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MARKET INSIGHTS

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From RiverPoint Capital Management

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Like everything we do, it is designed to bring you talented resources and proactive advice with a single purpose in mind – to help our clients achieve financial security and peace of mind.

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October Sound Bites on the Market and Economy

We're in that final period of the calendar year and what a year it has been indeed. We'll take more like this one anytime! The economic data has been not only solid but surprisingly robust. We're just now getting early results on Q3 "earnings season" as companies begin to report, but we anticipate earnings for the quarter beating once again and delivering a solid mid-single digit growth figure, which should put the S&P 500 on good footing for double digit earnings growth for the year…with zero help from potential fiscal stimulus out of Washington. Further, global economies are doing well. While the S&P 500 is up roughly 14% on a year-to-date basis through 9-30, developed international is up 20% and emerging market equities are up over 28%. This is supported by solid fundamentals, reasonable valuation, and excellent underlying price trends in the market that exhibit broad participation in advancing stocks rather than narrow leadership by only a large few names that would spell warning signs of a market top. Further, we particularly like this very measured advance in the market…it has simply continued to creep-up gradually (the market has only moved more than 1% in a single trading day this year on eight occasions) rather than exhibit sharp blow-off moves to the upside typical of bull market peaks. So, what do we think about Q4 and the set-up for 2018? While never relaxed or "complacent", we remain positive on equities based on our research and the facts, and will walk you through some of the items we are watching closely.

Don't Count On It, But Tax Cuts Could Take the Economy and Earnings to an Even Higher Gear

Clearly, we are skeptical about the final outcome on initiatives for tax reform. The good news is that earnings are moving higher without them. It looks like S&P 500 earnings will advance to over $131 in 2017 and to $145 in 2018, based on a steadily improving economy and an associated renaissance of sorts in revenue growth. At current P/E levels of 18 times on these expected S&P earnings levels (which we think are not only reasonable but very normal when rates and inflation are this low), the market maintains healthy upside in 2018…before any thought of tax cuts come into play. But, tax cuts do matter, and, if they indeed occur, they could take the economy and the markets to a higher gear than current baseline fundamentals warrant. According to our work as well as that of others, such as Strategas Research, tax cut proposals as outlined by the GOP could boost S&P 500 earnings by anywhere from $7 to $11 in 2018. Put an 18 times multiple on these incremental earnings figures and that's an additional 125-200 points on the S&P… or additional gains of 5-8% OVER AND ABOVE the almost double -digit return we would look for in 2018 without tax relief. We would definitely suggest not drinking the cool aid out there that tax cuts won't impact the economy and boost growth. History

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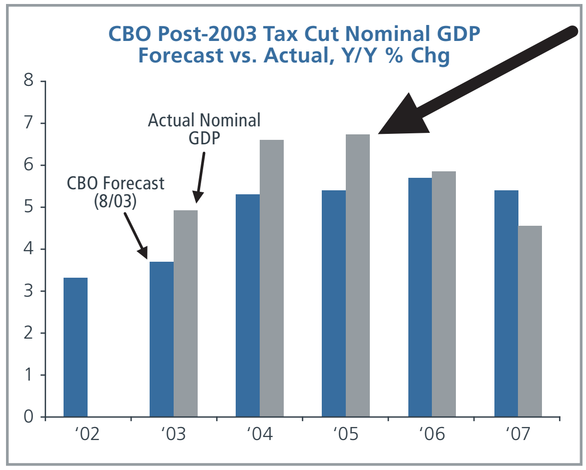
suggests they do in a big way. The year 2003--the last period of tax relief--is a prime example. The adjacent chart shows that back in '03 the Congressional Budget Office (CBO) underestimated the nominal GDP impact from proposed tax cuts that eventually passed. Specifically, they underestimated the positive influence on GDP by more than 2% (200 basis points) and the economy saw a very nice lift after passage. What we like about the current proposals are that they are broad--corporate and individual--and have attractive elements that address the potential repatriation of foreign earnings held hostage overseas as well as incentives to spur capital investment. Again, we're not basing our positive view on this occurring, but it would be nice icing on the cake if it happens--any of it. The "ingredients in the cake" are already quite fine. To wit, GDP for Q2 was revised up to 3.1% and was very balanced with a pick-up in capital spending and strong export growth finally complementing strength in consumer demand. We hadn't seen this in a while. The survey data for both manufacturing and service activity are at 13-year highs and at roughly the 60 level on both these indices which is absolutely robust. In fact this data is in sync with underlying GDP growth of more than 4%! Even the latest employment data for September, which was negatively impacted by hurricanes, contained data showing that wages increased at almost a 3% annual rate this past month. All of this has very good implications for trend in the economy and earnings. This is why we aren't passing out holding our breath for tax legislation to "come to the rescue". The picture is solid without them.



Nice September Bodes Well for Q4 and Year End Finish

There are some nice elements to the market's advance recently and this year as a whole that signal ample runway ahead…

- **Fun Stats:** We're not ones to blindly throw out historical performance stats and suggest they are great forecasting tools and that the market always repeats but there are several interesting market factoids to be cognizant of. First, we had a positive September which many times is not the case (worst month in the market overall historically) AND we set record highs in both the market price index in September and in the advance-decline line (record number of stocks advancing in price versus declining in price). This combination of record highs in September has only happened 15 times since 1928 and when it happens, Q4 is positive over 80% of the time with average return for the quarter of close to 6%.
- **Shift in Leadership:** Further leadership shifted in September sharply to the weaker YTD stock performers and higher beta, more cyclical, and smaller cap names leading...such rotation to the heretofore "neglected ones" suggests that the market is broadening and the bull market has additional runway. These things don't typically occur at market tops.
- **Steady Eddie Advance:** While the market has continued to advance, it has done so in very steady Eddie fashion...this has been a more tortoise-like rather than hare-like market which gives us comfort as well. There has been a record low level of +/- 1% moves in the market this year and last. The reason this matters is that market tops are generally accompanied by price surges in blow-off like fashion similar to the characteristics of the way the hare runs the race. These typical price surges and generally accompanying heavy flows into equity funds are simply absent in this measured advance in the market. This illustrates investors are sober and rational, not euphoric so there's buying power still on the sidelines to support further gains.

So, what would worry us and cause us to adjust our more rosy view? The data...and to that end specifically rates. Reflation and rising rates at too swift a pace would cause us significant concern. This potential occurrence would render stocks less attractive relative to bonds and would get us defensive. We'll be on the lookout. If simulative tax legislation passed AND euphoric market sentiment served as catalysts for a blow-off like surge in the market coupled with rates spiking above 3%...well, we would say time to take some profits. That might be a good time to move to the lower end of clients' long term equity targets. The good news is that we think that's quite a few positive points away in the S&P 500 price level. Stay tuned!

Thanks for your confidence and ongoing support. All the Best from all of us at RiverPoint!

Thanks,
RiverPoint Capital Management

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