Smith Group
ASSET MANAGEMENT

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INVESTMENT TEAM

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

Not too Hot, Not too Cold, Just Right?

The market continued its slow, steady march higher in the second quarter with very little fanfare. As of June 28th, the return for the S&P 500 was +3.8% and for the Russell 2000 it was +3.2%. The largest drawdown for the S&P 500 was -1.9% over two days in mid-May but it recovered immediately over the next five days. The Russell 2000 small cap index suffered a bit wider -4.5% drawdown, but that is still quite modest compared to historic volatility in smaller companies and it was also recouped by early June. The CBOE Volatility Index hovered close to ten year lows for the whole quarter. On the surface it would appear that the market is in a goldilocks phase where the global economy and rising earnings are just strong enough to incrementally add to investor confidence.

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Due to the July 4th holiday we are publishing the quarter end Market Perspectives on June 30th.
All return data is as of June 28th.

Total Return to June 28	2Q17	1 Year
Russell 1000	3.8%	18.9%
Russell 1000 Growth	5.9%	21.8%
Russell 1000 Value	1.6%	15.9%
Russell 1000 Cons Disc	3.5%	19.1%
Russell 1000 Cons Stap	2.4%	9.1%
Russell 1000 Energy	-7.7%	-5.3%
Russell 1000 Financial	3.5%	33.4%
Russell 1000 HealthCare	8.3%	14.8%
Russell 1000 Industrial	4.4%	22.3%
Russell 1000 Info Tech	6.3%	35.7%
Russell 1000 Materials	3.8%	20.3%
Russell 1000 Telecom	-6.4%	-9.1%
Russell 1000 Utilities	3.1%	3.7%

Total Return to June 28	2Q17	1 Year
Russell 2000	3.2%	25.5%
Russell 2000 Growth	5.5%	25.7%
Russell 2000 Value	1.0%	25.3%
Russell 2000 Cons Disc	3.0%	16.6%
Russell 2000 Cons Stap	-3.9%	3.3%
Russell 2000 Energy	-21.2%	-8.5%
Russell 2000 Financial	0.7%	32.4%
Russell 2000 HealthCare	10.1%	32.2%
Russell 2000 Industrial	2.5%	27.3%
Russell 2000 Info Tech	6.3%	37.6%
Russell 2000 Materials	-0.5%	31.6%
Russell 2000 Telecom	16.4%	11.7%
Russell 2000 Utilities	4.0%	8.8%

Total Return to June 28	2Q17	1 Year
S&P 500	3.8%	18.7%
MSCI AC World*	3.9%	20.1%
MSCI AC World Ex U.S.*	4.2%	22.4%
MSCI World (Developed)*	3.6%	19.9%
MSCI Emerging*	6.5%	19.3%
MSCI Dev. Europe*	3.6%	22.4%
MSCI Pacific Ex Japan*	1.4%	18.0%
MSCI Japan*	6.3%	30.8%
MSCI China*	11.5%	33.5%
USD/EURO	6.8%	2.5%
USD/U.K. £	3.0%	-2.9%
USD/MSCI EM FX	-0.2%	4.6%

* in local currency, net of tax withholding

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A Trump Economy by Rick Villars, CFA

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Yet scratch below the surface and the environment is hardly benign. In reality there have been some stocks in a steep tailspin and others reaching spectacular new highs.

Many investors are lamenting the lack of a buyable market dip and are determined that as soon as that happens they will be putting cash to work. At a more granular level, there have been many buyable dips. Year-to-date, of the 62 S&P 500 GICS industries, 23 of them have traded at least -10% below their previous 12-month high at some point. About two-thirds of them have had a -5% correction. Many of these industries have gone on to recover to new 12-month highs (Exhibit #1).

In some respects the rising market is supported by the underlying earnings story. After two years of flat earnings in 2015 and 2016, earnings are finally expected to grow double digits in both 2017 and 2018. Exhibit #2 shows the trend of expectations for S&P 500 earnings for each fiscal year. Expectations in 2015 and 2016 suffered quite substantial downward revisions, but then mostly flattened in the final months of each year. The downward slopes for 2017 and 2018 have been less steep and are looking more likely to achieve a result closer to current expectations than has been the case the last couple of years. Most of the time the trend is downward. Exhibit #3 shows the trajectory of 2017 and 2018 earnings expectations relative to average, best, and worst years. Both of them are trending modestly above the average at this point.

This positive earnings momentum is further reflected in Exhibit #4, which shows its breadth. The ratio of positive to negative earnings revisions for both this year and next was in positive territory for all of the second quarter. This is fairly rare. It has only happened in six other quarters since 1996. Those were during the 2003-2004 and 2009-2010 ranges, then one quarter in 2011. If you look at the trajectory of the estimate revisions in Exhibit #2 you will see that in each case those were periods where expectations were sustainably rising. So have we entered a goldilocks period for earnings? Overall aggregate price movement and the revision ratio would imply that it is.

However, the wide disparity of market performance between industries should give us some pause in examining

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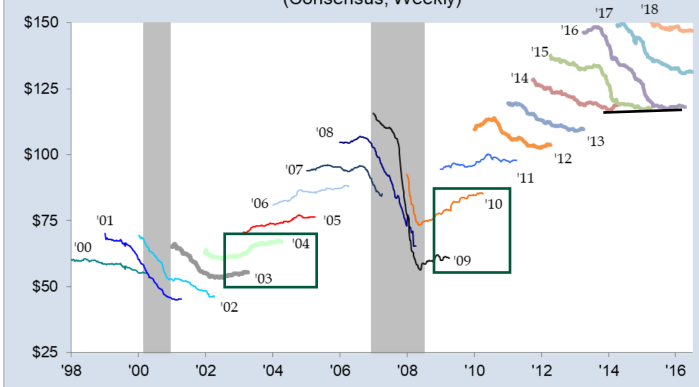
** diffusion is the number of positive analyst revisions minus negative revisions during the last 30 days divided by the number of estimates.*

Exhibit #1: Industries with a -5% correction during the first half, but recovering to new 12-month highs

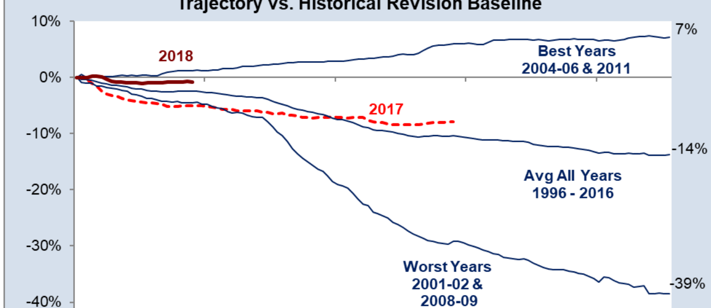
Airlines	Household Durables
Auto Components	Household Products
Beverages	Internet Retail
Biotechnology	Internet Software & Services
Capital Mkts	Life Science Tools & Services
Containers & Packaging	Road and Rail
Electric Utilities	Tobacco
Health Care Equipment	

Exhibit #2: S&P 500 Annual Earnings Estimates
(Consensus; Weekly)



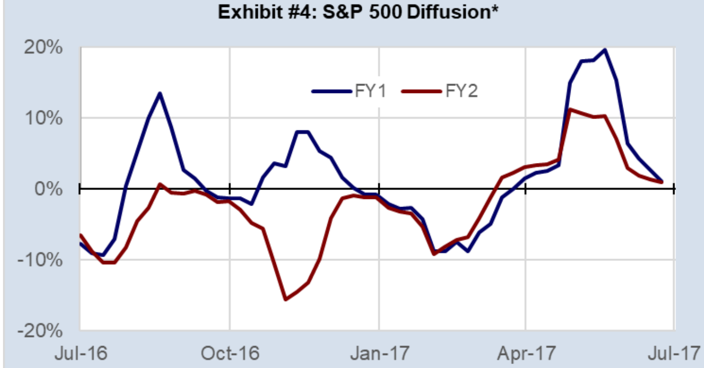
Source: Strategas Research Partners

Exhibit #3: S&P 500 Consensus 2017 & 2018 EPS Estimate Trajectory vs. Historical Revision Baseline



Source: Strategas Research Partners with Smith Calculations

Exhibit #4: S&P 500 Diffusion*



Source: Smith Group Asset Management

that question. Significant industries like Life Sciences, Airlines, and Internet Software & Services had positive returns in the double digits for the quarter, while Energy Equipment and Multiline Retail were significantly negative. Some of that discrepancy can be linked to earnings momentum.

Ironically, the hardest hit stocks during the quarter, Energy Equipment, are expected to grow the fastest. Their earnings are snapping back due to the ramp up in production after the deep dip in oil prices last year ground activity to a virtual stand still. The recovery is currently expected to deliver a 31% increase in sales and a 341% jump in earnings in 2017. But the industry also suffered the biggest downward revision to those earnings expectations during the quarter, slipping -16%. This was driven by a drop in the price of oil from $50/barrel to $44/barrel. This -15% drop is expected to dampen activity in some of the higher cost regions, which will mute the expected earnings recovery.

Multiline Retail on the other hand is expected to be one of the few industries to suffer declining earnings in the next twelve months. In fact, earnings growth expectations are pretty muted across all of retail except for Internet Retail, which is expected to increase earnings +24% this year and +40% next. That is the highest expected combined 2017/2018 growth rate of an industry not in the Materials or Energy sector, which have benefitted from rising commodity prices. With Amazon leading the way, internet shopping has accelerated and old retail business models are suffering.

The other pocket of earnings weakness is in automobile production, where sales and earnings are both expected to decline this year. These expectations were revised lower during the quarter as car sales data continued to weaken. There is finally analyst discussion about peak auto sales. It appears that the tactic of automakers pulling sales forward using easy credit and extending loan maturities may have finally reached its limit. Automobile components in contrast are expected to have reasonable growth.

We admit to being a bit concerned about the composition of the S&P 500 2017 earnings recovery. It is very dependent on the recovery in commodity prices in the resource sectors, Energy & Materials. While earnings are also getting a boost from some Information Technology industries, the rest of the index is mostly on target to grow less than 10%. In fact, 72% of S&P 500 industries are expected to grow

Exhibit # 5: Expected Earnings Growth Select Industries

	2017	2018
Energy Equip & Services	+341%	+134%
Oil & Gas	+371%	+36%
Metals & Mining	+103%	+16%
Construction Materials	+33%	+31%
Semiconductors	+29%	+7%
Internet Retail	+24%	+40%
Banks	+9%	+14%
Biotechnology	-3%	+8%
Multiline Retail	-3%	0%
Airlines	-5%	+15%
Automobiles	-6%	+2%

Source: Thomson Reuters IBES

earnings by less than the 10% that the aggregate index is expected to deliver. This is especially worrying considering the recent weakness in oil and some industrial materials prices. But looking out to 2018 expected earnings growth broadens out. Next year resource and internet related businesses are still the growth leaders, but there is a better balance of industries expected to grow earnings at least by than the 12% expected for the aggregate index. It also gives us comfort that 63% of industries saw positive revisions for 2018 earnings in the last three months, indicating good momentum. Financial industries, which are a large component of aggregate earnings, are also expected to grow nicely in 2018, Select consumer and capital spending related industries are also looking better in 2018. Retailing and automakers are still expected to struggle next year (see Exhibit #5 above right).

If we were a meteorologist describing the earnings picture as weather we would probably use the phrase 'scattered thunderstorms'. While some industries are enjoying nice tail winds, others are suffering from isolated storms. There are secular changes at play that are benefiting some industries at the expense of others. The shift in where consumers spend their money is one, while shifts in the supply and demand of resources is another. The aggregate earnings picture may look calm and steady on the surface, but underneath there is considerable variance in growth dynamics.

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While day-to-day market fluctuations continue to be driven by headlines and tweets, the trend of the market appears to be connected to momentum in earnings and the economy. In this regard the evidence is mixed, which is consistent with the narrow trading range. Earnings revision ratios for both 2017 and 2018 are positive (see exhibit #4 on page 2) indicating the earnings outlook is improving. This is supportive of stock prices. On the other hand, the economic momentum that supported the initial market surge late last year and early this year has abated (see the solid blue line in Exhibit #6). A negative Citi Economic Surprise Indicator (CESI) implies that economic expectations were too optimistic and actual reports are falling short of those expectations. Historically, that has weighed on stock prices. This is somewhat offset by better than expected economic data outside of the U.S., including positive CESI readings for Europe, Japan, and Emerging Markets. After all, a large portion of S&P 500 earnings are driven by overseas profits. With this conflicting data there is a tug-of-war on stock prices consistent with the modest, narrow positive slope. Absent any game changing fiscal policy action or a complete meltdown in oil prices the market could very well mark time without a large move up or down. Of course, the inputs that drive stock prices have never been static and we do not expect this time to be different. We fully expect future events to create some movement, however those events are hard to predict.

Longer term, we believe the global economic drivers are on balance positive. While the way forward for the U.K. is even more cloudy, the political winds in Europe have settled a bit with the defeat of the nationalist movements in the Netherlands and France. There is even some hope of structural reform in France. Confidence in the U.S. is still quite positive despite unsettled political activities. Once again, the global economy seems to be finding ways to grow despite politics, instead of because of politics.

Against this backdrop the market may suffer some setbacks, but is apt to continue its upward bias until the Fed gets aggressive about tightening credit. So far they have eased off the accelerator, but have not really even applied the brakes. Our new advisory board member and SMU professor, Harvey Rosenblum, recently pointed out the Fed's dilemma through some work done by the Dallas Fed (which happens to be his former employer). Exhibit #7 highlights that while nationally employment statistics may seem robust, the situation across the various Fed districts is quite disparate. The Dallas and San Francisco districts have seen strong employment growth, but employment in the Cleveland, Philadelphia, Chicago, and St Louis districts is barely higher than it was ten years ago. How can the Fed aggressively tighten policy when a large swath of American workers are still in such stress? That stress has also served to keep a cap on wage growth, which historically has been a trigger for when the Fed begins to seriously worry about inflation. In addition, those districts were strong supporters of President Trump, who will be appointing new Fed Governors in the months ahead. Given all that is at play, we do not believe the Fed is on the verge of aggressive tightening. Since recessions are almost always associated with aggressive Fed tightening, and bear markets are almost always linked to recessions in some way, a full blown bear market could still be delayed to sometime in the distant future.

Exhibit #6: Citi Economic Surprise Indices

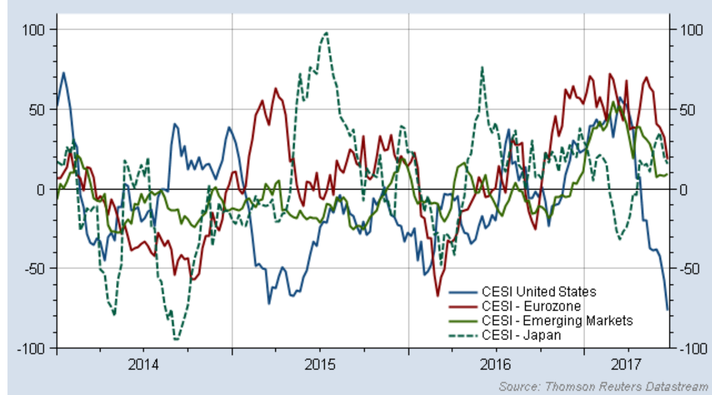
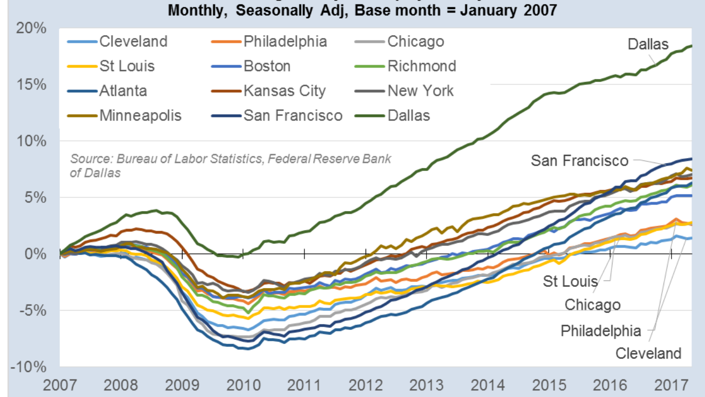


Exhibit #7: Change in Payroll Employment by Fed District
Monthly, Seasonally Adj, Base month = January 2007



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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