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MARKET INSIGHTS

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From RiverPoint Capital Management

February Sound Bites on the Market and Economy

Well, we're seeing some gravity and a sharp rise in volatility take effect in early February after a very strong start in the U.S. stock market in January. And we think this weak start to the second month of the year is quite normal… not alarming or a sign of "madness". Interestingly and perhaps ironically, this softness in the market and long anticipated rise in volatility in early February is occurring in the midst of robust U.S. and global economic news and smack-dab in the middle of the release of stellar earnings reports and strong EPS guidance for calendar 2018. It's also happening in the face of a warranted rise in optimism, emanating from stimulative tax cuts that are occurring much more quickly than investors imagined only weeks ago (if ever!). In addition, investors can't help but be impressed by the concurrent, broad and surprisingly strong positive reactions of corporations to the reduced tax rates via their plans to share the upcoming tax windfall by providing one-time cash bonuses to employees at all levels.

This can spark positive secondary effects and a virtuous growth cycle of sorts in consumer spending. All of these factors are catalysts to drive stock prices higher. **It sure doesn't sound like a backdrop to spark a stock market pause or correction, does it? And yet, that sure feels like where we are headed. How can this be and why now? Is this "madness"? The short answer to these questions is not at all. A short, modest correction would be quite normal and healthy from our perspective**, given how far we have come in this measured advance over the last two years without hardly a wiggle or hint of pause or sell-off. Perhaps the more important questions on your mind include: **1. Is this a market top?…** the highly probable occurrence that so many have repeatedly and incorrectly prophesized over the last 8 years, time and time again; and, **2. How does this early February soft patch impact our outlook and positioning going forward?** The bottom line is that **we remain positive on equities in 2018**, albeit we are slightly less enthused about potential returns for 2018 than going into 2017 (and, as you know, we were quite enthused in both 2016 and 2017). We would embrace a short and relatively shallow correction as a timely cleansing and a healthy reset for future advancement later in 2018. And, **we continue to monitor specific data that would cause us to alter this view and to turn more defensive…a meaningful rise in interest rates and inflationary pressures from here and/or signs of slowdown, chief among them. Read on!**

Earnings News—No Sign Of Slowdown!

If one is looking for signs of deteriorating/decelerating earnings growth to turn cautious or bearish, you just won't find them. Earnings are getting stronger and seldom will you find markets peak when earnings are meaningfully improving like they are today. The following are impressive stats on this:

- With regard to earnings being reported by S&P 500 companies in Jan/Feb 2018 for the Q4, 2017 earnings period, 75% of companies are beating expectations. More impressive, 80% of

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companies are beating expectations for revenue growth, with an impressive aggregate growth rate of 7.5% on the top line. The expected S&P 500 EPS growth rate for Q4 2017 has now risen to 13.4%, up from the expected 11% figure forecast for the quarter earlier on 12-31-17…so expectations have risen as these strong results are being reported. Strength is broad-based with all eleven sectors of the market reporting positive EPS AND positive revenue growth. This marks the third time over of the last 4 quarters where EPS growth has been at a double digit pace and represents by far the strongest revenue growth in the last 10 years.

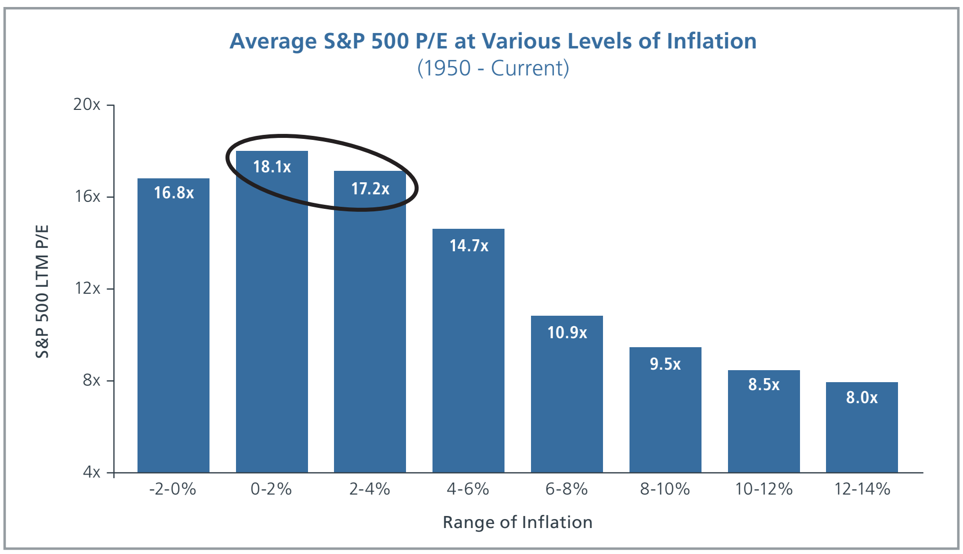
- So far this year, 2018 calendar year earnings estimate revisions appear to have been equally if not more impressive. Specifically, per Factset, consensus estimates for S&P 500 have risen from $147 to $155, implying 17% annual growth in earnings in calendar 2018… **this represents the largest increase in annual EPS estimates over the first month of a year since Factset began tracking this data back in 1996.**

Is This a "Market Melt-Up" We Saw in January and Early 2018? Is this a "top"?

In short…no and no are the answers to these questions as we see it:

- **Market Melt-up?** We're not trying to get cute here…this just doesn't qualify as a "blow-off" or euphoric surge in prices that might signal more than a pause or modest and short correction is in order. Yes, the market was up 5 % in January and that does place it in a "top 10 start to the year" based on January returns going back to 1950. But the move was not extreme in a broader historical perspective. Truly extreme, "melt-up" type price surges generally are characterized by 6 month price changes that result in stock market price appreciation qualifying to be in the 95 percentile, i.e. in the top 5% of rolling historical 6 month returns. Per Strategas Research, that would have required a 6 month price move of over 21% over the trailing six months through January 31…the actual trailing 6 month return for the S&P 500 is a much lesser 14% through the end of January…far below a top 5% figure characteristic of a melt-up surge. In addition, US equity flows have still been NEGATIVE in 2018, despite the strong January start. Retail investors have been SELLING US equities this year rather than chasing them. Chasing equities in a big way, not selling them is the norm in an ascent to a market top and generally one of the key signals of a melt-up that is a precursor to an extended bear market.

- **Is this a Market Top?** Again, we do not see signals of this. And we rigorously scour for them. As we have stated many times these signals come from the Fundamental, Valuation, and Technical price trend data we consistently examine. Market tops generally form around periods of economic and earnings deterioration in trend or absolute weakness. Hopefully we've made the case these are trending in a positive direction at present, not a negative one. Importantly, valuation is also still reasonable or normal for the environment we are in…not excessive like many boast. To wit, the P/E on the S&P 500 is below 18 times earnings following these positive earnings revisions discussed earlier. A P/E of 18 on forward earnings is the norm when inflation and unemployment are these levels as shown in the adjacent chart.



Bottom Line—What are We Keying on to Drive Decisions and Positioning in This Market?

There are a couple of key points:

- **Embrace the Volatility.** We've been saying this for quite a bit and trying to steel you up for higher volatility in 2018…higher, that is, but just NORMAL. 2017 was too easy on the volatility front. We didn't have even a 5% pullback in calendar year 2017 and only saw 10 days when the S&P 500 wiggled plus or minus 1% in a single day. This level of calm almost never happens! In fact, the average pullback WITHIN a year, when the market posts a positive return for the full calendar year, is 14%. In other words, the market normally declines 14% sometime during the year, even in years when it is up for the full 12 months. We normally experience at least 40 days every calendar year (out of the 250 trading days) when the S&P 500 moves plus or minus 1%...far more than the 10 days this occurred last year. So, while this feels uncomfortable as we go back to normal volatility, the point is that it is only a return to normal and something we can take advantage of at proper moments.

- **"It's Interest Rates, Stupid!"** This is a play on a tag line Bill Clinton used very successfully to win the 1992 presidential election and focus voters' attention on what he thought voter's cared about and what mattered most from his campaign's perspective: "It's the economy, stupid." History proved this view to be correct and he won the election. **Our research tells us this year, the most important incremental driving force and determinant of market results will be trends in inflation and interest rates.** Hence the tag line above about interest rates. In a nutshell, modest increases in rates are welcome in 2018; sharp and higher than anticipated ones are not. The market should perform well in the former scenario, not in the latter. The reason rates are important is that their particularly low levels these past 4 years has made stocks, with competitive dividend and attractive earnings yields, very attractive to own versus bonds. If rates rise sufficiently, however, bonds with the higher yields following these potential rate increases, would become tougher competition for investor's attention, and we could see stocks' P/E multiples contract as a result. Therefore a higher than anticipated spike in rates could lead to disappointing stock returns, even if earnings and the economy deliver as advertised. Not necessarily negative…we expect them to be positive (because the economy and earnings growth are simply robust with no recession in site) but just ok in magnitude, if this happens. But still, this would be disappointing versus 2017. So, we are closely monitoring this positive Yin in the market called accelerating earnings and economic growth that is being challenged by some Yang—fears of a potential sharper than expected increase in inflationary pressures and rates. After all, what caused the 3.5% sell-off in the S&P 500 the week of 1-29-18? That's right, ironically GOOD fundamental news—a strong employment report. Unfortunately, investors had a negative knee jerk reaction to the faster pace in wage inflation of 2.9%. Rather than focus on the positive implications this wage growth has for consumer spending and the economy, **investors fretted about what this might imply for inflation and rising rates going forward**. The 10-year Treasury yield jumped to 2.85% on the news. And, we get this fear! So in our research at present, we are closely following the signals of inflationary pressures and technical factors that would indicate whether rates were headed higher in sustainable and meaningful fashion OR just emotional/fear induced rate spikes that aren't grounded in the economic data. The former would not be good for stocks whereas the latter would imply rate spurts would be short-lived and revert to a stable glide path higher that would be positive for stocks. Specifically, we are closely watching wage growth trends and trends in capacity utilization as indicators of rising rate pressures. Observations of dollar exchange rate movements will be part of this analysis as will observation of the trend in foreign interest rates such as the German Bund…recent increases in foreign rates could put additional pressure on US rates, for example. At present, we expect rates to rise in measured fashion, and we expect 10-year Treasury yields to remain within our 2018 Crystal Ball forecast range of 2.75% to 3.25%, which should be supportive of current P/E levels and solid stock market gains.

Conclusion—Outlook and Positioning

How is this interplay between solid earnings growth and rising interest rate trends impacting our decision making and positioning at present? Because the fundamentals, valuation levels and technical price trends of the market are as favorable as they are, you might normally hear us say, "Buy the Dip". And in the coming weeks, we would anticipate employing this line of thinking at the proper point. But, we respect this fear of rising inflationary pressures and understand there could be more temporary downside as the market tries to determine how high rates might go and at what pace. So at present, we will put this "buy the dip" option on pause for just a moment. **The Yin and Yang of two polar forces—the tailwind of a strengthening economic and earnings environment juxtaposed against the potential headwind of rising inflationary pressures and interest rates cause us to maintain healthy exposure to US stocks but to move to neutral or to the mid-point of our targeted equity range for clients at this time rather than hover at the high end of that range where we have been for some time.** We can say with high conviction that we would view any near term pullback as normal and short and modest in tenor and clearly see no signs of recession or other signals indicative of a deeper bear market…hence our continued healthy exposure to equities.

As always we thank you for your trust and confidence and the privilege to serve you.

Thanks,
RiverPoint Capital Management

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