KANAWHA
CAPITAL MANAGEMENT

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EARNINGS MATTER

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It is difficult to recall another period in recent times with as much political and geopolitical discord. Yet global stock markets experienced a banner year in 2017 as investors tuned out much of the extraneous noise to bid prices higher. Proof once again that it is dangerous to make investment decisions on the basis of headlines or tweets.

How did stocks manage to overcome the cacophony from naysayers? In short, an improving outlook for corporate profits buoyed investor confidence, propelling the rally.

Slow, steady

At the same time, stock market volatility evaporated, a remarkable outcome given the tumultuous cross currents. For the year, the S&P 500 Index's average daily change (up or down) amounted to only 0.3%, the lowest reading since the 1960s. The robust market returns were constructed from stocks grinding steadily higher. Out of 252 trading days, only *eight* experienced a one-day move of +/- 1%. In contrast, 2016 saw 48 such daily moves while 2015 produced 70.

The lack of volatility is confounding and some observers worry that it represents a false calm. Almost two years have now passed since the market last pulled back 10% or more. Bears warn that investors have become complacent, beguiled by the upward drift in prices. However, other signals support the strength.

And broad

For instance, market breadth has been healthy. Last year's price gains were spread widely across individual companies and industries. Approximately 75% of S&P 500 constituents saw positive price changes in 2017. In 1999, towards the end of the tech rally, less than half of stocks were up for the year; in 2007, prior to the last market peak, only half of stocks had risen.

The phenomenal performance of FANG (Facebook, Apple, Netflix, Google) has dominated the news, obscuring the pervasiveness of the market's strength. As the year closed, all S&P 500 sector groups were trading above their 200-day moving averages as were three-fourths of individual stocks.

It's the earnings, stupid

The Dow Jones Industrial Average breached the 25,000 level three trading days into the new year. Talking heads at financial news outlets briefly took a break from hawking Bitcoin to celebrate this milestone. Investors seem sanguine that a synchronized pickup in global growth will extend the rally. In fact, all economies tracked by the OECD (accounting for 80% of global GDP) expanded in 2017. And global growth may well accelerate in 2018.

Against this backdrop, corporate profits surprised to the upside last year. According to FactSet Research, S&P 500 earnings growth approached 10% in 2017. This performance followed a two-year profits slowdown and marked the fastest pace since 2011. Reflecting the broadening recovery, U.S. companies with a majority of sales derived from outside the country fared significantly better than domestically-focused counterparts: Their earnings rose 15% vs. 7%.

Importantly, the profits picture appears to be strengthening. The current period marks the first time since 2010 that analysts *raised* earnings estimates heading into a new year. Typically, Wall Street sets too high a bar and must continuously scurry to revise downward. Forecasts now point to low double-digit profit growth for the S&P 500 in 2018.

Meanwhile, the full impact of the new tax legislation on corporate income statements is probably not reflected in these forecasts yet. With the statutory corporate rate lowered from 35% to 21%, many firms will see higher profit margins, earnings per share, and cash flows. Earnings estimates could be revised up as the year progresses.

Will it trickle down?

Supporters of the package have argued that the businesses will be encouraged to step up reinvestment, boosting the economy more broadly. Along with the corporate income tax cut, the rate for repatriated cash was lowered from 35% to 15.5%. American companies looking to avoid paying domestic taxes have been holding onto $3 trillion in overseas earnings. They will now be induced to shift some of this cash to the United States.

The incremental cash flows from the corporate reforms will likely be directed toward share repurchases and dividends. The notion that the cash will be unleashed in a burst of expansion and hiring seems like wishful thinking. Surveys have indicated that an outlook for lackluster demand growth, not access to capital, has been restricting capital spending. And the experience of the 2004 "tax holiday" on overseas earnings also points to an emphasis on buybacks and dividend increases. Therefore, while the improved cash flows should certainly benefit stock prices, the multiplier effect on the overall economy has likely been overstated.

Yet one new measure could indeed encourage business investment; namely, the provision allowing companies to immediately write-off 100% of the cost of acquisitions of plant and equipment. Unlike the tax cuts, this 100% bonus depreciation rule is set to phase out after 2022. To the extent a business wanted to add capital resources, this change could bring forward such spending.

Restocking

Businesses' hesitancy to expand aggressively has dampened the pace of the economic recovery from the last recession. It has been the key missing link. Meanwhile, the country's capital stock has continued to age. Capital spending tends to accelerate in the latter stages of a business-cycle expansion as more firms realize they have insufficient capacity to meet rising demand. And some metrics suggest a ramp-up has begun to occur.

Recent surveys by the National Federation of Independent Businesses (NFIB) indicate high levels of optimism on the part of small business owners. They cite an improved sales outlook and more benign regulatory climate. Perhaps this restored confidence, along with a boost from the tax package, will unleash some *animal spirits* and propel a new investment cycle. An infrastructure program would further aid this side of the economy.

Goldilocks

Heading into 2018, the global backdrop is one of broad-based growth, benevolent fiscal policy, and accommodative monetary policy (ex-US). We seem to be witnessing a shift in economic momentum and along with that, a shift in investor sentiment.

The current rally has often been termed the "most hated" bull market in history. Throughout the cycle, investors as a group have been under-allocated to equities. Flows into bond funds dominated those into stock funds. And even some of the equity exposure was only held grudgingly, an alternative to low-yielding cash and bonds.

Years of rampant skepticism have started to give way to a more optimistic view of stocks. Flows into equity funds have picked up and brokerages such as T.D. Ameritrade report high levels of market exposure by account holders. On the surface, the environment should prove favorable for the stock market. But how long will the Goldilocks scenario persist and how much is priced in already?

And two bear scenarios

Given the length of the current rally and the significant run-up in prices, some pundits have been calling for a correction. Stretched valuations could be an obstacle to the rally but, absent another catalyst, are not effective as a timing indicator.

Most likely, *if* it occurred this year, a correction would stem from one of two sources: In Ned Davis Research's terminology, from either an "earnings-driven retreat" or a "rate-driven reversion". The first scenario refers to the possibility that corporate profits fall short of the mark. This happens from time to time. In the context of an expanding global economy, such a pullback should be shallow.

The second scenario denotes the case where inflation accelerates, leading to hawkish central bank policy and a breakout by bond yields. Bond fund holders incur losses and sell, further moving yields up. Some investors would also likely sell stocks to reduce risk and multiples would contract. This scenario would mark a structural change in the market's underpinnings and be more problematic.

Melt-up not meltdown?

At this point, however, the outlook for earnings remains positive and inflation is still relatively tame. With improving fundamentals and surging investor confidence, could we actually see a "melt-up" before a meltdown? Jeremy Grantham recently posited that the bull market shows signs of entering just such a phase. And if it did, stock prices would perform quite nicely — perhaps for a while — but we would be ultimately left with a bubble.

Grantham notes that asset bubbles historically have shared several characteristics. First, obviously, they are marked by extreme overvaluation — although that fact alone does not signal that a market will burst. A bubble requires not merely high price levels but also sharp price *acceleration;* in addition, a sense that investors have become euphoric and are getting carried away. Towards the late stage of a bubble, the market narrows and the winners become concentrated as investors chase those stocks out of a "fear of missing out".

Currently, stock prices are high but not through the roof. Both institutional and retail investors have become more confident about the market's prospects but certainly not euphoric. Lastly, as evidenced by the market's advance-decline line (number of rising less falling stocks), there is still broad participation in the rally. It is therefore premature to label this environment a bubble. On the other hand, the market's valuation leaves it vulnerable to disappointing news. So now is the time for vigilance not complacency.

— Christopher J. Singleton, CFA, Managing Director

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