January 2017

Economic Comment and Market Outlook

With trends in corporate profits turning the corner and resuming growth in the second half of 2016, US equity markets found the strength to push higher, ending the stall that began in May 2015. The S&P 500 set new records for closing index values beginning in July and carrying through to December while the Dow Jones Industrial Average made a serious attempt to break the 20,000 level. Propelled by the improving momentum in earnings growth and then by optimism surrounding the results of the US elections, the S&P 500 generated a total return of 12.0% for the full year. From its inception in March 2009 through the end of this past year, the current bull market has spanned over 2,800 days and seen the S&P 500 increase over 230%. That performance qualifies as the second longest and third strongest advance since the S&P 500 began in 1928. While the market's assessment of the election impact might be a little exaggerated, we believe that the support from earnings growth will continue to provide the fuel to move the market upward. Furthermore, with superior earnings growth prospects and more reasonable valuations, our portfolio companies appear poised to generate the financial results needed for further gains.

At the conclusion of our last letter, which just followed the United Kingdom's "Brexit" referendum, we noted that there was a tremendous sense of dissatisfaction with the failure of economies around the world to deliver improving living standards. Riding such sentiment, Donald Trump won the Presidential election, and the Republican party performed much better than expected in its Congressional races, preserving majorities in the Senate and the House. As those results became clear, the futures market initially reacted negatively to the surprise in overnight trading. However, investors then focused on the prospects for lower regulation, lower taxes, and greater fiscal stimulus, engendering a stock rally and a powerful, risk-seeking rotation in the marketplace. Smaller capitalization stocks outperformed large; value stocks outperformed growth; cyclical and bank stocks outperformed defensives; and domestically-oriented companies outperformed global ones. Many of these post-election moves were so large that they dramatically impacted returns for the full year.

Investors have generally been excited and optimistic about the economy and equity markets since the election, but it is important to recognize that most of the factors that have constrained growth worldwide did not just disappear. At the margin, less regulation, lower taxes, and some additional fiscal stimulus could definitely help. However, high levels of debt outstanding, aging demographics, lower investment, weak productivity growth, and numerous geopolitical concerns remain. In particular, the massive growth of debt over the past decade will act as a brake on economic activity and the government's ability to finance its programs, especially when interest rates rise. The reality of a $20 trillion federal debt is that every fifty basis point increase in its cost represents $100 billion per year in extra interest expense. Furthermore, some of the policies—or tweets!—of the incoming administration and Congress may not be as friendly to business as the market has initially assumed, especially surrounding trade, taxes, or health care. Some participants in the recent rally may need to temper their enthusiasm as a result.

While Brexit caused precipitous drops in bond yields worldwide, Trump's victory immediately raised US interest rates. The yield on the benchmark 10-year US Treasury note, which began the year at 2.27%, fell to a low of 1.37% in July after the jolt from the UK. Having risen back to 1.88% by election day, the yield climbed as high as 2.60% in mid-December. Investors anticipated a shift to larger deficits and pro-growth policies would raise the likelihood of inflation and the future trajectory of Federal Reserve interest rate increases. Fed officials had already telegraphed plans for an interest rate hike prior to the election, and they followed through at the December meeting, raising the Fed Funds rate by a quarter percent, like they did one year before. Therefore, over the course of 2016, the midpoint of the targeted range for the Fed Funds rate rose 25 basis points to 0.63%, and the yield on the 10-year Treasury note rose 18 basis points to 2.45%. While the year may have felt like a roller coaster to bond traders, the net effect was a measured increase across the yield curve. With a slight increase in yields combining with their already paltry level, the Barclays Aggregate Index of fixed income instruments returned 2.7% for the full year. That low single-digit return is consistent with our expectations for what investors in these markets stand to achieve for the time being. We also expect the yield curve to continue to shift upward in a gradual fashion. On the short end, the Federal Reserve is signaling three separate 25 basis point hikes in 2017. On the longer end of the curve, investors will most likely demand higher yields to compensate them for rising inflation risk caused by steady economic growth, low unemployment, and the potential for some fiscal stimulus.

Completing a five year stretch where the S&P 500's total return has beaten the MSCI EAFE Index of foreign stocks by approximately 7.5% annually, foreign markets again trailed the returns of US stocks in 2016. Measured in local currencies, the EAFE index provided a return of 5.9%; once translated back into dollars, those returns shrank to only 1.5%. In the past several years, the strength of the US dollar has clearly driven some of this return difference. However, corporate profit growth for the companies in the S&P 500 has also been markedly superior to those in other regions. Even fighting against the dollar's appreciation, forward earnings estimates for the S&P 500 have risen 35% from December 2007 to the end of 2016. Over the same time period, forward earnings for the MSCI Japan and MSCI Europe indices have declined by 2% and 19%, respectively. Donald Trump is promising to "Make America Great Again," but in the category of corporate profitability, the country certainly never lost its leadership position!

S&P profits now appear poised to register material improvement in 2017 and 2018, creating a favorable backdrop for additional stock price gains. A 3.1% increase in the third quarter of 2016 represented a return to year-over-year growth in S&P profits after two years in which the drop in the price of oil and the rise in the value of the US dollar relative to other currencies combined to prevent that growth. Using estimates from David Bianco at Deutsche Bank, S&P 500 earnings growth could improve to 9.2% in 2017, from a level of approximately $119 per share in 2016 to $130 per share in 2017. Bianco sees another 7.7% increase to $140 per share in 2018, and if President Trump and the Republican Congress agree on a corporate tax cut, his figures suggest a 4% increase in net income for every 5% reduction in the current 35% federal corporate income tax rate.

Benefitting from more exposure to the rebounding energy sector and stronger growth inherent in many of our portfolio companies, we currently 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, and we believe most of our companies will be beneficiaries of the proposed tax plans being discussed by President Trump and Congressional leaders. Some holdings would find greater benefits in tax rate reductions on their domestic earnings while others might see opportunities created by an ability to repatriate significant foreign cash balances. While we foresee faster growth in earnings per share at the companies in our portfolio, the typical Sarofim portfolio is trading at a discount to the S&P 500. Based on our expectations for 2017 earnings, the Sarofim portfolio's price-earnings multiple is 16.3x, a 15% discount to the S&P 500. As a result, we are optimistic about the portfolio's future return potential. Combined with the downside protection that our portfolio has traditionally provided, as this bull market and economic cycle stretches into its ninth year, we believe that combination of return potential and risk mitigation should strike an increasing number of investors as very attractive.

We remain convinced that our portfolios are well-positioned to generate superior risk-adjusted returns over the long term, and we will continue to analyze the ever-changing environment and adjust accordingly. As always, we welcome your questions and thank you for the trust that you have placed in our firm.
