Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

SEPTEMBER 2018 | Volume 24, Issue 3

INVESTMENT TEAM

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

Headwinds or Hurricanes

This might be the most hated bull market of all time, but businesses and consumers are brimming with confidence. Unemployment has dipped to levels not seen since 2000 and the late 1960s. Purchasing managers are indicating strong momentum in U.S. factories according to the ISM Manufacturing survey. Small businesses are enjoying record optimism as measured by the NFIB survey. Large company CEO surveys are equally optimistic. The Conference Board leading indicator is at a new high. There is an estimated $700 billion of liquidity being repatriated to the U.S. by companies that had parked earnings overseas. Both large and small company sales growth has reaccelerated to peak recovery levels. Profit margins are expanding toward previous peaks. Earnings and sales estimates for U.S. companies have been persistently rising for most of the year. Consumers are as optimistic as they were in 2000 according to both the Conference Board

(Continued on page 2)

Total Return	3Q18	1 Year
Russell 1000	7.4%	17.8%
Russell 1000 Growth	9.2%	26.3%
Russell 1000 Value	5.7%	9.5%
Russell 1000 Cons Disc	6.9%	28.9%
Russell 1000 Cons Stap	5.4%	3.3%
Russell 1000 Energy	0.9%	15.4%
Russell 1000 Financial	4.0%	8.6%
Russell 1000 HealthCare	14.3%	19.0%
Russell 1000 Industrial	9.7%	11.7%
Russell 1000 Info Tech	9.5%	32.3%
Russell 1000 Materials	0.0%	3.5%
Russell 1000 Telecom	7.5%	1.9%
Russell 1000 Utilities	2.5%	4.1%

Total Return	3Q18	1 Year
Russell 2000	3.6%	15.2%
Russell 2000 Growth	5.5%	21.0%
Russell 2000 Value	1.6%	9.3%
Russell 2000 Cons Disc	3.9%	19.3%
Russell 2000 Cons Stap	-1.8%	11.5%
Russell 2000 Energy	-2.8%	10.5%
Russell 2000 Financial	1.1%	7.8%
Russell 2000 HealthCare	7.6%	29.2%
Russell 2000 Industrial	4.4%	11.3%
Russell 2000 Info Tech	6.4%	22.9%
Russell 2000 Materials	1.1%	5.5%
Russell 2000 Telecom	21.7%	23.6%
Russell 2000 Utilities	3.5%	6.2%

Total Return	3Q18	1 Year
S&P 500	7.7%	17.9%
MSCI AC World*	4.7%	11.2%
MSCI AC World Ex U.S.*	1.5%	4.5%
MSCI World (Developed)*	5.3%	12.3%
MSCI Emerging*	-0.1%	2.7%
MSCI Dev. Europe*	1.2%	2.0%
MSCI Pacific Ex Japan*	0.6%	9.5%
MSCI Japan*	6.3%	11.2%
MSCI China*	-7.6%	-2.0%
USD/EURO	0.4%	-1.5%
USD/Chinese Yuan	-3.5%	-3.0%
USD/MSCI EM FX	-1.1%	-3.5%

* in local currency, net of tax withholding

RECENT PAPERS IN SMITH GROUP RESEARCH LIBRARY

(WWW.SMITHASSET.COM)

S&P Earnings Report Update (3Q 2018) by Chris Zogg, CFA
Market Perspectives (June 2018) by Rick Villars, CFA

For additional information on **Smith Group** and our investment strategies and capabilities, please visit www.smithasset.com. The website contains information you may find useful regarding Smith Group including research articles, our economic and financial market outlook and detailed information on our team and investment capabilities.

100 Crescent Court, Suite 1150 | Dallas, Texas 75201 | 214.880.4600 | 800.582.3435 | F 214.880.4640 | www.smithasset.com

and the University of Michigan surveys. Retail sales are growing at the fastest pace since 2010. Workers have more confidence quitting for a new job than ever before as seen in the percentage of job separations initiated by the worker. The ratio of respondents saying jobs are plentiful versus jobs are hard to find has only been better in 2000 as shown in Exhibit #1. Many aspects of the economic and earnings cycle are looking more mid-cycle than late. So what is not to like?

Raging Tempest or Rain before the Rainbow

The trade war is the most visible concern at present, but as mentioned last quarter it is hard to know what the final terms will be until they are finally reached. All of the key trade negotiators seem to have read "The Art of the Deal" and are following the same script as our negotiators. They are all aiming high and pushing to achieve those lofty goals knowing that they must fight back hard in order to not lose an edge in the deal. We should probably all expect trade talks to go on for some time to come, with a few settlements along the way, but the endgame will continue to be unpredictable. It is more productive to think through the earnings impact of existing tariffs on specific companies or industries. Companies like Deere and Caterpillar are enjoying rising sales, but in the last quarter their cost-of-goods-sold rose even faster than sales did. Similarly, Molson-Coors saw a 3% year-over-year jump in their cost-of-goods-sold despite flat sales. But these obvious early impacts of the steel and aluminum tariffs are few and far between. More notable may be some of the outlook statements citing lower sales expectations in China or Europe and those worried about supply chain disruption yet to be felt. For instance, BorgWarner, an engine and drive train manufacturer with more than 75% of sales overseas, warned of a more challenging sales environment causing forward sales expectations to drop 2%. But even that seems a modest revision given the fear that seems to be emanating out of Wall Street. It appears that the ultimate impact to earnings estimates is also still yet to be determined as the strong economy is so far overwhelming trade war fears and earnings estimates for U.S. companies continue to rise.

Prevailing Fed Winds Strengthening

We still think Fed tightening will be a headwind for stock prices and the economy as a bit of inflation prompts them to move rates up. Yes, inflation is still well under control with the CPI between 2.0-2.5%. But as previously mentioned, the labor market is tight with unemployment at historic lows and more job openings than people to fill them. Because of this wages are rising at a faster pace (Exhibit #2), which was exactly what was intended with the fiscal stimulus of last year. Growth is not at the 4% threshold that normally attracts a more aggressive response from the Fed, but they are headed in that direction. Without a much awaited improvement in productivity, companies will either suffer margin compression or have to pass higher costs on to customers. Capacity is also getting tight, which has a

Exhibit #1: Consumer Confidence Survey

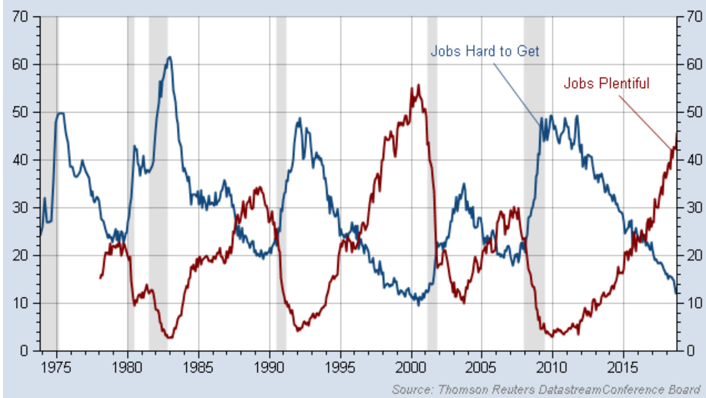
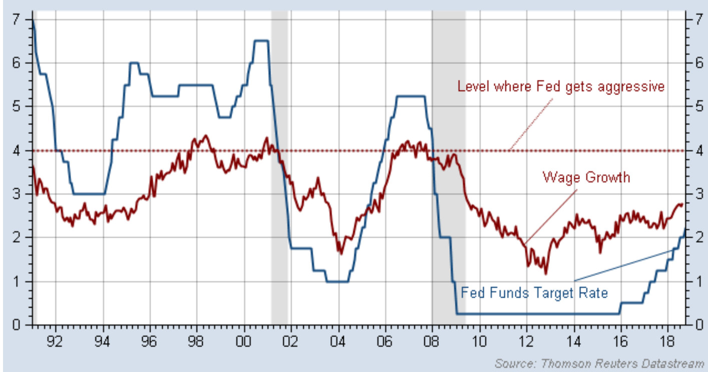


Exhibit #2: Fed Funds vs.
Ave Hourly Earnings - Private Production (12 mo change)



similar impact. Idle capacity being put to use is good for profitability, but once it is gone more costs are incurred to expand, driving either higher prices or reduced margins. Normally a stronger U.S. dollar serves to keep input prices down, but the trade war looks like it will more than offset the currency impact. That will probably be the case whether the conflict is won or lost. Global supply chains have been a key to keeping production costs in check. So onshoring production may be a boon to job creation, but it will inhibit the ability of companies to control input costs and will likely even reverse some past gains. In the meantime, tariffs on inputs will add costs to a broad swath of industries and will have to be absorbed or passed on to customers. None of this should be unexpected given the strength of the economy. That strength will keep the Fed on the path to normalization and eventually to tightening to take some of the heat out if prices do accelerate. The risk is that they go beyond what is necessary when taking into account economic conditions or in a way that inhibits confidence. The flattening yield curve is an indicator that is closely watched for signs of trouble. But clearly, the market at new highs is interpreting the outcome of both the trade war and Fed tightening positively. With the Fed funds rate tighter but still at an accommodative level maybe that should not be surprising. For now we expect the Fed to be a headwind instead of a storm that sinks the ship. The economy and market can

(Continued on page 3)

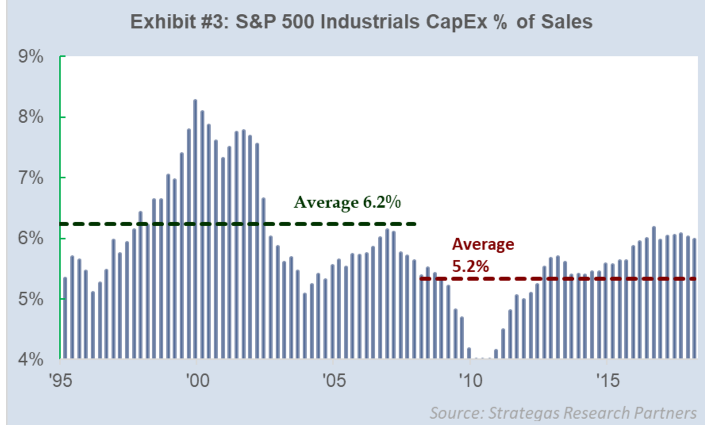
track higher but it is apt to be a bit more choppy than in the past few years.

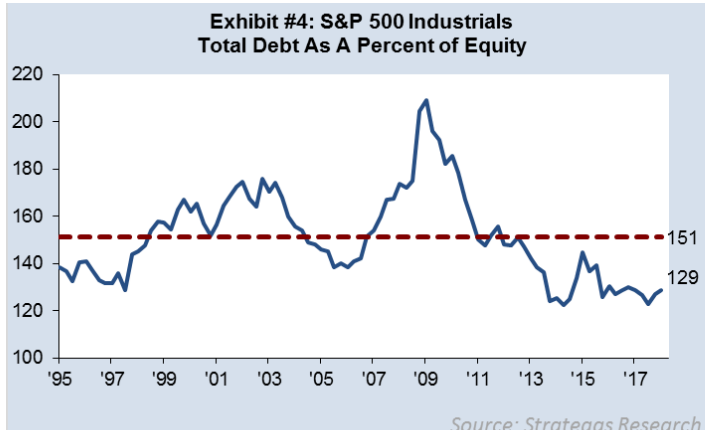
Inclement Weather Opens Opportunity

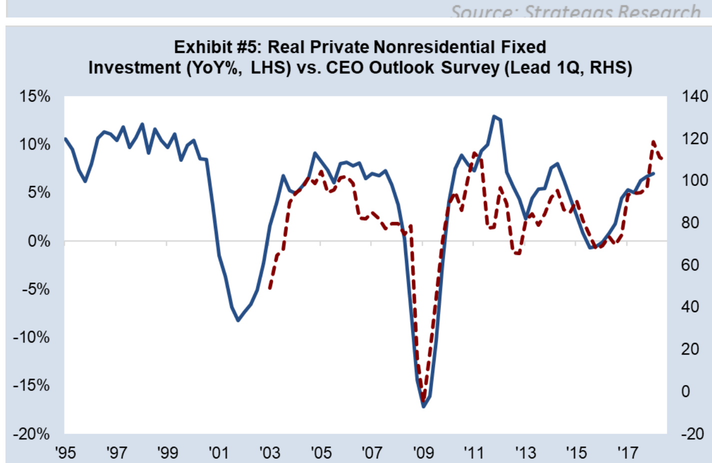
Many companies in the Industrial sector are heavy exporters and could be subject to retaliation in a trade war. But the dynamics of the trade war and a tightening of labor and capacity are also likely to be stimulative for the sector. Onshoring more manufacturing is actually likely to lead to investment in more efficient equipment as much as it is to more production jobs, especially when the pool of workers has been drained. Over the past couple of decades, when the labor market tightened, companies looked to trading partners to supply more workers. Given current trade relations that is not a very good option, so we would expect domestic companies to invest in more efficient equipment. Tightening manufacturing capacity exacerbates that production problem, once again leading to more investment. Last quarter we made the case for accelerating capital expenditure citing; 1) a need for investment, 2) confidence in a growing economy, 3) intent to invest, and 4) plenty of liquidity to fund that investment. Those drivers are still in place and have actually strengthened. The trade war and production bottlenecks have increased the need. The under investment indicated in Exhibit #3 has left the average age of equipment the highest it has been since the mid-1960s. Small businesses are even more confident than they were three months ago. Companies were already flush with cash to spend, but repatriation is on pace to reach $700 billion this year. Some of that will go directly to investment and some should make its way through the system to make cash available for companies to tap into for investment. Debt loads of capital intensive companies are historically low (Exhibit #4). These drivers would imply that there is still plenty of room to run in the nascent capital investment trend. Whether it continues to play out will largely depend on continued confidence in the business community. There is a fairly strong correlation indicated in Exhibit #5 between confidence and investment. Despite plentiful comments about the risk to business that a trade war poses, that confidence remains high - for now.

Just Catching the Wave or Headed for a Wipeout

Investor views about where we are in the U.S. economic and earnings cycles have become about as polarized as U.S. politics these days. There is a group that is determined to build the case that we are late in the cycle and about to head into some pretty tough times. But there is an equally adamant contingent committed to a mid-cycle placement. We think both sides have quite strong arguments and both are right about various aspects. We actually saw the slow growth environment as part of the reason the expansion was going on so long. The traditional bottlenecks that led to inflation were kept at bay and the Fed stayed dovish. Now the Trump Administration's fiscal stimulus package has poured fuel on the fire and







those bottlenecks are becoming a bigger issue, albeit not overly troublesome just yet. The stimulus will take some time to work its way through the system and investment in new technologies can give businesses the productivity boost that has been elusive. But with the current momentum so high expectations have become quite stretched and will be more difficult to achieve. One has to wonder if this is as good as it gets. Well, Exhibit #6 on the next page would indicate that those peaks are getting pretty darn close. It should also be noted, however, that previous peaks preceded recessions and bear markets by years and were not the precursor

(Continued on page 4)

of an imminent storm. Peak earnings *growth* does not mean peak earnings. If S&P 500 earnings growth drops from the mid-20's to the high teens investors should still be quite pleased. Especially encouraging is the fact that sales growth is still accelerating. It is now approaching double digit growth, as shown in Exhibit #7 (see S&P500 line). Other than the initial snapback after the recession this is the first time in this expansion we have seen such strong underpinnings for real growth relative to financial engineering. This is the type of growth that is more sustainable and considering there has been so little of it since the recession one could postulate that the real expansion is just getting started. That would be on the optimistic extreme, but it is not out of the question.

The Rising Tide might not Float all Boats

In one respect the earnings cycle is looking more mature in a way that is welcome by us as earnings driven investors. The easy credit of the last decade has served to keep companies in business that would normally have failed. Indicative of this condition is that 35% of Russell 2000 companies are operating at a loss, which is as high as normally experienced during a recession. The dispersion of operating results in larger companies has been quite narrow for most of this expansion. But rising interest rates, the changing business landscape, and solid topline growth for well run companies is changing that, as seen in the rising dispersion shown in Exhibit #8. In this environment the importance and opportunity for unexpected earnings growth comes even more into play.

Earnings across the Pond

The economic and earnings momentum enjoyed by U.S. companies has not been shared with their global counterparts. Exhibit #7 also shows sales growth for non-U.S. companies. A steep acceleration in international growth in 2017 surpassed that of the U.S., but has decelerated in the last six months. It is worth noting that overseas earnings expectations were still rising in the first quarter and recent downward revisions have only brought them back even with where they were earlier in the year. The year –to-date 1.7% drop in the MSCI ACWI ex.-U.S. in local terms certainly could be worse considering the trade risks and economic deceleration seen in Europe. The strength of the U.S. dollar has actually been a bigger drag on offshore returns for U.S. investors. Of course, there have been some countries that have felt the pain a bit more than others. Earnings expectations in China have fallen about 8% since tariffs were first announced. But Chinese stock prices have fallen even more. The bottom so far has been -20% in local terms in mid-September, but it has since recovered to about -15%. The largest downward earnings revisions since tariffs were introduced actually have nothing to do with the trade war. Both Turkey and South Africa have suffered dramatic economic deceleration and are looking increasingly likely to be entering recession, dragging expectations lower in the Emerging Europe, Middle East, and Africa region

(Continued on page 5)

Exhibit #6: U.S. Confidence

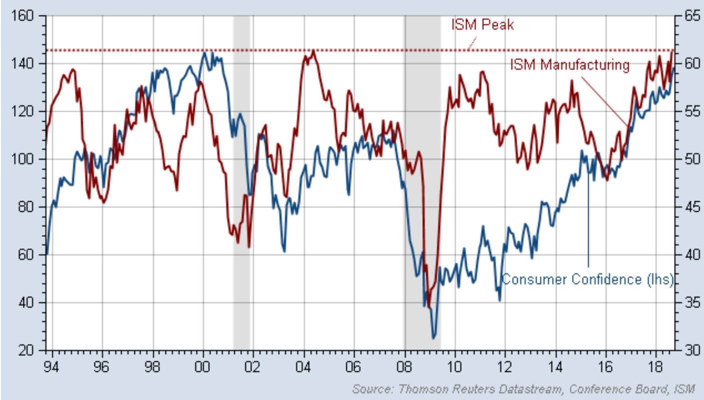


Exhibit #7: Trailing 12-month Sales
YOY % change

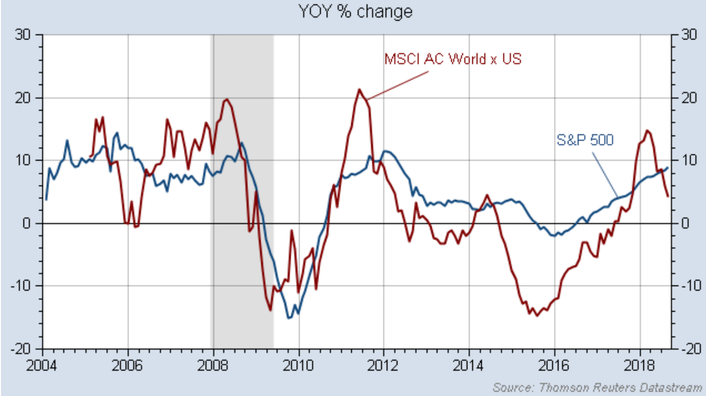


Exhibit #8: Russell 1000 Operating Result Dispersion
(Historical Standard Deviation of TTM EPS Y/Y Pct. Chg.)

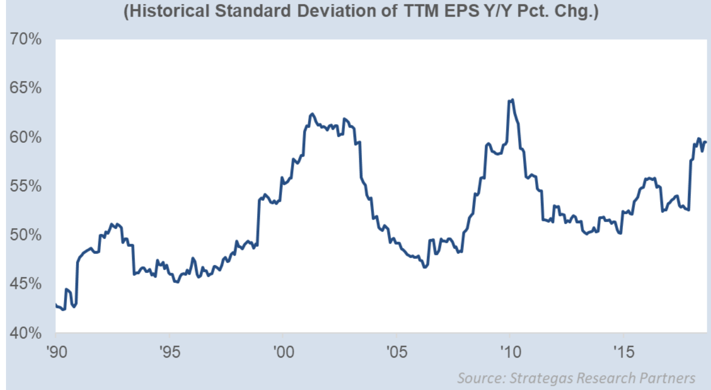
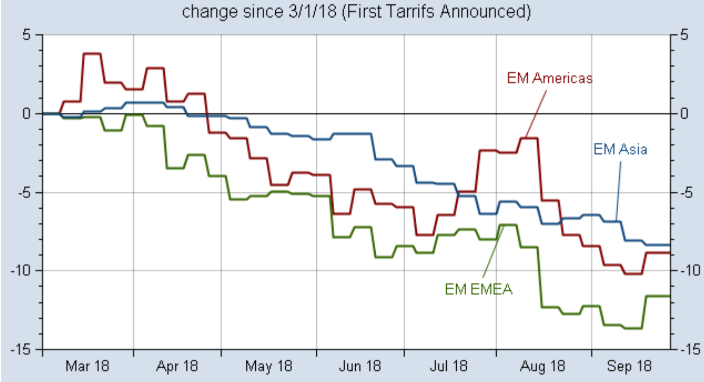


Exhibit #9: ACWI Emerging Regions 2019 Expected Earnings
change since 3/1/18 (First Tarrifs Announced)



(Exhibit #9). In contrast, the rest of Emerging Europe and Asia ex.-China has been relatively resilient. Earnings expectations in countries in the developed world have been surprisingly stable since the threat of tariffs was introduced. The hardest hit has been Germany where expectations have fallen by about 4%. Some trading partners in the news, like France and Canada, have actually seen expectations rising in the 3-4% range. Given the daily barrage of tweets and taunts about the trade war one might have expected to have seen much worse downward momentum.

Favorable Tradewinds?

There has been quite a bit of talk about a peak in the growth rate of U.S. earnings as illustrated by Exhibit #10 at right which shows declines over the last two quarters. But considering that the long term average for S&P 500 earnings growth is in the single digits, high teens seem quite acceptable. Some pundits have suggested the market will drop lower because of this deceleration. If earnings continue to grow in the mid- to high- teens it is difficult see more than a temporary correction. This is especially so given the fact that expectations are still rising for both this year and next, as seen in Exhibit #11. If you turned all the media off and only looked at what is going on with expected earnings it would be very hard to conclude that the market is about to roll over. Exhibit #12 shows some interesting momentum at the industry level since tariffs were introduced. Not surprisingly there is a growing trepidation about earnings in the automotive industries. This is partially driven by trade war fears, but also by slowing U.S. auto sales. On the positive side are some industries that are pretty economically sensitive. Machinery is a good reflection of the momentum discussed in capital investment. Strength in trading and transportation companies is generally seen as indicating good economic momentum.

Clearly, there are headwinds that could turn into hurricanes for earnings. But so far the numbers do not support a dire prediction. At the end of the day we would expect some of the current momentum to abate, but that does not mean the end of an upward trend. However, the changing rules of engagement in global business means there will be winners and losers, and therefore opportunities for finding growth that surpasses expectations.

Exhibit #10: S&P 500 Quarterly EPS Y/Y Growth Rate (Source: First Call)

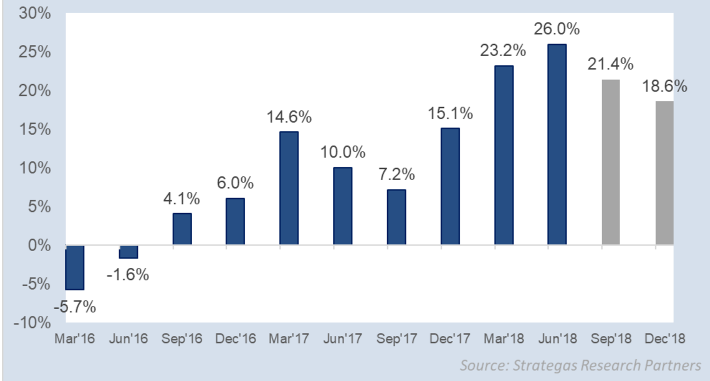


Exhibit #11: S&P 500 Consensus CY'17, CY'18 & CY'19 EPS Estimate vs. Historical Revision Baseline

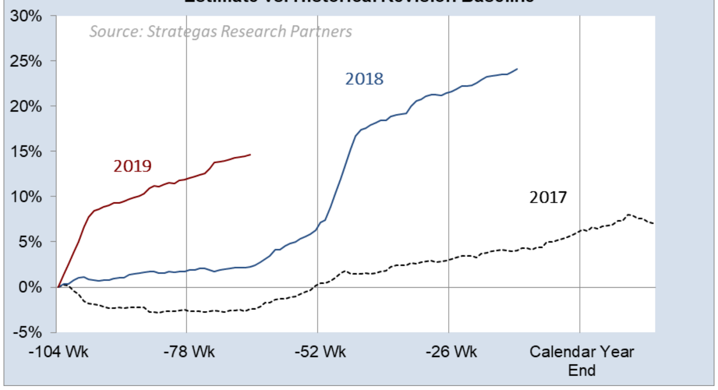
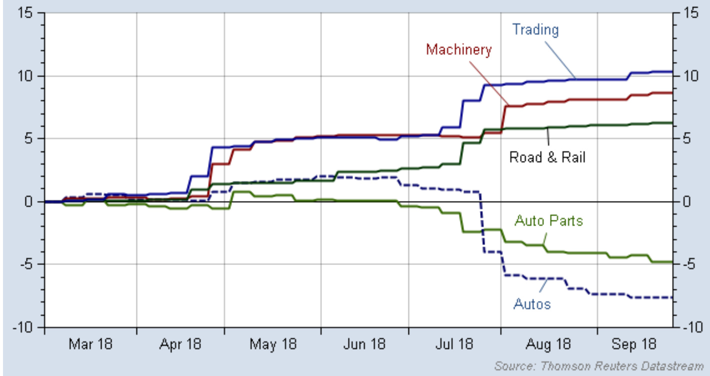


Exhibit #12: S&P 500 Industry 2019 Expected Earnings
change since 3/1/18 (First Tarrifs Announced)



Disclosures

Founded in 1995, Smith Asset Management Group, L.P. ("Smith Group") is a registered investment advisor that specializes in equity investment management services. The firm manages assets for a diverse list of clients, which includes foundations, endowments, corporate pensions, public funds, multi-employer plans and high-net worth individuals. Effective Jan. 1, 2006, the firm was redefined to exclude wrap SMA business. Smith Group claims compliance with the Global Investment Performance Standards (GIPS®). Smith Group has received a firm-wide verification for the period Jan. 1, 1996 - Dec. 31, 2017. To receive a complete list and description of Smith Group's composites and/or a presentation that adheres to the GIPS® standards, contact John Brim, CFA at (214) 880-4608, or write to Smith Group, 100 Crescent Court, Suite 1150, Dallas, TX 75201, or john@smithasset.com. The S&P 500, Russell 1000 Growth, and Russell 1000 Value indices, are unmanaged indices of the shares of large U.S. corporations. The Russell 2000 and Russell 2000 Growth indices, are unmanaged indices of the shares of small U.S. corporations. The MSCI ACWI (All-Country World Index) and Russell Global Large Cap indices are free float-adjusted market capitalization weighted indices designed to measure the equity market performance of developed and emerging markets. All index performance includes capital appreciation and reinvested dividends and is presented gross of fees.

Past performance is not indicative of future results. As with any investment vehicle, there is always a potential for profit as well as the possibility of loss. Actual results may differ from composite returns, depending on account size, investment guidelines and/or restrictions, inception date and other factors. Nothing contained in this presentation should be construed as a recommendation to buy or sell a security or economic sector.

Nothing contained in this presentation should be construed as a recommendation to buy or sell a security or economic sector.

The material is based upon information we consider reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such. Opinions included in this material are as of Sep. 30, 2018 and are subject to change without prior notice.

This message is intended only for the designated recipient(s). It may contain confidential, privileged or proprietary information. This message does not constitute an offering for investment interests. This message is not, and under no circumstances is to be construed as, a prospectus, advertisement or public offering of investment interests. If you are not a designated recipient, you may not review, copy or distribute this message. If you receive this message in error, please notify the sender by reply email and delete this message. Thank you.

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