PROFITABLE RISKS/UNPROFITABLE RISKS

Loss avoidance is a key to long term investment success. We deem certain risks profitable, to be exploited with sound research, while other risks are inherently unprofitable and should be avoided.

Our Risk Management Tenets

✓ We believe in extensive asset class diversification
✓ We actively manage tactical asset allocation policy
✓ Our stock selection process emphasizes intrinsic value, innovation, and durable competitive advantages
✓ We believe excess returns are achievable due to market inefficiencies that persist over time
✓ We seek to build diversified portfolios of stocks with attractive valuations, quality balance sheets and above-average earnings growth
✓ We closely monitor valuation measures to limit downside risk
✓ We carefully control portfolio average capitalization and beta

EQUITY MARKET OUTLOOK

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Betting on Trump

With a healthy dose of skepticism, equity investors have been monitoring the action in Washington, DC, and, in most respects, seem to like the odds they face. In addition, equity markets have gotten a degree of fundamental support from a fairly solid, if a bit disappointing, earnings season. Equity markets, thus, in the first four months of 2017 have been in a broad based upward trend. This uptrend has been measured and has even been tempered somewhat with a bit of a reversal during the last two months. However, the combination of earnings reports for the fourth quarter with more promising action in the public policy sphere have investors betting that profit growth during 2017 will be healthy.

• After the initial post-election run-up in stock prices, US equity markets took an early spring break and pulled back beginning in early March. Skepticism about early developments in the administration’s legislative agenda drove an increase in caution during that time.

• Corporate fundamentals continue turning around and displaying solid evidence of growth.

• Valuations have become a major source of concern as equity markets both home and abroad appear to be priced more-and-more for perfection. Risk, therefore, continues to be high even though certain measures of short-term volatility have been trending downwards.

• The overall economic picture remains cloudy as expectations for growth throughout 2017 and 2018 remain very depressed.

• A more activist foreign policy re-introduces investors to the concept of “geopolitical risk.”

In the spring edition of the Capital One Asset Management Equity Market Outlook, we review the major possible effects from the advancement of the agenda of the new US presidential administration as well as the emergence of growth opportunities around the world.

The Trump Agenda Advances

Despite much headline news coverage of the things not yet accomplished during the first months of the new administration, many actions promised by candidate Trump have materialized. The problem with governing by executive orders is that they are much less durable than legislative actions built upon consensus. And so the parts of the Trump agenda that can be implemented by executive order are being implemented. These new orders serve to lessen the burden on private
sector production, which inevitably results in more resources being available to the private sector to make investment choices that they prefer and that they expect to be profitable. Thus an “animal spirits” rally in economic activity has the potential to be a self-advancing prophecy.

Immediately after the November election, one of the surest displays of this potential appeared in surveys of business sentiment and investment spending plans, especially in the small business arena. Both measures spiked higher. After a long-period of underwhelming growth in capital expenditures driven by lower confidence in aggregate economic growth, a period where investment spending accelerates would be a very positive development with implications both for equity investors as well as the economy overall.

In keeping with the theme of healthy skepticism developing over the most recent past, the very latest readings of some of these indicators shows a small introduction of caution after the initial post-election euphoria. However, the trend of rising sentiment and investment spending plans is clearly rising.

In other areas as well, the Trump agenda continues to advance, despite some stalls in Congress. For the most part, the new administration’s cabinet selections are all in place and taking actions within their spheres of influence that will have some effect in terms of relief from regulatory burdens. The President’s nominee to the Supreme Court to fill the seat vacated by Justice Scalia’s passing is in place.

In total, and in direct contradiction to the image created by the failure of the Republican dominated Congress to advance its first major legislative item – health care reform – the agenda of the new Administration has been advancing at a steady pace. For holders of residual-claim assets, as equities are, this has important implications, most of which are positive. Profit growth in the corporate sector was already expected to advance in 2017 from the stall in 2015/16. Any lessening of the burden on the private sector vis-à-vis the Trump agenda, should signal a potential higher level of growth.

**Quality Growth Returns, and Returns to Favor**

Earnings growth in the first quarter of 2017 is sending positive signals, mixed with a bit of caution. At the beginning of the quarter, aggregate expectations were for S&P500 earnings growth to come in at a 12.5% increase, compared to year-ago levels. At the close of the quarter, those expectations had been drastically reduced and hovered around 8.8%. As of the end of April and with 182 out of 500 companies reporting, the blended growth rate (which combines companies which have already reported with estimates for the rest) stands at 10.5%. So profit growth has been better than the most recently updated analysts estimates, but worse than it was expected to be on January 1. (Source Factset)
In a stark reversal from the market trend in place during the rally from early 2016 lows through year-end, investors have returned to their long-term behavior of favoring quality and quality growth. On average, the sectors that have underperformed the S&P500 in terms of price change year-to-date have delivered lower earnings growth than the sectors that have outperformed. A similar profile exists when examining estimates for the full year of 2017.

There is a good bit of distortion in this quarter’s reports to take note of. Foremost among these distortions, expectations for the Energy sector earnings growth for the first quarter of 2017 and the full calendar for all of 2017 are very high. This, of course, is the result of the massive retrenchment in the sector after the drop in the price of oil. With the price of a barrel of oil having leveled out around $50 over the last 8 – 12 months, and considering that energy companies have already cut back on expenses, any increase in earnings growth will face very favorable comparisons.

As of April 13, 2017, if Energy sector earnings are removed from the tally of first quarter S&P500 earnings, the expected growth rate drops to 5.5%. (Source: Factset Earnings Insight, April 13, 2017 issue).

Considering that earnings growth hovered very close to zero for 6 straight quarters ending in the fourth quarter of 2016, any resumption of growth is welcomed. But considering also both the trend in expectations over the full quarter as well as the distortions from the energy sector, investors would be advised to be wary of too-high expectations as the year progresses.

**Valuations Still Reflect Extreme Optimism (or is that Trumptimism?)**

Equity valuations today reflect a high level of optimism about future growth. Relative to history, price-to-earnings multiples, price-to-sales multiples, and many other barometers are all in the high end of the range of experience. The market has been more overvalued than it is today, most notably in 1999 and 2000, but not very often.

Borrowing on a concept originally suggested by Benjamin Graham and popularized more recently by Yale economist Robert Shiller, Ned Davis Research has further analyzed cyclically-adjusted-price-to-earnings ratios (CAPE) and concluded that current valuation levels for the S&P500 have only been exceeded in 1930 and in 2000. Equity investors should note that, while markets may remain over (or under) valued for some time, subsequent return experiences when valuation extremes such as exist today have been reached have been far below average. (Source: Ned Davis Research Inc.)

In addition to being an expression of sentiment, valuations are also driven by central bank liquidity, as global liquidity flows have driven capital into equities. Current valuation levels are a warning sign to investors and leave little room for either negative surprises or further multiple expansion. The environment for growth is improving and high valuations may yet prove validated by accelerating earnings expectations. Investors should remain mindful of high valuations, however, and remain agile in asset allocation considerations. Much rides on the execution and delivery of President Trump’s ambitious growth agenda.

With further valuation (multiple) expansion off the table as a source for equity returns, equity investors have to look to margins and organic growth for returns. Corporate profit margins remain at the high end of historical experience. Investors therefore, should not expect future margin expansion to be a driver of earnings and stock performance. Thus organic growth remains as the primary source for prospective equity returns. Discounting current earnings growth expectations by the energy sector distortion leaves fairly mild organic growth.

In an environment where aggregate economic growth is expected to remain modest and drivers for better corporate profit performance and stock returns are limited, any optimistic expectations rooted in structural changes from a governance perspective should be tempered with a degree of skepticism. While Information Technology companies are showing robust
earnings growth rates currently, many other segments are not. Consumer related sectors, for example, are expected to deliver sub-par earnings growth in calendar year 2017. Meanwhile technological advancements continue to be highly disruptive and may, through inexorable advancement to more automation, cause temporary dislocations among working populations. While technological change is always an aggregate good in the long run, it is not good for the factory worker who has been automated out of a job.

Conclusion
Given the improved outlook for longer-term economic growth, earnings growth and better economic and regulatory policies, we have become more constructive on the U.S. equity outlook. We are mindful though of being over-optimistic based on the challenges of fairly weak underlying economic growth combined with the risks of high levels of valuation. We maintain a recommendation of neutral positioning of equities in balanced portfolios. Within equity portfolios, we continue to emphasize U.S. over International stocks and mid- and small-cap over large cap. In addition to other risks already noted, the rapid increase of sovereign debt in the developed world over the last decade will continue to present challenges to growth and to fiscal flexibility for overly-indebted governments. While we remain wary of growth prospects in Europe, Japan and China, we see value in equities in emerging markets that have completed a currency adjustment and which are also less dependent on China; and consequently, we are selectively adding modest exposure to emerging markets equities.
Unless otherwise noted, all performance and return data sourced from Bloomberg, LP, April 25, 2017.

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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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