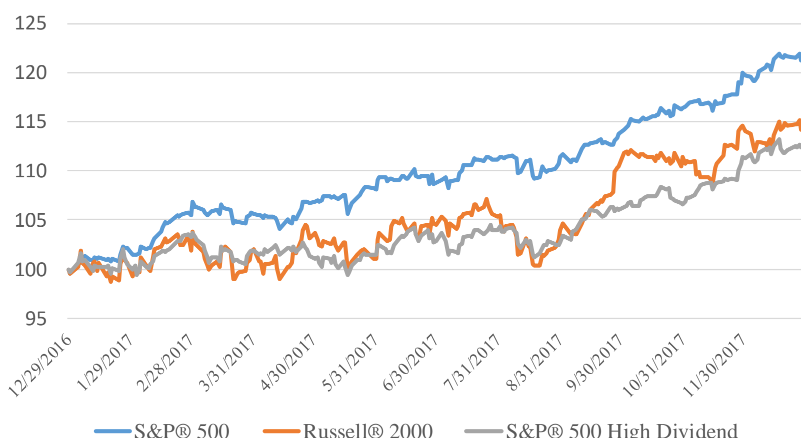
PALOUSE CAPITAL MANAGEMENT, INC.
Annual Commentary
January 2018

Quarter and Annual Recap

	4Q17	3Q17	2017	2016
S&P 500®	6.8%	4.5%	21.8%	12.0%
S&P 500® Equal Weighted	6.3%	3.6%	18.9%	14.8%
Russell 2000®	2.9%	5.7%	14.6%	21.3%
S&P 500® High Dividend	6.0%	3.1%	12.8%	25.0%
Consumer Discretionary	10.4%	0.8%	23.0%	6.0%
Consumer Staples	6.7%	-1.3%	13.5%	5.4%
Energy	6.5%	6.8%	-1.0%	27.4%
Financials	8.4%	5.2%	22.2%	22.8%
Health Care	1.2%	3.7%	22.1%	-2.7%
Industrials	5.6%	4.2%	21.0%	18.9%
Technology	9.6%	8.6%	38.8%	13.8%
Materials	6.1%	6.0%	23.8%	16.7%
Telecom	4.7%	6.8%	-1.3%	23.5%
Utilities	0.0%	2.9%	12.1%	16.3%
Real Estate	3.6%	0.9%	10.8%	3.4%
Crude (WTI)	18.3%	12.2%	12.5%	45.0%
10 Year Treasury Rate	3.8%	1.3%	-1.6%	7.7%
30 Year Treasury Rate	-4.1%	0.9%	-10.6%	1.6%
Dollar Index	-1.0%	-2.7%	-9.9%	3.6%
Vix	7.7%	-14.9%	-21.4%	-22.9%



Market Recap

2017 was a great year for the domestic equity market; the S&P 500® index ("SPX") returned a whopping 21.8%[i], over twice the long-term return achieved since 1988. Small caps also had a good year, although they badly trailed larger cap stocks. The best sector in 2017 was, by far, technology. Much of the technology sector's performance was driven by the so called "FANG" stocks; Facebook Inc., Amazon.Com Inc., Netflix Inc. and Alphabet Inc. (some include a few other stocks in the FANG group). We estimate that the FANG group returned over 46% in 2017.

The worst sector in 2017 was telecommunications, which was only down marginally. The energy sector was also down about 1% in 2017 despite strength in crude oil prices. Nine of the eleven large cap equity sectors were positive last year; that indicates a broadly-based move, especially when one considers the uniqueness of the two sectors that were down.

The fourth quarter of 2017 was also a very good quarter. The big market returned 6.8% in 4Q17 and ten of the eleven large cap sectors were positive; the utility sector was the only negative sector and it was only slightly down. The best sector in 4Q17 was consumer discretionary, which was only slightly better than technology. The S&P 500 retailing index, a sub-index of the consumer discretionary sector, was up almost 16% in 4Q17; some retail stocks

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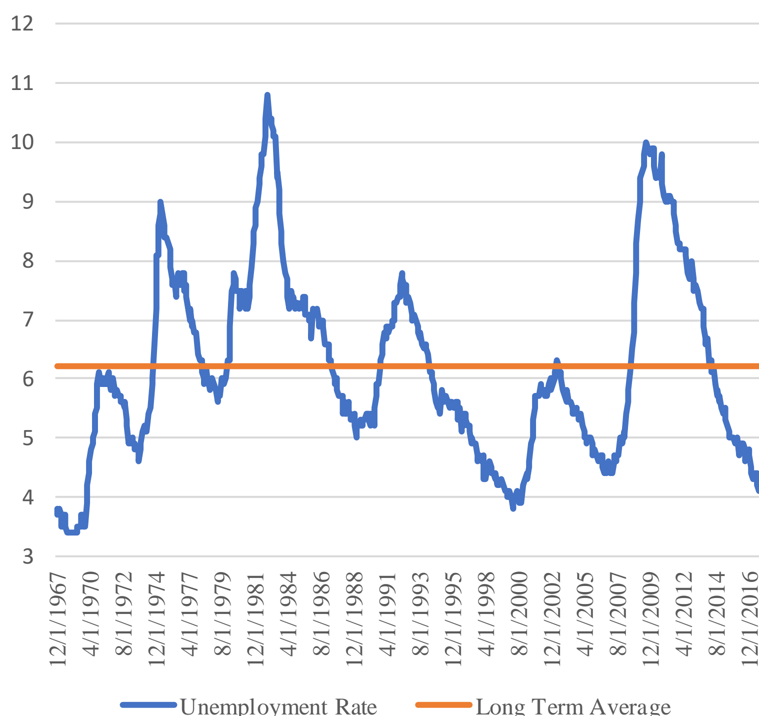
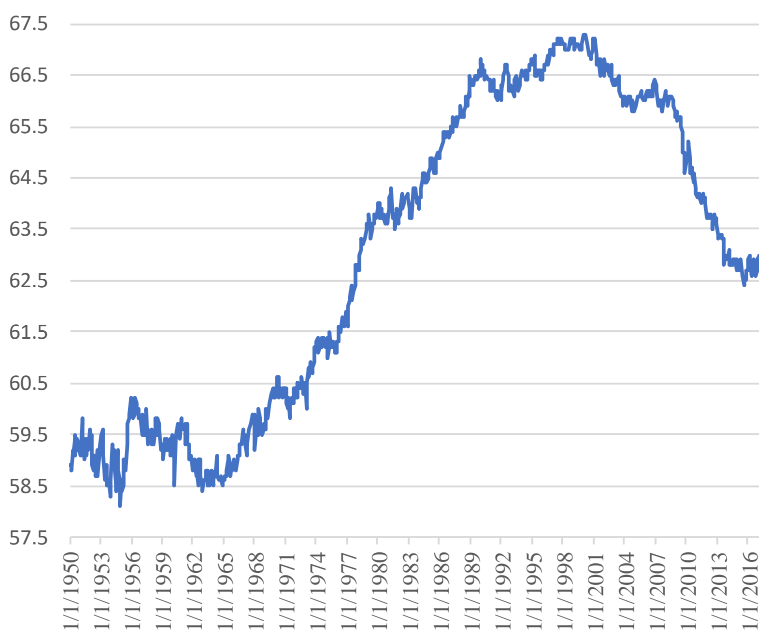
Source: Bloomberg. Past performance is not indicative of future results.





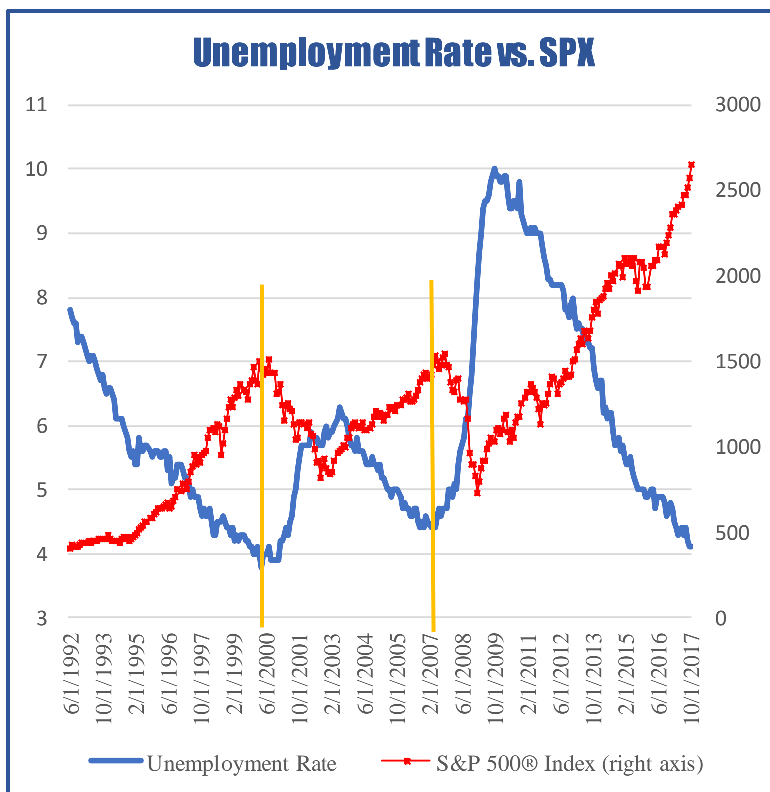
showed promise after getting pummeled in previous quarters.

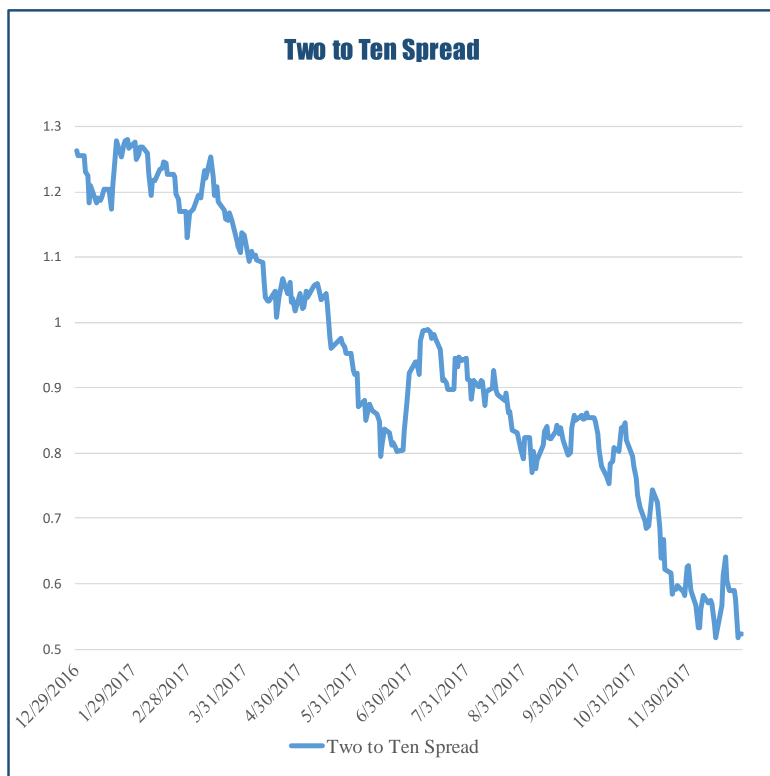
2017 showed continued progress with the domestic economic recovery, which translated into SPX EPS growth of about 7%; that is about equal to the long-term SPX EPS growth rate and better than the two previous years. While earnings growth was a primary driver of the excellent market year, increased investor optimism was demonstrated by the significant increase of trading multiples. The big market's current forward P/E ratio is on the high side of the long-term range (about 18.7x average EPS estimates for 2018).

One of the biggest equity market stories of 2017 was tax reform, particularly the decrease of the domestic corporate tax rate from 35% to 21%. The tax cut will add to future EPS of domestic companies by varying degrees, but we think the effect will be especially pronounced in the smaller cap range. Tax reform was a back and forth issue all year, but it seems like the market got stronger as the bill got closer to passing in December. While we think that investors correctly anticipated the impact of tax reform on future earnings and stock prices, it is possible that the market overshot the effect. That is one of the reasons that we are concerned about the current level of market forward P/E ratios.

Macroeconomic Observations

The domestic labor market continued to strengthen in 2017, and that was a good sign for the economy and the equity market. As of the end of November the domestic unemployment rate was 4.1%, lower than the previous low point achieved in 2007 and nearly as low as the low point in 2000. On the surface, a very low unemployment rate might suggest that the economy is in the latter stages of a recovery; however, we point out that the labor force





participation rate is currently materially lower than it was in both 2007 and 2000 and we therefore think the labor market has some room for improvement.

There has been an eerie connection between the labor market and the stock market, particularly relating to the two previous low points mentioned above. The unemployment low point in 2000 corresponded to an approximate top in the equity market that was followed by a nasty bear market that lasted through the fall of 2002. The 2007 unemployment rate low point roughly corresponded to the top of the market in that year, which was followed by a bear market that lasted until the Spring of 2009. While we are not suggesting that labor market conditions have predictive power over the stock market, the connections just mentioned are enough to raise an eyebrow – especially if unemployment is actually approaching a turning point.

Another economic phenomenon we are watching is the flattening of the treasury yield curve. While a difficult phenomenon to interpret from historical data, a flattening yield curve *can* be a harbinger of an economic slowdown. While the ten and thirty-year treasury rates did not change much in 2017, the two-year treasury rate rose from about 1.2% to 1.9% (the move was quite pronounced in the last few months of the year). The two to ten spread (the difference between the ten-year rate and the two-year rate) therefore dropped materially in 2017. While this flattening may or may not signal an economic slowdown, it might spell trouble for bank earnings and is therefore one of our worries on the small cap side; banks make up a much large proportion of smaller cap indexes than large cap indexes.

We think there is some risk that tax reform will accelerate an already heating up domestic economy in a way that spurs inflation quicker than many now expect. That would speed up the Fed's timetable for fed

PCM Market Model

1/2/2018 18:09	Forward P/E	Price to Book Value	Upside to Target
S&P® 500 Index	**18.5**	**3.2**	**8.2%**
Consumer Discretionary	20.9	5.0	7.3%
Consumer Staples	20.0	4.9	5.9%
Energy	25.4	1.9	5.6%
Financials	15.5	1.5	4.4%
Health Care	16.8	3.9	11.0%
Industrials	19.5	4.6	4.5%
Information Technology	18.2	5.3	12.9%
Materials	18.3	2.9	7.4%
Telecommunications	13.3	2.8	-0.3%
Utilities	17.3	2.9	8.0%
Real Estate	38.2	2.9	7.8%

Ex-Energy and Ex-Real Estate Forward P/E	**17.93**

SPX trailing P/E multiple	**22.63**

funds rate increases, which could cause the economy to pump its brakes sooner than equity investors now expect. While this increases the probability of an equity market slide, only time will tell.

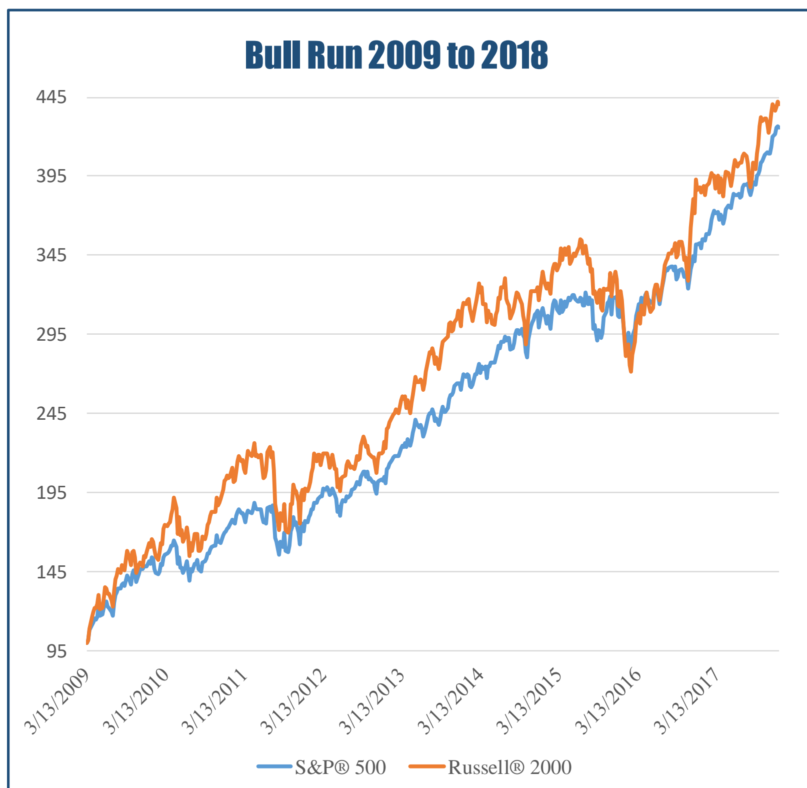
Market Model and Outlook

Our market model currently shows 8.2% potential upside for the SPX based on current sell side targets. For those not familiar with our market model, which we update every weekend for our weekly report and podcast, it is based on a computer program that analyzes EPS estimates and average sell side target prices for all the stocks in the SPX. The model simply calculates the market's "upside to target" – and the upside for all of the SPX's sectors - using the current market caps for all index members for weightings.

We think that the model is more of a barometer for relative value than a predictive tool. Right now, the model's 8.2% upside is slightly low, indicating that the market could be approaching a relatively full valuation. Over the past couple of years, the model upside has ranged from about 7% to about 12%.

Our model also calculates the forward P/E ratio for the index, stripping out the energy and real estate sectors; we take those sectors out because they tend to trade more off of cash flow than earnings (they also carry large P/E ratios). The ex-energy and real estate forward P/E ratio is now 17.9x, which is historically high but a little better from where it was tracking earlier in 2017. We think that the model's current forward P/E ratio might also indicate that the market is approaching a relatively full valuation.

The market model also examines the forward P/E ratios and upside potential of each sector, and we find that tracking these figures weekly helps provide a historical context for our bottom up analysis. Right now, the market's upside potential is skewed towards the technology and healthcare sectors, which is not unusual.



The staples, energy, financials, industrials and telecommunications sectors all have relatively weak upside potential. Note that essentially all of the stocks in the SPX will get fresh estimates and target prices within the next month or so; therefore, the upside figures might be temporarily low right now, assuming that the outlook for many stocks will improve. We think that an overall improving outlook is likely based on the trend of earnings strength and tax reform.

As of December 22, 2017, the median 2018 SPX target of the major Wall Street firms is 2,855, about 4.6% higher than the current level – that is a much smaller potential return than the big market has put up in four of the past five years and a much smaller number than the market's long-term return. The same group's median SPX EPS estimate for 2018 is $146, indicating a forward P/E of 18.7x - which feels like a high number. Looking at these figures naively might indicate a full market valuation.

An elephant in the room is that on January 6, 2017, the same strategists were looking for an SPX level of 2,350 for the end of 2017 – about 5.5% higher than the beginning of year level. Their predictions were way off, as they often are. While the market did significantly better than all of the strategists' predictions, at least part of the error had to do with rising multiples, which was connected to tax reform. Tax reform was fuzzy at the time the strategists set their targets last year.

In consideration of tax reform and the length of time since the market has corrected, we think that the earnings season we have just entered is going to be an important one. Anecdotally, the 3Q17 earnings season was characterized by severe earnings miss punishments, especially on the small cap side. We think that could spill over into the current earnings season. We also think that guidance will be especially important this time because it is the first earnings season after the tax reform bill passed. We are hopeful that guidance will be very upbeat; we might need that to avoid a correction.

While bull and bear markets do not have official beginning and end times, we consider March 13, 2009 to be the approximate beginning date for the current bull run (using weekly data). Since then, the SPX and Russell 2000® have returned 325.4% and 340.7%, respectively. The bull run is now almost nine years old – and that is a long market phase and one of the longest bull runs in history. There have been a few corrections since then, but they were nothing like the two previous bear markets.

While there are factors that might indicate the beginning of a slowdown, there are also factors that hint to prolonged earnings growth and continued economic recovery. The bull run is old by historical standards, but we think there are reasons that it could continue for a while. That said, we think the probability of a correction has grown based on current valuations and the time that has passed since the last one (over two years). It is possible that earnings and guidance this earnings season

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might fall short of what investors are looking for in order to keep multiples and share prices where they are. While this would create buy opportunities, especially for value-based stock pickers like us, it could spur a correction. Based on our current outlook, we would most likely consider a correction to be an overall buy opportunity.

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. We provide these services to our clients free of charge and they are not available to non-clients. 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.

[i] Note that all equity return figures mentioned in this report include the effect of dividends.