

## Equity Outlook: Fundamentally Sound, Valuations Still Key

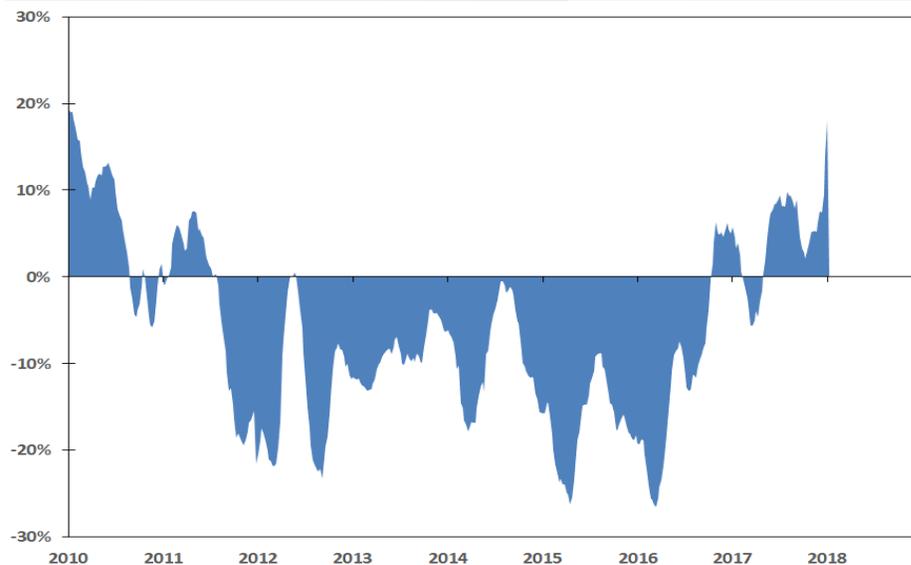
On January 26, 2018 the S&P 500 closed at a record high, and up 7% for the year to date. On February 5, the S&P 500 was down 1% for the year-to-date, reflecting a decline of 8% from its record high. Fundamentally, not much has changed. If anything, the earnings outlook has actually improved.

### Earnings Outlook: Still Improving

It continues to be the case that earnings estimate increases are significantly outpacing estimate decreases for companies in the S&P 500. Figure 1 illustrates that, on a weekly basis, the current period of net estimate increases that began in the Spring of 2017 has been the most extended since 2010.

**Figure 1: Percentage of Net Upward Estimate Revisions within the S&P 500**

*# estimates up minus # estimates down as % of total # of estimates. Three month moving average of weekly data*

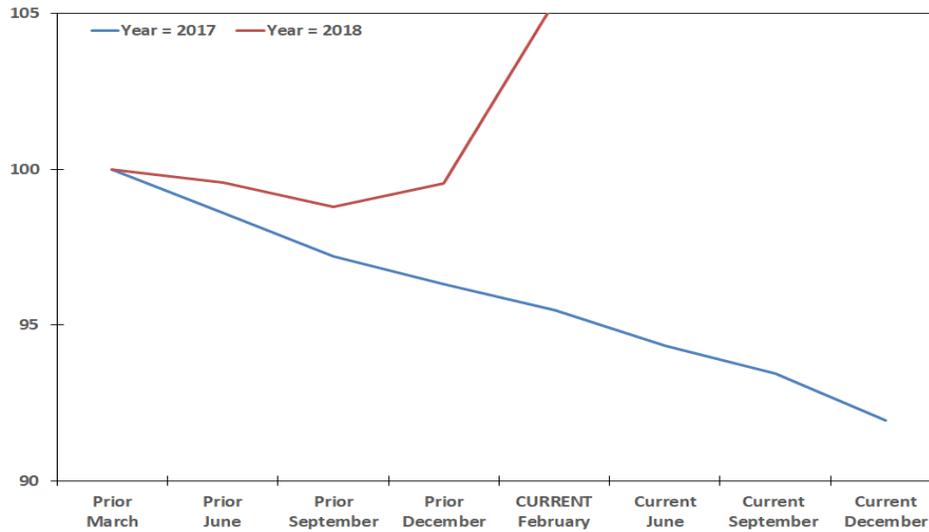


Source: First Call

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Not surprisingly, the consensus estimate for 2018 S&P 500 operating EPS *has continued to increase*. — Figure 2. This is quite unusual because the usual pattern — seen in 2017 — is for the consensus earnings estimate to steadily *decline* with the progression of time.

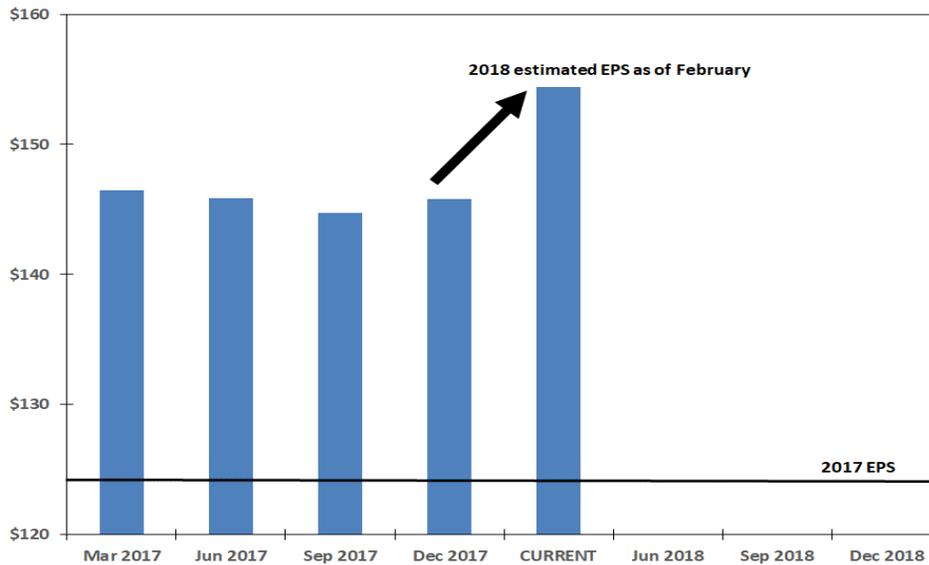
**Figure 2: S&P 500 Operating EPS – Consensus Estimates for 2017 and 2018**  
(Index: March = 100)



Source: S&P

In fact, Figure 3 illustrates that the current estimate of 2018 S&P 500 EPS is now 6% above its level just two months ago.

**Figure 3: S&P 500 Operating EPS — Consensus Estimate for 2017 and 2018**



Source: S&P



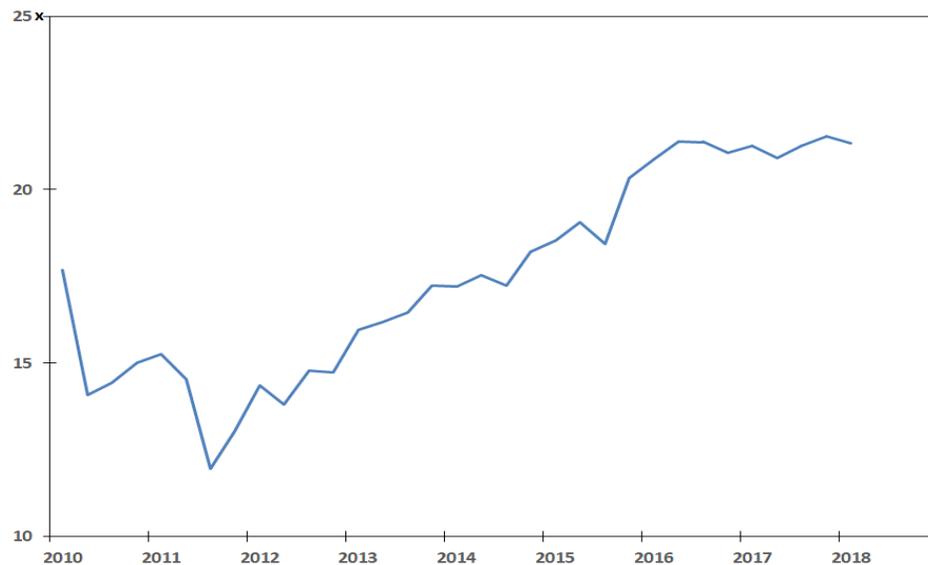
## Valuations Remain Elevated

In our January 19, 2018 report “Equity Outlook – Tax Reform An Earnings Wildcard in 2018” we listed the factors behind the strong earnings momentum:

- Favorable bottom-up factors: sales growth, margin expansion.
- Synchronized global economic growth.
- Significant tax reform in the U.S.

We also acknowledged that valuations remained elevated. Figure 4 illustrates the price-to-earnings multiple of the S&P 500 reflecting the closing price on February 5, 2018. While the multiple has declined somewhat, it still remains elevated by historical standards.

**Figure 4: S&P 500 Price-to-Earnings Multiple**



Source: S&P

In our January report, we acknowledged that a risk for equities was a compression in P/E multiples driven by an increase in interest rates. Indeed, that seems to be the factor that has pressured stock prices lately. The increase in interest rates is likely a reflection of:

- A strong US economy that’s been given an additional boost by tax reform.
- The need for additional government borrowing to fund the tax cuts and, also, perhaps to fund a significant infrastructure spending program.
- Concerns about some signs of wage pressure, although the situation remains unclear.
- Further interest rate increases by the Federal Reserve, reflecting a combination of the factors listed above.

## Positive Equity Outlook Remains Unchanged

Our positive equity outlook remains unchanged. In a conservative scenario, Figure 5 illustrates that a further 5% increase in the current consensus 2018 EPS estimate, combined with a reduction in the P/E multiple to its long-run average of 17x, would suggest about a 5% gain in stock prices in 2018. We continue to believe that the strength in corporate profits will, to some degree, offset pressure on P/E multiples so that stock prices are likely to end 2018 with gains of 5-10%.

**Figure 5: Sensitivity Analysis – P/E Multiple and 2018 EPS**

<b>Current S&amp;P 500 level</b>	<b>2649</b>				
<b>Current Trailing EPS</b>	<b>\$125</b>				
Current Trailing P/E	21				
Current Consensus 2018 EPS	\$154				
<b>5% Increase in Consensus 2018 EPS</b>	<b>\$162</b>				
P/E Multiple	21	20	19	18	<b>17</b>
<b>Implied 2018 S&amp;P 500 Level</b>	<b>3436</b>	<b>3274</b>	<b>3111</b>	<b>2949</b>	<b>2787</b>
% Change from Current Level	30%	24%	17%	11%	<b>5%</b>

Source: S&P, Cornerstone Capital Group



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