Palouse Capital Management, Inc.

Investment Commentary

4Q 2016

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MARKET OVERVIEW

What, me worry?"----Alfred E. Neuman

These words from this great iconic, but fictional, American philosopher appear to have permeated investors' minds given the stock market rally we have seen from its start on November 9 (the day after the election). The S&P 500 rallied about 5% during the month after Trump's victory, which is reminiscent of the 7% rally the stock market experienced in November after Reagan won in 1980.

In addition to the fear of missing out on the market move, some of this rally appears based on expectations of fundamental improvement. Trump's proposed policies to build infrastructure, reduce taxes and regulation, and encourage job creation may help improve economic activity and corporate earnings. There have been estimates that tax reform alone could add 5-8% to corporate profits, which is about what the market has rallied since the election.

However, the market's move may have already priced in some of these expected positives, while not factoring in the dysfunction we have seen from Congress over the years. The stock market can get impatient fairly easily, so if things get bogged down and delayed we could see some of the post-election gains reversed. That was the case with Reagan, who also ran on a "fix Washington" platform, yet after the market rallied after the election, the S&P 500 declined about 10% in 1981.

Even if Congress acted quickly on an infrastructure spending bill, the effects would not likely be felt until late this year or more likely in 2018 (very convenient, just in time for the mid-term election). A law designed to encourage companies to repatriate overseas cash in exchange for a lower tax rate could have a much faster impact on the economy. However, overall tax reform could be a very sticky issue that could take a long time to resolve; as well as amending and fixing the problems with Obamacare. If the new Administration chooses to fill the vacancy on the US Supreme Court or propose amending Dodd-Frank, these actions could divert attention away from efforts to promote economic growth.

It could be that the Republican majorities in the House and Senate have had time to coordinate a game plan to do a lot of this quickly, but the market seems to have priced this prospect in, given the rally. We should get a sense of what the priorities are after January 20.

Another issue for investors to focus upon is the Federal Reserve and interest rate policies. In 2016 there were expectations of 3 to 4 rate increases, but we only saw one. The FED has telegraphed a gradual path of future rate increases, depending on how the economy and inflation perform. However, if Trump's plans for higher growth take hold, the economy's growth could accelerate and inflation could pick up too (energy prices could be higher, increased minimum wages and wage growth in a somewhat tight labor market are potential factors). In the wake of the US election, interest rates have already gone up in anticipation of higher growth. So if Trump's growth initiatives get bogged down in Congress, interest rates could come down a little, but if growth and inflation accelerate the FED may be forced to act more aggressively than the market expects.

Other risks include foreign policy and trade relations. Given the "America first" tone of the campaign, some dictator may test Trump to see if America has abdicated its former role as the world's policeman. The market appears to be assuming the talk of trade wars is just talk; however, a trade war could be bad for the market.

MARKET OVERVIEW CONT.

On a positive note, it appears the earnings slowdown we have seen over the past year has come to an end, and there is a potential for earnings to rise 10% or so in 2016. Given the higher than average valuations and the prospect of higher interest rates having some effect, it appears that the market is capable of rising to the extent that earnings rise in 2017. However, given the current level of expectations and the potential for disappointment, we could be facing a choppy, uneven stock market over much of the year.

During 2016 the S&P 500® Index rose at a faster rate than forward earnings estimates, resulting in an increasing forward P/E ratio for the market as a whole. The ratio started out 2016 at around 15.5x and rose to a little over 17x by March. After dipping a couple of times, notably due to Brexit and pre-election worries, the ratio ended the year at a little over 17x. That's a fairly high number in the historical context, but not high enough to cause alarm in our offices. We calculate the ex-energy and ex-real estate forward P/E multiple at 16.8x, which does seem a little high in the recent historical context.

As of the time of writing, our market model suggests 9.6% upside to the S&P 500 Index, not including dividends. A figure in that range is about normal and might suggest that the market is fairly valued going into an earnings season. In contrast, right before the "Trump Rally" began the market upside was around 13.8%, which would have suggested a relatively inexpensive market, or at least a perception of an above average level of risk. As our regular podcast listeners know, our market model is simply a computer program that examines all of the consensus sell side target prices, earnings estimates, market caps for each stock in the S&P 500 Index, and then uses that information to calculate target prices for each sector and the index as a whole. We track all of that data weekly to get a feel for relative valuations and how both management teams and analysts think about the next year.

Fourth quarter earnings seasons are always interesting given that many companies roll out guidance for the entire year based on their annual business planning initiatives. The earnings season into which we are now heading could be a little more interesting if sell side analysts and management teams begin addressing the prospect of lower corporate tax rates and other new government related initiatives. Chances are this will be an issue for speculation for at least a couple of quarters, and this might be one of the catalysts for choppiness mentioned above.

STRATEGY FOCUS

Equity & Fixed Income Strategies

The much anticipated Santa Claus rally failed to materialize again this year. In fact, we experienced a market decline during the last week of the year. What we did get, was a continuation of the "Trump Rally", which started after the November election. The gains in December were broad-based, with nine of the eleven sectors posting gains. For the completed year, ten of the eleven sectors posted a positive gain, with health care being the only negative.

Our Diversified Income Strategy out-paced its benchmark during 4Q16, posting strong results, due primarily to our positions in consumer discretionary and consumer staples. With financials posting the strongest gain for the quarter, our under-weight in this sector was a negative. For 2016, this strategy again exceeded the index returns, with our individual stock selection being the main driver. Out-performance was mainly found within financials and consumer discretionary.

The Large Cap Value Total Return Strategy continued its strong performance as we closed the year, posting a return above the index. Out-performance was due to individual stock selection in health care, which was a negative for the index. These positions, along with our stock selection in financials, were the main contributors to our out-performance for the completed year.

Stock selection performance carried over into our Small/Mid Cap Strategy as well, as this strategy also performed better than its corresponding index. Out-performance within this strategy was more broad-ranging, with gains found in financials, consumer discretionary, industrials, health care and information technology.

Individual stock selection in the financial sector also contributed to our Large Cap Value Strategy out-pacing the index for 4Q16. However, selections in health care, information technology and consumer discretionary caused this strategy to lag its respective index for the completed year.

Conference Call and Podcast

All of our clients are invited to our weekly podcast and conference call. In each of these programs, Ken Roberts and Bryn Harman discuss market developments and trends that we observe in our week to week research efforts. Please contact Bryn Harman at bharman@palousecap.com for more information.

[1] PCM obtains all financial/performance data cited herein from Bloomberg, S&P Dow Jones Indices, and Russell Investments, as applicable.

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Strong Values-High Integrity-Exceptional Service Since 1994

Palouse Capital Management, Inc., formerly Ken Roberts Investment Management, Inc., a boutique asset management firm founded in 1994, providing active asset management nationally to high net worth individuals, foundations and endowments, corporations, and public funds. The firm's fundamental "value" philosophy is consistently applied across the core equity strategies; Large-Cap Value, Large-Cap Value Total Return and Small/Mid Value. The firm also offers a Diversified Income Strategy for those clients seeking income from diversified asset classes, which may include fixed income, equities, preferred stock, REITS, and other income producing securities.