MARKET PERSPECTIVE

JANUARY, 2018

"Even without excessive media attention, large market movements encourage buy and sell decisions that are based on emotion rather than on logic"

Burton Malkiel, *A Random Walk Down Wall Street,* 2015

IN FOCUS:

This recent market corrective period reminds us that many investors will often succumb to self-destructive behavior, when overreacting to the severity of market declines. Despite the recent pickup in market volatility, we remain bullish because the fundamental outlook for earnings continues to be very upbeat. Industry analysts have raised their consensus S&P 500 earnings estimate for 2018, over the past several weeks, by $9.00 per share to $155/share. That's mostly on guidance provided by managements, during January's Q4-2017 earnings season, reflecting the very positive impact of the corporate tax cut enacted late last year. The actual Q1 earnings season is still ahead of us and we expect that corporations are likely to report that the weak dollar will boost their earnings as well.

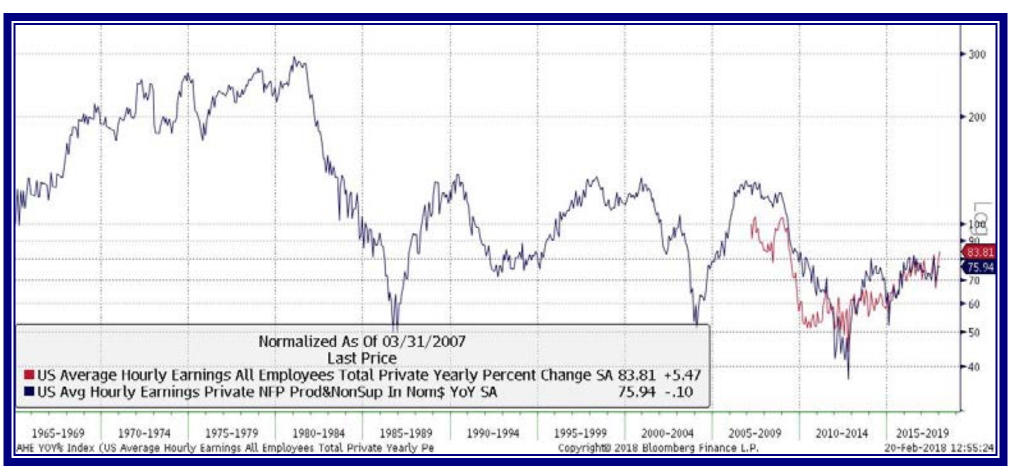
It's worth noting that the sharp decline in stock prices, as February unfolded, was not about corporate earnings. Rather, the fear was that wage inflation is making a comeback and that the Fed will respond with more aggressive monetary tightening. Initially, we would expect that higher inflation and rising interest rates could depress valuation multiples, as tighter monetary response could cause a recession by tightening credit conditions or indirectly by triggering a financial crisis.

Wage inflation may finally be picking up, but not by much. Shortly after she was appointed Fed Chairwoman four years ago, Janet Yellen said she expected that the Fed's easy monetary policies would boost wage inflation from around 2.5% to 3.0%-4.0%. It just may reach that zone now that she has left the Fed, and markets may have overreacted to any evidence of rising wages.

Recent average hourly earnings for all workers rose 2.9% y/y through January, the highest change since June 2009. However, wages for production and nonsupervisory workers (82% of all private sector payroll employment) saw slower growth, up 2.4%, which is roughly where it has been for the past few years.

Exhibit I

Average Hourly Earnings Growth



CLOSE-UP: The Economic Landscape

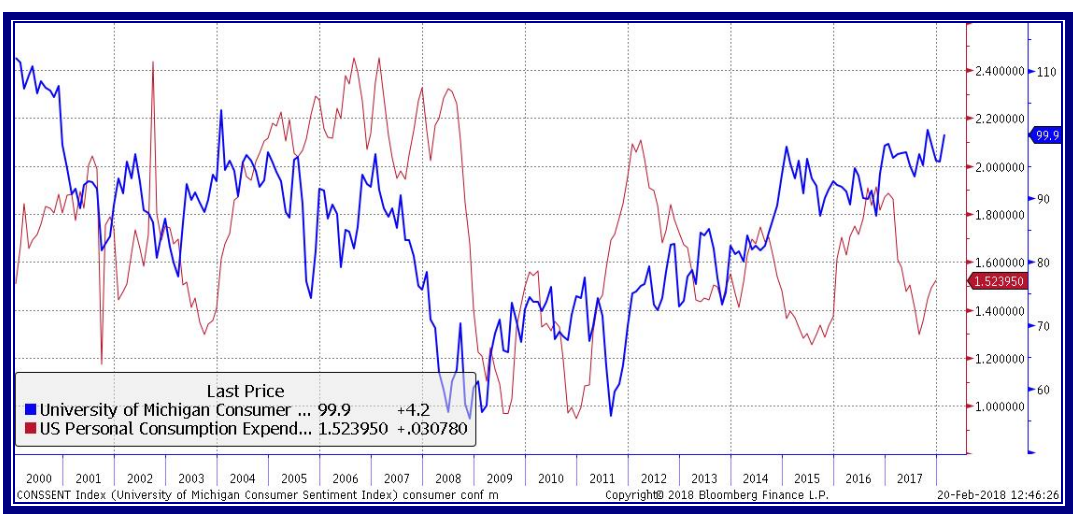
The U.S. economy in early 2017 had a weak start at 1.2% real GDP growth in the first quarter, but then began accelerating to 3.1% and 3.2% in the second and third quarters, and settling at our expectation of 3.0% or more in the fourth quarter. The Bureau of Economic Analysis announced its first estimate of fourth quarter and 2017 annualized GDP growth was 2.6%. We believe that with the passage of the Tax Cuts and Jobs Act in December, it might have the effect of helping achieve better than 3.0% economic growth in 2018. This forecast of accelerating economic growth from the weak trend of 2.1% established over the past eight and a half years has been endorsed as the "new normal" by the majority of economists.

The underlying causes for the recent improvement in economic statistics include a significant reduction in regulations brought about by our new administration - a noteworthy gain in individual and corporate sentiment that resulted in higher consumption and an advance in capital investment. Keep in mind that the improvement in many foreign economies, after a lagged recovery from The Great Recession, has been a significant contributor to the U.S. economy. Looking ahead, we believe that 2018 will bring even faster economic growth because of the new tax legislation, a program of infrastructure spending and continued strong economic growth from abroad. Also, with unemployment at 4.1%, wages should increase above their current 2.5% y/y rate. After nine years of relaxed monetary policy by the Federal Reserve, the new fiscal expansion will require tighter monetary policy in terms of higher interest rates and a continued shrinkage of the Central Bank's balance sheet, a program started in the fall. Normalization in the interest rate environment will prevent a higher inflation rate from current levels of about 2.0% in the future, in our view. Historically, the Federal Reserve's actions have tended to lag inflation.

As the chart below indicates, the University of Michigan Consumer Sentiment rose in February with a year/year gain of 3.7%. Favorable references were made towards governmental policy in contrast to negative references to recent market volatility. The survey reflected outlooks for improved economic conditions, although higher interest rates are on the radar as well. Drivers of higher sentiment are stemming from higher anticipated wages and job security. While the momentum appears to be continuing, the souce of energy has shifted somewhat from prior currents of lower prices and lower rates.

<u>Exhibit II</u>

University of Michigan Sentiment Index vs Personal Consumption



Source: Bloomberg

In terms of current business conditions, they could hardly get better. New home sales increased 17.5% in November to an annual rate of 733,000, the highest level since July, 2007. Existing home sales increased 5.6% y/y in November to a 5.8 million level, the highest in a decade. The boom in housing has led to record low inventory levels, and the only restraint is the lack of available workers to build new homes and the record high prices that is making renting relatively more affordable. Employment, in terms of nonfarm payrolls, increased by 228,000 in November, with unemployment falling to a new low at 4.1%. Retail sales advanced 0.8% in November and are up 5.8% y/y. Auto sales were up 6.3% y/y, building materials by 10.7% y/y and gasoline sales up by 12.2% y/y. Industrial production rose 0.2% in November and is up 3.4% y/y. The leading indicators at present are up 5.0% and productivity in the third quarter increased by 3.0% (an annual rate) after being flat in 2016. The main concern currently is over-confidence, suggested by the falling consumer savings rate that has been in a steady decline all year from 6.0% to 2.9% in November. The falling savings rate has partially financed consumption this year. It fell to a negative level just before the financial crisis of 2008-9.

Our forecast for 2018 primarily incorporates faster economic growth, higher inflation, and significantly higher corporate profits largely based on the new tax law. We are expecting 3.5% GDP growth, 2.7% CPI inflation, and corporate profits gain of 15%. In terms of the S&P 500 Stock Index, earnings would increase to $155 per share, versus our forecast of $130 per share in 2017. The main caveat would be considerably higher inflation leading to a potential recession.

A Note on Taxes:

Following is a summary of some of the key details of the Tax Cuts and Jobs Act. The corporate tax rate will be reduced from the statutory rate of 35% to 21%, while pass-through businesses (the majority of all businesses) will get a 25% reduction in the effective tax rate. Overall, the tax cut for businesses amounts to an estimated $1 trillion over the next decade. This implies that the S&P 500 corporations' tax bill will be lower by about $70 billion this year. Last year, they paid an estimated $280 billion in Federal corporate income taxes, according to Morgan Stanley Research.

The portion of individuals who currently pay no Federal tax will rise from 44% to 47.5% of households. For those who do pay taxes, the number of brackets will remain at seven, with the top rate going from 39.6% for married couples making $470,700 or more down to 37.0% for those making as much as $600,000 in the future. The child credit will rise from $1,000 to $2,000 for families making up to $400,000. For those families with children and not paying taxes, they will get a refundable credit of $1,400 from the government. The state and local tax deductions along with property taxes will be capped at $10,000. Mortgage interest loan deductions will be allowed for new loans up to $750,000 down from one $1 million. The standard deduction will double to $12,000 for single filers and to $24,000 for married couples. Estates will not be taxed up to $22 million for married couples, up from $11 million currently. These are just a few of the details from a massive tax over-haul, the first in 31 years.

Those individuals in high tax states, such as California, Connecticut, New Jersey and New York, could possibly pay higher taxes under the bill because of the $10,000 cap on state, local and property taxes. Individuals who pay the Alternative Minimum Tax (4.5 million taxpayers), and don't currently get these deductions, might fare better because the income level has been raised for the application of the tax. Overall, the new tax plan favors businesses directly, probably more than individuals, but to the extent that the country prospers, individuals should benefit indirectly. Certainly, lower business taxes should make the U.S. more competitive compared to foreign businesses and should lead to more investment in the U.S. Also, the approximately $2 trillion held abroad by corporations will lead to some repatriation of funds because of the lower corporate tax.

The Financial Markets:

The S&P 500 Stock Index and the Dow Jones Industrial Average finished the year up 21.8% and 28.1% respectively. Foreign markets also boomed in 2017 with Europe (FTS EuroFirst 300) up 26.1%, Japan (TOPIX) up 26.6%, Emerging markets (MSCI) up 37.3% and China rising by 16%. Since equity markets tend to be forward looking, the higher equity prices are projecting stronger economic growth ahead. However, there are always of course elements of speculation encompassed in equity prices - and so investors must carefully keep themselves informed of the economic and financial fundamentals while judging the merits of various investments. Currently, the S&P 500 Stock Index, hovering over 2700, sells at a P/E ratio of 20.6 and 17.9 times our 2017 and 2018 estimates of $130 and $150 per share. These P/E ratios would represent earnings yields of 4.5% and 5.6% respectively and would compare to the current yield on 10-year Treasury bonds of 2.5%. Historically, P/E ratios have been about 15 times the current year's earnings or 6.7% in terms of earnings yield.

One must keep in mind, however, that current interest rates are still exceptionally low, despite the Federal Reserve's recent moves to raise interest rates. Investing is all about alternatives, risk levels and therefore asset allocation. The Federal Reserve's December rate increase of 25 basis points resulted in the federal funds rate of 1.25 -1.50%. They also indicated that three more rate increases could occur in 2018 depending on the rate of inflation and other measures of the economy's health. The prime rate is currently 4.5% versus 3.75% a year ago. The Federal Reserve's preferred measure of inflation, the personal consumer expenditures index, is currently 1.5% twelve months through November. This index, excludes energy and food, and at present is lower than other measures of inflation such as the consumer price index (+2.2% y/y) and the producer price index (+3.1% y/y).

We should also mention that oil prices are at two-year highs with West Texas Crude at $58 per barrel and Brent Crude at $65 per barrel. As mentioned in past investment commentaries, energy is a major ingredient of inflation. In summary, we believe that inflation will increase from current levels in 2018 against the backdrop of a very strong economy - and that bonds accordingly will be at risk with the 10-year Treasury bond yield rising to 3.0% from 2.5% currently. Since equities are also at historically high levels, a fall in bond prices could have an impact on equities. Since the Great Recession, equity and bond prices have tended to be closely correlated.

LOOKING AHEAD TO 2018:

As we go forward, we are focusing our efforts on the underlying trend in earnings to gain a perspective on market valuations. The trend of the annual growth rate in S&P 500 reported earnings since 1935 has ranged between 5% and 7%, according to a Ned Davis study. However, we have given more weight to S&P 500 forward earnings, the time-weighted average of analysts' consensus earnings estimates for the current year and the coming year. It has fluctuated around a 7% trendline since the late 1970s, according to Yardeni Research. We estimate that S&P 500 operating earnings per share totaled $130 per share last year. A 7% growth rate would raise it to $141 in 2018 and $151 in 2019. Although the earnings season isn't over, the consensus estimate S&P 500 earnings could rise from $9 currently to $10-12 once all the companies have reported and provided guidance. So we are holding a 2018 forecast of $155 for the Standard and Poor's 500. Based on a 7% growth rate, next year's earnings for the S&P 500 could reach as high as $165. This would be a significant upward revision for us. We don't think the latter estimate is reflected in the market, certainly not during the recent correction. Indeed, the consensus 2018 estimate of the 10 investment strategists last year at the start of the year was $145. The latest 2018 and 2019 analysts' consensus estimates are even higher than our latest forecasts. Analysts tend to be too optimistic about the future prospects for their companies. That's why there is usually a downward drift in their estimates for both the level and the growth of earnings as they converge to actual results. Their 2018 numbers should decline toward our current estimate as the year progresses, assuming we are on target.

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However, the analysts' 2019 estimate, which should soon start drifting lower, may very well still exceed our forecast for 2019 at the end of this year. It is their estimate that will be discounted in the market, not ours. That's based on our view that the market discounts forward earnings, which will be the same as analysts' consensus expectations for 2019 at the end of this year.

Global growth is in the midst of a synchronized upswing, led by developed markets, and with support from recovering emerging economies. The U.S. is benefitting from loose financial conditions and a strong labor market, while growth surprises are significantly driving up the Eurozone outlook. In 2018, we are expecting a modest slowdown overseas, but we expect growth to remain above trend.

Overweighting equities in balanced portfolios remains our preferred strategy in 2018. After the run-up in stocks last year, we expect moderate but positive returns in 2018, supported by the continuing expansion and earnings. Equities in the U.S., as measured by the S&P 500 Stock Index, currently sell at 19.8x earnings, and a 15% growth expectation for next year brings valuations still within historic ranges. The recent correction in the S&P 500's forward P/E, which dropped from a high of 18.6 on January 26 to a low of 16.3 on February 8, has been offset by a rapidly rising outlook for earnings. This should revive valuation multiples.

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