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What Happened to the Summer Swoon

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With the exception of a short lived BREXIT dip and some volatility in September, the summer was a quiet affair with an upward bias. For the quarter, the S&P 500 returned 3.9% and the Russell 2000 delivered a more robust 9.0%. This occurred during an earnings reporting period that marked the fifth straight drop from the year ago quarter and projections are for another negative quarter in the next reporting season. So what gives?

Digging below the surface there were several factors that supported a rising market. First, while last quarter's aggregate earnings were down, the median S&P 500 company reported a +6.5% rise in earnings per share versus the same quarter last year. The bulk

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Total Return	3Q16	1 Year
Russell 1000	4.0%	14.9%
Russell 1000 Growth	4.6%	13.8%
Russell 1000 Value	3.5%	16.2%
Russell 1000 Cons Disc	3.4%	9.3%
Russell 1000 Cons Stap	-2.6%	15.5%
Russell 1000 Energy	2.7%	17.4%
Russell 1000 Financial	4.3%	8.2%
Russell 1000 HealthCare	1.6%	10.2%
Russell 1000 Industrial	4.1%	18.6%
Russell 1000 Info Tech	12.6%	21.8%
Russell 1000 Materials	4.2%	23.6%
Russell 1000 Telecom	-4.7%	26.1%
Russell 1000 Utilities	-5.7%	18.5%

Total Return	3Q16	1 Year
Russell 2000	9.0%	15.5%
Russell 2000 Growth	9.2%	12.1%
Russell 2000 Value	8.9%	18.8%
Russell 2000 Cons Disc	3.8%	1.3%
Russell 2000 Cons Stap	2.3%	18.7%
Russell 2000 Energy	10.4%	0.4%
Russell 2000 Financial	8.2%	16.5%
Russell 2000 HealthCare	13.5%	8.2%
Russell 2000 Industrial	9.2%	20.5%
Russell 2000 Info Tech	16.3%	25.8%
Russell 2000 Materials	12.2%	37.0%
Russell 2000 Telecom	-6.9%	16.9%
Russell 2000 Utilities	-5.1%	24.1%

Total Return	3Q16	1 Year
S&P 500	3.9%	15.4%
MSCI AC World*	5.1%	10.8%
MSCI AC World Ex U.S.*	6.4%	6.9%
MSCI World (Developed)*	4.8%	10.5%
MSCI Emerging*	7.6%	13.0%
MSCI Dev. Europe*	5.7%	7.0%
MSCI Pacific Ex Japan*	6.5%	13.3%
MSCI Japan*	7.2%	-5.2%
MSCI China*	13.9%	13.1%
USD/EURO	1.2%	0.5%
USD/U.K. £	-2.5%	-14.3%
USD/MSCI EM FX	1.4%	3.8%

* in local currency, net of tax withholding

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of the aggregate drop in earnings was due to a dip in Energy profits, where the median company saw a -76% haircut. So the typical company had better earnings support during the reporting season than is commonly recognized. Exhibit #1 shows 2016 median expected earnings growth for S&P 500 companies of +6.4% and a positive expected result for seven of eleven sectors. Two of them are expected to have a 2016 median in excess of 10%. Quite a contrast to the lack of growth currently reflected in 2016 aggregate earnings expectations.

A better earnings revision pattern was also somewhat supportive. The diffusion* index for S&P 500 next year earnings (FY2) shown in exhibit #2 has been hovering around the long-term average this summer after being stuck below average from the fall of 2014 to the spring of 2016. This less frequent incidence of downward revisions served as a release from the negative pressure earnings and the market have been swimming against for quite some time. That improvement was also confirmed by similar revision experiences to sales forecasts as well as in small cap companies.

Finally, the market was supported by a strong patch of economic data in July and August. This surprised economists as indicated in exhibit #3. The first real positive surprise they have had since the beginning of 2015. Periods of improving economic momentum are generally good times to own stocks as more optimistic economic outcomes are assumed to translate into better earnings. However, that strong patch lost some steam in September and the economy has been less of a positive driver of late.

We are entering the time of year when investors shift focus from what is happening in the current year to what is expected to happen next year. That is probably a good thing because 2016 is shaping up to be the second year in a row with little or no aggregate earnings growth. The current expected growth for 2016 is -0.1% and for 2017 aggregate earnings are expected to increase +13.8%. On the surface this would seem to provide some light at the end of the

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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.*

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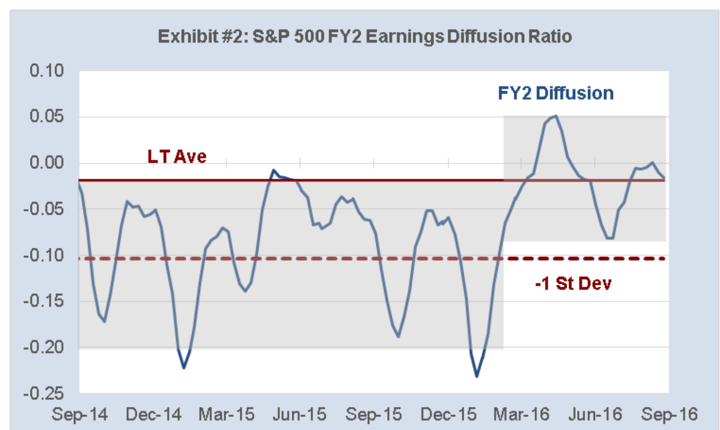
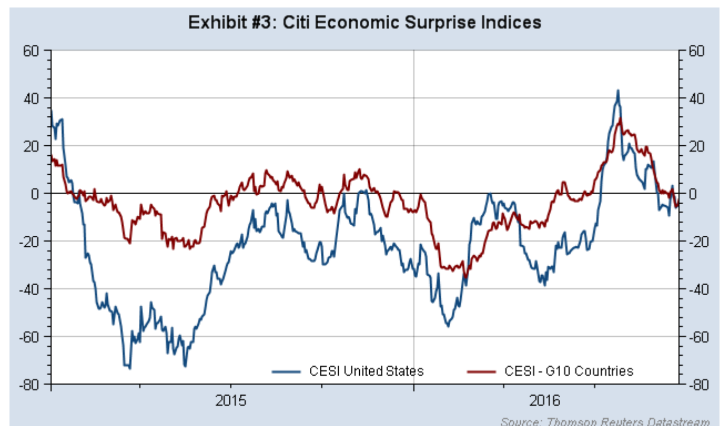
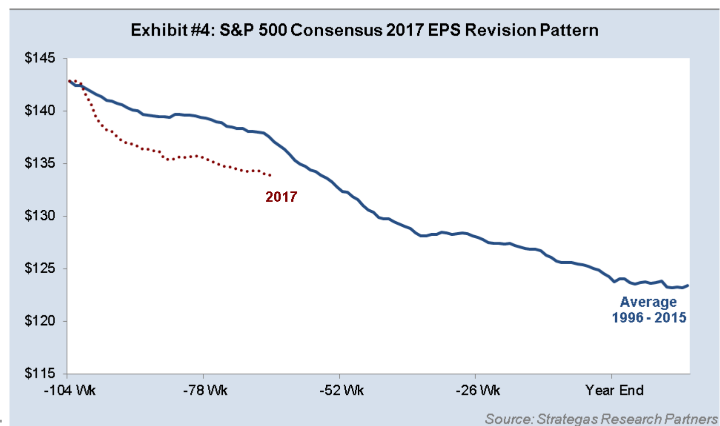
Exhibit #1 Median Expected EPS Growth;	2016	2017
S&P 500	**6.4%**	**10.1%**
Consumer Discretionary	11.2%	10.8%
Consumer Staples	5.8%	9.1%
Energy	-66.7%	83.1%
Financials	2.5%	11.2%
Health Care	10.1%	11.1%
Industrials	5.6%	8.1%
Info Tech	9.8%	10.8%
Materials	1.7%	11.2%
Real Estate	-2.3%	5.1%
Telecom	-2.5%	3.6%
Utilities	4.7%	5.4%

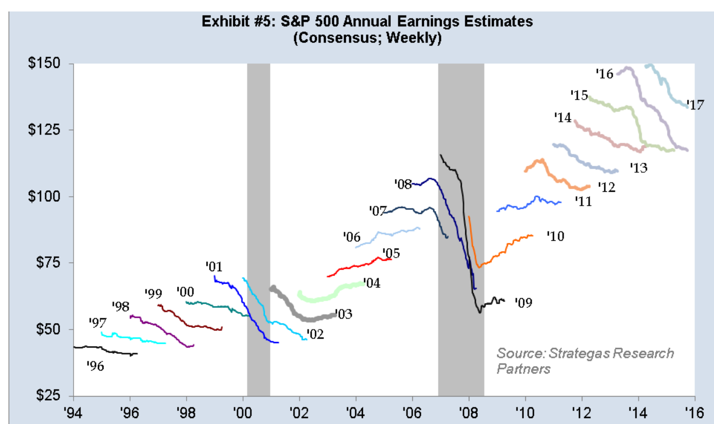




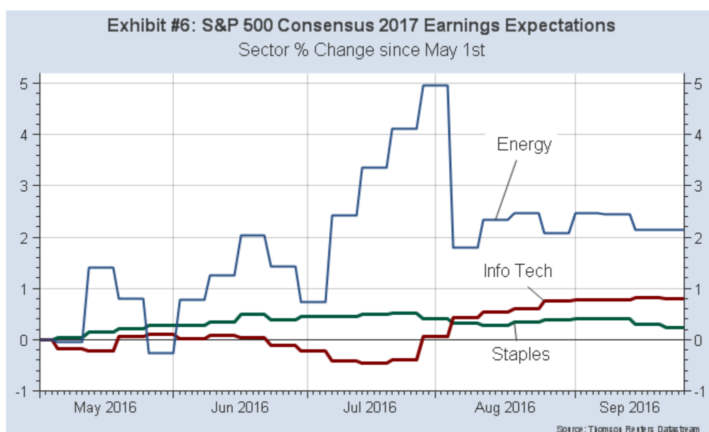


tunnel with a solid double digit increase next year. But as exhibit #4 shows consensus estimates are on average revised down over time. In fact, on average the consensus estimate for a period ending 12 months in the future will be revised lower by -10.2% over that period. That would negate the majority of current earnings growth expected in 2017. So solid earnings growth looking out to next year is not a forgone conclusion at this point if history is repeated.

But there are reasons to believe 2017 earnings may be more resilient relative to consensus than the average. Exhibit #5 shows there are only two historic instances since 1996 of negative or low S&P 500 earnings growth outside of a recession, in both cases the following years did not experience as steep of a downward trajectory and ended with quite robust annual increases. In the first instance, 1998 earnings fell short of 1997 by -10%, but rebounded +17% in 1999. Revisions in 1999 were modest and actual earnings ended only -2% lower than consensus at the beginning of the year. In the second instance, 2002 earnings were up a modest +2% over 2001, then were followed by +18% growth in 2003. During 2003 consensus actually rose in the second half of the year and actual earnings ended +1% higher than consensus at the beginning of year. This experience would be in direct contrast to the negative average slope. Also note the wide variety of shapes and slopes of the progression of consensus estimates over the course of each year. As is often the case with averages, few of the individual years mirror the average making it an inexact predictor.



Examining exhibit #5 it is apparent stock analysts have periods of pessimism and optimism. Analysts that make up the consensus are by nature an optimistic bunch and start the majority of years expecting companies to do great things. Then those great expectations have to be modified as reality becomes more apparent. But after an extended period of disappointing earnings growth that also may have involved multiple large downward revisions that optimism can turn quite negative. The result in those cases are consensus expectations at the beginning of the period that are either closer to the final earnings outcome or in some cases in need of upward revision. Presently, analysts have now lived through two years of no growth and both 2015 and 2016 saw larger than average downward revisions. The current trend of 2017 aggregate earnings estimates has been worse than normal. It would be understandable if analysts had become quite conservative in their estimates at this point. Assuming that is the case the current +13.8% growth estimate for 2017 might be nearer to the mark than would be inferred by the average revision pattern.



In addition, the two main drivers of negative revisions, dropping oil prices and the rising U.S. dollar, have largely stabilized.

Some of the sectors seeing recent positive earnings expectation momentum are shown in exhibit #6. Earnings for Consumer Staples companies have had modest positive momentum for most of the year. Much of this is driven by improvement in the packaged foods industry as noted last quarter. Energy earnings expectations are readjusting after the January drop in oil prices partially reversed and have

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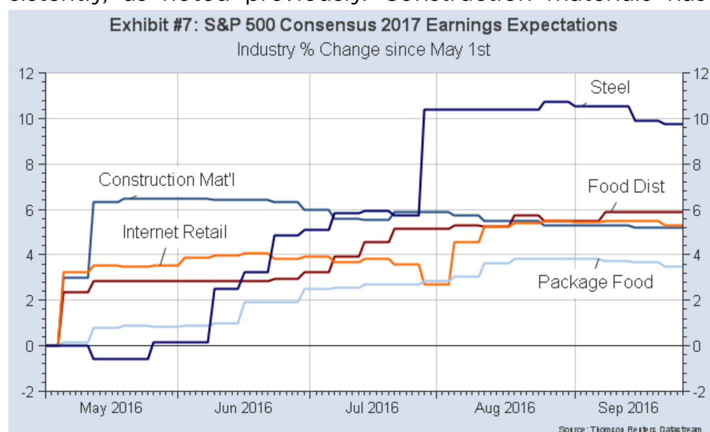
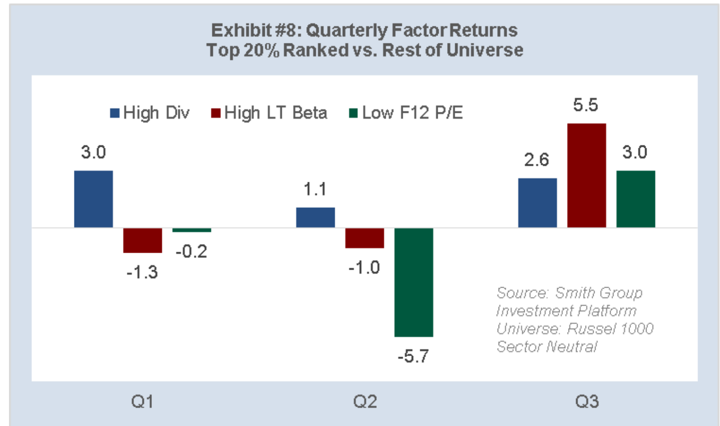
found equilibrium around the $45/barrel range. The steep drop in prices had been a primary driver of negative adjustments to sector earnings expectations over the last 18 months. With such an extended, dramatic period of negative adjustments, industry analysts could be forgiven for feeling quite pessimistic in the second quarter about any improvements in the oil patch. So this period of positive readjustment is likely a natural occurrence after many thought the oil industry was on life support not that long ago. The final sector with some positive momentum is Information Technology.

Digging deeper to the industry level reveals some interesting dynamics. Exhibit #7 highlights five areas that have experienced rising expectations for next year over the last five months. The largest revision is at first surprising since it is an industry suffering from global overcapacity. But steel pricing has recovered of late and expectations had become very pessimistic. As often happens when an industry shows a little pricing power after being all but dead, the beginning of the recovery is the sharpest. Expectations for food distribution and package food producers have been rising consistently, as noted previously. Construction materials has



emerged as a stalwart in the materials sector as the outlook for homebuilding and potential infrastructure projects takes shape. Finally, internet retailing continues to take market share away from traditional retailers.

Investors have been attracted to high dividend paying stocks for most of the year without regard to much else. In the first half of the year they were happy to chase a dividend yield with little regard for growth prospects or valuation. Exhibit #8 show that in the third quarter dividends were still important, but investors began to pay attention to



a stock's valuation as part of the buying decision. Investors also were attracted to higher Beta stocks with a rising market. We are encouraged that the focus seems to be shifting from a one dimensional yield play, to a broader set of fundamentals.

As noted in our research perspectives piece, The Complexities of Index Valuations (see the research tab at www.smithasset.com), current aggregate valuations make us uncomfortable. But the ineffectiveness of valuation as a historical decision tool for calling the direction of the market, coupled with dramatic differences in composition of the index between today and history helps to settle our stomach a bit. We still believe prices of segments of the market, like high dividend paying stocks, are quite inflated compared to history. But also recognize there are segments that are also quite reasonable.

Ultimately, we believe that earnings growth will drive stock prices in the next twelve months. Valuations seems to reflect a belief in double digit earnings growth next year. There is reason to believe that companies may deliver that growth. While projecting a raging bull market in the year ahead is not justified, a year of modest earnings growth and an upward bias for stock prices would not be a surprise.

For stock pickers, median growth expectations are a much better indication of the opportunity set, and there appears to be plenty of opportunity (see table on page 2). As always our focus on finding companies growing faster than expectations helps us to avoid those companies most likely to experience a falling outlook and own those with rising potential.

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