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# MARKET INSIGHTS

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From RiverPoint Capital Management

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## November Sound Bites on the Market and Economy

We're down to the home stretch for the year. As they say though, this is not the time for us to become complacent; on the contrary, it is the time to stay vigilant in our research. While investors would surely embrace a Thanksgiving/ Santa Claus rally, many might be skeptical about that possibility given the almost 17% return we've seen already in the S&P 500 in 2017. In our "Crystal Ball" webinar in January, we projected a 2400-2500 price level for the S&P 500 by the end of this year, and stated that we felt risks were to the upside, if earnings came in as handsomely as we thought they could. Earnings indeed have been robust and at roughly 2575 today, it looks like the upside case for the S&P 500 is close at hand. At this juncture, many ask us… can this advance continue? Well, for those trivia enthusiasts, we would note the interesting stat that on the few occasions the S&P has advanced 15% or more through the first 10 months of the year (has only happened 17 times since 1950), the market has gone on to advance almost 5% on average in the final two. So, just because markets have been rewarding doesn't mean they can't continue. But, this interesting historical data has nothing to do with cause and effect. You know very well by now that when we discuss our outlook, it is based on our view of market fundamentals, valuation levels, and technical price trends (the F's V's and T's as we call them). We still think these three metrics set-up nicely for 2018, albeit with the normal corrections that we should expect from time to time. In this issue, we'll update you on four topics in which investors appear to be most interested as we approach the Holiday Season:

- Is it a bad sign that we have gone so long without a 5-10% correction?
- How do we feel about earnings going forward?
- Are Tax Cuts "baked-in" stock prices already?
- What about this new guy at the Fed?

### 1. Is That a Stealth Correction Happening Out There?

It is true that we have gone more than 225 trading days without a pullback of even 3% and more than 300 without one of 5% or more. Given that we NORMALLY see a 10% or greater correction each and every year, this is a bit unusual. But as we've said before, corrections are not the same things as market tops and should not be feared as long as the F's, V's, and T's are solid and healthy as they are today. Market corrections in this case can be taken advantage of to upgrade holdings and swap into securities we may have been eyeing for a while that have just gone "on-sale". Corrections are simply short term price adjustments and pauses where a little momentum is let out of the market and the table is set for resumption of upward advances. On the other hand, if these FVT metrics are

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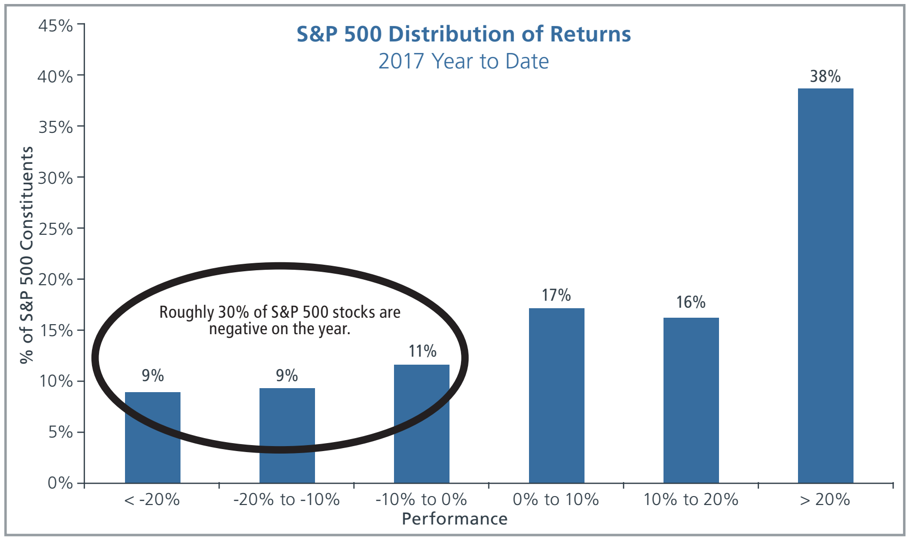
rolling over while the market is pulling back, then indeed it could be a sign of something worse. We simply don't see such negative signs of an ugly market top today…and believe us when we say we rigorously look for them. What we do see, perhaps, is a Stealth Correction that is happening right under investors' noses…but this really hasn't been recognized yet. While the headlines are harping on new records the S&P and Dow are setting, it has gone unnoticed that there's a bit of a bi-furcated market right now…the winners and the losers. And there are more losers than you might think. Since October 1, almost 40% of S&P 500 stocks have declined for the quarter, half of those are down more than 5% and a quarter of them are down 10% plus. Supposed up-and-comer, Under Armour, is off 27% and traditional retailers, such as Nordstrom's and Macy's, are off 18% and 12% respectively; household healthcare related names such as CVS and Merck are each off more than 12%; and how bout General Electric—off more than 20%. Good old AT&T is down 13%...we could go on for a bit. And, on an YTD basis, 30% of the S&P 500 stocks have negative returns. We don't bring this up to alarm or depress you; despite this, the S&P 500 sports a nice double digit return and the number of stocks advancing versus declining is still in an uptrend as are the LONGER TERM price trend charts of most stocks. We're just pointing out that a bit of a healthy "stealth correction" may be underway and doing some cleansing in the market already. This would concern us if the FVT picture was weakening, but such corrective behavior in prices when the F's, V's and T's remain solid is construed by us as a positive sign.




## 2. The Earnings Picture Still Looks Very Good

Q3 "earnings season" is almost over and it is looking like another good one. The overall EPS growth for S&P 500 companies in the quarter looks to be roughly 6.1% which is impressive for a hurricane impacted period. In fact, excluding insurance companies that were negatively impacted by the storms, EPS growth was over 8%. Further the EPS outlook brightened as the reporting period evolved…on September 30, the expected EPS growth for Q3 was only 1.8% versus this 6.1% ultimate result. Other positives…revenue growth was over 5%; Full Year 2017 EPS is on course for the expected 10% increase this year (and they were revised-up as well); and 2018 is looking good with expected growth of 11% in earnings, excluding any potential benefit from tax relief. It is worth noting that US based companies with significant international exposure reported far superior EPS growth than US domestically-focused companies, so tax relief would be beneficial to US focused businesses, if it did occur. Bottom line, though, the earnings picture is quite solid and this is a key pillar for the stock market.

## 3. Our Take on the State of the Union on Tax Legislation—And is it "Baked-In"?

The framework of the tax plan, for both the House and Senate versions, has been made public. Both versions are likely to be approved by both bodies in the next several weeks and then the arduous task of marking-up those plans and trying to come to a joint agreement will begin. We do think the odds slightly favor legislation being signed into law in the first half of 2018, but, as we have outlined numerous times before, we are not counting on this for the economy and markets to advance in 2018. The economic data in the US continues to impress and strengthen without any such legislation. To wit, US GDP has risen by over 3% for the past 2 quarters and has broadened out with business spending and export growth contributing versus prior quarters in which the onus of GDP growth seemed to fall solely on the backs of consumers. The consumer continues to exhibit signs of health, whether you examine employment or spending trends. And, earnings growth remains on a nice flight path as discussed above. So, we believe the market is supported by solid fundamentals, not hoped for tax legislation. If we don't get it, sure, we expect a temporary negative reaction (that we may or may not get….think about the headlines that appeared it papers in November, 2016 but never happened, e.g. "Market will Crash if Trump is Elected President"), but we would be buyers on such a dip with this positive fundamental backdrop.

It is not our purpose in this issue to summarize all the differences between the House and Senate proposals for tax reform. The plans have more in common than they have differences, though there are several noticeable ones. Suffice it to say that both provide significant tax reductions for corporations. On the individual front, there will be winners and losers, as currently proposed, with low to lower- middle income folks getting tax breaks and upper-middle to affluent taxpayers being anywhere from slightly better-off to worse-off. Affluent itemizers will probably see a tax increase of some sort. But what we do know is that EPS of corporations would be significantly higher. Specifically S&P 500 EPS could rise from the currently expected $145 figure in 2018 to $155 or higher and that is worth an incremental 200 points or 8% gain on top of the decent returns we already expect for next year. Further, if anything close to what is proposed becomes law, this would be the third largest tax cut in American History, averaging 1% of GDP over the next 3 years. **And, based on history and the impact of prior cuts close to this magnitude…this would have some serious stimulative economic impact!**

## 4. Let us Give Thanks—For Our Blessings and For New Fed Chair, Jerome Powell!

Clearly, we all have our many blessings to be thankful for as we celebrate with our families over the Holidays. As investors, one of them is President Trump's pick of Jerome Powell as the next Fed Chair. Quite frankly, this was one of our concerns coming from Washington. Earlier in the year, we feared that perhaps a more rules-based person would be chosen who would differ from Janet Yellen's measured/dovish approach to Fed policy and cause angst in the markets about drastic changes in monetary policy. Nothing could be further from the truth with Powell. We give President Trump an A for this selection. Powell shares the same moderate view of Janet Yellen with regard to raising rates. However, unlike Yellen, Powell is more sympathetic to loosening the more restrictive regulation in the Financial Industry that should be a positive catalyst for bank stocks and selective insurers. So net-net, this is indeed a blessing in our eyes!

We'll close by wishing you all a wonderful Thanksgiving and appreciate the opportunity to serve you. Stay tuned for our December issue where we will wrap-up some key observations for the year and prepare for our "Crystal Ball" publications early in 2018.

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

**Thanks,**
**RiverPoint Capital Management**