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Stay the Course, Open an Umbrella, or Build an Ark?

Ignore Chaos in Washington

I suggest ignoring the noise of politics and look to the real world of economic and corporate earnings and look to the market fundamentals in making investment decisions.

U.S. Fundamentals

S&P 500 Reporting Record-High Net Profit Margin for Q1 2018

Highlights from FactSet

Profit Margins – 4/23/2018

The blended net profit margin (combines actual results for companies that have reported and estimated results for companies yet to report) for the S&P 500 for Q1 2018 is a great 11.1%. If 11.1% is the actual net profit margin for the quarter, it will mark the highest net profit margin for the S&P 500 since FactSet began tracking this data in Q3 2008.

5/28/2018 update – FactSet has not updated their profit margin reporting with now 97% of companies reporting. However, as of 5/22/2018 Yardeni Research reports the profit margin is 12.0% - better than the earlier 11.1% stated by FactSet when there were fewer reporting companies.

What is driving the higher net profit margins for the index? The reduction in the corporate tax rate due to the recently passed tax law is likely a significant factor, as the lower tax rate has boosted earnings for companies in the index for the quarter - although it is important to note that net profit margins were improving prior to the tax bill becoming law. In any event, it appears the lower tax rate is more than offsetting any impact of higher wages and other rising costs, resulting in a record-level net profit margin for the index for the first quarter.

It is interesting to note that analysts expect even higher net profit margins for the remainder of 2018 for the S&P 500. Based on current earnings and revenues estimates, the estimated net profit margins for the second, third, and fourth quarter of 2018 are 11.5%, 11.8%, and 11.7%, respectively.

Earnings Growth Updated 5/25/2018

For Q1 2018, with 97% of the companies in the S&P500 reporting, the blended earnings growth rate for the S&P 500 is 24.6%. This is the highest earnings growth since Q3 2011 (34%). It also is the fourth time in the past five quarters that the index has reported double-digit earnings growth.

In addition, 78% have beat EPS estimates, marking the highest percentage of "beats" since FactSet began tracking EPS beats in Q3 2008.

In terms of sales revenue the year-over-year sales growth rate for the first quarter is 8.5%. 77% report actual sales above estimates which marks a tie with the previous quarter for the highest percentage of S&P 500 companies beating sales estimates since FactSet began tracking sales beats in Q3 2008.

Double-Digit Earnings Growth Expected For All of 2018

For the first quarter, companies are reporting earnings growth of 24.6%. Analysts currently expect earnings to grow at double-digit levels for the remainder 2018. For Q2 2018, analysts are projecting earnings growth of 18.8% and revenue growth of 8.6%. For Q3 2018, analysts are projecting earnings growth of 21.1% and revenue growth of 7.4%. For Q4 2018, analysts are projecting earnings growth of 16.9% and revenue growth of 5.8. For all of 2018, analysts are projecting earnings growth of 19.5% and revenue growth of 7.5%.

Analysts Project 13% Increase in Price Over Next 12 Months

The bottom-up target price for the S&P 500 is 3086.30, which is 13.1% above the closing price of 2727.76 (These analyst estimates can not be assured and are just estimates based on current market conditions.)

Ratings

Overall, there are 10,991 ratings on stocks in the S&P 500. Of these ratings, 53.2% are Buy ratings, 42.2% are Hold ratings, and 4.6% are Sell ratings.

Stocks Still Expensive?

Not as much as in my report: **The Bull Market's Next Act - 2018 Outlook** (end of Tax Law Discussion)

written at the end of December. I reported that the S&P500 traded at 18 times the next four quarters' expected earnings, although if it were recomputed excluding the four "FANG" stocks that had an average ratio of 115 times earnings, the overall S&P500 valuation would be much lower.

FactSet reports based that on current earnings, the current ratio is down to about 16. We continue to believe that so long as corporate earnings keep climbing and the Federal Reserve raises rates in a measured way, the market has more room for gains at least for 2018.

Massive Tax Cut Adjustments Now Behind Us.

In **2018 New Tax Law – Potential Market Results** I did an in-depth analysis of the chaos in the market on 12/22/2017. Many stocks had trading halted "news pending" as corporations had to recalculate in only four business days the effect of the tax cuts vs. interest rate limitations on their deferred tax liability reserves and report to the SEC. Overall the net adjustments were not significant for most companies, as I discussed in the example of Mallinckrodt, etc. Going forward the tax cuts will benefit earnings, but the complicated required accounting adjustments are over. If you didn't receive this report, the details of the less well-known tax changes may also be of interest.

Tax Cut Benefit Mostly Going to Shareholders

The positive effect on the broad economy is expected to be minor compared to the benefit to shareholders. While the favorable expensing rules may result in more capital spending, companies overall already had record amounts of cash and have been able to borrow at near- record low interest rates for the last few years.

In mid-April 2018, Just Capital reported a survey of 120 companies that had announced bonuses or wage increases to employees. The results were only 6% of their tax windfall that went to wages that weren't just one-time bonuses.

According to Just Capital "Many companies have already made clear their intentions to prioritize shareholders. CEOs from Coca-Cola, Cisco, Amgen, and others have stated that the extra money will largely flow to the investment community through increasing dividends and stock buybacks. According to an S&P Dow Jones survey of 302 companies surveyed, 65 percent said they planned to boost dividend payments, and 46 percent forecast share buybacks."

According to Protradingresearch.com 4/20/2018: "Assuming there will be increased buybacks with less CAPEX spending than expected, it is safe to conclude that the real economy will underperform. After all, we have decades of data showing that trickle-down is not nearly as effective as advocates believe. Not only that, its marginal effect is also decreasing.

"Yet even though buybacks will not kick start the real economy, it will have an effect on the financial economy. We can expect stocks to be goosed higher in the coming quarters as the buybacks kick in. Many projections have buybacks increasing by over 75% this year. This is from an already elevated level. The relentless bid from corporates purchasing their own shares will not be going away anytime soon and, in fact, will increase in intensity in the coming months." This, of course, is positive for stockholders, since buybacks of stock decrease the price/earnings per share valuations with fewer shares outstanding.

On the negative side, the stimulus to the financial economy might encourage the Fed to increase rates faster, and if the real economy GDP doesn't grow as much as the very high growth needed to support the loss of revenue from the tax cuts, this could lead to a major problem in U.S. debt financing.

Further, stock buybacks (or higher dividends) are tax-favored, so this will not increase tax revenues as much as ordinary income. It is a complex situation, and the outcome, especially beyond 2018, is dicey if we do not get high GDP growth.

In addition to the tax cuts, with the Republican spending bill that passed, the Congressional Budget Office on 4/09/18 forecasted a deficit of over $800 billion in 2018, climbing to annual deficits of at least $1 trillion for nine consecutive years beginning in the fiscal year 2020.

Debt held by the public will stand at a staggering $29 trillion by 2028, prompting a warning from CBO Director Keith Hall. "Nobody knows what's too much debt — what will cause a fiscal crisis," he said, detailing the grim news. "The bigger the debt, the bigger the chances of a fiscal crisis."

Smaller Stocks

Both in the U.S. and globally, smaller companies have the potential for faster growth, and with so many more smaller companies than large, good research can potentially find hidden gems. Smaller companies' stocks are often more volatile with less trading volume, but over the long term have rewarded investors.

Foreign Stocks

As always, I recommend carefully selected foreign exposure in selected companies with favorable

outlooks. There are pros and cons in all markets, but individual selection is key by managers with solid long-term track record of outperformance for the risk taken.

On 4/23/2018 the IHS Markit survey reports that the eurozone economy continued to grow at a solid pace in April but that the pace of expansion has eased in recent months.

In Asia the outlook is overall favorable, with China taking over Asian leadership with the "One Belt, One Road" (OBOR) trade initiative, which takes its inspiration from the ancient Silk Road trading route. After Trump abandoned the Trans-Pacific Partnership (TPP) China, Russia and Asian nations are taking over economically in Asia. This could be beneficial to some Asia companies in some of our recommended investments.

Chinese President Xi in 2017 announced new $124 billion in funding for the OBOR initiative, including loans, grants and $8.7 billion in assistance to developing countries. Some $1 trillion has already been invested in OBOR, with another several trillion due to be invested over the next decade.

OBOR spans more than 68 countries and up to 40% of global GDP. It is China's push to put it in a position of world leadership as the US under President Donald Trump takes a more protectionist approach and gives up the mantle of globalization.

Time to start ark building? Or at least grab your umbrella?

I believe there are still opportunities to invest especially in smaller and in global growth companies using managers with a long-time track record of outperformance vs. risk.

However, for those who are more risk averse and want to lock in some of the large market gains of the last few years, I continue to suggest shifting to our more defensive "participate yet protect" strategies which I can review for clients based on their objectives and risk tolerance. We avoid most bonds given their high-interest rate risk, but recommend a variety of other alternatives.

As Wealth Management pointed out, "Ocasionally markets go through periods of extreme volatility and declines. It's easy to ride out small fluctuations when you have a long-time horizon. But in the case of large declines, experienced investors like to seek protection or hedge. In fact, for active investors, hedging might be considered as another form of diversification."

Buy in May and Stay to Play?

The old saying is "Sell in May and Go Away." During the summer there is often less trading volume, especially from Europe with their long summer holidays.

"Yet selling in May hasn't worked well lately. When you look at how the Dow Jones Industrial Average following the rule would have caused you to miss out on gains in four of the past five years." Source: "A Foolish Take: Should You Sell in May and Go Away?" 4/23/2018 The Motley Fool

Market fundamentals are far more important than seasons.

Bonds May Not be Part of Ark Safety

The recent rise in the 10-year Treasury to near 3% and the surge in LIBOR rates may signal the trend to long overdue higher interest rates and resulting losses in bond values if not held to maturity – locking in below-market income.

Therefore, we do not recommend most bonds. If a bond has a duration of 7 years, it would be expected to lose 7% in value for each 1% increase in interest rates – absent other factors.

Investor Action Recommendations

The outlook for 2018 is on balance favorable but with risks. A well-diversified portfolio should span geographies as well as sectors of the market

Since 1950 the stock market has done fine even with rising interest rates, provided the annual growth in earnings exceeds the 10-year Treasury yield.

Recommended Equity Strategies:

"Participation Yet Protect" equity growth strategies: This helps maximize potential market gains with a widely diversified portfolio. Instead of "dumb" index funds with no stock selection based on individual company outlooks, or similar ETF's (only make sense for traders, not investors), we suggest managers with long-term track records of outperformance compared to the category they invest in, and compared to the risk taken (Alpha vs. Beta in investment terms) – not just raw returns.

Avoid most bonds (due to ongoing expectations of higher interest rates), other than some forms of secured floating rate debt that can benefit from higher interest rates.

We may also recommend alternatives without stock or bond market exposure for more cautious income, or participation in part of equity gains

without downside risk backed by a strong insurance company[1].

[1]All guarantees are based on the claims-paying ability of the insurance company

Required Disclosures: Past performance does not assure future results. Investors cannot directly invest in indices. There is no assurance that objectives will be met. Investments in securities do not offer a fixed rate of return. Principal, yield and/or share price will fluctuate with changes in market conditions, and when sold or redeemed, you may receive more or less than originally invested. No system or financial planning strategy can guarantee future results.

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