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Steady As She Goes

If you take away the daily noise of the issues of the world and only looked at the U.S. stock market one would think we had reached nirvana. The S&P 500 notched up 13 new all-time highs in the quarter and had the highest percentage of companies reporting better than expected earnings since 2010.

The earnings growth recession is now over with aggregate S&P 500 2Q17 operating earnings jumping almost 20% over 2Q16. This compares to a long-term compound average growth rate of 5.6%. Aggregate earnings are on track to grow double digits for both 2017 and 2018 but are expected to begin slowing toward the end of 2018. We prefer to look at median growth numbers, as aggregate numbers are inflated by the big recovery in some large resource companies. In addition, the median is more reflective of what the average

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Large Cap	3Q17	1 Year
Russell 1000	4.5%	18.5%
Russell 1000 Growth	5.9%	21.9%
Russell 1000 Value	3.1%	15.1%
Russell 1000 Cons Disc	1.2%	15.9%
Russell 1000 Cons Stap	-1.3%	4.2%
Russell 1000 Energy	6.9%	-0.8%
Russell 1000 Financial	5.1%	35.1%
Russell 1000 HealthCare	3.4%	15.5%
Russell 1000 Industrial	4.7%	22.9%
Russell 1000 Info Tech	8.6%	28.3%
Russell 1000 Materials	5.7%	21.8%
Russell 1000 Telecom	6.5%	0.8%
Russell 1000 Utilities	2.9%	3.7%

Small Cap	3Q17	1 Year
Russell 2000	5.7%	20.7%
Russell 2000 Growth	6.2%	21.0%
Russell 2000 Value	5.1%	20.6%
Russell 2000 Cons Disc	3.7%	16.3%
Russell 2000 Cons Stap	2.7%	3.1%
Russell 2000 Energy	5.9%	-9.9%
Russell 2000 Financial	5.5%	29.2%
Russell 2000 HealthCare	7.9%	24.2%
Russell 2000 Industrial	8.7%	26.8%
Russell 2000 Info Tech	5.0%	21.7%
Russell 2000 Materials	6.8%	25.3%
Russell 2000 Telecom	0.5%	19.1%
Russell 2000 Utilities	5.2%	8.8%

Global	3Q17	1 Year
S&P 500	4.5%	18.6%
MSCI AC World*	4.4%	18.3%
MSCI AC World Ex U.S.*	4.4%	19.1%
MSCI World (Developed)*	3.9%	17.9%
MSCI Emerging*	7.6%	21.8%
MSCI Dev. Europe*	3.5%	17.7%
MSCI Pacific Ex Japan*	2.2%	12.9%
MSCI Japan*	4.2%	26.8%
MSCI China*	14.7%	33.8%
USD/EURO	3.4%	5.2%
USD/U.K. £	2.9%	3.3%
USD/MSCI EM FX	0.5%	-1.7%

* in local currency, net of tax withholding

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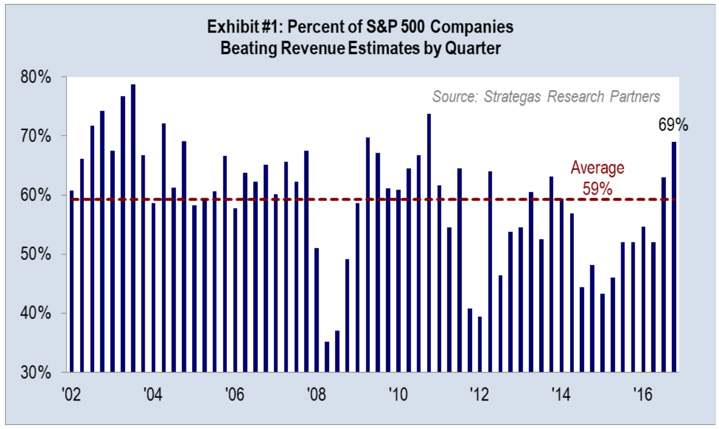
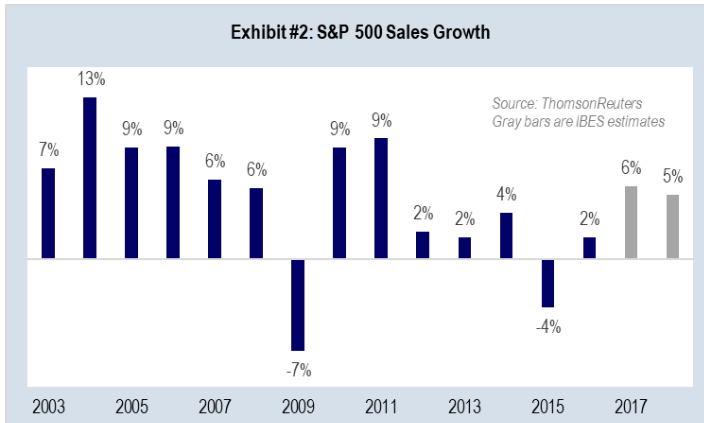
company is apt to earn. Median growth is expected to be 8.5% for this year and 10.5% for next. While lower than the aggregate growth projections, the medians are still quite respectable considering the long-term compound growth rate is less than 6%.

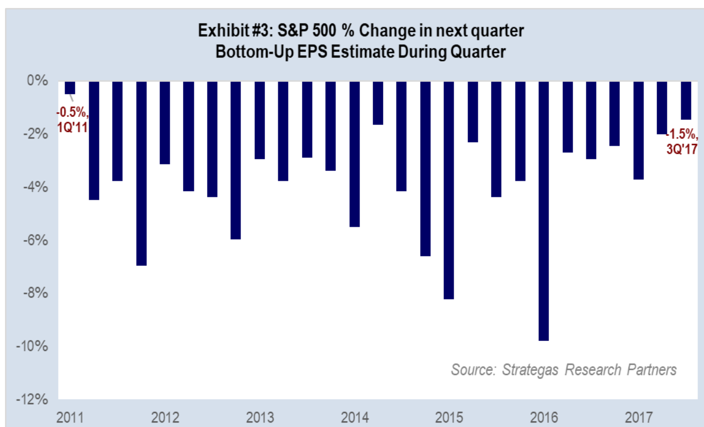
Tepid topline growth has defined most of this expansion with per share earnings growth coming via cost cutting and reduced share count. This has been a source of trepidation for us about the sustainability of earnings growth. Eventually you have to sell more stuff to grow your business. It appears that companies are finally starting to move in that direction and are delivering encouraging sales momentum. In fact, in the latest reporting period companies exceeded revenue expectations at the highest rate since 2010 (Exhibit 1). The fact that those were positive surprises on top of the highest expectations we have seen since 2011 adds some credibility to the topline momentum aspect of this earnings recovery. Interestingly, the aggregate sales growth numbers are similar to the median numbers shown in Exhibit 2, where sales growth has accelerated to pre-recession levels. That would indicate that the uptick in sales growth is broad-based and not just driven by higher oil prices. While these sales growth numbers do not indicate boom times, they certainly are much more respectable than companies have been delivering for the last five years.

Under the surface there do appear to be some moving parts. For instance, Energy and Semiconductors have both enjoyed double digit sales gains (median) this year, but both are expected to slow to about half of their current rate next year. On the other hand, Software companies have enjoyed the third fastest sales growth this year and are pegged to deliver a similar result next year. The two industries with some acceleration expected between this year's sales and next are Automotive and Food Beverage & Tobacco. Both are experiencing very slow revenue growth now and analysts are hoping for a modest uptick next year. We still would like to see better topline strength, but are feeling some optimism by the current momentum.

Another aspect of the current earnings environment that gives us some encouragement is the lack of downward pressure of estimates. As is widely known, estimates generally fall over time and companies eventually report actual earnings that are lower than those originally projected by analysts. This is thought to be a combination of companies' management lowering guidance to make it easier to report a better than consensus result and/or analysts' tendency to become more realistic about overly optimistic expectations the closer it gets to report date. In the lead up to reporting season it is not uncommon to see a flurry of activity that result in downward pressure on estimates. That has not really been the case in the third quarter. The ratio of positive to negative revisions has been better than average the whole quarter for FY1, FY2, FQ1, and FQ2. For much of







the quarter the ratio for the 2017 fiscal year was firmly in positive territory. This indicated there was upward pressure on estimates early in the quarter before turning slightly negative at the end. This ratio for sales revisions was even better for all time periods, remaining in positive territory for the full quarter. Exhibit 3 shows the magnitude of downward revisions for each upcoming quarter during the lead up to reporting season. This quarter the downward movement has been very minor. The last time the de-

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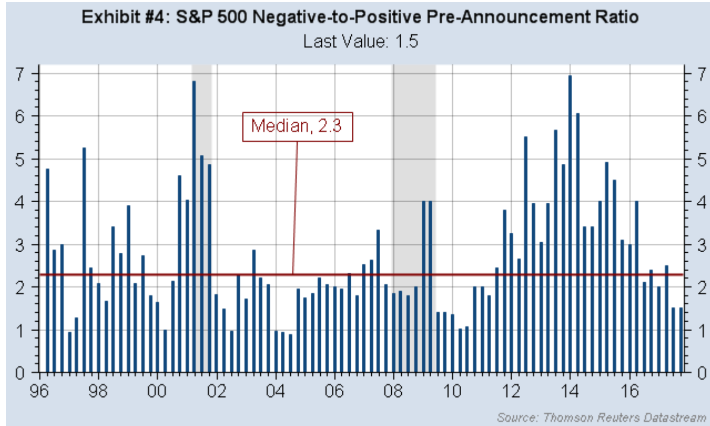
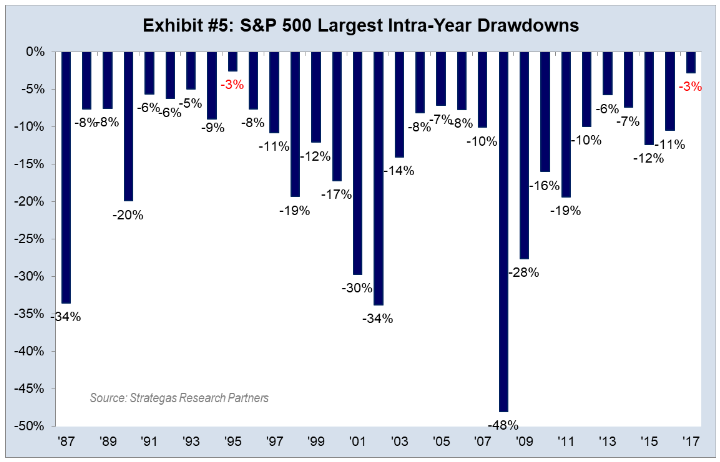
cline was this small was in 2011 in the wake of a strong snapback after the recession. Analysts are not finding reason to lower expectations and Exhibit 4 shows that management is not giving them much reason to turn pessimistic. The long-term median ratio of negative-to-positive preannouncements is 2.29, but in the last two quarters management teams have not been that pessimistic. Currently the ratio is running at about 1.5 times. The last time it was this low was in 2010 during the earnings bounce after the recession. In fact, it is not far from the best readings for the last twenty years at around a one-for-one ratio. Management optimism about the future remains high and they are much more confident in achieving their prior guidance. This has spilled over into the analyst community as well.

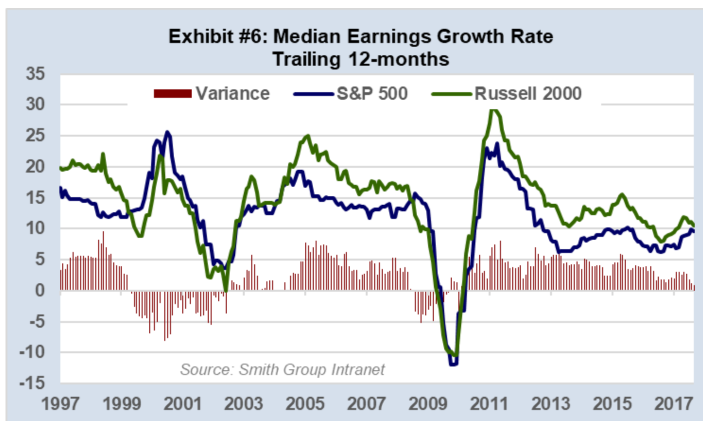
It would appear that we are in a virtuous circle when it comes to the earnings picture. Companies and consumers are optimistic about the future, which stimulates activity. This activity results in increasing sales for companies, whether they be to the consumer or other businesses. Firmer sales growth makes it easier for companies to generate sustainable profit growth, which leads to more optimism.

But investors should not get carried away with their enthusiasm toward stock prices. First of all, the S&P 500 is up 14.2% year-to-date, while earnings expectations have fallen 1.3% for 2017 and 2.0% for 2018. While this drop in earnings projections is smaller than normal, it is still a downward slope. This means that the valuation investors place on stocks is rising by virtue of lower earnings expectations, in addition to increasing stock prices. That is in spite of a rising interest rate environment. With the median company expected to increase earnings 8.5% this year and 10.5% next, is a forward price/earnings ratio of 18 times justified? Those growth rates are higher than historic averages, but they are not eye-popping hyper growth either. Investors have become complacent about the risks to the global business outlook. The CBOE Volatility Index continues to trend lower to all-time lows. Exhibit #5 shows the largest drawdown of the S&P 500 this year has been a mere -3%. The only other time that has happened in the last 30 years has been in 1995. This was at the start of the 1990's tech boom when earnings expectations were on the rise. Yes, business is humming and earnings are growing again after an earnings recession which gives investors a reason to celebrate. But there are still plenty of risks that could undo the virtuous earnings circle.

In fairness, there are also potential policy changes that could give earnings a boost as well. But the most meaningful of them will be difficult to achieve and are likely to take considerable time to negotiate. They might be achieved at a magnitude that could affect the current earnings picture but the odds of something impactful enhancing near-term earnings are difficult to predict.







Despite their September rally, small cap stocks have been a laggard in 2017. That is probably well deserved because they have not been delivering superior earnings growth relative to large companies, yet have a premium valuation. Exhibit 6 shows the trailing twelve month median earnings growth for both the S&P 500 and the Russell 2000. Most of the time small company growth is nicely ahead of their larger brethren as indicated by the red bars. But in the most recent period the comparison is roughly a wash between the two and the differential is not anticipated to improve much in the next twelve months. This ratio has inverted twice in the last

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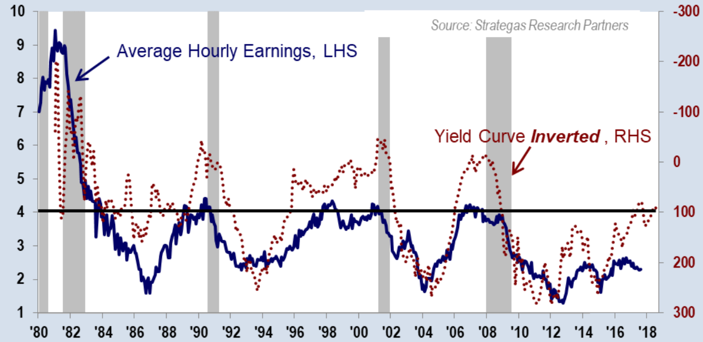
twenty years. The first time that the growth comparison turned negative was during the last few years of the DotCom era, when it was widely believed that if a small cap company was making money they were not spending enough to capture users for future monetization. It is not totally surprising to see this distortion in an environment where managers were punished for making money. The other time was at the depth of the last recession, when many small companies were struggling just to stay afloat, much less make money. Neither of those two conditions are present today so the lack of superior growth is a bit of a conundrum. However, there are a couple of anomalies at work under the surface.

One is the expected growth differential between the large cap and small cap medians for energy companies in 2017, which is quite large (large = 79%, small 37%). Since the industry is the 6th largest by number of names in the Russell 2000 index it has a significant impact of the median growth rate. The growth discrepancy is likely related to large companies' ability to more quickly ramp up production in response to the recovery in oil prices due to being better capitalized. The other industry negatively impacting the small cap median is Pharma/Biotech. With a flood of new early stage biotech companies coming to market, most without earnings, it has grown to more than 10% of the names in the Russell 2000 and is now the second largest industry group in the index. Since many of these companies are not making a profit the median expected growth rate for 2017 is only 0.1%. This contrasts with an expected growth rate of 11% for large cap companies in the same industry group, where most proven, profitable drugs reside. This will continue to be a headwind for the growth comparison between large and small companies.

The more important question is, "why have small cap stock prices rallied so strongly in September relative to large cap companies?". The Russell 2000 was up 6.2% for the month compared to 2.1% for the S&P 500. Earnings expectations have not been rising for either index. The growth profile for next year is not really improving. But the best explanation seems to be that it is in response to a rising possibility of tax reform. Smaller companies generally have less opportunity to take advantage of some of the tax strategies that large companies employ. As a result they tend to have higher tax rates and will benefit more from lower statutory rates. It is also anticipated that any tax reform will include an incentive for large multinational companies to repatriate offshore profits. That would give them buying power for acquisitions, with small cap companies being the primary target. Both of those aspects of tax reform would likely boost small cap prices. So it appears the market is telling us there is rising possibility of tax reform.

With the current economic expansion and bull market more than eight years old it is reasonable to be thinking about when and how both of these runs will end. We continue to believe that economic expansions do

Exhibit #7: Average Hourly Earnings: Production and Nonsupervisory Workers (Y/Y, SA, $/Hour) vs. 10/2 Spread (bps, 12 Mo Lead)



not die of old age and the slow growth nature of the current one has kept the excesses normally seen at peaks at bay. However, it is prudent to keep an eye on the conditions normally present when expansions end. Two of those data points are wage growth and the yield curve. Exhibit 7 shows the average hourly earnings change for non-executive workers and the 10/2yr yield spread. Wage growth around 4% is a trigger for when the Fed gets aggressive about tightening. While the current rate has risen over the last few years, it is still well short of 4%. Thus the Fed is apt to stay measured in removing stimulus. The yield curve is another precursor of a recession. The current yield curve has flattened, but is not looking like it will invert in the near future. Given current conditions it is reasonable to expect the expansion to run for at least a couple more years, assuming no exogenous shock.

We believe valuations are full but bear markets without a recession are rare. We think *absent significant fiscal policy reform* modest earnings growth will likely support stock prices enough to avoid a bear market for the near term. But given full valuations and modest earnings growth, it will be difficult to move higher through multiple expansion. That does not mean it will not happen, just that it probably will be difficult to rationalize.

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