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MARKET INSIGHTS

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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February Sound Bites on the Market and Economy

Wow, what a totally different and far better start to 2017 versus 2016 for investors. This is more like it! The S&P is up over 5 percent YTD, and economic data releases continue to signal accelerating growth. This time last year, the market was down roughly 11 percent, and we were off to the worst start to a new year in HISTORY. For 2017 we do expect another fertile year for returns, based not on hope about legislative and policy reform in Washington and the associated "animal spirits" emanating therefrom, but based on good old healthy fundamentals, valuation levels and technical price trends. Now, if enacted, these growth oriented policy measures being considered, such as tax reform, could take us even higher—this is just math via the positive impact on earnings from such changes. But, we are not counting on such events for solid returns to develop. No doubt, Trump tweets and events in his administration's first 100 days have created some nail biting drama and heightened political uncertainty, but angst on the political front contrasts boldly with the sharp rise in business, consumer and investor confidence and the economic reality…and these latter factors are what drive markets. Listed below are several of the intriguing elements to the start to this 2017 calendar year that are worth watching and highlighting:

The Yin and Yang of Growth versus Value stocks — We suggest embracing both in 2017.

One of the interesting themes since 2015 has been this ongoing battle between growth and value stocks for leadership. There have been very definable chapters where one has leap-frogged the other and dominated returns. Value stocks were up 17 percent in 2016 while Growth stocks advanced a mere 7 percent last year. Many have suggested leaving Growth stocks out to pasture in 2017. We do not! While we do find value stocks in the Financials, Materials, and Industrials sectors attractive, we also see very good value and attractive earnings profiles in certain, growthier areas. Examples include Disney, Marriott, Fortune Brands, Carnival Cruise lines, and Amazon in Consumer Discretionary; Broadcom, Mellanox, Facebook, Google, Microchip Technologies within Technology; and Celgene within Healthcare. So far this year this intuition to stay with such growth stocks and to blend them with the more cyclical value oriented plays has paid-off. YTD through mid-February, growth stocks are up almost 7 percent and handsomely outpacing the 4.2 percent return of value. The point is that we believe balance is important this year and a blend of growth AND value will be additive rather than a decided tilt in either direction.

"It's the Earnings, Stupid"

Sorry, we don't mean this in a disrespectful way. This is just an updated play on Bill Clinton's phrase, **"It's the Economy, Stupid"** that he used very effectively back in the 1992 presidential campaign. This phrase was instrumental in defeating George Bush (Sr.) Our point is that many seem to want

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to link the late 2016/early 2017 strong post-election rally in the S&P 500 merely to hopes about legislative changes the GOP and Trump Administration may initiate and orchestrate through Congress. If we indeed thought this stock market advance was just based on hope of legislative change, we would be concerned. It is not from our perspective. We see it as based on positive inflection in both economic and earnings growth…so either of the above phrases would be apropos to describe causation in these healthy market returns. The global and US economy were accelerating prior to the election as reflected in the 3.5 percent US GDP growth figure in Q3 and the 2.8 percent overall average growth rate in the second half of 2016. The more recent data just released illustrating 5.5 percent annualized growth in US retail sales in early 2017, inflation accelerating to the 2.5 percent level and manufacturing on a solid growth path only reaffirm this rally is not based on smoke and mirrors but is based on substance. Global data is equally impressive. More important, this portends good things for US corporate revenue and earnings…key items that drive stock prices. After essentially 2 years of flat earnings growth and five consecutive quarters of year over year declines in earnings, the "profits recession" is over. We had positive earnings growth in both Q3 and Q4 of 2016, and we look for 10 percent growth in 2017 BEFORE considering any legislative changes Congress and the President are considering. We base our decisions and conclusions on the trend in the data, not on hope and speculation about policy.

What about all this hype about Tax Reform — is it just going to be all talk once again and result in more partisan Gridlock?

We would be way too confident if we gave a definitive answer here as we will have to see how this plays out, but there are reasons to be optimistic on this front. Again, let's be clear, our base case assumption of an 8-10 percent return for the S&P 500 is NOT based on some hope of tax reform, but based instead on the facts that the economic data is improving and earnings growth is accelerating. Tax reform, should it occur, would only increase earnings growth above our base case. In fact, it could double them…this is just the math. So, if it is accomplished, we'll take it, but we don't count on it in establishing our investment strategy for the year. Why do we think tax reform has a good chance of moving forward and getting done in some form? To begin with, it's only one of a few initiatives that garner bi-partisan support. The other areas that also have bi-partisan backers include infrastructure spending and repatriation of US corporate cash held overseas. Both of these are closely linked with tax reform. This discussion is relevant to you as an investor in that legislative initiatives on any or all of these could positively impact economic growth, and, ergo, your returns. Now all this talk of a border tax adjustment (BDT) as part of tax reform does muddy the waters a bit. The Senate is against the BDT, House leadership is for it, and the Trump Administration waivers, depending on the day. If the BDT is part of the package, then we should see a HUGE reduction in corporate tax rates from 35 percent down to 15 percent as the BDT will supposedly generate the additional revenue needed to pay for such a significant tax cut…that's how supporters justify it. If the Senate's more pessimistic view on the BDT wins out (and President Trump just can't get on board with the BDT), we are very likely to see simple and smaller corporate tax relief via a more straightforward tax cut and a lesser reduction in the rate from 35 percent to something like 27.5 percent and no BDT... the BDT becomes unnecessary in this scenario give the watered down rate cut. If neither of these two different paths to tax reform/ relief get done and gridlock as usual takes root, then we are likely to simply see new tax incentives for infrastructure spending and some sort of tax holiday to inspire US corporations to repatriate a portion of the estimated $2 trillion in cash they have parked overseas. This mound of cash could be used for dividends, buybacks, capital expenditures, and hiring. And then, of course, in a final scenario on this front, nothing at all above could get done. So there are many potential outcomes…how do we process this in terms of what it means for investors? We go back to the point that we count on nothing getting done in our base case 8-10 percent return scenario for US stocks in 2017 and embrace the final scenario…status quo. We are being conservative. If either scenarios 1 or two above were to occur, expected 2017 earnings growth would accelerate from our current 10 percent figure to more like 20 percent and that's why there is meaningful upside to our base case outlook. The bottom line is any of these proposals would be "gravy" to our current expectations. Stay tuned.

Closing Remarks

In closing, you can see that our process demands that we make fact based decisions and embrace John Maynard Keynes words that, "when the facts change, I change my view". We are not always positive; when the data begins to inflect negatively or the risk/reward proposition becomes unattractive we become more defensive. One scenario that would make us more defensive would be if the so-called "animal spirits" and excitement about Washington growth policies did get out of hand and cause a market melt-up to 2500 or more…too soon too fast. We would anticipate dialing back risk if that would occur, and that would be a delightful problem.

Thanks,
RiverPoint Capital Management