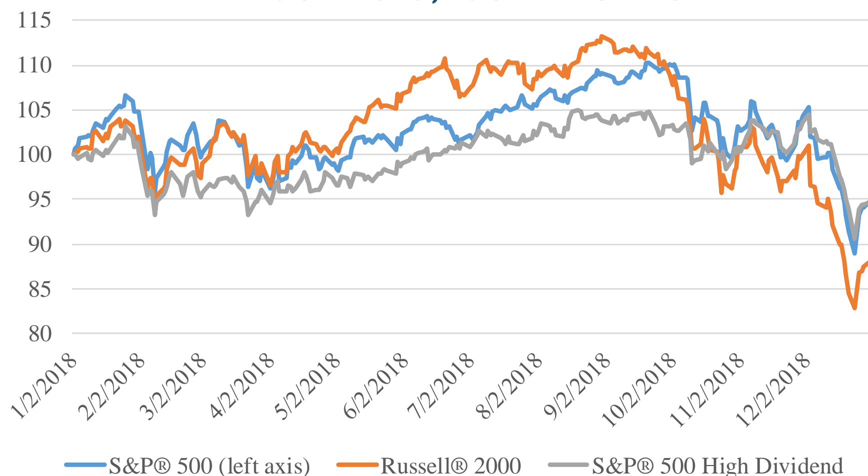
PALOUSE CAPITAL MANAGEMENT, INC.
Annual Commentary
January 2019

Quarter and Annual Recap

	4Q18	3Q18	2018	2017
S&P 500®	-13.8%	7.7%	-4.4%	21.8%
S&P 500® Equal Weighted	-13.9%	5.4%	-7.6%	18.9%
Russell 2000®	-19.1%	3.6%	-11.0%	14.6%
S&P 500® High Dividend	-8.1%	1.8%	-4.8%	12.8%
Consumer Discretionary	-16.3%	8.2%	0.8%	23.0%
Consumer Staples	-5.2%	5.7%	-8.4%	13.5%
Energy	-24.9%	0.6%	-18.1%	-1.0%
Financials	-13.4%	4.4%	-13.0%	22.2%
Health Care	-9.2%	14.5%	6.5%	22.1%
Industrials	-18.0%	10.0%	-13.3%	21.0%
Technology	-17.7%	8.8%	-0.3%	38.8%
Materials	-13.2%	0.4%	-14.7%	23.8%
Telecom	-13.1%	9.9%	-12.5%	-1.3%
Utilities	1.7%	2.4%	4.1%	12.1%
Real Estate	-3.0%	0.9%	-2.2%	10.8%
Crude (WTI)	-39.7%	-1.2%	-24.8%	12.5%
10 Year Treasury Rate	-13.0%	7.0%	11.6%	-1.6%
30 Year Treasury Rate	-6.8%	7.2%	10.0%	-10.6%
Dollar Index	0.9%	0.7%	4.4%	-9.9%
Vix	111.8%	-24.7%	130.3%	-21.4%



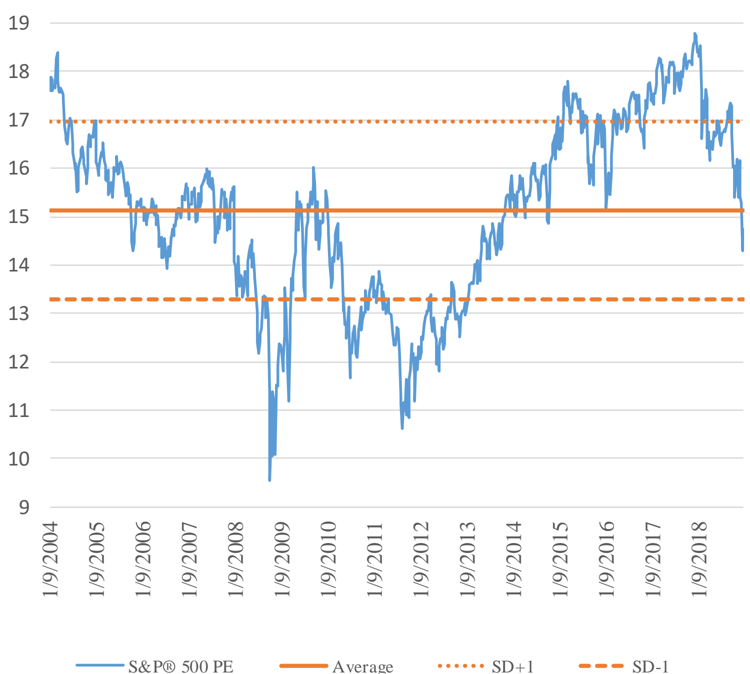
Market Recap

As I sat down to write this year's annual commentary, I naturally went back to see what I wrote last year. In last year's commentary I opined that market valuations were looking full and that the risk of correction was relatively high. The S&P 500® Index ("SPX") did correct about 10%[i] between January 26th and February 8th, although it was really strong in the first few weeks of 2018. I think investors got a little too excited about tax reform in the winter of 2017/2018, and that pushed valuations to a risky level in January. The SPX's forward P/E ratio at the bottom of that correction was still above the long term average, but that was better than the 19x levels a few weeks before that.

The January correction was a quick one and the big market was back to start of year levels by mid-February. Things were choppy for a while after that and then the SPX rose back to record levels by the end of July. By September the big market's forward P/E was back to almost 18x, which was again a relatively full valuation.

What happened after that is something we have not seen in a long time. The SPX fell almost 20% between September 20th and December 24th – and in a very choppy fashion. Most investors would consider that move to be a bear market or at least a severe correction. The last

Bryn Harman, CFA ✧ Palouse Capital Management, Inc. ✧ 509-220-4253 ✧ bharman@palousecap.com
2026 N. Washington Street, Spokane, WA 99205
Source: Bloomberg. Past performance is not indicative of future results.

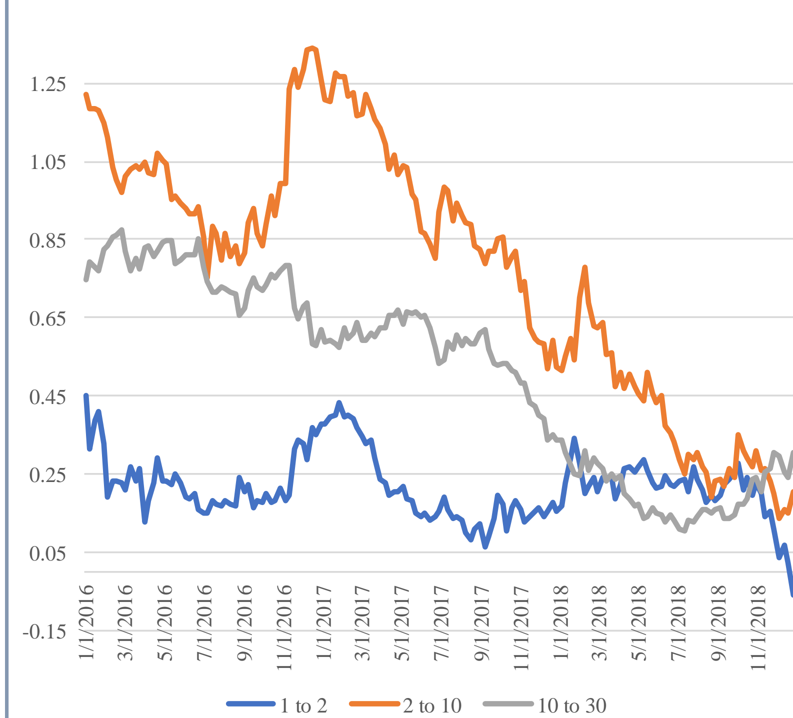


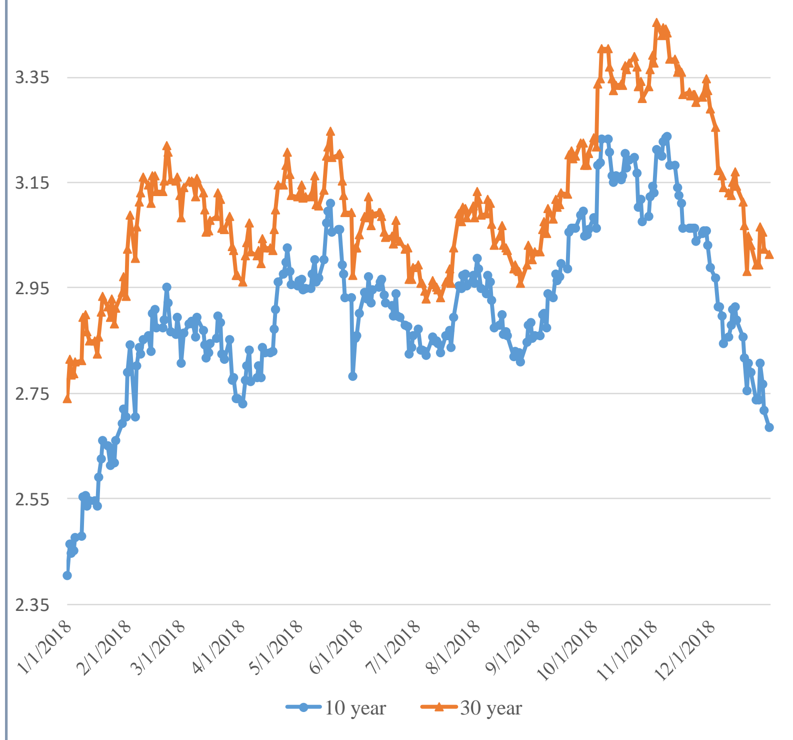
prolonged downturn before that was in 2016, and that one was much milder. Small cap stocks took it much worse than large caps at the end of 2018; the Russell 2000® index ("RTY") dropped close to 27% between August 31st and December 24th.

So, why did this happen? While the domestic economy was strong in 2018, which resulted in general earnings improvement, the Tax Cuts and Jobs Act of 2017 also boosted earnings - and investor exuberance might have become too pronounced as a result. Consequently, the market's forward P/E multiples last January and July were the highest levels for that series since the dot com bubble. Markets like earnings growth; therefore, the hot domestic economy and tax cut gave investors a couple of reasons to be exuberant in 2018.

That said, all through 2018 investors increasingly worried about a few intertwined macroeconomic developments. One of these was the increasing general level of interest rates. Rising interest rates can be bad for equities on a few different levels. The thirty year treasury rate rose from about 2% in 2016 to almost 3.5% in November of 2018. The ten year treasury rose from about 1.36% in 2016 to over 3.2% in November of 2018. The two year treasury rate has risen rapidly – from about 55 basis points in 2016 to almost 3% in the fall of 2018. Note that the Federal Reserve ("the Fed") started raising the fed funds rate in December of 2015, and the move in treasury rates - especially on the short end of the curve - is not a coincidence.

Another area of worry was the flattening yield curve - a phenomenon that has been associated with the onset of recessions in the past. While the curve has been flattening for some time, some spreads actually inverted at the end of 2018. The two to ten spread fell from about 1.2% in 2017 to a low of about 10 basis points by the end of the year – that is a major move.





With what had been going on with both interest rates and spreads, investors increasingly focused on the Fed through the year. During the downturn the market was incredibly sensitive to anything the Fed said. One could argue that fed rate increases are the primary worry in the market now, likely because of what happened a decade ago.

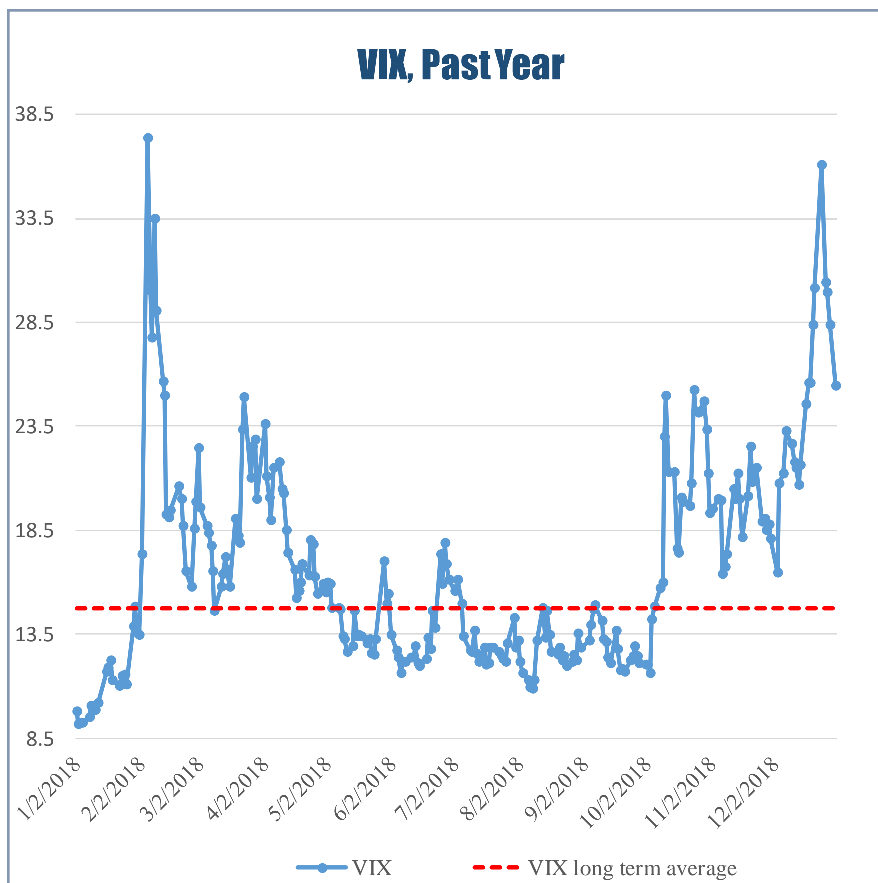
Another major worry in 2018, especially in the fourth quarter, was international trade. The market was very sensitive to any news about new tariffs. While the effect of tariffs on public company earnings is still blurry, investors seem to think the overall effect will be negative.

As the fourth quarter painfully wore on, there seemed to be a lot more stories about the slowing global economy and that became a focus of investors, along with interest rates and international trade. The Chinese and European economies appear to be slowing down, and that is something that could be made worse by tariffs. The readthrough is that this could be quite negative for public company revenues and earnings.

So, to conclude on the great 2018 downturn, I think it was the result of generally full valuation or overvaluation in September of 2018. When the SPX was trading at a forward P/E of about 18x stocks were susceptible to negativity – and that negativity came in droves, especially later in the year. The more speculation about a slowing domestic and global economy there was, the worse the market got.

All in, the SPX fell 13.8% in 4Q18 and 4.4% in 2018. The last year in which the big market put up a negative return was 2008. 2018 was also the fourth worst year for the SPX going back to 2000. There were three large cap sectors up (healthcare,

Bryn Harman, CFA ✧ Palouse Capital Management, Inc. ✧ 509-220-4253 ✧ bharman@palousecap.com
2026 N. Washington Street, Spokane, WA 99205
Source: Bloomberg. Past performance is not indicative of future results.



PCM Market Model

1/3/2019 9:59	Forward P/E	Price to Book Value	Upside to Target
S&P® 500 Index	**14.4**	**3.0**	**25.6%**
Consumer Discretionary	17.8	6.5	27.5%
Consumer Staples	16.8	4.9	14.3%
Energy	13.7	1.6	36.7%
Financials	10.4	1.3	27.6%
Health Care	14.6	4.0	21.0%
Industrials	13.5	4.2	27.5%
Information Technology	15.0	5.8	30.5%
Materials	13.6	2.5	24.0%
Communications Services	14.7	3.1	27.0%
Utilities	15.8	1.9	9.4%
Real Estate	34.8	3.1	16.8%

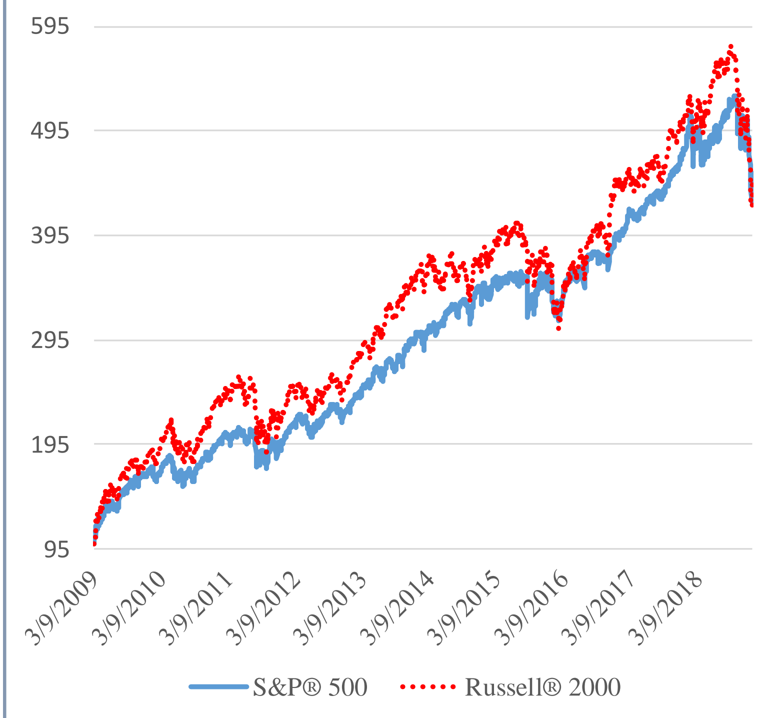
utilities and consumer discretionary) and eight down in 2018. The worst large cap sector in 2018 was energy, which was down about 18% on an almost 25% drop in crude prices. The best large cap sector was healthcare, which managed a 6.5% return in 2018.

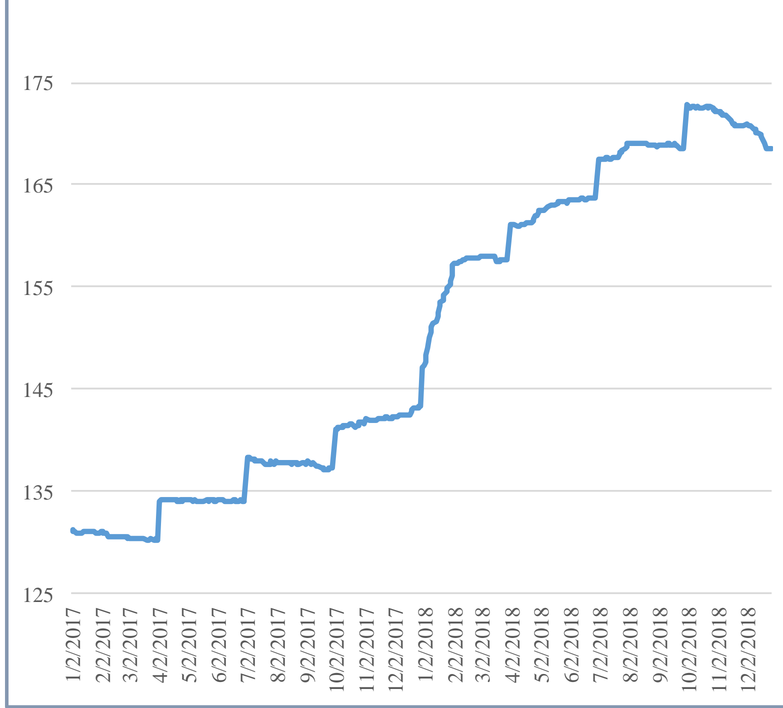
Market Model and Outlook

Right now a group of 22 sell side strategists tracked by Bloomberg have a mean SPX target of 2,975 for the end of 2019; that would indicate a pre-dividend return of 18.6% for 2019 as of the time of writing. One might look at that figure and conclude that the market is attractive. At the end of December 2017 the same strategists had a mean SPX target of 2,855 to end 2018; while that number was materially higher than the actual year end result, it was pretty close to where the SPX got before the selloff.

I think the sell side strategists are more accurate with their SPX EPS predictions than they are with index targets. The mean 2019 SPX EPS estimate for the 22 strategists was 172.34 at the end of December 2018. While we will not have a 2018 year end SPX EPS number to compare for a while, the figure implies 8.3% EPS growth for 2019 (according to Bloomberg). While that is slower than the EPS growth achieved in 2018 (which was boosted by tax reform), it is not what I would call a bad number in the historical context.

The SPX is now trading at about 14.5x forward EPS, which is below the long term average. Again, that might look attractive





relative to where the market has been recently, but there is more implied uncertainty in the market now than there was in the past year or so. There is also a perceived inverse correlation between P/E multiples and interest rates, so if rates are in a rising trend then multiples should be falling. I say "perceived" here because I have never been able to actually show the negative correlation in my research. That said, people talk about this on CNBC periodically and that can affect investor perceptions.

Our market model currently shows 25.6% one year upside potential 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 do not use the model to time the market and we see it as more of a barometer of relative value over time. While the 25.6% upside number looks attractive, I would not read too much into it right now. I think that a lot of sell side target prices will be coming down in January and February, which will "normalize" the upside potential of individual stocks, sectors and the market as a whole.

Earnings seasons are always important, especially the one that occurs in January and February. I think that the earnings season we are now in is going to be critical to the direction of the market. Guidance from big companies is going to be highly scrutinized, especially in light of Apple Inc.'s recent profit warning. I think that investors will key in on any language about China, the world economy, trade, credit and inflation.

The general perception seems to be that the domestic economy will not enter a recession in 2019. Bloomberg's consensus GDP growth estimate for 2019 is now 2.6%; that seems like a decent enough number to support earnings growth, although it is down from the 2.9% estimated GDP growth in 2018. At 1.9%, the 2020 GDP growth number currently looks problematic, however. One of the growth estimates in the consensus for 2020 is only 40 basis points, which would be recessionary.

As of the time of writing, if we are now in a bear market, the bull run for the SPX was a nearly ten year phenomenon that only included a few corrections. While the past few months have been gut wrenching for equity investors, accurately timing the top and bottom of market phases is impossible, and a long term approach is the best way to go. Between 1932 and 2017 there were only four five-year periods in which the SPX generated a negative return on an non-dividend basis, and the average return over those periods was -10% (not annualized). Over the same time frame there were 13 five-year periods in which the SPX generated positive returns on a non-dividend basis, and the average return over those periods was +64% (not annualized).

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:

Past performance is not a guarantee of future results and there is no assurance that any predicted results will actually occur; actual events and results may differ materially from those discussed herein. The opinions expressed are those of Palouse Capital Management, Inc. (PCM), and are based upon information available at the time of the printing of this report, and subject to change. Furthermore, these opinions are not the opinions of your custodian or broker. The information provided in this report should not be considered a recommendation to invest in a particular security, strategy or purchase or sell securities in a particular industry or sector. There is no assurance that securities or securities within the sectors mentioned in this report will be in a client's portfolio. Holdings are subject to change. This information is not intended to be used as the primary basis of investment decisions nor should it be construed as advice designed to meet the particular investment needs of any specific investor. Approved for investment professional and client use. Small-cap investing typically carries more risk than investing in well-established large cap companies since smaller companies generally have limited product lines and financial resources and a higher risk of failure. Historically, smaller companies' stocks have experienced a greater degree of market volatility than the average stock. PCM's Small/Mid Value Strategy may not be suitable for everyone. The income generated by the securities held in PCM's Large-Cap Value Total Return and Diversified Income strategies may decline. Generally, the prices of fixed income securities decline as interest rates rise. The Diversified Income Strategy may include investments in lower quality, higher yielding fixed income securities which may be subject to great price fluctuation than higher quality fixed income securities. Index returns and other historical data were gathered from resources believed to be reliable; PCM does not guarantee their accuracy. The performance of the indices may be materially different from the individual performance attained for a specific client. The S&P 500 is a capitalization-weighted Index of the prices of common stock of the 500 leading companies representing the leading industries of the US economy, which are actively traded in the United States on the New York Stock Exchange or the NASDAQ. The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the US equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The source for all market data is Bloomberg, S&P Dow Jones Indices, and Russell Investments. Information regarding the services provided by PCM is available in Form ADV Part 2, which is available upon request or on PCM's website at www.palousecap.com.

Bryn Harman, CFA ✧ Palouse Capital Management, Inc. ✧ 509-220-4253 ✧ bharman@palousecap.com
2026 N. Washington Street, Spokane, WA 99205

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.

[i] We use total return indexes for all return measurements in our regular reports.