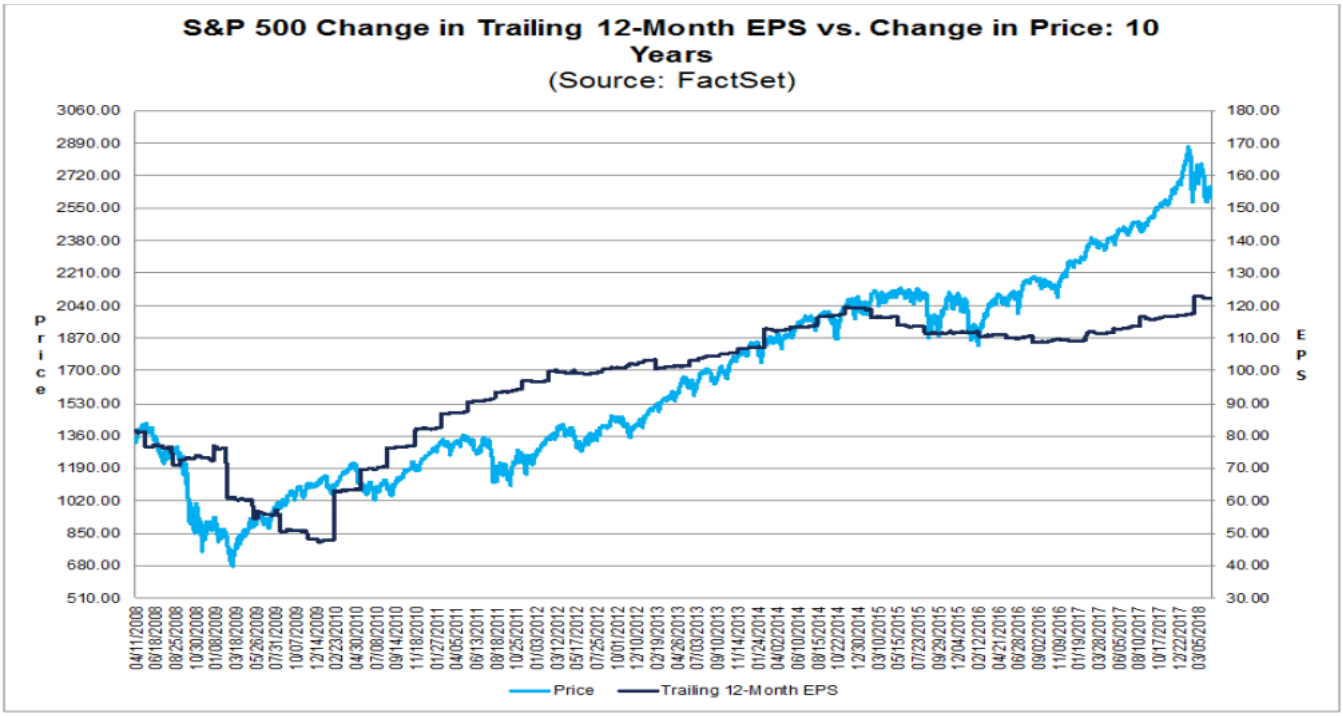
Market Insights for Week Ending April 13, 2018

It's All About Earnings

Having put the talks of a trade war in the rearview mirror for the time being, the market will now turn its attention to corporate earnings. According to FactSet Earnings Insight, the expected earnings growth rate for Q1 2018 is 17.1%. If in fact that number comes to fruition, it will mark the highest earnings growth since Q1 2011. In addition, the expected revenue growth rate for Q1 2018 is 7.4%. It is important to distinguish between the two measures based on what exactly they are telling us and how they are created. First, an earnings growth rate of 17.1% is a very big number and would certainly go a long way towards potentially propelling equity prices higher. Yet, while we often spend time focusing on earnings, revenue is also very important. Positive revenue growth shows that companies have been able to increase profits through improved sales rather than just cutting expenses. In addition, revenue is the one figure that is pretty much immune from the manipulation of creative accounting. This can be a better gauge of the true health of businesses and their ability to generate returns on a sustainable basis.



The chart above shows the price of the S&P 500 (light blue line) and the cumulative earnings per share of the companies that make up the S&P 500 (dark blue line). You will notice that for a good portion of the last decade, the lines have moved in a similar direction. They haven't always been in lockstep with one another but for the most part, the movements appear to mirror one another. But starting in early 2016, you will notice a fork in the road, so to speak. The price of the S&P 500 continued to move higher while the actual earnings of the companies that make up the index stagnated and even contracted slightly at the beginning of that period. This gap has been described as the growth premium that investors are willing to pay for the potential to receive higher future returns, believing that at some point earnings would accelerate and justify the higher prices.

Why Do We Care?

As HCM continues to review portfolio allocations, we must ask ourselves what to make of the gap we see above. For several quarters now, investors have been willing to pay higher prices for future expected growth, most of the time with little to no consideration as to whether or not it would actually come to fruition. Most of the concern was likely buried under suppressed volatility. When the market goes up, everyone is happy and most people don't ask questions. However, the best investors are constantly asking questions and thinking about what could go wrong as much as celebrating what is going right.

HCM believes this earnings season will be extremely important for market direction for several reasons. First, we have just come off the first negative quarter for equity markets in quite a while. The overall market mood has been shaken somewhat by the volatility experienced in the first quarter and investors are now starting to consider things that 12 months ago were simply an afterthought. A positive earnings season would go a long way in helping to return some stability to the market.

Second, the gap from the chart above has to be reconciled at some point. Either earnings (dark blue line) need to move up or the S&P 500 (light blue line) needs to come down, or possibly a combination of both. The volatility we have seen over the past few months may be a result of this tug of war playing out in real time.

Finally, even with a strong earnings season expected, the bar has been set extremely high. The market likes to discount future events into the present, and judging by the chart above, the market is expecting blowout earnings growth. But what if we get 10% growth instead of 17%? 10% would still be a strong number, but it would be almost 50% less than the market is priced for. That doesn't mean the market would sell off by 50%, but there would likely be a re-pricing of expectations and in turn, an adjustment in real time prices.

Overall, HCM expects earnings to be strong and supportive of equity prices. The question is whether they will be strong enough to propel prices higher from current levels and ultimately close the gap that has been generated in the chart above. In the event of a poor earnings season, we would expect to see increased volatility and the potential for risk reduction in our portfolios.

Weekly Focus – Think About It

"I never see what has been done; I only see what remains to be done".

-Buddha

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Gain of 2.00%
- Developed Foreign Markets (EFA) – Gain of 2.00%
- Emerging Markets (EEM) – Gain of .70%
- Fixed Income (AGG) – Loss of .17%

(Note: performance is based on the change in net asset value

Last Week's Headlines

-Global equites rose, with energy and tech stocks leading. Market fears over a US-China trade war eased after President Xi Jinping reiterated his pledge to open up the Chinese market.

-Brent oil prices rose to multi-year highs as the US threatens to take military action in Syria.

-March US CPI confirmed firming inflation while minutes from the Fed's March meeting showed confidence in their growth and inflation forecasts.

Eye on the Week Ahead

-Companies representing 15% of the S&P 500 market cap are scheduled to report first-quarter results.

If you have questions about the upcoming earnings season, please contact a member of HCM's Wealth Advisory Team:

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Additional Notes:

- The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
- Past performance does not guarantee future results.
- You cannot invest directly in an index.
- Consult your financial professional before making any investment decisions.

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