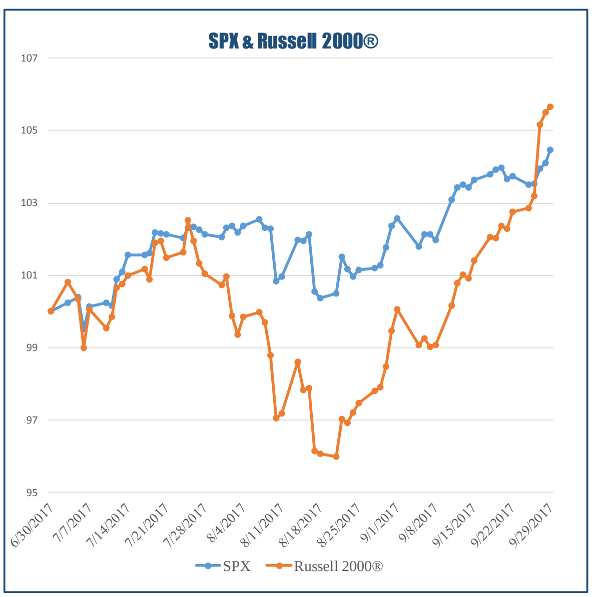
PALOUSE CAPITAL MANAGEMENT, INC.
Quarterly Investment Commentary

Third Quarter 2017

QUARTERLY RECAP	Last Quarter	Previous Quarter	YTD	Past Twelve Months
S&P 500®	4.5%	3.1%	13.8%	19.6%
S&P 500® Equal Weighted	3.6%	2.5%	11.9%	17.2%
Russell 2000®	5.7%	2.5%	10.8%	22.1%
S&P 500® High Dividend	3.1%	1.0%	6.4%	10.5%
Consumer Discretionary	0.8%	2.4%	11.5%	15.5%
Consumer Staples	-1.3%	1.6%	6.7%	5.4%
Energy	6.8%	-6.4%	-6.6%	1.5%
Financials	5.2%	4.2%	12.1%	38.2%
Health Care	3.7%	7.1%	19.6%	16.7%
Industrials	4.2%	4.7%	13.8%	23.4%
Technology	8.6%	4.1%	27.4%	29.6%
Materials	6.0%	3.2%	15.8%	22.1%
Telecom	6.8%	-7.0%	-4.9%	-0.4%
Utilities	2.9%	2.2%	12.0%	11.2%
Real Estate	0.9%	2.8%	7.3%	2.1%
Crude (WTI)	12.2%	-9.0%	-3.9%	8.0%
10 Year Treasury Rate	1.3%	-3.5%	-4.5%	49.6%
30 Year Treasury Rate	0.9%	-5.8%	-6.7%	25.6%
Dollar Index	-2.7%	-4.7%	-8.9%	-2.6%
Vix	-14.9%	-9.6%	-32.3%	-32.2%



Large cap stocks were up about 4.5% in 3Q17, better than the previous quarter[1]. The S&P 500® index ("SPX") is now up almost 20% in the past twelve months, a good annual return in the historical context. The SPX is still outpacing the equal weighted SPX index, suggesting that the very large cap stocks have been outperforming their smaller large cap counterparts. High dividend stocks only managed a 3.1% return in 3Q17 and they are materially underperforming the SPX and small caps in the year to date and past twelve-month time frames.

The small cap swing was perhaps the biggest story of the third quarter. Looking at the chart, small caps and large caps were neck and neck until the end of July, after which small caps slid for a month. We think that was largely an earnings-based phenomenon; the last small cap earnings season was not a good one in our view. There were a lot of strongly negative small cap stock moves on earnings surprises and guidance changes in 3Q17. That kind of earnings season for small caps is not unusual, but there has not been one like this in a year or so.

Our value-oriented philosophy is partly based on the premise that stocks, especially in the smaller cap ranges, tend to overreact to "bad" news. Multiples tend to compress when the market punishes stocks for bad news. Value investors then take advantage of what are seen as short term undervaluations, which then pushes stocks higher. It feels like that was what happened with small caps last quarter. While there were a few real earnings issues, it seems like the market overreacted to a lot of the surprises.

I also note that small cap indexes initially suffered and then later benefitted from their relatively high proportion of financial stocks in 3Q17. Also, small cap companies will also theoretically benefit more than large caps from tax reform, perhaps creating some "extra" demand for the stocks later in the quarter.

[1] Note that all of the figures here include dividends.

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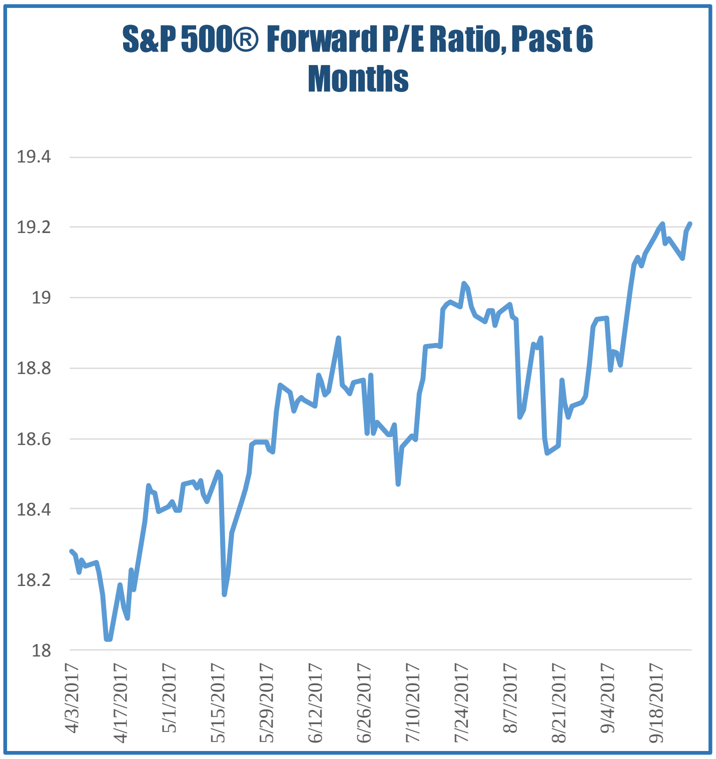
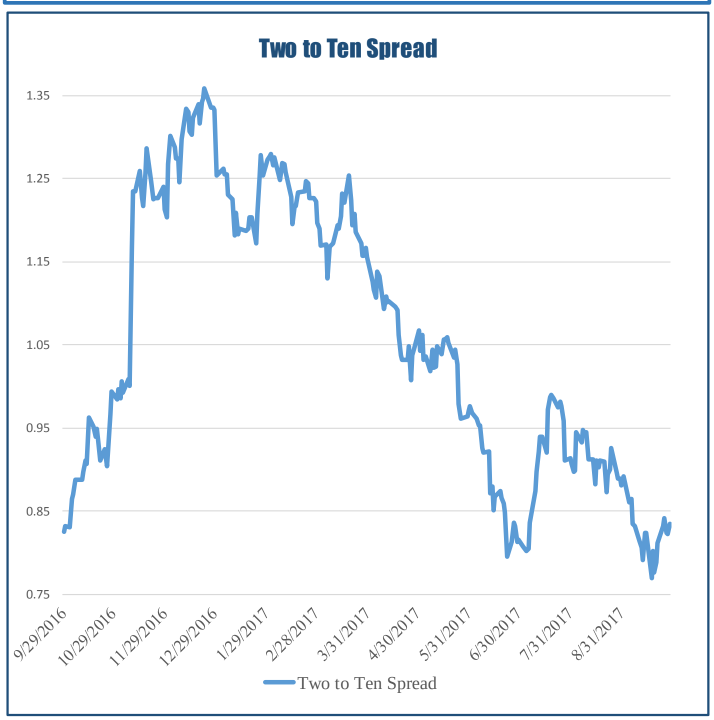
Source: Bloomberg. Past performance is not indicative of future results.





The forward P/E ratio for the SPX continued to climb last quarter. The trend there has been concerning for a long time, although relatively high multiples are easier to explain given the pending tax reform and still very low interest rates. A decent earnings growth picture has also helped. All in, it is a stretch to say that we are happy with multiples here, even though the market seems to be.

3Q17 saw 10 large cap sectors up and only one – consumer staples – down. Some issues with staples right now include a malaise in the packaged foods industry and worries about Amazon's recent purchase of Whole Foods Market. The best sector last quarter was technology, which was up a whopping 8.6%. Technology is now up 29.6% in the past twelve months, which is excellent, yet still a little below the return on financials in the same time frame. Energy and telecom both bounced back during 3Q17. Thankfully for the energy sector, crude was up about 12% last quarter and is now fairly stable around $50. Telecoms were up 6.8% in 3Q17, almost the same amount they were down in the prior quarter.

Financials were helped by a slight rise in interest rates in the second half of the quarter. The two to ten spread also increased slightly later in the quarter, which might have been seen as favorable for bank stocks.

In addition to the past two quarters of good earnings results, the equity market has acknowledged the likelihood of continued earnings growth, due to the synchronous world economic recovery and accommodative central bank policies. The US dollar has declined so far this year, and that potentially could help the earnings of multinational companies. The stock market has been worried about the FED raising rates too quickly, but these concerns have diminished due to recent lower inflation trends and assurances by the FED that they will be gradual in shrinking the balance sheet and raising rates.

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Weekly Report, Conference Call and Podcast

Our clients are invited to receive our CIO's weekly podcast and weekly report. In addition, all clients are invited to participate in our weekly conference call. In the weekly report and the audio 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.

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All data used to create this report was provided by Bloomberg.

"Market cap" means market capitalization.

"LCV" refers to PCM's Large Cap Value Strategy.

"TR" means our Large Cap Total Return Strategy.

"SMID" means Small to Mid Capitalization and also refers to our Small/Mid Cap Value Strategy in certain contexts.

"ACT" means our All Cap Tilt Strategy.

"SPX" and "the big market" refer to the universe of stocks in the Standard & Poors® 500 Index ("S&P® 500"). The Standard and Poor's 500 Index is a free-float capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic equity market. The S&P 500 equal weighted index is the equal weighted version of the SPX. The S&P High Dividend Yield Index measures the performance of 80 high dividend yield equities within the SPX.

The Russell 3000® Index is a float-adjusted, market capitalization weighted index comprised of equities of the 3000 largest domestic companies. The Russell 2500® index is a subset of the Russell 3000 index comprised of the 2500 smallest cap equities in the Russell 3000 and represents the SMID segment of the domestic equity market. The Russell® 2000 Index is a subset of the Russell 3000 index comprised of the 2000 smallest cap equities in the Russell 3000 index and represents the small cap segment of the domestic equity market.

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