Smith Group
ASSET MANAGEMENT

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INVESTMENT TEAM

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

On a Sugar High?

In some respects 2017 ended as it began. A year ago we were wondering how the market had rallied despite a President-elect who possessed no real legislative record to forecast a likely policy direction. Now the question could be asked how the S&P 500 rose nearly 22% in 2017 despite a GOP majority that failed to deliver a significant legislative win to business until the final week of the year. We have often contended that political headlines are a distraction, while the economy and markets ebb and flow in spite of Washington. While that may be an overstatement, history has proven that it is more profitable to attempt to filter out political noise and focus on what is going on with corporate earnings and why.

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Total Return	4Q17	1 Year
Russell 1000	6.6%	21.7%
Russell 1000 Growth	7.9%	30.2%
Russell 1000 Value	5.3%	13.7%
Russell 1000 Cons Disc	9.2%	23.3%
Russell 1000 Cons Stap	6.4%	12.9%
Russell 1000 Energy	6.4%	-1.3%
Russell 1000 Financial	8.3%	21.6%
Russell 1000 HealthCare	1.5%	22.2%
Russell 1000 Industrial	6.5%	21.6%
Russell 1000 Info Tech	8.9%	38.5%
Russell 1000 Materials	7.0%	24.0%
Russell 1000 Telecom	3.3%	-1.0%
Russell 1000 Utilities	0.6%	12.3%

Total Return	4Q17	1 Year
Russell 2000	3.3%	14.7%
Russell 2000 Growth	4.6%	22.2%
Russell 2000 Value	2.1%	7.8%
Russell 2000 Cons Disc	7.8%	16.1%
Russell 2000 Cons Stap	7.3%	3.9%
Russell 2000 Energy	6.8%	-18.3%
Russell 2000 Financial	1.6%	6.4%
Russell 2000 HealthCare	2.6%	35.5%
Russell 2000 Industrial	6.3%	19.9%
Russell 2000 Info Tech	0.9%	16.8%
Russell 2000 Materials	4.0%	16.9%
Russell 2000 Telecom	-3.7%	5.1%
Russell 2000 Utilities	1.2%	14.6%

Total Return	4Q17	1 Year
S&P 500	6.6%	21.8%
MSCI AC World*	5.4%	19.8%
MSCI AC World Ex U.S.*	4.2%	18.2%
MSCI World (Developed)*	5.3%	18.5%
MSCI Emerging*	5.7%	30.6%
MSCI Dev. Europe*	1.3%	13.1%
MSCI Pacific Ex Japan*	7.1%	19.4%
MSCI Japan*	8.6%	19.8%
MSCI China*	7.7%	55.0%
USD/EURO	1.6%	14.1%
USD/U.K. £	0.9%	9.5%
USD/MSCI EM FX	1.8%	6.7%

* in local currency, net of tax withholding

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S&P Earnings Report Update (4Q 2017) by Chris Zogg, CFA
Corporate Taxes' Slippery Slope by Chris Zogg, CFA
The Complexities of Index Valuations by Rick Villars, CFA

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This year has been a prime example. Throughout most of the year, the economic and earnings momentum that started late last year continued. A broad-based, synchronized global expansion created a sweet spot for another leg up in the earnings cycle. It has been quite some time since economic growth was consistent across all major economies. U.S. companies benefited from that stronger nominal economic growth as well as a weaker U.S. dollar. That combination produced growth in sharp contrast to the last few years, as seen in Exhibit #1. Global nominal GDP in USD terms is on pace to rise greater than 5% this year and over 6% next year. That compares to an average of 0.7% in the previous five years.

Domestic activity is seeing its share of this acceleration. U.S. manufacturing activity saw a renaissance in 2017, while services built on past strength. The ISM manufacturing purchasing managers index averaged 57 this year compared to 51 last year, while the services index averaged 57 this year compared to 54 last. Anything over 50 signals expansion, but a reading of 57 is strong growth compared to a fairly tepid 51. Exhibit #2 at right even shows the manufacturing index slipping below 50 a couple of times in previous years. Reported economic data was better than expected early in the year then accelerated to the upside later in the year. In fact, the Citi Economic Surprise index, which tracks positive and negative surprises, ended at a high for the year in the top 1% of all historical readings. Data is painting a picture of broadly accelerating economic activity.

Against that backdrop earnings have seen good momentum. Earnings diffusion, the ratio of positive to negative revisions of earnings estimates for the next fiscal year, has been above average for 42 of the last 52 weeks, and 24 of the last 26. This resulted in an upturn to 2018 expectations in September, as seen in Exhibit #3. Expectations for this year saw a similar change and 2017 now looks poised to deliver earnings close to what was expected at the beginning of the year. As the graph illustrates, the norm is for expectations to persistently fall over time. Over the last twenty years there are only six, 2003-2006 and 2010-2011, that have experienced rising expectations. Generally, rising expectations are reserved for a few years following recessions. Given the mini earnings recession we had in 2015/2016, maybe this improving pattern is not that unusual. It does however, help explain the strength in stock prices.

S&P earnings are currently on pace to rise about 11% this year and prior to the tax bill were expected to rise about an equal amount in 2018. After a couple of years of very little growth this feels like a welcome respite for investors. For the first time in five years accelerating sales are a significant contributor to a rising bottom line. Exhibit #4 shows the power of the upturn in sales momentum during the last twelve months. Sales are on track to be about 6% better than last year, then close to that rate again in 2018.

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Exhibit #1: Global GDP's Impact on Domestic Earnings
Nominal Global GDP Growth in US$

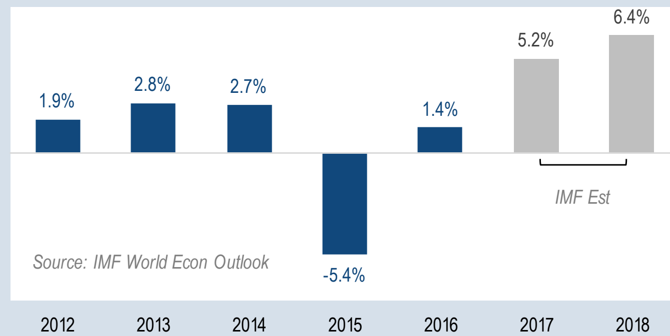


Exhibit #2: ISM Surveys
over 50 expansion, under 50 contraction

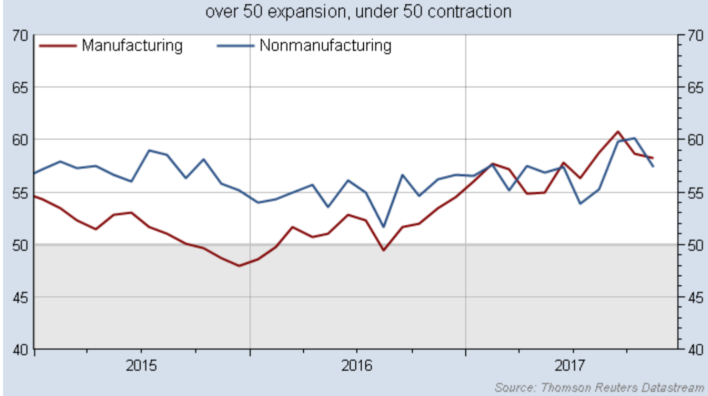


Exhibit #3: S&P 500 Consensus 2018 EPS Revision Pattern
vs. Historical Revision Pattern

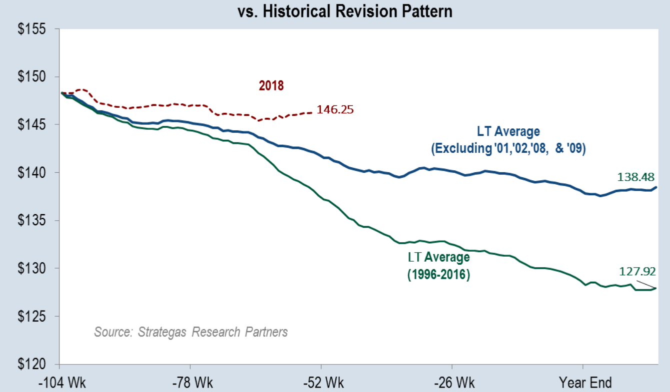


Exhibit #4: S&P 500 Trailing Sales
YOY % change

That compares to an average of less than 2% for the previous four years. We are always encouraged about the sustainability of earnings growth when it is driven by rising sales instead of expanding margins.

Clearly, there have been fundamental underpinnings to the market rally in 2017. But with S&P earnings up about 11% and the price of the index up around 20% one could easily come to the conclusion that the rally was overdone. The number of new highs in large cap indices this year was a record. High valuations, the lack of a meaningful correction in over a year, low levels of cash in portfolios, and extraordinarily low volatility add to the cocktail of things that should give us food for thought as we contemplate the year ahead.

A contrarian would point to the potential peak of some indicators. With the economic surprise index in the top 1% of historic readings it is poised to fall. In order to stay at this level economic data would have to continue to surprise at the same extraordinary rate as it has in the past three months. Since economists eventually adjust their expectations higher the bar gets increasingly hard to beat. The same applies to equity analysts that raise expectations making it harder for companies to report a beat. Similarly, the purchasing managers indices are calculated by a survey where managers reply that business activity is getting better, worse, or the same as last month. The latest reading needs to be getting better at the same frequency just to stay even. The current manufacturing survey reading is in the top 20% historically and has fallen the last two months. These momentum indicators tend to support stock prices when they are rising. When they peak and begin to fall that support is removed. While it does not always result in lower stock prices, it does mean that other drivers have to offset the lack of momentum support.

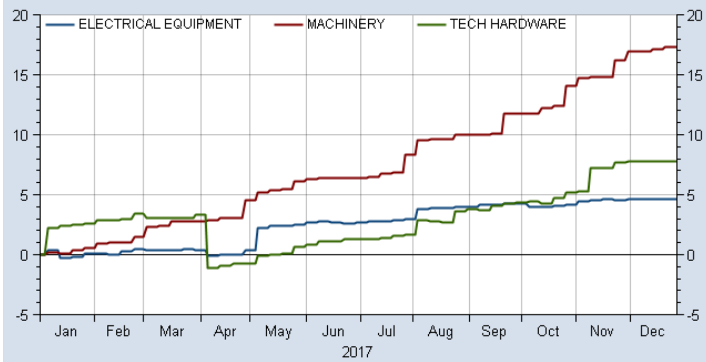
A new driver that could help support prices, and for that matter economic and earnings momentum, is the passage of the U.S. tax plan. How much of the benefit to earnings is already factored into the market is a subject of great debate. Given the move in the market in excess of earnings growth one would contend that current market prices reflect at least some of the tax code revisions. But that is an oversimplification because the tax code is quite complex, with benefits unevenly spread across businesses and individuals. In addition, the legislation was also passed in record time, which tends to result in a variety of unintended consequences.

One area that appears ripe to benefit from revisions to the tax code is capital expenditures and in turn the earnings of capital goods companies. Even without tax-driven factors the ingredients for an uptick are in place. First, rising sales and earnings are important. Capital intensive companies with rising sales need more production capacity and rising earnings give them a ready financing source. Management confidence is also on the rise, leading to plans to increase capital spending, and rising new orders for capital equipment. Exhibit #5 shows this was all in motion even before the tax bill. Now add to that 100% expensing for capital expenditures, lower tax rates freeing up cash for investment, plus repatriation of offshore cash hoards. As such, many of the building blocks are in place for further strength in capital investment. Exhibit #6 shows that momentum is already picking up in sales for capital expenditure intensive industries. We expect that to continue. The strength and breadth of the global expansion is a prime condition for these industries and changes to the tax code will likely provide further fuel for growth.

Exhibit 5: CEO Survey & CAPEX Orders

Source: Thomson Reuters Datastream, Business Roundtable

Exhibit #6: S&P 500 2018 Industry Sales Expectations
Rebased to Dec-16



Source: Thomson Reuters Datastream

The economic expansion, while long in the tooth, does not appear to be close to an end. Stimulus is apt to give activity a boost. But ironically, the fiscal stimulus added so late in the cycle may hasten the end of it. In fact, the objective of the stimulus is to increase job growth at a time when parts of the labor market are already tight, increase production when capacity utilization in some industries is tightening, and boost wage growth. Economic theory would imply these forces should lead to inflationary pressures. If inflation picks up the Fed may get more aggressive about monetary policy, which is generally the precursor to the end of an economic cycle.

Any time there is a significant structural change like the tax bill there is a rotation within markets as investors sort out the winners and losers. The

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overall stimulus probably means an upward bias to stock prices. But we worry about the sustainability of the broad level of optimism across business, consumers, and investors. Consumer confidence readings are in the top 14% of all time and the current institutional sentiment bull/bear ratio is in the top 3% of historic readings. While the individual investor bull/bear ratio is less extreme, it is still in the top 20% of historic readings. Couple that with high stock valuations, rising interest rates, inflationary pressures, lack of a meaningful correction, very low volatility, and a general complacency about events that could cause economic disruption and there is plenty to worry about. While the market bias is still likely to be upward, we believe these factors will result in more volatility in the year ahead.

Here at the Smith Group we do not believe market timing is a profitable activity for our strategies. But we are encouraged about the opportunities for stock selection due to structural changes, global economic momentum, and an environment less impacted by Federal Reserve policy. These changes will lead to business activity the has not been previously anticipated. In addition, Fed tightening will put pressure on companies that have survived mainly because of excess liquidity and low rates. In a rising rate environment, earnings quality will become more important and investors will increase differentiation between companies on that basis. We look forward to a new year.

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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