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This short update is being provided to provide useful information to consider in light of recent market volatility. We will take a look first at current quarter earnings announcements to gauge the health of corporate earnings growth as well as forward guidance. The below information is being provided by Factset.

- **Earnings Scorecard:** For Q4 2017 (with 50% of the companies in the S&P 500 reporting actual results for the quarter), 75% of S&P 500 companies have reported positive EPS surprises and 80% have reported positive sales surprises. If 80% is the final number for the quarter, it will mark the highest percentage since FactSet began tracking this metric in Q3 2008.

- **Earnings Growth:** For Q4 2017, the blended earnings growth rate for the S&P 500 is 13.4%. All eleven sectors are reporting earnings growth for the quarter, led by the Energy sector.

- **Earnings Revisions:** On December 31, the estimated earnings growth rate for Q4 2017 was 11.0%. Ten sectors have higher growth rates today (compared to December 31) due to upward revisions to estimates and positive earnings surprises.

- **Earnings Guidance:** For Q1 2018, 25 S&P 500 companies have issued negative EPS guidance and 25 S&P 500 companies have issued positive EPS guidance.

- **Valuation:** The forward 12-month P/E ratio for the S&P 500 is 18.0. This P/E ratio is above the 5-year average (16.0) and above the 10-year average (14.2).

Record-High Increase in S&P 500 EPS Estimates for Q1 To Date

- During the month of January, analysts increased earnings estimates for companies in the S&P 500 for the first quarter. The Q1 bottom-up EPS estimate (which is an aggregation of the median EPS estimates for all the companies in the index) rose by 4.9% (to $36.04 from $34.36) during this period. How significant is a 4.9% increase in the bottom-up EPS estimate during the first month of a quarter? How does this decrease compare to recent quarters?
- On average, the bottom-up EPS estimate usually decreases during the first month of a quarter. During the past year (4 quarters), the bottom-up EPS estimate has recorded an average decline of 1.0% during the first month of a quarter. During the past five years (20 quarters), the bottom-up EPS estimate has recorded an average decline of 2.1% during the first month of a quarter. During the past ten years, (40 quarters), the bottom-up EPS estimate has recorded an average decline of 2.5% during the first month of a quarter.

- In fact, the first quarter of 2018 marked the largest increase in the bottom-up EPS estimate over the first month of a quarter since FactSet began tracking the quarterly bottom-up EPS estimate in Q2 2002. The previous record for the largest increase in the bottom-up EPS estimate was 3.5%, which occurred during the first month (April) of Q2 2010.
- At the sector level, ten of the eleven sectors recorded an increase in their bottom-up EPS estimates during the first month of the quarter, led by the Energy (+20.3%) and Financials (+10.8%) sectors.
- What is driving the increase in the bottom-up EPS estimate for Q1 2018? The decrease in the corporate tax rate for 2018 due to the new tax law was clearly a significant factor in the upward revisions to EPS estimates. The rapid increase in earnings expectations for Q1 2018 occurred just after the tax bill was signed into law. However, it is difficult to quantify the exact impact of the changes in the tax rate on the upward revisions. Other factors also have fueled the increase in earnings estimates as well. For example, rising oil prices have contributed to the large increase in earnings estimates for companies in the Energy sector. Expectations for higher interest rates in 2018 have also likely contributed to the significant increase in earnings estimates for companies in the Financials sector.

In our view, the economy is experiencing a marked shift back to free-market capitalism that rewards private risk-taking, and we believe this will inspire growth. The two major catalysts driving this change are lower tax rates and a rollback of regulatory hindrances to encourage business formation and supply-side spending. The pro-business inclination is also catching fire across the globe, and we believe that while tax cuts will be the single greatest source of growth fuel, the regulatory rollback in addition to the business tax cuts will potentially unleash a new wave of economic prosperity.

As you are likely aware, President Trump signed into law last month a tax reform package, which has lowered corporate tax rate to 21 from 35 percent. This relief is estimated to increase earnings of S&P corporations by as much as 8.5%, which was likely the catalyst for strong equity market performance in 2017. Over the last 12 months the U.S. economy has continued to grow at a steady rate of almost 2.5% on an annualized basis as measured by GDP. Companies have added over 170,000 jobs per month on average over that same period, and the current unemployment rate of 4.1% is the lowest in nearly 17 years. Consumer confidence is high despite a somewhat unsettling geopolitical backdrop, and as noted, corporate profits are rising.
Stock valuations, while higher than one year ago, are still, in our view, reasonable given anticipated earnings gains. It is worth noting that while much financial media attention is directed toward stretched valuations, in June 1999 the Dow Jones Industrial Average sold at 28x earnings. Today the Dow sells at just under 20x earnings and still offers a dividend yield on par with the 10-year government bond at 2.4%. Similarly, the S&P currently trades at 19.9x, just slightly above its 10-year average multiple.

For some odd reason more attention is given to price than to earnings by market watchers. Perhaps it's akin to "bad news sells."

Main Street's recovery has been muted by comparison, and given Wall Street's performance, we must recognize that most recoveries have a phase in which Main Street fares better than Wall Street. The question is, are we entering such a phase? Several measures of economic momentum have recently posted their best readings of the expansion at a time when the Fed seems determined to "normalize" policy after years of monetary accommodation. In a sense, we should think of the pool of liquidity being filled in an accommodation period and slowly drained in a period of normalizing. Essentially businesses and consumer sectors are competing for a shrinking pool of liquidity; at times this has resulted in less robust stock and bond markets.
While such late cycle economic risks may be on the rise, we believe it is likely too early to prepare for a major peak in stock prices. We look at bull market peaks as a process rather than an event, typically requiring a period of at least six months to unfold and often punctuated by unanticipated factors rather than something anticipated such as Fed policy action. Despite this bull market's near-record longevity, we see little evidence that such a topping formation has even begun.

When tight Fed monetary policy finally begins to impact the economy adversely, it often manifests itself in the underperformance of small cap, financials, transport stocks, and utilities. Among these groups, only the utility stocks have failed to reach new cyclical highs as the new year kicked off, and we suspect that may be due to market concern for this sector in an age of alternative energy technologies. As market liquidity diminishes, we would expect to see MOST IF NOT ALL of these sectors lagging behind the S&P averages, although this common topping precursor may not be seen for several years.

Finally, consider that the S&P has historically retested its 50- and 100-day moving averages several times per year. last Friday and todays S&P declines have breached the 50-day but have not yet breached the 100-day moving averages, many market watchers consider this to be a very healthy, albeit swift retracement. Retesting moving averages presents buying opportunities which are often sought by those with excess cash looking to invest, but not willing to do so until a suitable buying opportunity is presented. While we do not know the identities of the buyers and sellers in recent days. We will speculate that given the swift and volatile movement in the major market averages, computer trading programs have been busily at work. If this is the case, we would expect things to calm within a few days.

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In summary, given corporate earnings have been largely exceeding expectations, often accompanied with upbeat future guidance, and evidence of economic growth slowly accelerating, causing the Fed to continue gradually increasing interest rates, we believe that recent market weakness should be an impetus to alter current investment allocations for investors who are currently appropriately allocated to meet their long-term investment goals and risk tolerance.

Please feel free to call us to discuss your particular allocations if you have concerns you would like to discuss with us.

Be well
Art Doglione

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