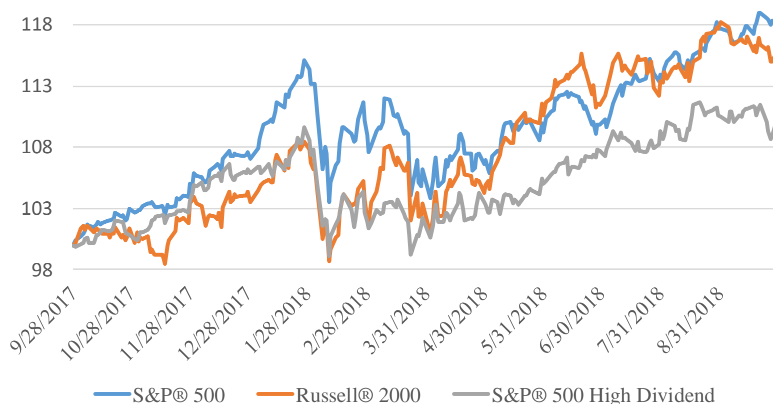
Palouse Capital Management, Inc.
Quarterly Commentary
October 2018

QUARTERLY RECAP

	Last Quarter	Previous Quarter	YTD	Past Twelve Months
S&P 500®	7.7%	3.4%	10.6%	18.3%
S&P 500® Equal Weighted	5.4%	2.8%	7.3%	14.4%
Russell 2000®	3.6%	7.8%	11.5%	15.4%
S&P 500® High Dividend	1.8%	5.4%	3.6%	9.6%
Consumer Discretionary	8.2%	8.2%	20.6%	33.0%
Consumer Staples	5.7%	-1.5%	-3.3%	2.8%
Energy	0.6%	13.5%	7.5%	13.9%
Financials	4.4%	-3.2%	0.1%	9.1%
Health Care	14.5%	3.1%	16.6%	19.0%
Industrials	10.0%	-3.2%	4.8%	11.5%
Technology	8.8%	7.1%	20.6%	32.5%
Materials	0.4%	2.6%	-2.7%	4.0%
Telecom	9.9%	-0.9%	0.8%	4.6%
Utilities	2.4%	3.7%	2.7%	2.8%
Real Estate	0.9%	5.9%	1.7%	5.1%
Crude (WTI)	-1.2%	14.2%	21.2%	42.1%
10 Year Treasury Rate	7.0%	4.4%	27.3%	32.6%
30 Year Treasury Rate	7.2%	0.5%	17.0%	11.7%
Dollar Index	0.7%	4.8%	3.3%	2.2%
Vix	-24.7%	-19.4%	9.8%	26.9%



Market Recap

The S&P 500® Index ("SPX") returned 7.7% in 3Q18, resulting in a year to date return of 10.6%. High dividend stocks were up only 1.8% during the quarter and small cap stocks, represented by the Russell 2000® index, returned 3.6% in 3Q18. The SPX outperformed its equal-weighted sister, indicating that stocks of very large companies dominated performance during the quarter. All eleven large cap sectors were positive during the quarter. The best large cap sector in 3Q18 was healthcare, and the worst was materials.

Overall, 2Q18 earnings season (i.e. for the quarter ended June 30, 2018) was quite good. We now calculate trailing annual EPS growth of 19.2% for the SPX as of the end of quarter. Earnings trends have been quite positive, and we expect that to continue during the earnings season that is now upon us. The impact of tax reform was and will continue to be positive, perhaps especially so in the smaller market cap ranges. What should be interesting, however, is the effect of new tariffs on the earnings expectations of public companies. Management comments and guidance should be examined closely.

Macroeconomic Observations

After the ten year treasury rate started the quarter at 2.87%, it rose to just over the psychologically important 3% level by the end of the quarter. The thirty year treasury rate rose from about 3% to 3.2% during 3Q18. Both the ten and

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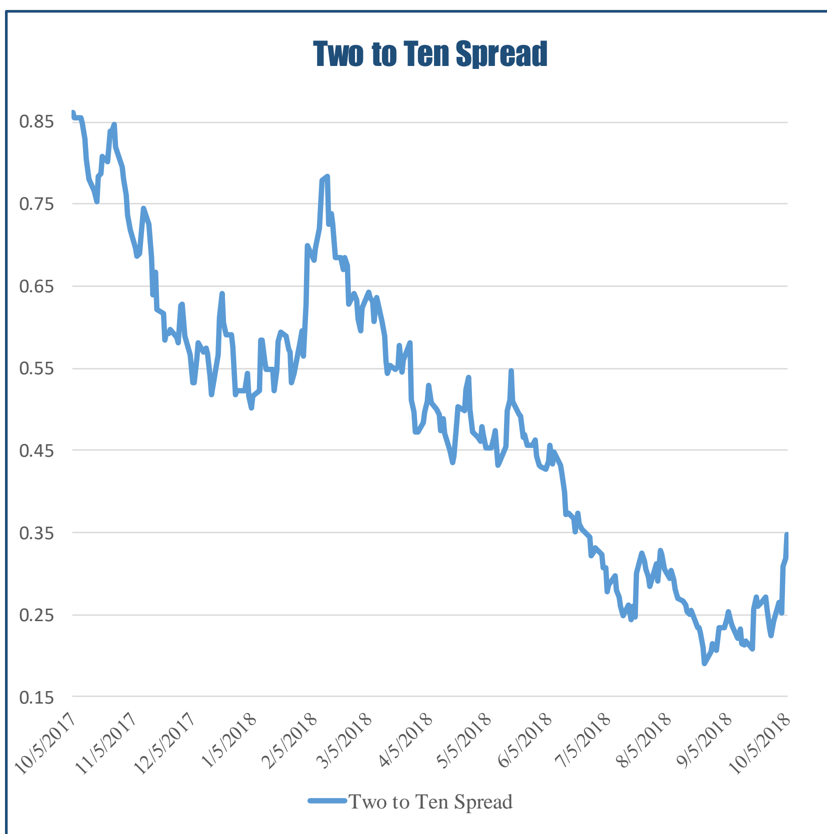
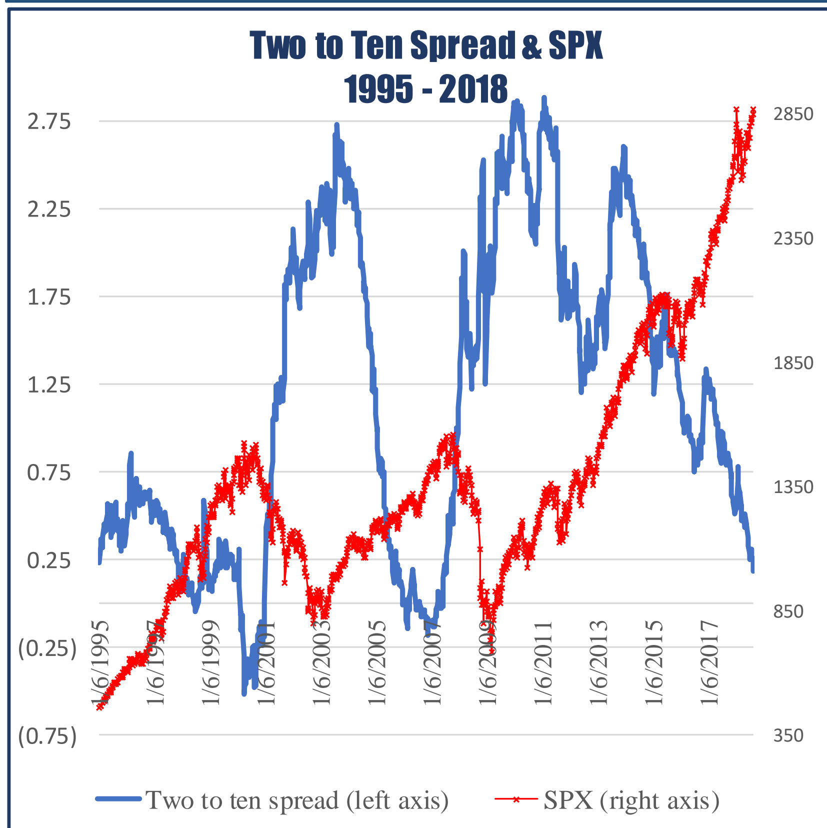
Source: Bloomberg. Past performance is not indicative of future results.



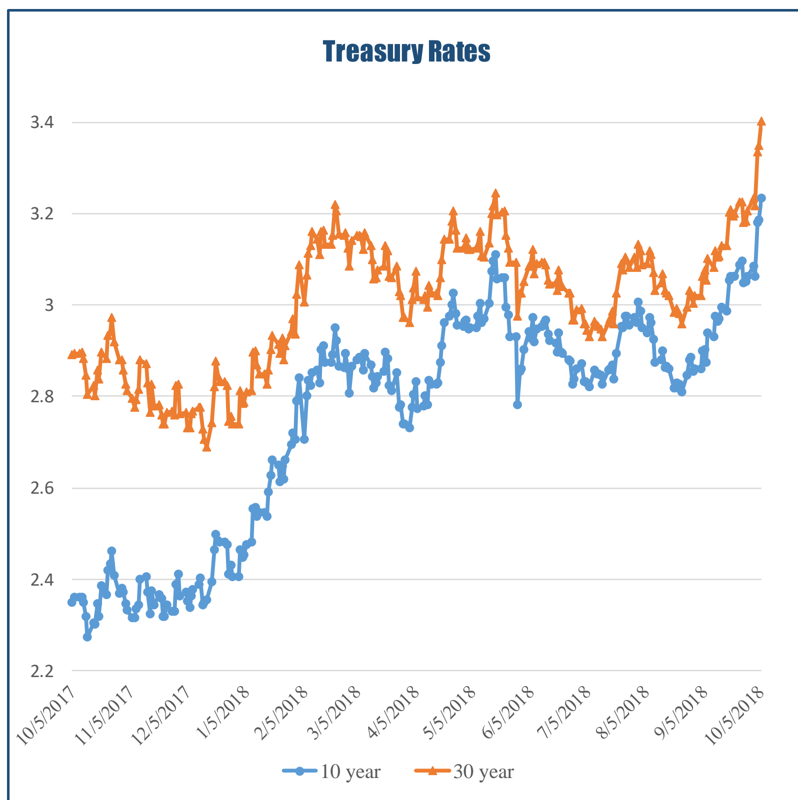


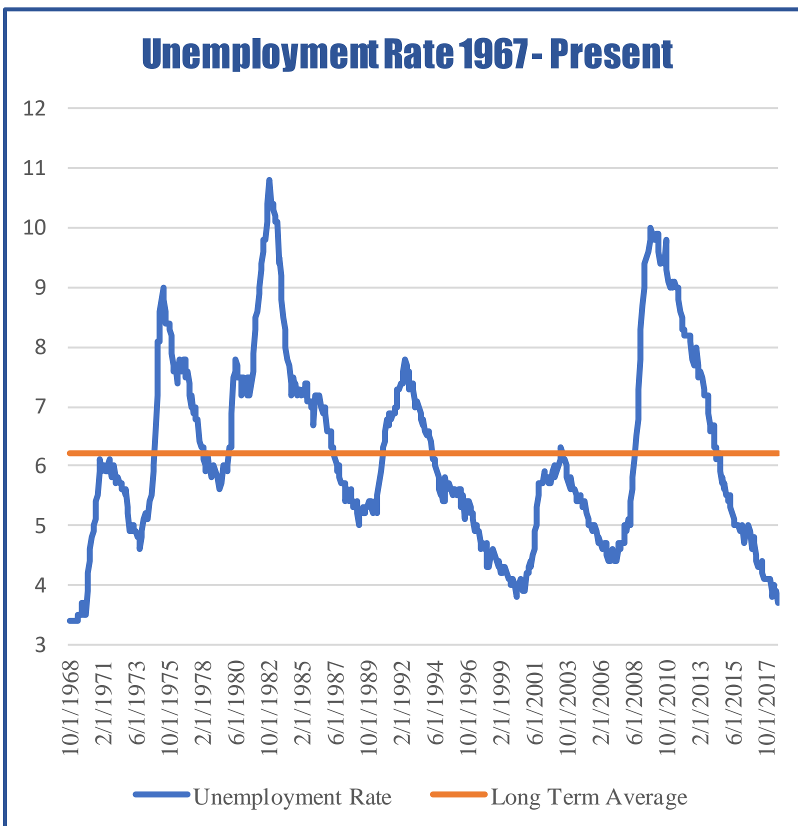
thirty year rates have risen materially in the past year, with the ten year rate rising significantly faster than the thirty year in that time frame. The ten to thirty year spread therefore dropped materially in the past year.

The two to ten spread also continued on its downward trajectory during the quarter, ending the quarter at the 25 basis point level – that is the lowest level for that figure since 2007. Why is this important? A flattening yield curve has been associated with the beginning of recessions in the past (not every time). Also, the "bottom" of the two to ten spread corresponded fairly closely to the "top" of the equity market in both 2000 and 2007. While we would not suggest a predictive quality to this historical relationship, the coincidence is at least somewhat ominous given where the spreads are today. Note that the two to ten spread did move up in the week following the end of the quarter, which some might see as a positive sign.

We are also watching the domestic employment situation closely. The unemployment rate closed the quarter at 3.7%, the lowest level since the end of 1969. The unemployment rate has fallen steadily from the 10% level back in 2009 as the economy recovered from the last recession. We think that the economy has been running at more or less full employment for several months. The number of unemployed persons less job openings has fallen steadily since 2009 and the number actually turned negative in March of this year (i.e. there are more job openings than people to fill them). That is a rare situation.

The labor force participation rate ended the quarter at 62.7%, in line with a fairly tight sideways range going back to 2015. Before that the rate fell from about 66% back in 2007. Some would argue that a relatively low labor force



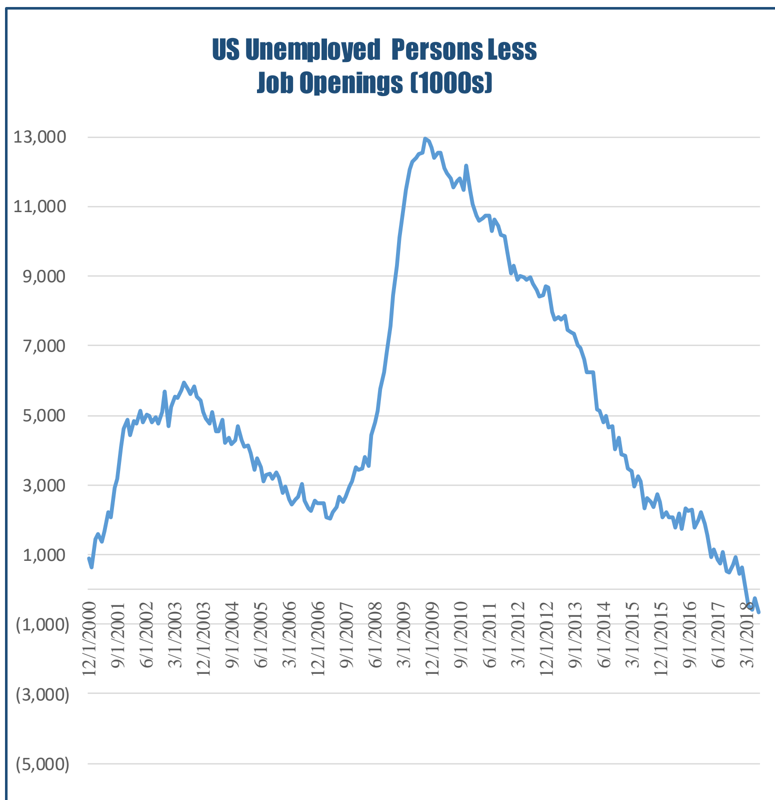


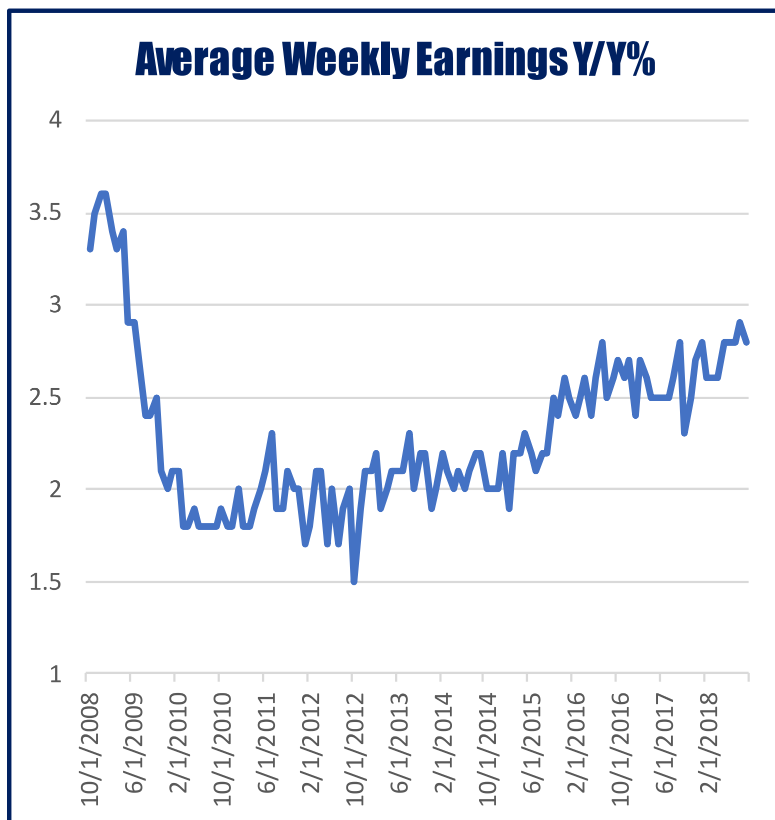
participation rate means that a good number of workers *could* enter the workforce; that is not exactly what has been happening, partly due to a large number of "baby boomers" leaving the workforce over the past few years. This is an exacerbating factor for the declining unemployment rate and "tight" labor market.

The tight labor market could lead to price inflation, which is why it makes sense to also track the average weekly earnings series. The year over year wage growth figure for September was 2.8%, in line with the average for the past year and up from a low of 1.5% back in 2015. While the series still has a way to go to hit the 3.5% peak reached back in 2008, it has been rising steadily as the unemployment rate decreased.

To sum things up, the domestic economy is currently characterized by good economic growth, very low unemployment, a sideways labor force participation rate, rising interest rates, a flattening yield curve and potentially accelerating rates of inflation. It is too early to tell how new tariffs will affect these issues, although it is logical to assume that they will add to inflation and higher interest rates. It is also logical to assume that the fed will be more likely to increase the fed funds rate when the longer term rates have increased because they will be less to blame for "creating" a flat or inverted yield curve.

It is really difficult to predict interest rates, but it seems like the trend is an increasing one. We tend to focus on security valuation when making investment decisions; when one considers that the value of every investment is tied to the present value of a future stream of cash flow, it makes sense that investment valuations ought to be lower in higher interest rate environments. The macroeconomic "cooling" effect of higher interest rates will also put





pressure on corporate earnings. The combination of those things will eventually affect equity prices in a negative way. The equity market has been great, but that will not continue forever. It would be nice if the economy and market did not ebb and flow over time, but that is just not the case.

Market Model and Outlook

Our simple market model, which is based only on sell side target prices, now suggests an 11.4% one year upside potential to the SPX. The big market's forward P/E multiple is currently 16.7x, on the high side of the historical range, but perhaps at a comfortable level given the strength of corporate earnings.

We do not think that a bear market is on the immediate horizon. The current strength of the economy is marvelous but that does not mean that a recession will hit in the immediate future. Despite the prospect of rising inflation and interest rates, we think that the positive earnings trend will continue for at least a couple of quarters.

That said, equity valuations are on the high side of the historical range; that makes at least part of the investor population nervous. We think that a correction (i.e. not a bear market) could be in the works, perhaps even during the current earnings season. Based on the strength of earnings and what happened in the past couple of corrections, we would probably see a correction as a buy opportunity. Focusing on stock picking can work in any earnings season because many stocks overshoot on "bad" news, especially when valuations are on the high side.

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PCM Market Model

10/7/2018 6:39	Forward P/E	Price to Book Value	Upside to Target
S&P® 500 Index	**16.7**	**3.5**	**11.4%**
Consumer Discretionary	20.9	7.5	14.2%
Consumer Staples	17.9	5.2	8.1%
Energy	16.2	2.1	12.0%
Financials	12.4	1.5	12.6%
Health Care	16.7	4.5	6.2%
Industrials	16.8	5.1	9.1%
Information Technology	18.0	6.9	11.8%
Materials	15.2	2.6	16.9%
Communications Services	16.7	3.5	16.9%
Utilities	16.8	1.9	3.7%
Real Estate	36.1	3.3	10.9%

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.

Important Disclosures:

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If readers have any questions about anything mentioned in this report please feel free to contact us any time at 800-624-3833. Readers can also refer to our website, www.palousecap.com, for more information and can email PCM's Chief Investment Officer directly at bharman@palousecap.com with any questions. Readers should not assume that any investments in the securities mentioned in this program were or will be profitable or will continue to be held in the future. Pursuant to Rule 206(4)-1(a)(2)(A) we will provide a list of all trades made on behalf of clients in the past year upon request.

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.

The PCM Market Model examines forecasted earnings and average sell side target prices to arrive at market capitalization weighted average upside and trading multiples for the S&P® 500 index and all of its sectors. PCM does not use the actual S&P index weights to perform the calculations (i.e. we do not float adjust the model).

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