Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

MARCH 2018 | Volume 24, Issue 1

INVESTMENT TEAM

Stephen S. Smith, CFA
John D. Brim, CFA
Andrew Chalk, PhD
Robert E. Fletes, CFA
Stephanie C. Jones, CPA
William C. Ketterer, CFA
Eivind Olsen, CFA
Richard C. Villars, CFA
Christopher M. Zogg, CFA

The Headline May be More Smoke than Fire

Remember when politics in the media was relegated to the Sunday morning talk shows? What a contrast to the daily barrage of blogs, Russian trolls blasting propaganda on Facebook, and the endless rotation of market pundits expressing opinions on all the business channels. Now that Wall Street icons, news anchors, and the commander in chief have all taken to Twitter, soundbites are coming at us even faster. With the fire hose of news and opinions spewing out 24/7/365, expressed with the most emotion that can be conjured up, investors can be forgiven for feeling like they need to react to every tidbit of information. Clearly, technology and cable television are both acting as accelerators when it comes to investment information, emotions and unfortunately, decisions. But history has taught us to take a step back and take time to explore and better

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Total Return	1Q18	1 Year
Russell 1000	-0.7%	14.0%
Russell 1000 Growth	1.4%	21.3%
Russell 1000 Value	-2.8%	7.0%
Russell 1000 Cons Disc	2.3%	16.4%
Russell 1000 Cons Stap	-6.8%	-0.8%
Russell 1000 Energy	-5.8%	-0.5%
Russell 1000 Financial	-0.5%	17.8%
Russell 1000 HealthCare	-1.0%	11.4%
Russell 1000 Industrial	-1.8%	14.3%
Russell 1000 Info Tech	3.9%	28.1%
Russell 1000 Materials	-5.5%	10.3%
Russell 1000 Telecom	-7.4%	-5.3%
Russell 1000 Utilities	-3.0%	2.5%

Total Return	1Q18	1 Year
Russell 2000	-0.1%	11.8%
Russell 2000 Growth	2.3%	18.6%
Russell 2000 Value	-2.6%	5.1%
Russell 2000 Cons Disc	-2.7%	11.7%
Russell 2000 Cons Stap	-5.4%	-0.4%
Russell 2000 Energy	-11.4%	-18.9%
Russell 2000 Financial	0.8%	8.9%
Russell 2000 HealthCare	6.2%	28.0%
Russell 2000 Industrial	-2.9%	15.1%
Russell 2000 Info Tech	6.8%	17.9%
Russell 2000 Materials	-3.0%	7.2%
Russell 2000 Telecom	-5.5%	5.1%
Russell 2000 Utilities	-6.3%	2.6%

Total Return	1Q18	1 Year
S&P 500	-0.8%	14.0%
MSCI AC World*	-1.9%	11.2%
MSCI AC World Ex U.S.*	-3.1%	8.9%
MSCI World (Developed)*	-2.2%	9.9%
MSCI Emerging*	0.7%	22.0%
MSCI Dev. Europe*	-4.4%	2.0%
MSCI Pacific Ex Japan*	-2.8%	7.6%
MSCI Japan*	-4.8%	14.2%
MSCI China*	2.1%	40.0%
USD/EURO	2.7%	15.7%
USD/U.K. £	3.7%	11.7%
USD/MSCI EM FX	0.7%	2.9%

* in local currency, net of tax withholding

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(WWW.SMITHASSET.COM)

S&P Earnings Report Update (1Q 2018) by Chris Zogg, CFA
Market Perspectives (December 2017) by Rick Villars, CFA

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understand the implications of the information before reacting to it. Even then it is difficult for most investors to remove their biases from the analysis.

Impact of U.S. Tax Cuts and Tariffs not Clear Cut

Last quarter we suggested it was too early to believe that the implications of a tax package passed the week before publication of our newsletter could be sorted out. Even now theoretical relationships about which companies should benefit the most from the bill are not playing out as clearly as one would have thought. For instance, with a median effective tax rate higher than their larger brethren, small companies are widely expected to benefit more from the drop in corporate tax rate. But exhibit #1 at right implies that earnings expectations were rising pretty much in lock step between small, medium, and large cap companies in the months after the bill was passed. Large and mid cap companies are still largely aligned in their improved outlook, while the prospects for small cap earnings have deteriorated during the month of March.

There are several lessons in this graph. First, no matter how big the headline there are a lot of moving parts at any one time to determining earnings implications. The direct benefit of potentially paying lower taxes was likely dwarfed by the expectation of higher growth in the overall economy, which will help all sizes of companies. Second, sometimes the size of the headline does not equate to the size of the impact. The fact that large and mid cap earnings expectations were not fazed despite the volatility associated with the announcement of tariffs shows that the math of them did not match the hype. The amount of the tariffs announced so far is very small compared to the fiscal stimulus of lower taxes and repatriation. Third, there are often unintended consequences of attempts by politicians to manage economic outcomes. In this case, the attempt to help the steel and aluminum industry hurt the users of those inputs, many of which are small companies who do not have the flexibility of larger companies to adapt to higher prices. The current political environment seems to demand speed of action, but that also raises the probability of unintended consequences. We expect the tax bill and tariffs will have their fair share of those surprises.

Rising Expectations not Limited to the U.S.

We are also struck by the fact that rising earnings expectations are not just a U.S. phenomenon as shown in exhibit #2. If all of the upward revisions were driven by direct tax impacts the outlook in the U.S. would have risen while the rest of the world languished. In fact, some would argue that the tax bill was negative for foreign businesses because it incentivized businesses to invest in the U.S. as opposed to overseas. But international earnings momentum has largely kept pace with the U.S.. This fact suggests that global economic activity is the driver of an improving earnings outlook, of which the tax package is only one catalyst. In that environment

Exhibit #1: Change in 2018 Earnings Expectations
% change since the U.S. Tax Bill Passed

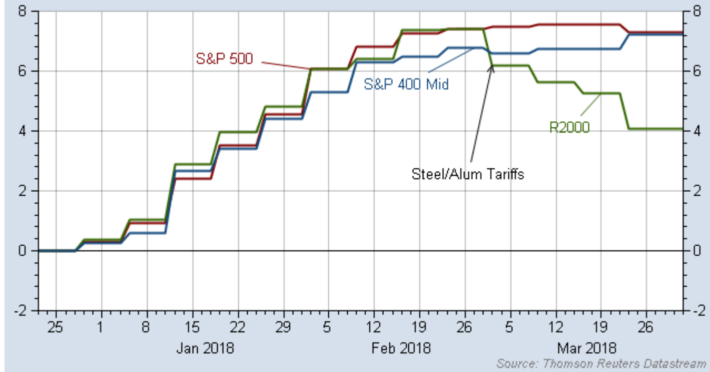


Exhibit #2: Change in 2018 Earnings Expectations
% change since the U.S. Tax Bill Passed

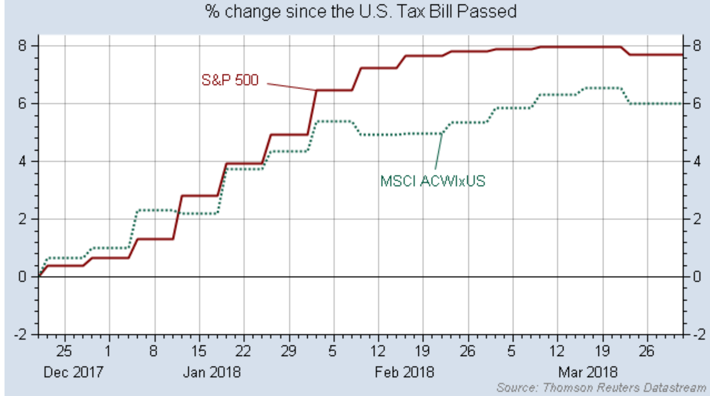
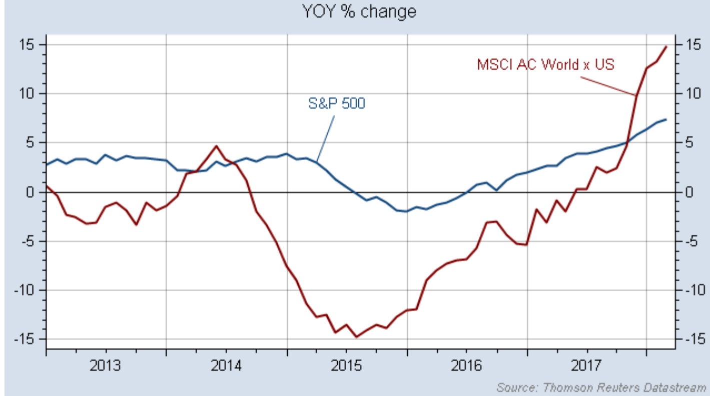


Exhibit #3: Trailing Sales Growth
YOY % change



winners and losers are not as clear cut as sorting them by who got the biggest tax cut.

Broad-based business momentum is evident in exhibit #3, which shows that accelerating sales growth began in 2016 and continued to pick up pace all the way through the current quarter. But look at the acceleration of sales of companies outside the U.S. (MSCI AC World ex-U.S.) Trailing sales for those companies contracted up until the middle of 2017 but have

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accelerated sharply since. There is some currency translation effect in that calculation, but the majority of it is a real uptick in sales. The acceleration of sales growth both in and outside the U.S. would suggest that a synchronized global expansion, driven my multiple factors, underpins much of the recent improvement in the earnings outlook. Yes, the politicians can take some credit for setting the stage for growth, but businesses and consumers around the world are regaining confidence and animal spirits are beginning to reassert themselves.

US Business Confidence Strong Despite Trade Tensions

The pessimists, however, have latched onto the current trade tensions as a reason to worry that business momentum could be undone. We admit that the threat to global trade was the biggest worry to us about the Trump campaign platform and now that is beginning to play out. But so far, the action has been skirmishes with few casualties and not outright war. Despite the shock and awe of announcements, the actual cost to the U.S. economy of the proposed tariffs is a pittance compared to the fiscal stimulus currently working its way into the flow of economic activity. In practice, the administration is sending the signal that these tariffs are negotiating tactics and they hand out exemptions to get favorable treatment in ongoing trade talks. We are still early in the process of these negotiations so it would be premature to assume the worst. Until a trade war escalates into something more substantial we will continue to be vigilant but not reactive. Equity analysts appear to be taking the same approach as there has been little change to earnings models since tariffs were announced.

So far, U.S. business confidence has not taken much of a hit. The surveys of both large company CEOs and of small businesses show they are the most optimistic they have ever been since the beginning of the indices. Granted the tariffs were so recent that the most recent survey readings may not have captured any nascent pessimism. But part of looking through the fog of constant headlines is letting the data guide us. Thus we are still expecting the pick-up in capital expenditure that the relationship in exhibit #4 would imply.

Legislative Stimulus Impacting Industries Unequally

However, legislative stimulus-related earnings momentum has been evident in several industries. For instance, the S&P 500 transportation, banking, and multi-line retail industries have experienced some of the largest upward earnings revisions post passage of the tax bill. Exhibits #5-8 show that the January rally in these stocks can be linked to similar or greater increases in the underlying earnings expected by analysts of the companies in those industry indices. However, the swoon in February and March stock prices is not matched by an equal decline in earnings expectations. Bank stock prices were hurt as the rise in interest rates ran out of steam, but analyst earnings did not reflect the same worries as stock prices. Multi

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Exhibit #4: U.S. Business Confidence
vs. Capital Expenditures

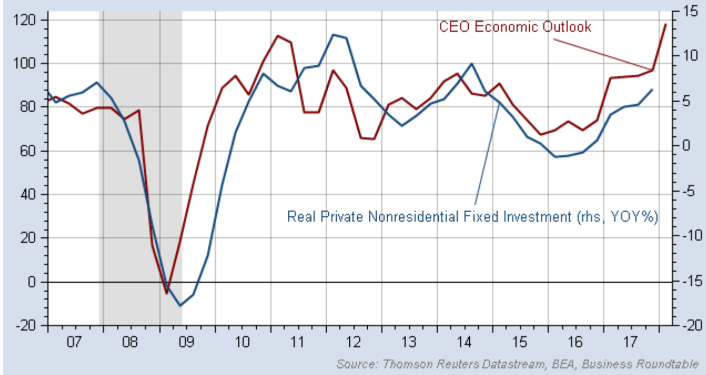


Exhibit #5: S&P 500 Multi-line Retail Index
change since 12/20 (U.S. Tax Bill Passed)

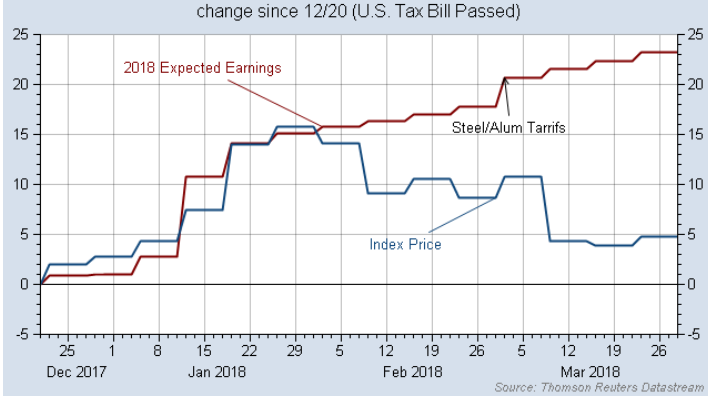


Exhibit #6: S&P 500 Banking Index
change since 12/20 (U.S. Tax Bill Passed)

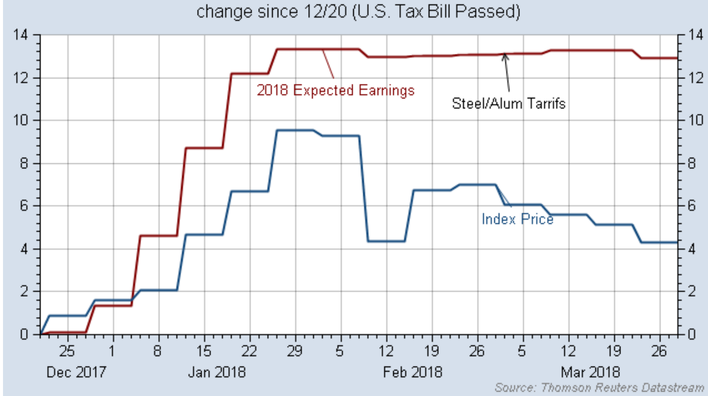
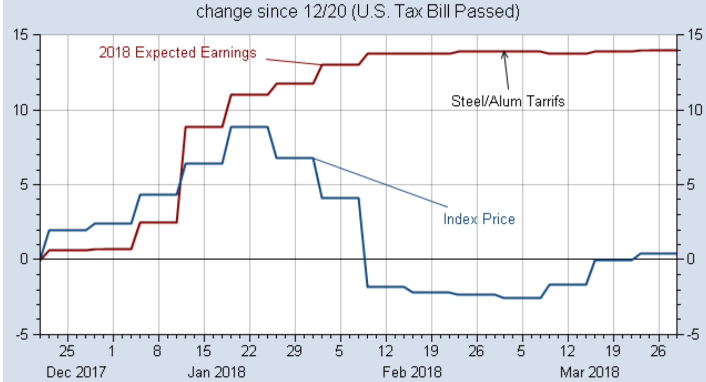


Exhibit #7: S&P 500 Transportation Index
change since 12/20 (U.S. Tax Bill Passed)



-line retail stock prices dropped 10%, while earnings expectations rose about 10% over the same period. A variety of worries hit transportation stock prices, like capacity worries in the airlines and Amazon doing some of their own delivery for the logistics companies. But similarly these worries did not show up in expected earnings. We suspect that the market has become jittery due to stretched valuations, a breakdown in leadership, and algorithms reacting to keywords without analysis. The volatility it causes should really not be a surprise. The surprise is it took this long to happen.

Small Cap Earnings Growth Rates Expected to Surpass Large Cap

While we still worry about stretched valuations, the earnings story is intact. Upward revisions to expectations for both earnings and sales are very rare and generally reserved for recovery periods after a recession. With recent upward revisions S&P 500 aggregate earnings are now expected to increase by almost 20% in 2018. It appears that analysts believe this is a one time shot because S&P 500 earnings growth expectations for 2019 do not reflect an acceleration. Yes, 2019 expectations have been rising, but not at the same rate as 2018. The result is that while there is a growth bump this year it is expected to normalize next year. This is not wholly consistent with our previous thesis that there is more going on in earnings than just the tax bill passage, so it will be interesting to see how expectations unfold during the rest of the year.

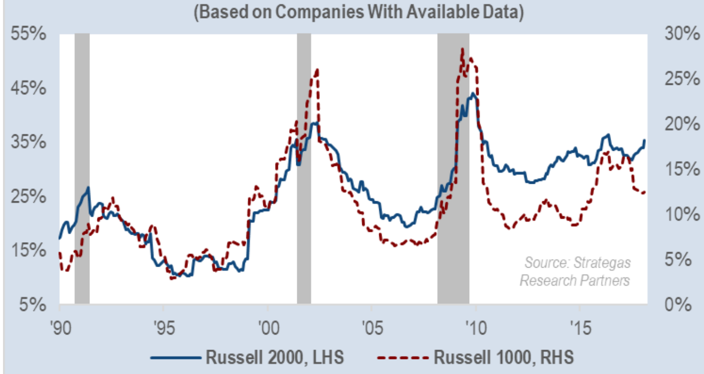
Similarly, the expected growth rate of small company earnings has increased for 2018, but 2019 is roughly flat compared to growth expectations prior to the tax cut. While 2018 small cap earnings were already expected to grow at a torrid pace above 35% before the tax bill, the growth rate jumped to about 45% and is expected to jump another 25% in 2019. This is quite the departure from the recent past where small companies have struggled to grow as fast as their larger brethren. We had thought this laggard status might be due to the high percentage of non-earner small caps (Russell 2000) companies was rising, while the proportion of the large cap universe (Russell 1000) that was loss-making was falling as seen in exhibit #10. But if this earnings acceleration does eventuate in 2018, it is evidence there is a fundamental change in the business climate for smaller companies.

With change there is opportunity for individual companies to surprise the market with earnings better or worse than expectations. Since identifying those companies is our specialty we are looking forward to the earnings environment we have entered. We still believe that the most sound investment decisions are data driven as opposed to reacting to the latest tweet and will stay focused on what we do best.

Exhibit #8: S&P 500 Expected EPS Growth Rate
since the U.S. Tax Bill Passed

Exhibit #9: Russell 2000 Expected EPS Growth Rate
since the U.S. Tax Bill Passed

Exhibit #10: Percent of Non-Earners
Russell 2000 vs. Russell 1000
(Based on Companies With Available Data)



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Should you require any further information, please contact: John D. Brim, CFA | John@smithasset.com
Or call us at 214-880-4600