

The First 100 Days

Summing up where we are now and how it effects our 2017 estimates



April 2017

The title, 'First 100 Days', implies a note about politics and the Trump administration. Success, failures, tweets, investigations, and all. What a great note that would be – that every journalist ever will write in the next month. Instead of being one of many, the first 100 days we are referring to is of the year 2017. When readers click to read this note, expecting it to be politically charged because of the title, and instead read a note about company earnings and GDP – they are likely to be disappointed (but hopefully not you). In the online advertising world this is called 'click-bait' – or giving a consumer something irresistible to click on only to redirect them to something not so great. Drives page views sure, but also breeds 1) reader disappointment and 2) a loss of trust (both things we hope our readers never feel!)

The market environment experienced throughout the first quarter **might** shape up to be 'click-bait' for investors. Market participants can be easily influenced by quick market gains and wooed by their own fabrication of how they see the future with tax cuts, big spending, and deregulation. The current multiple (the amount an investor pays for future cash flows) on the S&P 500 index is roughly 17.5x 2018 consensus earnings¹ versus a historical 15x (5-yr average).¹ This means investors either believe 2019+ earnings are going to be stellar or they really don't want to own anything else and hope others feel the same to keep the multiple elevated. As long term, fundamentally focused investors, we never want to own something using 'the greater fool theory'.²

The constant challenge all investors face daily, us included, is determining what is priced into a market and what isn't. To be clear, we aren't calling for a huge decline or rally – just reaffirming our views from December and calling attention to the lack of material fundamental change in the past three months. In our [2017 Macro Outlook](#), we note:

Scenario	Probability	2016 EPS	2017e EPS	2018e EPS	Fwd. P/E	Y.E. 2017 Target
Bull	30%	\$119.50	\$131.45	\$159.05	18.0x	2862
Growth		1.3%	10.0%	21.0%		
Base	55%	\$119.50	\$127.87	\$146.41	16.0x	2344
Growth		1.3%	7.0%	14.5%		
Base @ 26%		\$119.50	\$127.87	\$141.29	16.0x	2260
Growth		1.3%	7.0%	10.5%		
Bear	15%	\$119.50	\$115.92	\$104.32	14.0x	1465
Growth		1.3%	-3.0%	-10.0%		

All numbers adjusted. 2018 takes into account corporate tax cuts. Source: Doxa Research

¹ 17.5x consensus operating earnings of \$134/shr, 16x consensus adj. operating earnings.

² Or 'hoping there is a greater fool than you to buy an overvalued asset at a later date.'

“In short, our 2017 theme can be summed up into one sentence: A battle between late-cycle economic forces and ‘Trumponomics’. In slightly more detail: wage pressures, inflationary forces, higher cost of capital, and a strong USD versus the net effect of changes in tax policy, fiscal spending, deregulation, and trade policy.”

Nearly 4 months later, markets have rallied close to our year-end price target, yet all of these substantial issues are still undecided. If anything, one could argue that tax policy and deregulation will be less than expected because of the reality of government.

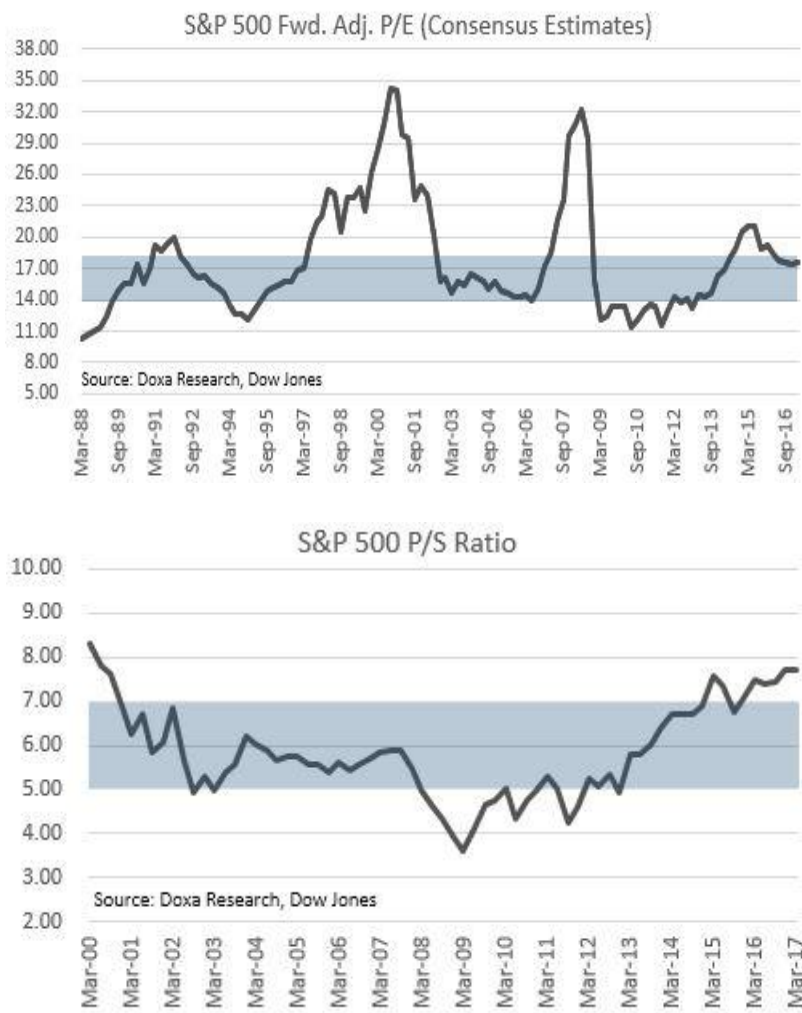
So what are we saying?

Our point is ‘don’t get caught up in sentiment swings and stay grounded in the fundamentals’. The possibility of a watered down corporate tax cut, a Bush-style personal tax cut, infrastructure spending pushed out to 2019 or 2020, plus a few deregulations is very real. In our view, these issues will alter earnings expectations greatly and should not be discounted. Again, despite recent market movements, we are largely reaffirming our 2017 base target of 2350.

S&P 500 Earnings & Target Update

The fourth quarter closed 2016 \$1.50 short of our expectations in December, which brings down our 2017 & 2018 targets a touch (not material).ⁱⁱ We are on the low end of consensus for 2017 because 1) some still believe a tax benefit will hit 2017 numbers[we do not], and 2) we do not see energy contributing as much as some expect. As mentioned in prior notes, 2018 assumes an 8% EPS benefit due to corporate tax cuts down to 21.5%. At this stage, we are materially less confident in 21.5%, so we find it prudent to add a scenario to our base case that only assumes a 4% EPS benefit due to tax cuts (25-28% range). As shown in the earnings table above, we are comfortable with an S&P 500 target between 2250 and 2350, based on the tax policy outcome³ – possibly not fully known until the fall.

Overall, the last quarter of 2016 turned out about how we expected with minimal surprises. Markets have clearly priced in large



³ NOTE: +/- 70 points on either side of the range would allow for a 0.5x margin of error in the forward multiple.

expectations for 2017, but we expected to get little, if any, color on deregulation and/or taxes from company management because of the uncertainty around policy. We got exactly what was expected there, with few companies mentioning a change in policy as a tailwind. The wait-and-see approach was alive and well.

Sector Notes:

Banks were very optimistic due to rate increases, a positive outlook on GDP growth, and oil price stabilization. However, we want to point out that a flattening yield curve hurts net interest margin (NIM) and loans and leases as a whole declined in the first quarter.ⁱⁱⁱ

The **energy** story was all about capex guidance for 2017. Numbers here came in modestly higher, most directed toward Permian plays.^{iv} Short cycle oil, inventories, and the Saudi's pending Aramco IPO all bear watching over the next couple of quarters. Generally, we think E&P's have gotten ahead of themselves – the oil price saga isn't over yet.

Perhaps the biggest story out of Q4 was the 'collapse' of **retail** and terrible consumer spending data. Most retailers close the quarter on Jan 30, so the first month of the year is included in quarterly numbers – and this year brought a lot of pain across the sector. Weather wasn't a big excuse as in prior years and 2015 Q4 numbers were unusually strong (making for tough y/y comparables). Nevertheless, the debate rages – is conventional retail dead? Has online, price competition, and discounting gotten the best of the consumer discretionary sector?⁴ We give merit to the antagonist here and don't disagree when it comes to pure distributors (think dept. stores, sporting goods stores, office supplies, etc.); however, we think strong brands still have pricing power and are adjusting accordingly.

So why the slowdown in retail? We do not believe enough is being made of the IRS tax refund delays for EITC and ACTC filers [new law delayed these returns until Feb 15th].⁵ Many of these filers are low income and rely on these refunds to restock on clothes and discretionary items for the year. On February 21, the treasury had paid out just \$36bn in tax refunds versus \$93bn at the same point last year.^v We find it probable that investors are assuming the 'death of conventional retail' is here and gone, when Q4 weakness can actually be attributed to payment shifts. Again, we don't disagree with the secular shift argument, but we believe it plays out over the span of years, not quarters – giving strong retailers and good brands ample time to adjust.

Data to watch: Wage growth, 1Q17 productivity, ISM index, Loans & Leases, & FY2017 guidance adjustments.

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⁴ E-Commerce as a % of total retail sales in the US was 8.3% in the fourth quarter.

⁵ PATH Act of 2015

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- ⁱ S&P Dow Jones, March 2017 Earnings Analysis
ⁱⁱ S&P Dow Jones, March 2017 Earnings Analysis
ⁱⁱⁱ US Bureau of Economic Analysis/FRED, Doxa Research, company data
^{iv} Company data
^v Morgan Stanley Research, IRS Data

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