

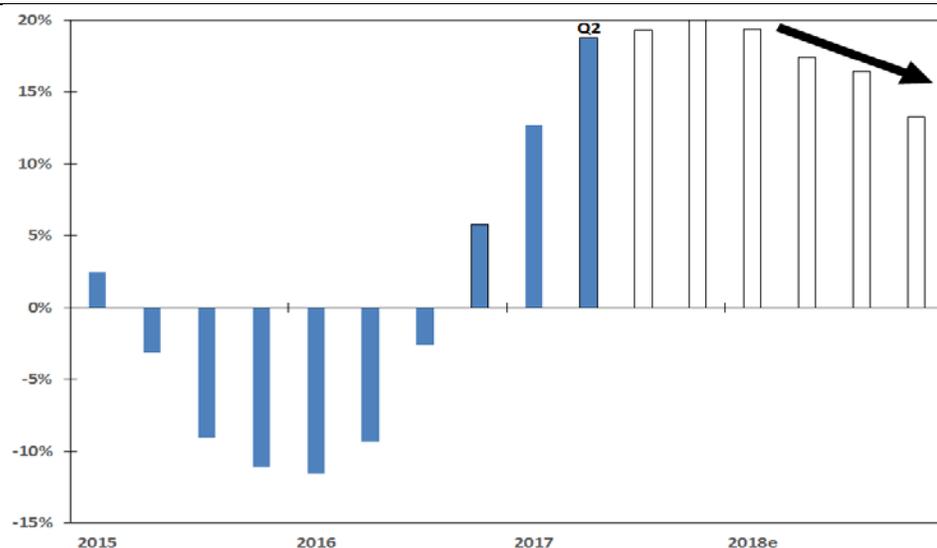
Equity Outlook: Tough Comparisons in 2018



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- **Earnings Growth Set to Slow in 2018.** S&P margins and earnings are now at record levels, while sales growth has accelerated in recent quarters. Likely reflecting tough comparisons, as well as anticipation of Federal Reserve interest rate hikes that could curb economic growth, the consensus expectation is for earnings growth to slow sharply in 2018.
- **A Risk of Earnings Disappointments.** Even as profits moved to record levels, 2017 earnings expectations have continued to fall, albeit modestly, suggesting that analysts have been a little too optimistic. But, with earnings growth forecast to slow in 2018, that raises the risk of earnings disappointments if expectations remain too high.
- **Sector Forecasts.** All sectors are currently forecast to experience earnings growth in 2018, which seems unrealistic. Energy, a key swing sector, is expected to see a 40% gain in profits, which is likely highly dependent on the direction of oil prices.
- **Market Outlook.** Slower earnings growth and higher interest rates could well pressure stock prices in 2018, especially with valuation multiples still elevated.
- **ESG Matters.** We have added a new section to this report, which recaps key Environmental, Social and Governance (ESG) developments during the month.

Figure 1: S&P 500 Operating EPS – Consensus Estimates for 2018
Year-to-year percentage change in quarterly EPS



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Source: S&P, Cornerstone Capital Group

July Global Markets Recap

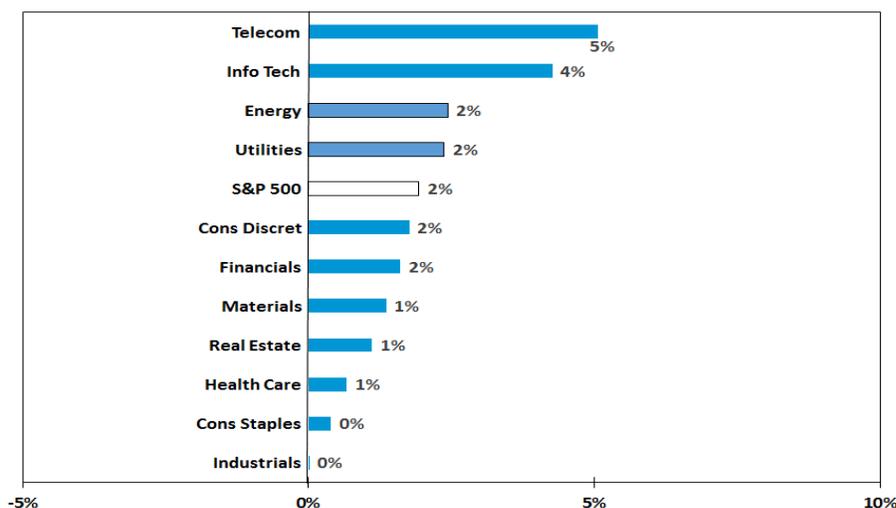
In July, the MSCI All Country World Index (ACWI) rose a strong 2.7% — Figure 13. All countries and regions that we monitor posted gains (in dollar terms). Emerging Markets (EM) were strong performers, most notably Brazil (+10.8%), India (+7.3%), and South Africa (+6.1%). Developing Markets lagged by a wide margin, with many countries posting gains of 3% or less. This DM versus EM divergence likely reflects that most Developed Markets remain in a slow-growth environment where central bank policies are becoming less accommodative. That said, a 3% monthly gain still yields a double-digit annualized return.

At the sector level, technology and telecom led the pack, with Internet Software (+5.6%) and Diversified Telecom (+5.1%) strongly outperforming the MSCI ACWI (+2.7%). In terms of investment styles, Cyclical strongly outperformed Defensive areas. So, for example, top-performing industries in the MSCI ACWI included Metals and Mining (+12.0%) and Materials (+5.0%), while the worst-performing industries included Food Products (-0.6%) and Pharmaceuticals (-0.6%).

Strength in Most US Sectors

Turning to the US, the S&P 500 rose another 1.9% in July, and is now up 10.3% year-to-date — Figure 14. No sector declined in value. In terms of specific areas of the US market, it's also the case that Telecom and Information Technology were the best-performing sectors — Figure 2.

Figure 2: S&P 500 Sector Price Performance Year-to-Date Through July 31, 2017

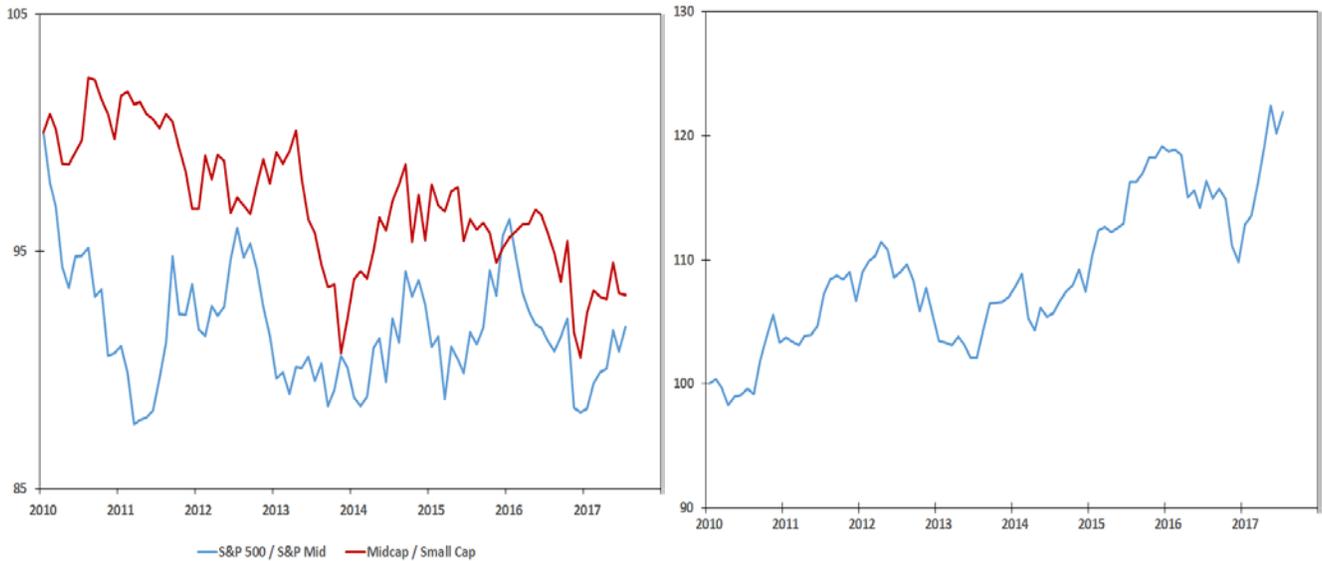


Source: S&P, Cornerstone Capital Group

Regarding market capitalizations, in July large-cap stocks outperformed mid-caps, but mid-caps underperformed small-caps (Figure 3). There was also a return to Growth strongly outperforming Value (Figure 4), a trend that had been in place for most of 2017.

Figure 3: Performance of S&P 500, S&P 400 (Midcap), and S&P 600 (Small Cap)

Figure 4: Growth / Value: Performance of Russell 1000 Growth Relative to Russell 1000 Value

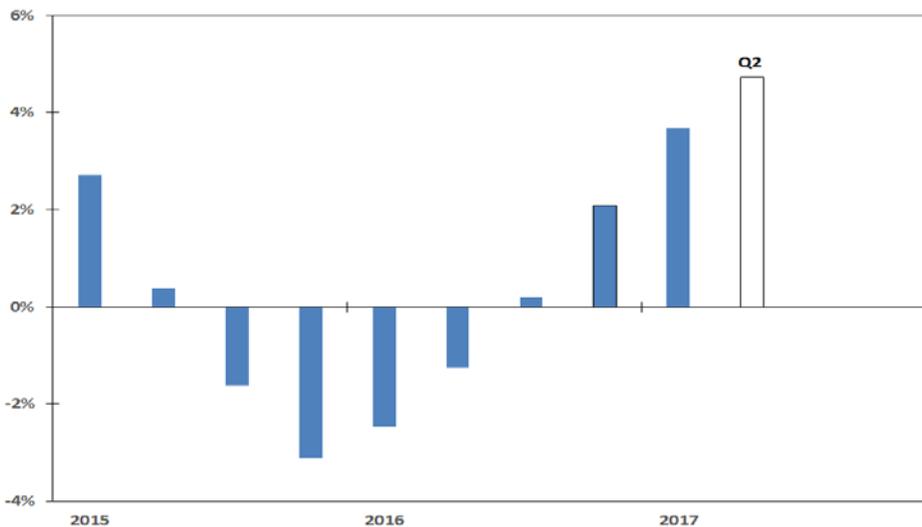


Source: Bloomberg, Cornerstone Capital Group

Profit Growth Set to Slow in 2018

S&P 500 sales growth has accelerated in recent quarters — Figure 5.

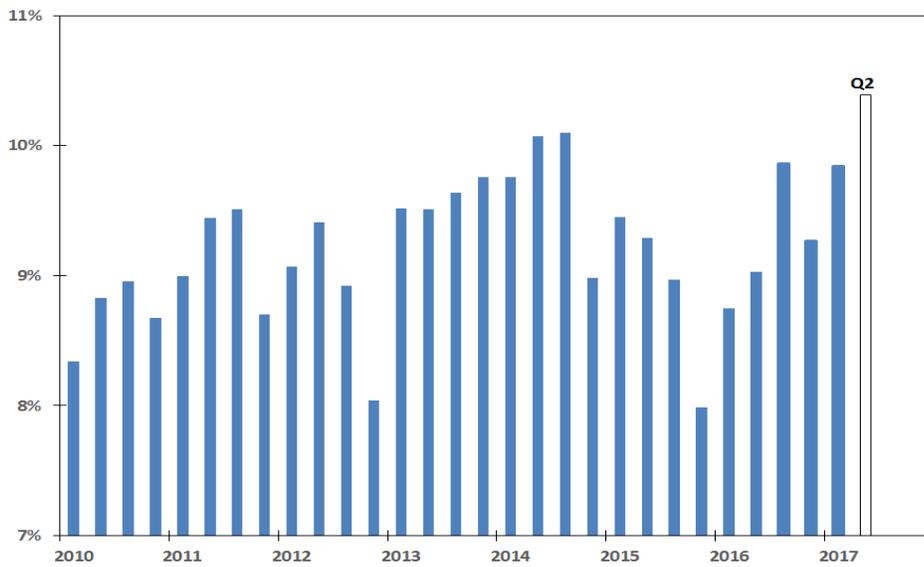
Figure 5: S&P 500 Sales
Year-to-year percentage change in quarterly sales



Source: S&P, Cornerstone Capital Group

At the same time, operating margins have reached record highs — Figure 6.

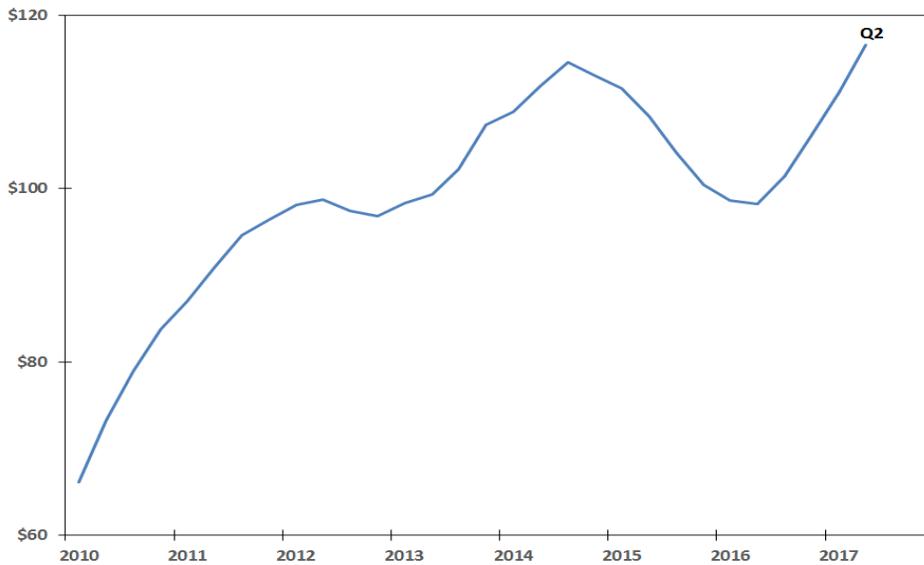
Figure 6: S&P 500 Operating Margin



Source: S&P, Cornerstone Capital Group

As a result, earnings also reached record highs in Q2 — Figure 7.

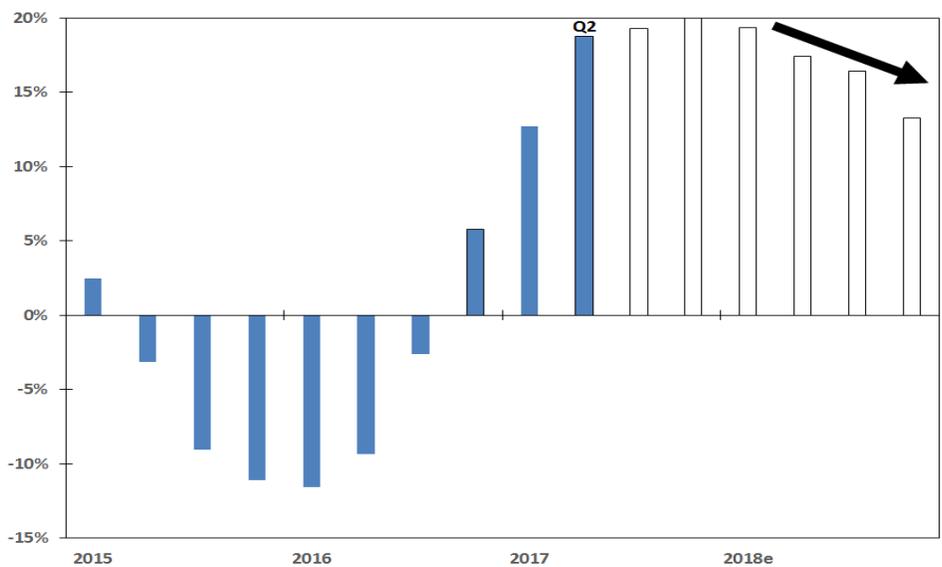
Figure 7: S&P 500 Operating EPS



Source: S&P, Cornerstone Capital Group

Today's robust earnings gains are tomorrow's tough comparisons. Indeed, Figure 8 shows the consensus expectation is for earnings growth to slow sharply in 2018.

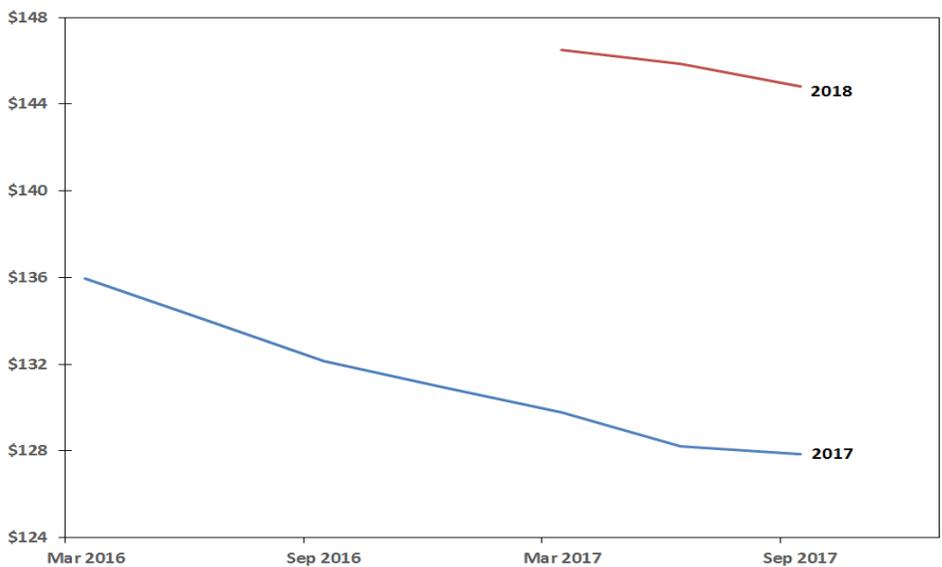
Figure 8: S&P 500 Operating EPS – Consensus Estimates for 2018
Year-to-year percentage change in quarterly EPS



Source: S&P, Cornerstone Capital Group

Moreover, even as profits have moved to new levels, earnings expectations have continued to fall (Figure 9), suggesting that analysts have been too optimistic in a generally positive environment.

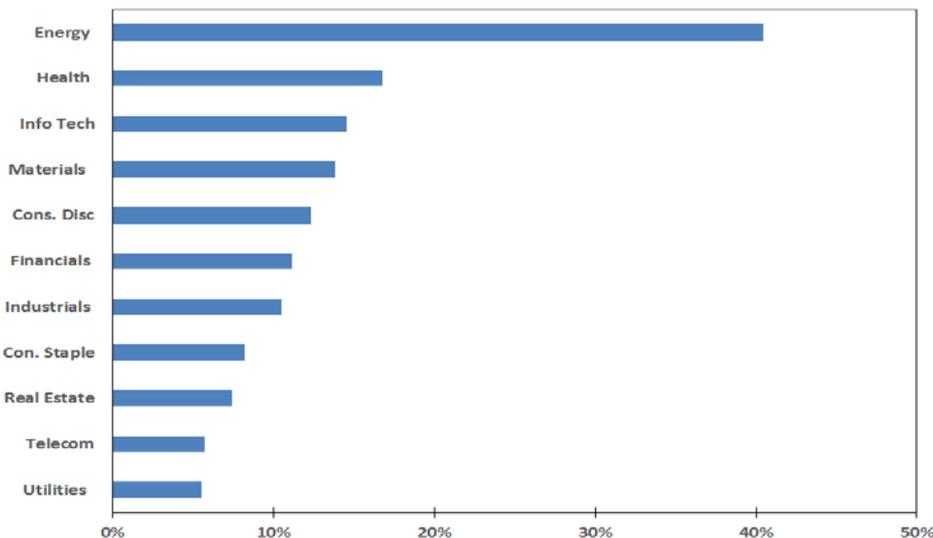
Figure 9: Time Series of Consensus 2017 and 2018 S&P 500 Operating EPS Estimates



Source: S&P, Cornerstone Capital Group

If expectations remain too optimistic, that raises the risk of earnings disappointments in 2018, especially as profit growth slows sharply. That risk is underscored by the fact that, currently, all S&P 500 sectors are forecast to experience earnings growth in 2018, which seems unrealistic — Figure 10. Energy, a key swing sector, is expected to see a 40% gain in profits, which is likely highly dependent on the direction of oil prices.

Figure 10: Consensus Expectation for 2018 Earnings Growth in S&P 500 Sectors

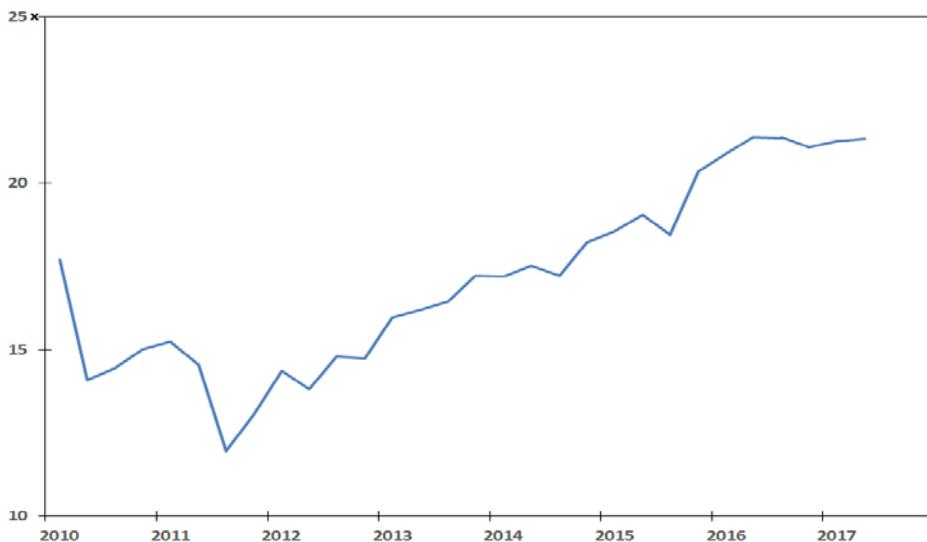


Source: S&P, Cornerstone Capital Group

Stock Prices Could Be Under Pressure in 2018

Slower earnings growth, and interest rate increases by the Federal Reserve, could well pressure stock prices in 2018, especially with valuation multiples still elevated — Figure 11.

Figure 11: S&P 500 Price-to-Earnings Multiple



Source: S&P, Cornerstone Capital Group

The current consensus estimate is that earnings growth will almost be cut in half in 2018, with that expected rate of earnings growth likely to fall further as expectations are lowered. Figure 12 shows that a two-point contraction in the P/E multiple combined with a 10% cut in the current 2018 earnings estimate would imply flat stock prices in 2018.

Figure 12: Sensitivity Analysis – P/E Multiple and 2018 EPS

Current S&P 500 level	2470					
Current Trailing EPS	\$117					
Current Trailing P/E	21					
Consensus 2018 EPS	\$145					
P/E Multiple	21	20	19	18	17	16
Implied 2018 S&P 500 Level	3069	2896	2752	2607	2462	2317
% Change from Current Level	24%	17%	11%	6%	0%	-6%
10% Cut in Consensus 2018 EPS	\$130					
P/E Multiple	21	20	19	18	17	16
Implied 2018 S&P 500 Level	2762	2607	2476	2346	2216	2085
% Change from Current Level	12%	6%	0%	-5%	-10%	-16%

Source: S&P, Cornerstone Capital Group

ESG Matters: A Monthly Recap

We introduce a new section, which summarizes key Environmental, Social and Governance (ESG) developments during the month.

Environmental

- **Just 100 companies responsible for 71% of global emissions, study says.** Just 100 companies have been the source of more than 70% of the world's greenhouse gas emissions since 1988, according to a new report. The Carbon Majors Report "pinpoints how a relatively small set of fossil fuel producers may hold the key to systemic change on carbon emissions," says Pedro Faria, technical director at environmental non-profit CDP, which published the report in collaboration with the Climate Accountability Institute.
- **Britain to ban sale of all diesel and petrol cars and vans from 2040.** Britain is to ban all new petrol and diesel cars and vans from 2040 amid fears that rising levels of nitrogen oxide pose a major risk to public health. The commitment, which follows a similar pledge in France, is part of the government's much-anticipated clean air plan.
- **Volvo Plans to Go Electric, to Abandon Conventional Car Engine by 2019.** Volvo will become the first major auto maker to abandon the conventional car engine — technology that has powered the industry for more than a century. All new Volvo models from 2019 would be either fully electric or a hybrid.
- **UK has nearly 800 livestock mega farms, investigation reveals.** US-style intensive factory farming of poultry, pigs and cattle is sweeping across the British countryside – raising concerns over animal welfare.

Social

- **Robots Are Replacing Workers at Many Stores.** The US economy has lost about 71,000 retail jobs since the beginning of the year as routine tasks become automated and thousands of stores close because of competition from e-commerce.
<http://www.newsmax.com/Finance/StreetTalk/robots-automation-retail-jobs/2017/07/19/id/802549/>
- **Robots Are Replacing Workers Where You Shop.** The U.S. retail industry's 16 million workers are at risk of seeing their jobs replaced by automation as large chains, under pressure from Amazon, increasingly use technology to do rote tasks.
<https://www.wsj.com/articles/robots-are-replacing-workers-where-you-shop-1500456602>

Governance

- **Swiss Re shifts entire \$130bn portfolio to ethical indices.** Swiss Re says it is the first insurer to base its whole portfolio on ethical principles. Guido Fürer, the chief investment officer, said that in future both internal and external managers of its money will be told to use MSCI's environmental, governance and social indices, rather than more traditional benchmarks.
- **SEC Lets More Companies Ignore Shareholder Proposals in 2017.** The Securities and Exchange Commission allowed a greater number of companies to exclude shareholder proposals during the 2017 annual meeting season, according to a report by law firm Gibson, Dunn & Crutcher LLP.

Appendix 1: Country and Region Statistics

Figure 13: Global Equity Markets Data

7/31/2017	% chg 1 Month (\$)	% chg YTD (\$)	P/E Ratio Trailing	P/E Ratio 5-yr Avg	2017 EPS Growth (e)
DJIA	2.5%	10.8%	18.7	15.8	10%
S&P 500	1.9%	10.3%	21.3	18.1	11%
S&P 400 Midcap	0.8%	6.0%	24.0	21.7	14%
S&P 600 Small Cap	0.9%	3.1%	26.4	25.0	19%
Russell 1000 Growth	2.6%	16.1%	25.8	21.3	14%
Russell 1000 Value	1.2%	4.6%	19.0	16.6	10%
MSCI AC World	2.7%	13.2%	20.4	18.0	10%
North America:	2.0%	10.2%	21.6	18.3	12%
----U.S.	1.9%	10.5%	21.7	18.5	12%
----Canada	4.0%	6.4%	18.9	18.9	10%
Europe x UK:	3.2%	19.1%	20.0	20.3	10%
----France	2.9%	18.3%	17.7	21.9	9%
----Germany	1.9%	15.3%	18.8	18.1	8%
----Switzerland	0.8%	16.4%	23.5	20.4	10%
----Netherlands	6.9%	26.5%	21.2	22.3	10%
----Spain	4.7%	28.2%	15.9	26.6	10%
----Sweden	0.9%	17.3%	14.4	17.0	10%
----Italy	7.5%	22.0%	NMF	77.2	15%
U.K.	2.4%	10.3%	30.6	27.8	8%
Japan	2.1%	11.2%	16.1	17.7	6%
Australia	4.3%	11.7%	19.1	19.3	4%
Emerging Asia:	5.1%	28.3%	16.3	12.9	12%
----South Korea	2.8%	31.9%	12.8	11.4	8%
----Taiwan	0.9%	22.5%	15.2	15.7	7%
----India	7.3%	28.6%	22.5	19.6	23%
----China	4.6%	15.2%	8.9	6.8	8%
Latin America:	8.2%	17.6%	19.5	21.2	12%
----Brazil	10.8%	12.7%	18.6	27.5	12%
----Mexico	4.1%	27.8%	21.0	22.7	9%
CEEMEA:	5.3%	8.8%	13.7	13.5	15%
----South Africa	6.1%	14.1%	20.7	17.0	20%
----Russia	1.8%	-13.8%	6.9	6.2	12%
----Turkey	5.8%	37.0%	10.2	10.1	15%
----Poland	6.0%	41.0%	18.5	18.7	2%

Source: Cornerstone Capital Group, Bloomberg

Appendix 2: Sector Statistics

Figure 14: S&P 500 Equity Sector and Industry Data
(Two Largest Industries in Each Sector)

7/31/2017	% chg 1 Month (\$)	% chg YTD (\$)	P/E Ratio Trailing	P/E Ratio 5-yr Avg	2017 EPS Growth (e)
S&P 500	1.9%	10.3%	21.3	18.1	11%
Consumer Discretionary	1.8%	12.2%	21.9	20.2	12%
---- <i>Media</i>	4.4%	11.3%	20.1	18.3	13%
---- <i>Hotels, Restaurants & Leisure</i>	-1.3%	17.9%	24.2	23.1	13%
Consumer Staples	0.4%	7.0%	21.9	19.8	8%
---- <i>Beverages</i>	1.7%	11.0%	24.4	21.0	7%
---- <i>Food Products</i>	0.8%	-2.6%	19.6	20.2	8%
Energy	2.4%	-11.7%	49.1	33.1	39%
---- <i>Oil, Gas & Consumable Fuels</i>	2.5%	-10.2%	46.2	32.0	34%
---- <i>Energy Equip & Services</i>	2.1%	-19.5%	79.3	42.6	89%
Financials	1.6%	7.7%	15.7	14.4	12%
---- <i>Banks</i>	0.2%	5.4%	13.9	11.8	13%
---- <i>Insurance</i>	2.9%	11.1%	15.9	12.9	9%
Health Care	0.7%	15.8%	21.0	20.6	9%
---- <i>Pharmaceuticals</i>	1.4%	13.2%	20.2	20.0	8%
---- <i>Biotechnology</i>	3.8%	17.2%	16.9	22.7	7%
Industrials	0.0%	8.3%	20.2	17.8	11%
---- <i>Industrial Conglomerates</i>	-2.9%	-3.8%	22.1	23.5	9%
---- <i>Machinery</i>	1.8%	16.9%	22.7	16.5	14%
Information Technology	4.3%	21.3%	23.1	18.4	12%
---- <i>Internet Software</i>	5.8%	29.2%	32.6	30.6	16%
---- <i>Software</i>	4.5%	24.6%	32.3	21.8	13%
Materials	1.4%	9.6%	20.5	18.8	13%
---- <i>Chemicals</i>	0.6%	10.9%	19.5	18.1	10%
---- <i>Metals and Mining</i>	11.5%	5.2%	21.1	17.8	19%
Real Estate	1.1%	5.8%	43.7	44.1	6%
-- <i>Retail REITs</i>	0.5%	-9.7%	31.1	38.8	12%
-- <i>Residential REITs</i>	1.4%	7.4%	59.5	158.9	3%
Telecom	5.1%	-8.4%	15.2	16.6	2%
---- <i>Diversified Telecom</i>	5.1%	-8.4%	15.2	15.7	2%
Utilities	2.4%	9.4%	18.7	16.7	6%
---- <i>Electric Utilities</i>	2.3%	10.2%	17.8	15.9	5%
---- <i>Multi Utilities</i>	1.5%	6.5%	19.9	18.2	7%

Source: Cornerstone Capital Group, Bloomberg



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