Investment Outlook, May 2018

The quarterly earnings reporting season is in full swing, and so far the results have been historic. With 53% of the companies in the S&P 500 Index having reported first quarter results, fully 79% have exceeded earnings forecasts, and 74% have exceeded revenue forecasts. Reported earnings are beating estimates by more than 9%, on average, and companies are reporting positive earnings surprises at the highest rate in 20 years.

One way to illustrate how strong the first quarter's results have been is to point out that before the reporting season began, consensus expectations were that first quarter's reported earnings would exceed last year's first quarter by 18%. It now seems likely that earnings will actually be up 23% on a year-over-year basis.

It is somewhat concerning, however, that the market's response to such strong results has been tepid, at best. The S&P is up just 3% from the April 2nd lows, and is still down for the year, suggesting that such strong earnings gains have become increasingly discounted in stock prices. Perhaps the tide of rising expectations has peaked, and in any case, late cycle earnings shouldn't be valued as highly as early cycle earnings. We have also commented in past *Outlooks* that, at some point, rising expectations become a potential negative for the market, as the bar inevitably gets set too high setting the stage for future disappointments.

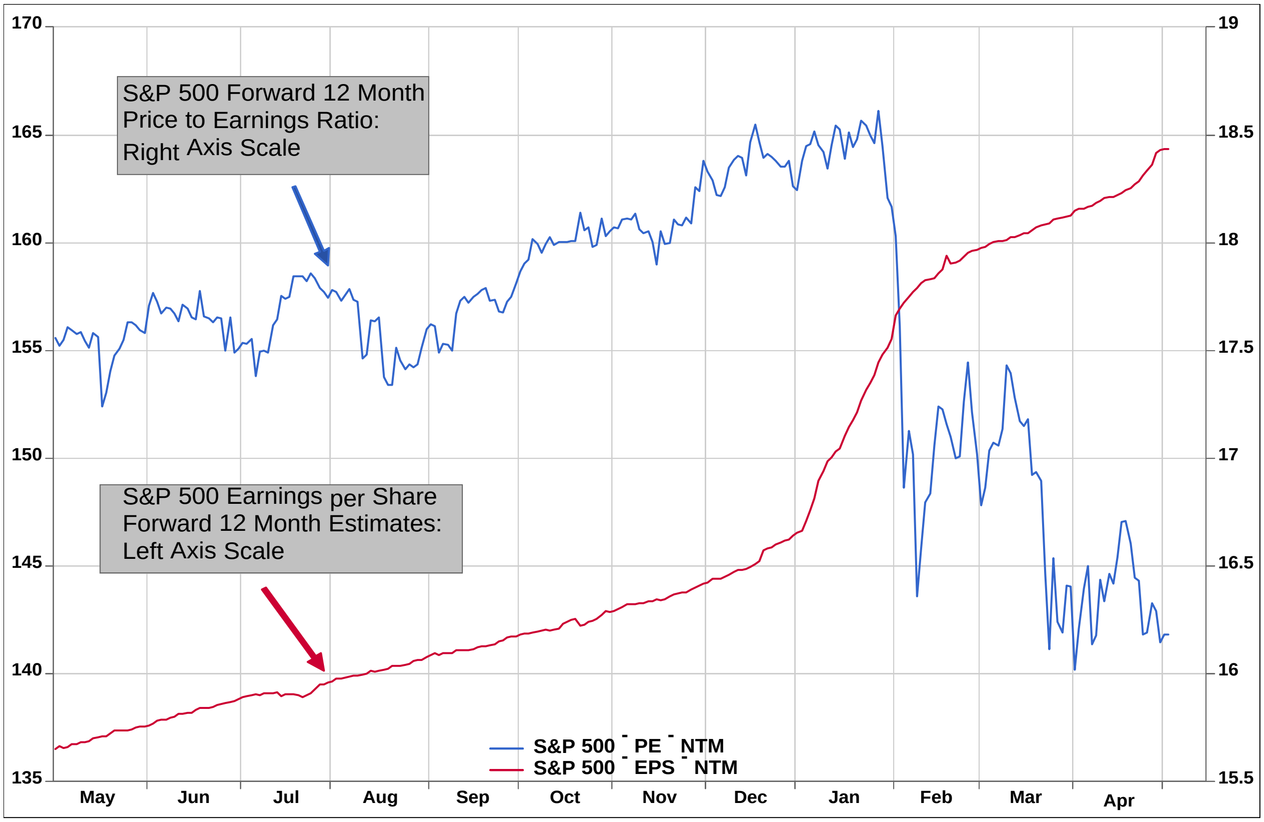
The market's weak performance in light of such strong fundamentals is reinforced by a Bank of America Merrill Lynch survey of global money managers, 58% of whom believe that the stock market has either already peaked, or will peak this year. These fund managers have raised cash and trimmed their equity holdings to their lowest levels since the 2016 election, despite the fact that U.S. economic data is still strong and a recession is nowhere on the horizon.

The most frequently mentioned concern of global money managers is trade and protectionism, which threatens to slow the rate of global economic growth. Just 5% of the money managers surveyed by Bank of America expect growth to accelerate from here, down from 40% a few months ago and the lowest since the June 2016 Brexit vote in the U.K. The IMF has warned that global economic growth is likely to slow after 2019. In such an environment, corporate profit growth is likely to slow as well. It is also well to remember that the current surge in profits is being driven, largely, by a one-time event – corporate tax cuts. Comparisons are likely to become more difficult in 2019 and beyond.

There is also the fact that the price of oil is rising, as the average price of a gallon of gasoline has risen to $2.78, up from $1.70 just 2 years ago, offsetting to some degree any benefit the average American consumer might have seen from tax reform. Beyond the normal supply/demand factors that drive the price of this commodity, geo-political concerns, primarily affecting oil producers like Russia, Iran, and Venezuela, are expected to keep prices high for the foreseeable future.

Rising interest rates are becoming more of a concern as well, with the yield on the 10-Year Treasury Bond exceeding 3% for the first time since 2014. At the short end of the curve, most money managers expect that the effects of the Fed's ongoing tightening will begin to have an effect later this year or early in 2019.

If there is a positive offset to the apparent lowering of expectations 12-18 months out, it is that valuations have become more reasonable, and bond yields have not yet risen to the point where they offer a compelling alternative to stocks. The chart, below, shows that the combination of rising



earnings estimates and flat-to-down stock prices has driven the market's price/earnings ratio to below 16.5, the lowest multiple since the market correction of 2015-16, and down significantly from the January peak of 18.5. A price/earnings ratio of 16.5 translates into an earnings yield of 6.1%, which seems quite fair compared to a 10-year Treasury Yield of 3%. And on a discounted cash flow basis, we estimate that the market is currently undervalued by about 7%.

That the market is a discounting mechanism, reflecting investors' expectations 12-18 months into the future, is seldom more clearly illustrated than today. The market's sharp rise throughout 2017 accurately discounted the strong fundamentals we are now experiencing. But investors are now focused on 2019 and beyond, and the outlook is less certain. Still, the market has more than tripled during this long recovery from the "Great Recession", and the next recession is not yet in anyone's forecast. A lost year in the midst of this extraordinary bull market to allow the market to adjust to another new normal is not too much to expect.

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