QUANTICO
ASSET MANAGEMENT
of Wells Fargo Advisors
Uncommon Sense®

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Historically typical volatility returned in the second quarter as uncertainty regarding U.S.-China trade relations, future Federal Reserve interest rate policy, and the state of the U.S. and global economies caused a more-than-6% pullback in the S&P 500 during May, before stocks broadly recovered in June and finished the quarter near fresh all-time highs.

In contrast to the monotonic movement of the first quarter, stock market performance in the second quarter was one marked by fluctuation. The S&P 500 logged a 4% gain in April thanks to solid first quarter corporate earnings reports, which further reduced concerns that earnings growth peaked in 2018. Volatility returned in the first week of May, however, as President Trump announced via Twitter that he would be raising tariffs on $200 billion in Chinese goods from 10% to 25% following the collapse of U.S.-China trade negotiations. Furthermore, the president threatened to levy additional tariffs on the remaining $325 billion worth of Chinese products imported into the United States. The stock market was able to find support and rebound strongly in June, however, as there was progress across the two main sources of volatility in the second quarter, U.S.-China trade and future Fed interest rate policy. First, at the June 19th meeting, the Federal Reserve reversed course from May and signaled an interest rate cut is likely in 2019, perhaps as early as July. That shift helped to re-validate market expectations of lower interest rates in the near future, and stocks rebounded strongly on that expectation. Second, President Trump and Chinese President Xi Jinping agreed to meet at the recently held G20 meeting, and the result of the meeting was a trade "truce" of no new tariffs while trade negotiations resume. Despite the uptick in volatility in the second quarter, U.S. stock market performance still resembled that of the first quarter as rising hopes for Fed rate cuts and a U.S.-China trade truce resulted in broad gains across most market segments and sectors.

By market capitalization, large caps outperformed small caps, which is a reversal from the first quarter. Large cap outperformance was partially due to investors reacting to underwhelming economic data, as large caps are historically less sensitive to a potentially slowing economy. Increased hopes for a U.S.-China trade truce in late June also helped large caps outperform as they have more exposure to global trade. From an investment style standpoint, growth again outperformed value mostly due to another quarter of strong returns by tech and consumer discretionary stocks.

On a sector level, 10 of 11 S&P 500 Index sectors finished the second quarter with positive returns; however, consumer staples and the financial sectors were the notable outperformers. Consumer staples were driven higher by solid earnings and investors' desire for some insulation from a loss of economic momentum and trade uncertainty, while financials benefitted from rising expectations for a Fed rate cut and the late-quarter steepening of the yield curve. The energy sector, meanwhile, experienced negative performance in the second quarter mainly because of declines in the price of oil. The healthcare sector also lagged the S&P 500 thanks to rising political risks via increasing calls for the expansion of government healthcare programs, dubbed "Medicare for All."

See Page 6 for Disclosure Information.

US Equity Indexes	Q2 Return	YTD Return
S&P 500	4.3%	18.5%
DJ Industrial Average	3.2%	15.4%
S&P 500 Value	4.0%	16.7%
Russell Mid Cap	4.1%	21.3%
Russell Mid Cap Value	3.2%	18.0%
Quantico Portfolios	**Q2 Return**	**YTD Return**
Large Cap	3.1%	16.1%
Mid Cap	-3.6%	12.2%

Source: Morningstar/Wells Fargo Advisors[1]

Looking internationally, foreign markets also had positive returns for the second quarter, but once again underperformed the United States markets. Foreign developed markets outgained emerging markets due to several factors, including less sensitivity to volatility in foreign trade relations, a stronger dollar (for most of the quarter) and rising hopes for more stimulus from the European Central Bank. Commodities saw mixed returns for the quarter, as gold surged to a multi-year high while oil declined. Gold rallied in the second quarter due to multiple factors including rising expectations for Fed rate cuts, an increase in geopolitical tensions, and the late-quarter declines in the U.S. dollar. In the fixed income markets, investors' expectations for future Fed rate cuts pushed the yield curve down. As a result, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) realized more positive returns in the second quarter. Further, corporate bonds, both investment grade and high yield, outperformed government bonds in the second quarter thanks to a better-than-expected earnings season and compression of spreads across the yield curve.

As we have in the past, we want to highlight some of the discussions we have had in previous letters. For this iteration, we want to revisit two themes from our second quarter letter in 2016, Gold Miners and Consumer Staples. Similarly to that time period, we are currently in the midst of geopolitical uncertainty coupled with global central bank easing desires. Given the old adage of History rhyming as opposed to repeating, we find ourselves in an unusual circumstance to take advantage of these themes twice in the past three years. In 2016, the macro uncertainty led to a rebound in the price of Gold from its doldrums. As a result, the miners saw an outsized rally (even relative to the increase in the price of Gold). As we did then, we do so now, by trimming our Gold Miner weighting into strength; selling our position to other investors who now desire to pay a premium for this recently popular trade. As one of our clients put it, the Miners are like "Cash on Steroids", and we are using them as such. Accordingly, we will use the funds to invest in un-loved and undervalued businesses. A majority of those names are related to the consumer as the Consumer Staples sector's rebound has not been evenly distributed amongst its constituent members and industries. As a result, we have found value in names like Kraft-Heinz and Kroger. Further, this asynchronous recovery has also yielded tremendous value in the other industries of the Consumer's realm, namely specialty retail.

See Page 6 for Disclosure Information.

We were recently rewarded with our emphasis on gold mines as they appreciated about 15% in the 2nd quarter. They have continued to advance 10% in Q3 and we are taking additional profits. The cheapest sector we screen now is in the retail space. Hit hard by the tariff concerns and the continued economic slowdown in Europe and China, many retail names are trading at valuations last seen in the great recession. At these discounted prices, we like Nordstrom, Tapestry (Coach), and Williams Sonoma. In the Consumer Staples sector, we are favorable to Kraft Heinz and Kroger at these levels.

The theme is similar across this set of companies. They have decent brands and are run by able management trading at what we believe to be discount prices. Further, we believe there is consensus about these discount market prices as each of the above names have considerable inside ownership that has publically stated their desire to increase their holdings at these levels. Given that desire, and that they all could take themselves private in less than 10 years with current cash flows, we think management will get more active in this area. We may have started accumulating a bit early, but have continued to add as prices have improved for patient investors, like ourselves.

Our patience and resolve is bolstered by the strong financial characteristics we observe in these companies. From stellar balance sheets to strong cash flows, we believe that the risk for financial distress is low; and this leads us to conclude that the mispricings are temporary. This confidence is further supported by our macro view, given that the consumer as a whole is holding up well and employment is firm. Further, despite the flat yield curve, our remaining recession indicators are not currently warning of an imminent recession.

As we have discussed in previous letters(3Q18), our research process, by definition, presents us with a universe of quantitatively strong companies. The screening tool that we have built first eliminates most companies at high risk of financial distress. Then, our qualitative deep dive, cash flow modeling, and due diligence steps allow us to confirm that our target companies are financially sound and enter positions with high conviction.

We end this letter with what we would argue is our mission statement at Quantico Asset Management of Wells Fargo Advisors. We will continue to try to exploit opportunities in the market as excessive fear and irrational exuberance tend to create oversold and overbought security prices. Our job is to identify those opportunities for our clients. If "fear" rears its head, with a corresponding reduction in asset price levels, we will invest excess cash to become fully invested. If "greed" shall resume, increasing asset price levels above fair value, we will accumulate cash by exiting or trimming fully valued positions. Buffett is fond of saying, "[t]he less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs". We agree.

See Page 6 for Disclosure Information.

What worked for Quantico Large Cap:

1. Disney (DIS) – Announcement of plans for Disney+.
2. Berkshire Hathaway (BRK.B) – Solid operating and portfolio results.
3. Newmont Goldcorp (NEM) – Gold outperforms.
4. Microsoft (MSFT) – Continued strength in Azure.
5. Qualcomm (QCOM) – Positive outcome regarding Apple litigation.

What didn't work for Quantico Large Cap:

1. Nordstrom (JWN) – Temporarily unloved retail name.
2. Macerich Co. (MAC) – Correlated to unloved retail names as it operates malls.
3. Bluebird Bio (BLUE) – Volatility surrounding drug trial news.
4. Occidental Petroleum (OXY) – Acquired APC and utilized Buffett for extra cash.
5. Kroger (KR) – Missed comparable growth forecasts.

Positions Added: (at attractive valuation)

1. Nordstrom Inc. (JWN) – Strong brands, high inside ownership, market discount.
2. Occidental Petroleum (OXY) – Market punished OXY too much for APC deal.
3. Emerson Electric (EMR) – Solid industrial supplier in an industry with high switching costs.
4. F5 Networks (FFIV) – Strength in Software Defined Networking, will be traffic cop of the cloud.
5. Intel (INTC) – Oversold on China trade fears.

Positions Exited:

1. Barrick Gold (GOLD) – Gold strength.
2. Hershey Foods (HSY) – Exceeded price target.
3. Qualcomm (QCOM) – Thesis fulfilled with positive Apple settlement.
4. JM Smucker Co. (SJM) – Exceeded price target.
5. Agnico Eagle Mines (AEM) – Gold strength.
6. Abbvie (ABBV) – Lost confidence in management with attempted Allergan acquisition.
7. Verizon (VZ) – Exceeded price target.
8. Campbell Soup Co. (CPB) – Exceeded price target.
9. Under Armour (UAA) – Better retail opportunities for Large Cap.

See Page 6 for Disclosure Information.

What worked for Quantico Mid Cap:

1. Del Frisco's Restaurant Group (DFRG) – Buyout offer.
2. Agnico Eagle Mines (AEM) - Gold strength.
3. Under Armour (UAA) – Strong performance from turnaround efforts.
4. Alleghany Corp. (Y) – Strong underwriting and portfolio performance.
5. Markel Corp. (MKL) – Strong portfolio performance.

What didn't work for Quantico Mid Cap:

1. Nordstrom (JWN) – Temporarily unloved retail name.
2. Urban Outfitters (URBN) – Temporarily unloved retail name.
3. Edgewell Personal Care (EPC) – Acquired Harry's Inc..
4. Macerich Co. (MAC) – Correlated to unloved retail names as it operates malls.
5. United Therapeutics (UTHR) – Weakness from policy proposals.

Positions Added:

1. Urban Outfitters (URBN) –Strong brands, high inside ownership, market discount.
2. Box Inc. (BOX) – Strong tech, B2B focus.
3. Cloudera (CLDR) – Strong name focusing on Cloud Architecture solutions.
4. F5 Networks (FFIV) – Strength in Software Defined Networking, will be traffic cop of the cloud.
5. Williams Sonoma (WSM) – Strong brands, great management, market discount.

Positions Exited:

1. Cirrus Logic (CRUS) - Reached/exceeded price target.
2. Alamos Gold (AGI) – Gold strength.
3. Western Union (WU) - Reached/exceeded price target.
4. Zillow Group (ZG) – Reached/exceeded price target.
5. New Gold (NGD) – Gold strength.
6. Axalta (AXTA) – Reached/exceeded price target.
7. Synaptics (SYNA) – Reached/exceeded price target.

In closing, we will continue to invest our clients' money as if it were our own and we also invest significant personal assets alongside our clients in the same strategies.

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See Page 6 for Disclosure Information.

Disclosures:

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Because advisory accounts are individually managed, and clients have the ability to impose restrictions on management, account performance and holdings will vary, perhaps significantly, from the statistics listed in this commentary. The strategies are subject to investment risk and there is no assurance that a strategy’s objectives will be attained.

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted index of 30 "blue-chip" industrial U.S. stocks.

S&P 500 Index: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

S&P 500/Barra Value Index: The S&P 500/Barra Value Index is an unmanaged, market-capitalization-weighted index of the stocks in the Standard & Poor's 500 Index having the lowest price to book ratios. The index consists of approximately half of the S&P 500 on a market capitalization basis.

Russell Midcap® Index: The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

Russell Midcap® Value Index: The Russell Midcap® Value Index measures the performance of those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values. The stocks are also members of the Russell 1000® Value index.

Bloomberg Barclays U.S. Aggregate Bond Index: Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

The value style of investing cannot guarantee appreciation in the market value of a strategy's holdings. The return and principal value of stocks fluctuate with changes in market conditions. The value type of investing tends to shift in and out of favor.

1 - Performance figures listed are net of program fees and expenses. Please see composite performance reports for full performance information. Reports are available upon request.

There are no guarantees objectives will be met.   Past performance cannot guarantee future results.

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