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"We are quality value investors.

We focus on companies

with strong fundamentals,

priced at a discount to their peers.

We believe these companies

will deliver superior returns

over a market cycle."

May 9th, 2017

Dear Client:

Corporate CEO's are getting more optimistic. The recently released Business Roundtable Survey of 141 chief executives indicated a sharp increase in sales expectations and hiring and investing plans. Regarding the future, 79% of respondents identified tax and regulatory reform as the two most effective policy initiatives to stimulate economic growth.

We are encouraged by their enthusiasm and agree with their conclusions regarding the economic impact from effective tax and regulatory reform. However, tax reform details are slim to none at this time and any bill faces a long slog through the legislative process. Consequently, we have no idea what its impact might be, let alone its timing. And even if one is passed, the odds of any impact on the 2017 economy are close to nil. Maybe next year.

We've felt for some time that effective tax and regulatory reforms are necessary to nudge the U.S. economy above the current tepid +2% or so secular rate. The sluggish growth rates of productivity and the labor force define the ceiling of real economic growth. In the absence of any meaningful pickup in labor force expansion—which is unlikely—the burden of more robust economic growth defaults to boosting productivity. And it's capital investment that drives productivity growth. Unfortunately, business investment has been pathetically subdued over the past eight years and is at the very low end of its band relative to GDP. That takes us back to our CEO's. It's our guess that it will take those tax and regulatory reforms to boost their confidence sufficiently to stimulate a robust capital spending cycle.

Ed Hyman of ISI Evercore expects faster economic growth in 2018 if the stimulus measures are enacted this year. We agree that a good bill would likely unleash corporate animal spirits. But we think it's too early to bake in much certainty of impact or timing into one's investment decisions.

TABLE I

Evercore ISI U.S. Outlook for 2017-2018

	With Tax Reform	
	2017 f [1]	2018 f [1]
Real GDP	2.3%	3.0%
GDP Price Deflator	2.2%	2.5%
Fed Funds Rate*	1.35%	2.35%
10-Year Bond Yield**	2.70%	3.00%
S&P EPS	$133	$140

	Without Tax Reform	
	2017 f [1]	2018 f [1]
Real GDP	2.0%	2.2%
GDP Price Deflator	2.0%	2.3%
Fed Funds Rate*	1.35%	2.10%
10-Year Bond Yield**	2.50%	2.75%
S&P EPS	$128	$134

[1] Forecast
***Effective Fed Funds Rate, year-end**
****Bond Yield, year-end**

Source: ISI Evercore

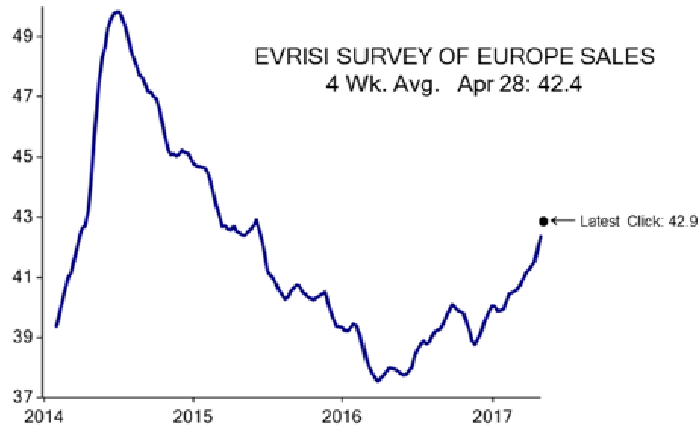
Both long- and short-term interest rates are heading higher—but only gradually. Bonds are not attractively priced relative to U.S. equities at the current level of interest rates, particularly given the likelihood of capital losses at the long end of the curve. Obviously as rates go higher, there will be a point when they will be more competitive with equities.

The Fed has begun its long expected tightening process. However, conditions don't yet warrant aggressive rate increases. As we've discussed before, equity markets have usually continued to advance during the first two or three years of the tightening cycle. But it's critical to be sensitive to the possibility of overheating and, if so, a more hostile Federal Reserve would surface. So far, inflation has not been a problem. And we doubt it will be for at least a year, so the path of Fed Funds rate increases will be gradual.

The secular forces that have driven the 35-year bull bond market have hit an inflection point. Most importantly, changing demographics will ultimately suppress global savings rates, reducing the supply of liquidity. And less liquidity means higher interest rates. More on this at another time.

A number of international equity markets offer some interesting opportunities. Europe, Japan and a number of emerging markets performed well in the first quarter. And many foreign economies, including Europe, are rebounding.

CHART I
SURVEY OF EUROPEAN SALES



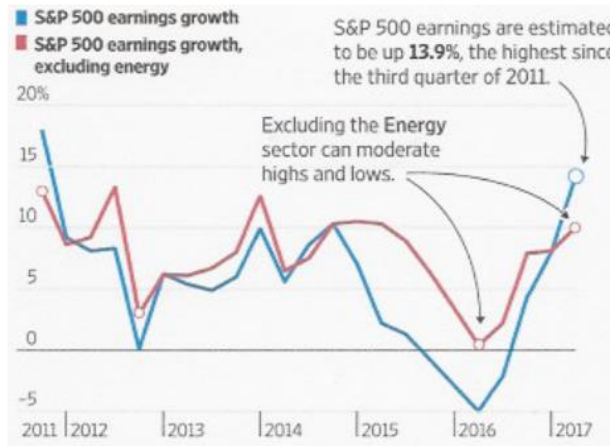
Source: ISI Evercore

European fundamentals are definitely improving. First quarter GDP increased at a +1.8% annual rate, earnings are beating expectations, deflation is no longer a significant risk, monetary policy remains extremely accommodative and political risks have abated (but look out for Italy in 2018). The Stoxx Europe 600 P/E on forward earnings has moved up slightly to 15x but is still below that of the S&P 500 at 18x. The improving fundamentals priced at a discount aren't being ignored.

The pace of profit growth will largely determine the bulk of future U.S. stock market returns. It's very difficult to make a case for a rerating of valuations given their premium to historical norms, particularly given investors' widespread expectations of rising interest rates and attractive opportunities outside the U.S.

First quarter earnings results were very impressive despite the lethargic 0.7% real GDP growth. Earnings jumped 13.9% in the quarter and +10% excluding the big recovery in energy sector profits. Moreover, 77% of reporting companies beat expectations while revenue growth was a surprisingly strong +7%.

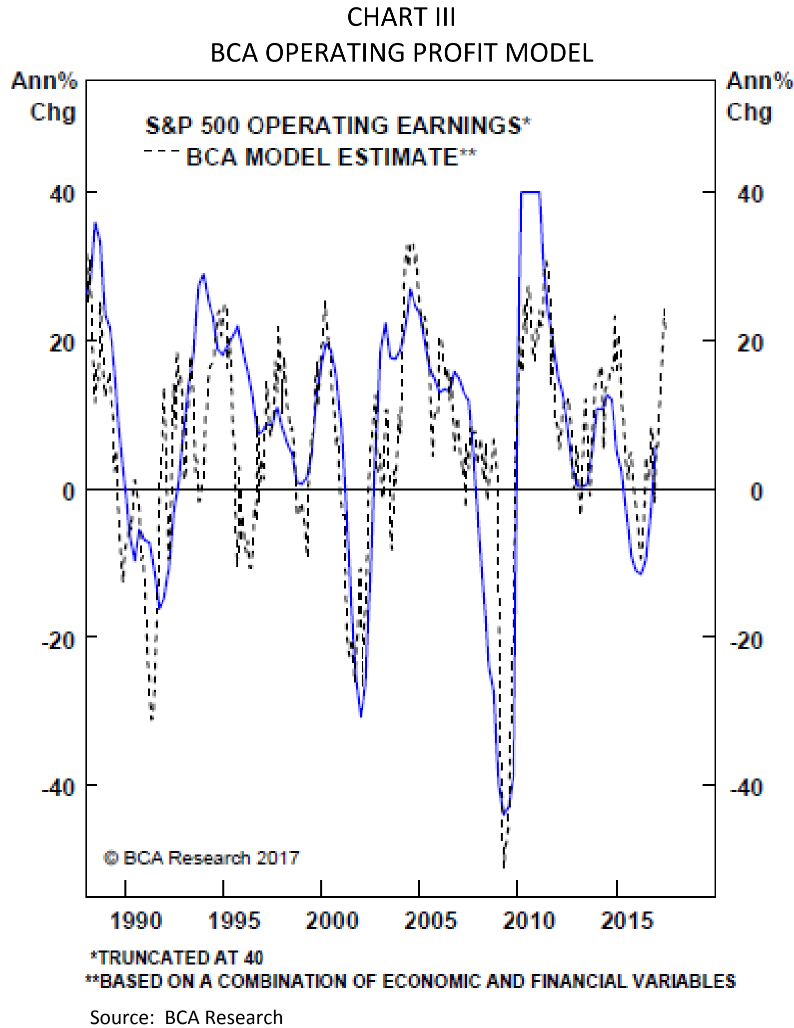
CHART II
Q1 S&P 500 EPS



Source: WSJ

The Bank Credit Analyst's Operating Earnings Model has turned decisively bullish, forecasting an increase of close to +20% by the end of the year. If they're right, the actual earnings gain might even match analysts' perpetually optimistic projections.

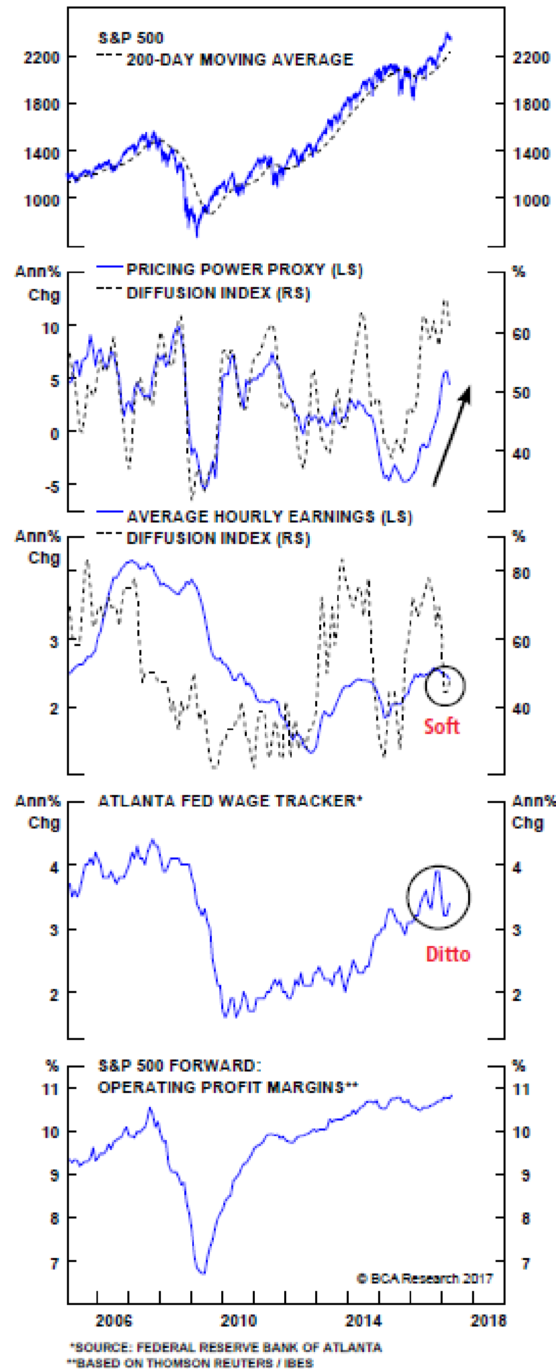
CHART III
BCA OPERATING PROFIT MODEL



Source: BCA Research

Implicit in their forecast is the controversial assumption of stable profit margins. They note that the Employment Cost Index rose at a subdued +2.4% rate in the first quarter. Also, Average Hourly Earnings increased at a sub-3% rate as well, and its diffusion index has been weakening. In contrast, both their Pricing Power Proxy and diffusion index have been rising. The combination of stronger pricing power and subdued employment cost increases is the basis for their relatively benign margin outlook.

CHART IV
PRICING POWER



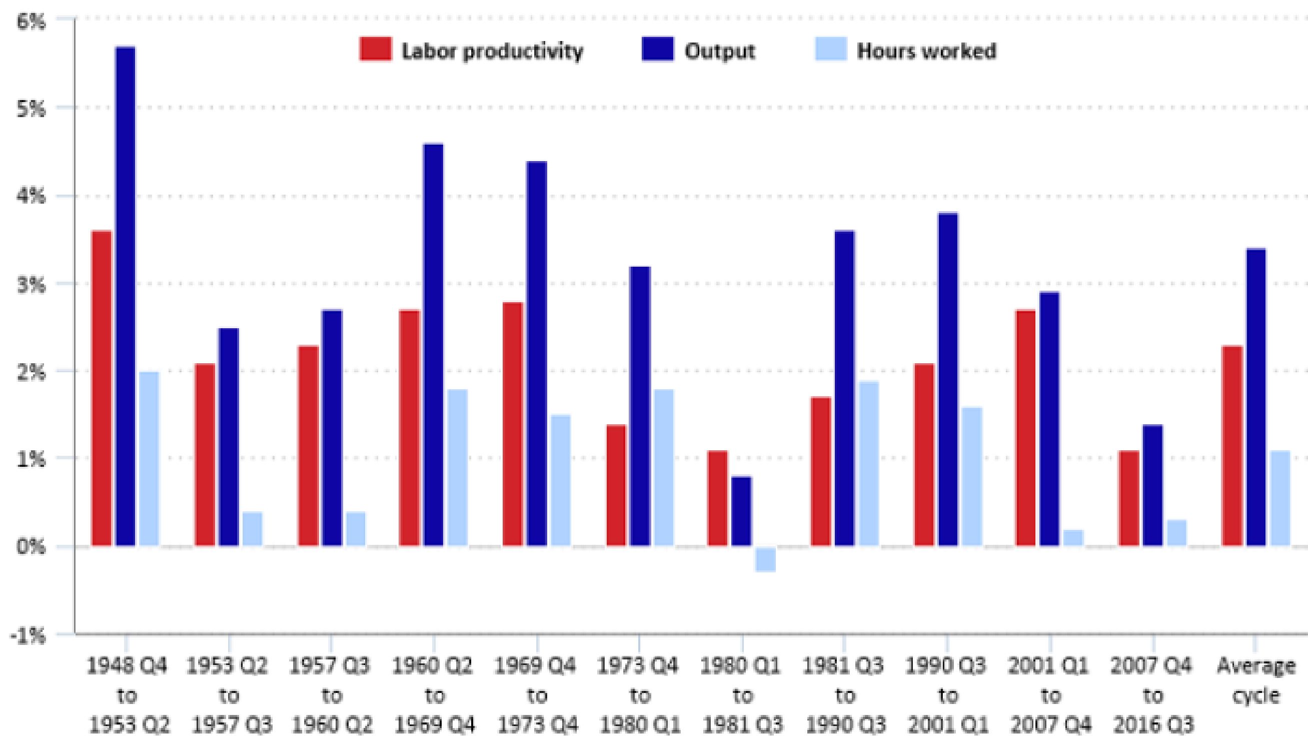
Source: BCA Research

But one's margin views are heavily impacted by compensation projections. ISI believes labor markets are tightening and will continue to do so. They forecast Average Hourly Earnings rising at a +3% rate by year end and by +4% late in 2018. They don't see the same strengthening in pricing power, so their projections of future profit margins are less sanguine.

Labor markets definitely look like they are tightening, and wage increases are picking up as one would expect. Meanwhile, productivity gains necessary to suppress unit labor costs continue to disappoint. First quarter productivity actually *declined* (0.6%) driving unit labor costs higher by +3.0%. We'd like to embrace BCA's positive case for strengthening corporate pricing power that is critical to offsetting rising unit labor costs. But we don't see much evidence of it. And in the absence of pricing power, it's difficult to make a case for margin maintenance, let alone strength.

Productivity and output growth have been paltry since the outset of the financial crisis and the subsequent Great Recession. Since the fourth quarter of 2007, productivity has grown at a subpar rate of +1.1% annually versus a healthy +2.2% over the entire 1948-2016 period. The combination of sluggish productivity increases and below average growth in hours worked led to the weakest recovery in the post-war era.

CHART V
PRODUCTIVITY AND OUTPUT



Source: Bureau of Labor Statistics

We think effective tax and regulatory reforms are *critical* to altering the current trajectory of sluggish productivity, economic and profit growth in the U.S. And U.S. equity markets need faster earnings growth to compete with some of the compelling opportunities offered in international markets. At 18x forward earnings, expected S&P 500 total returns will likely be limited to future earnings growth plus the dividend yield. If interest rates rise faster than we expect, or if there's a negative exogenous geopolitical event, returns will suffer.

We think the odds favor positive reforms. But no one knows much about their substance and even less about their timing. So, decision makers will likely remain cautious until there's more clarity. If the reforms are largely pro-growth, they will ultimately reinvigorate the economy and profits. If real growth migrated from the current +2% or so to +3% (forget +4%) and was driven by healthy productivity gains, real wages would rise without incurring inflationary pressures. Corporate revenue growth would likely increase to a mid-to-high single digit rate while earnings per share, boosted by about +2% a year from share repurchases, should grow faster. And the dollar would remain firm given the improvement in growth and the turn in the interest rate cycle. That's a compelling case for U.S. equities. But it won't happen without the effective policy initiatives. Let's hope.

Best regards,

Timothy G. Dalton, Jr.
Chairman