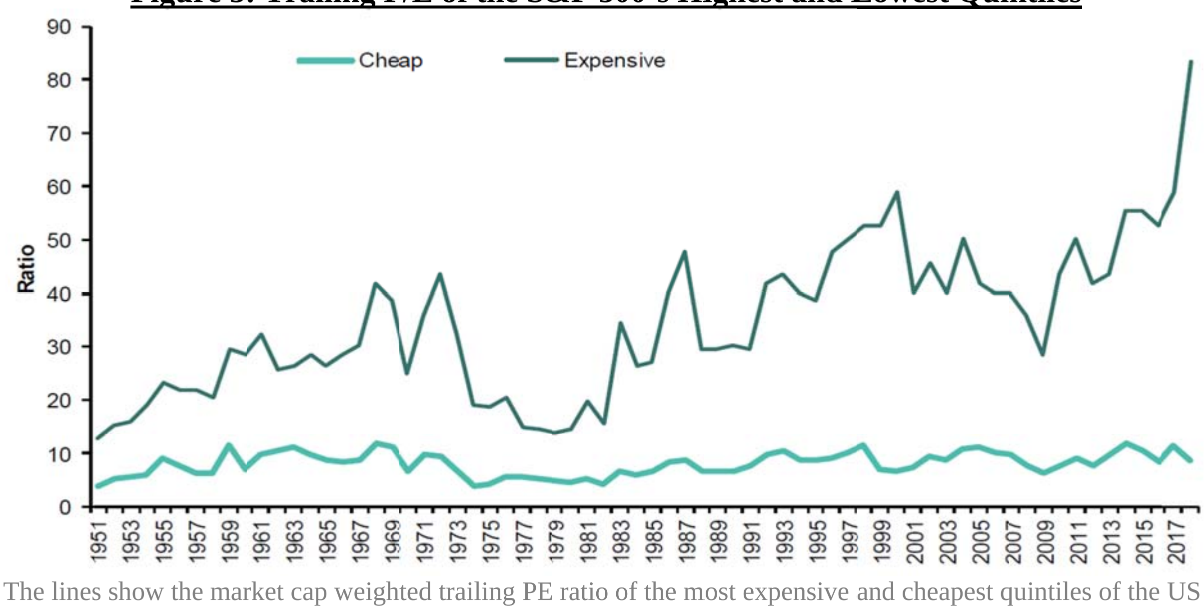



Source: JP Morgan, The Value Conundrum, 6/7/2019. Past performance is no guarantee of future results.

The considerable outperformance of Growth over Value has been attributed to the indexation and saturation of passive products which are pro-momentum, the perception that disruptive technologies have impaired wide swaths of companies in the Value space, and unconventional monetary policy (negative interest rates, quantitative easing). A number of events could trigger a reversal, including a market decline resulting in the liquidation of passive vehicles, increasing technology regulation or a reversal of the extreme crowding in Growth stocks.

With multiple expansion, the major contributor to returns this market cycle, the underperformance of Value can partially be attributed to the greater benefit Growth has experienced from multiple expansion. Valuation dispersion within the S&P 500 is at cycle highs, marking a significant hurdle for future returns on the most richly valued part of the market.

**Figure 5: Trailing P/E of the S&P 500's Highest and Lowest Quintiles**




The lines show the market cap weighted trailing PE ratio of the most expensive and cheapest quintiles of the US market.
Source: Bernstein Research, Global Quantitative Strategy, 6/19/2019. Data as of the end of 2018.

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Respectfully,
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