August 2017

Economic Comment and Market Outlook

Concurrent with an improving trajectory of corporate profit growth, the US equity market powered ahead to new record highs throughout the first half of 2017. By the end of June, the S&P 500 had surged to 2,423, representing a total return of 9.3% for the six-month period. As we noted in our last letter, confidence in the potential for strong profits sustained our optimism for the market despite a degree of concern that the market's assessment of the impact of the November elections was somewhat exaggerated. Furthermore, we drew conviction from superior growth prospects for our portfolio companies and also from their more attractive valuations. Steady US economic growth, improving global conditions, and a slight decline in the US dollar have provided additional support for our outlook, and we remain encouraged as we look into the balance of 2017 and beyond.

At the end of 2016, markets were enthused with the results of the recent elections, and expectations soared for stronger growth stemming from lower regulation, lower taxes, and greater fiscal stimulus. However, most of the factors that have constrained growth worldwide in recent years did not just disappear. Furthermore, in their first six months in office, the Trump administration and the Republican-controlled Congress failed to deliver any meaningful progress on many of their initiatives. The health care quagmire, ongoing investigations into Russian meddling in the election, and slow progress in filling governmental positions have resulted in a squandered opportunity for them to capitalize on the momentum that appeared to exist shortly after the election. As this reality set in, many investors recalibrated their expectations, and markets subsequently reversed some of the massive "risk-on" rotation that took place late last year. Larger capitalization, growth, global, and defensive stocks outperformed their smaller, value, domestic, and cyclical counterparts during the first half of the year.

As financial markets tempered their enthusiasm surrounding expected economic growth, long-term interest rates retraced some of their increase from 2016. Reduced expectations for pro-growth fiscal policy initiatives and consistently tame inflation readings facilitated a small decline in the yield of the 10-year Treasury note to 2.31% by June 30. Determined to move monetary policy back toward a less stimulative position, the Federal Reserve carried through with two 25 basis point hikes in the Fed Funds rate, bringing the midpoint of the targeted range to 1.13%. The Barclays Aggregate Index of fixed income instruments returned 2.3% during the first half, with roughly one third of the return driven by the decline at the longer end of the interest rate curve. With the Fed likely to begin shrinking its balance sheet later this year and potentially hike the Fed Funds rate an additional 25 basis points, the consensus estimate for the 10-year Treasury yield is 2.62% at the end of this year. In such a scenario, the total return for the Barclays Aggregate Index in the second half of the year would be close to 0%.

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While the main story in US financial markets seemed to be that the environment had not changed as much as investors were expecting, foreign markets, especially in Europe, did take note of some meaningful differences. In contrast to Trump's victory in the US, several notable European elections produced victories for more mainstream parties and politicians generally committed to the euro currency and a unified Europe. Most notably, Emmanuel Macron became the new President of France, beating out populist candidate Marine Le Pen and carrying his party to a comfortable majority in the Parliament. In addition, European GDP grew 2.1% in the first quarter, and forward earnings estimates for the MSCI Europe Index rose for the first time in 5 years. Finally, Mario Draghi, the President of the European Central Bank, suggested in late June that the ECB might consider slowing or stopping its stimulative QE programs, leading to rising long-term European interest rates at the end of the quarter. Overall, these developments resulted in outperformance of international equities and an appreciation of the euro relative to the dollar. In fact, many foreign currencies strengthened over the course of the first half, leading to a moderate decline in the dollar's value. Measured in local currencies, the MSCI EAFE index provided a return of 7.9%; translated into dollars with the benefit of the currency movements, those returns increased to 14.2%. Even within the S&P 500 Index, the 50 stocks with the highest percentage of foreign revenue outperformed the 50 stocks with the lowest percentage by a spread of 1,250 basis points in the same time period.

As we write this letter in the midst of a flurry of earnings releases, recent results continue to bolster our confidence in the strong corporate performance that provides the foundation for the equity market's advance. Using estimates from David Kostin at Goldman Sachs, S&P 500 profits remain poised to grow approximately 9% in 2017. First quarter profits for the S&P grew even faster at a 13% clip, aided by an easy comparison to a period in which the energy sector was dealing with oil prices below $40 per barrel. According to FactSet, expectations for second quarter growth were hovering at 6.4% as earnings season began, and if the early results are typical, companies beating expectations will cause that figure to be revised up to approximately 9%. Another 7% annual increase is possible in 2018, and any favorable changes in tax laws stemming from a reduction in the corporate tax rate could improve that rate of growth.

Benefitting from stronger growth in many of our portfolio companies, we continue to estimate profit growth of 16% in 2017 for a typical Sarofim portfolio's earnings stream. Furthermore, we expect superior growth to continue in 2018 and beyond. With new additions in several sectors over the past several years, we have made changes to our portfolios designed to improve earnings growth and the diversity of the portfolios' growth drivers. In addition, the headwinds created by US dollar appreciation and the fall in commodity prices have diminished. While we foresee faster growth in earnings per share at the companies in our portfolio, the typical Sarofim portfolio still trades at a discount to the S&P 500. As a result, we are optimistic about the portfolio's future return potential. Market volatility, often measured by the VIX index, has set record lows in the first half of 2017, and many observers expect it to rise back toward longer-term averages. If so, the strong balance sheets, resilient cash flows, and superior competitive positions of the companies in our portfolio have typically provided excellent downside protection in more volatile periods. As this bull market and economic cycle stretches into its ninth year, we believe that combination of return potential and risk mitigation should garner increased attention from investors.
