Cornerstone
CAPITAL GROUP

Equity Strategy **March 22, 2018**

Equity Outlook: Still Positive, Risks Increasing Modestly

Even as stock price volatility has increased in 2018, the U.S. equity outlook remains fundamentally sound. Strength in corporate profitability is broad-based, with nine of the eleven sectors in the S&P 500 currently forecast to post double-digit earnings gains this year.

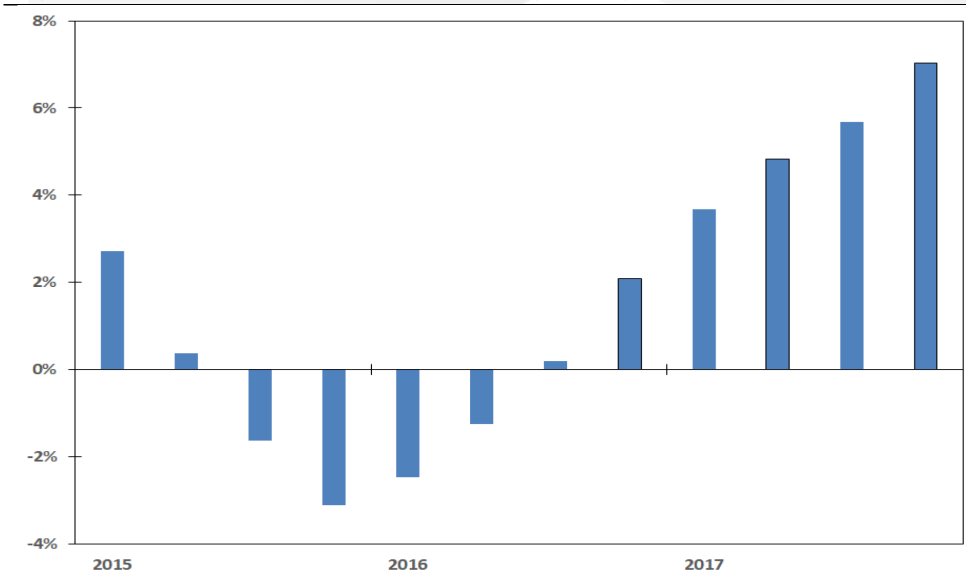
Exceptionally Strong Corporate Profitability

A number of factors have combined to create a very favorable operating environment for many U.S. companies:

- A robust US economy that's now in its ninth year of expansion, which is one of the longest periods of growth on record.
- Significant tax reform in the U.S. that's benefiting both corporations and consumers.
- Synchronized global economic growth. For the first time since the 2007-08 financial crisis, all the world's major economies are growing: Canada, U.S., Mexico, Brazil, U.K., Euro Area, Russia, Turkey, India, China, South Korea, Japan, Indonesia and Australia.

Even with little pricing power globally, S&P 500 revenue growth accelerated throughout 2017 — Figure 1.

Figure 1: S&P 500 Sales: Year-to-Year Percentage Change in Quarterly Sales

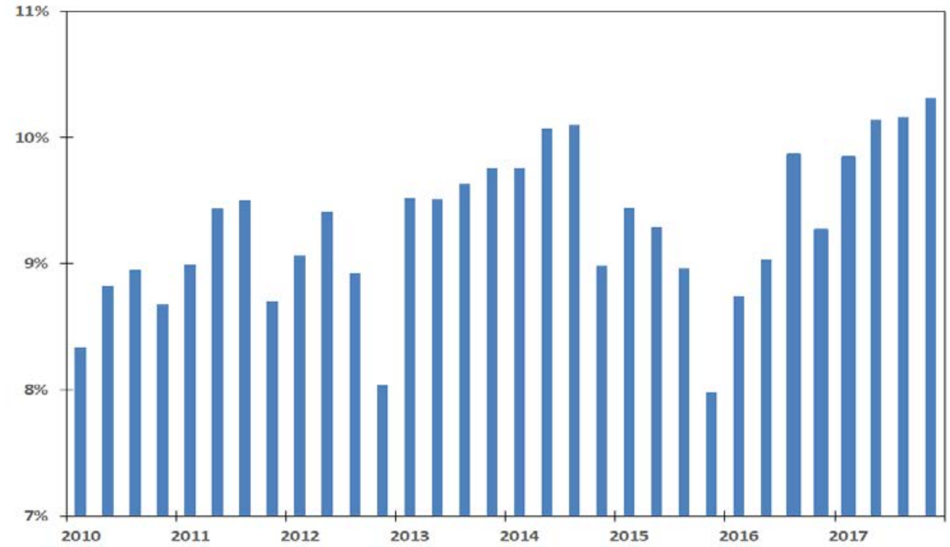


Source: S&P

Michael Geraghty
Equity Strategist

At the same time, operating margins have reached a record high of 10% — Figure 2.

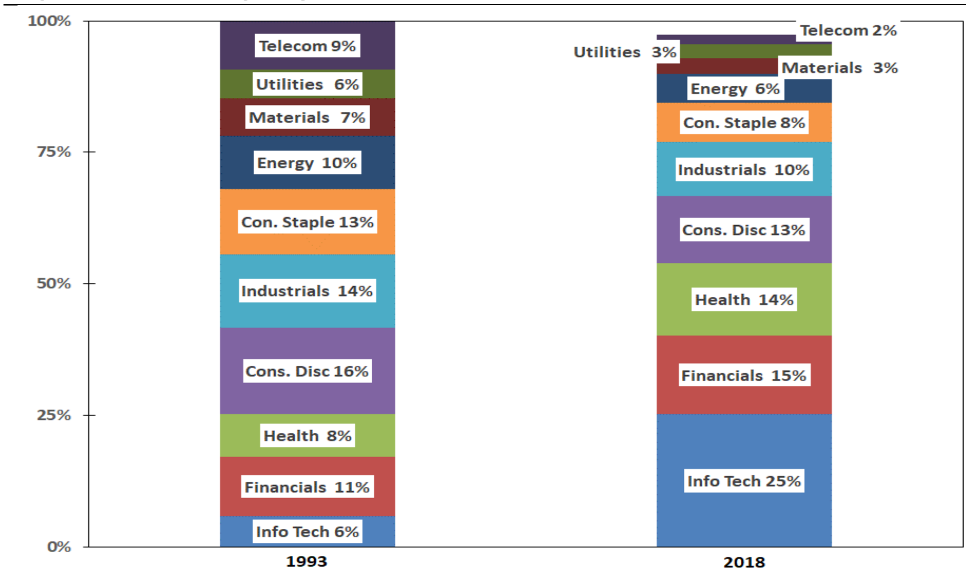
Figure 2: S&P 500 Operating Margin: Quarterly



Source: S&P

Note here that, with the Information Technology sector currently having a 25% weight in the S&P 500, the margin environment is quite different than in other periods. Today, Apple has a net income margin of 23%. In 1994, the S&P 500 operating margin was 6% reflecting, in large part, the dominance of the low-margin Consumer Discretionary sector (Figure 3); Ford and General Motors had net profit margins of 3.6% and 3.5%, respectively.

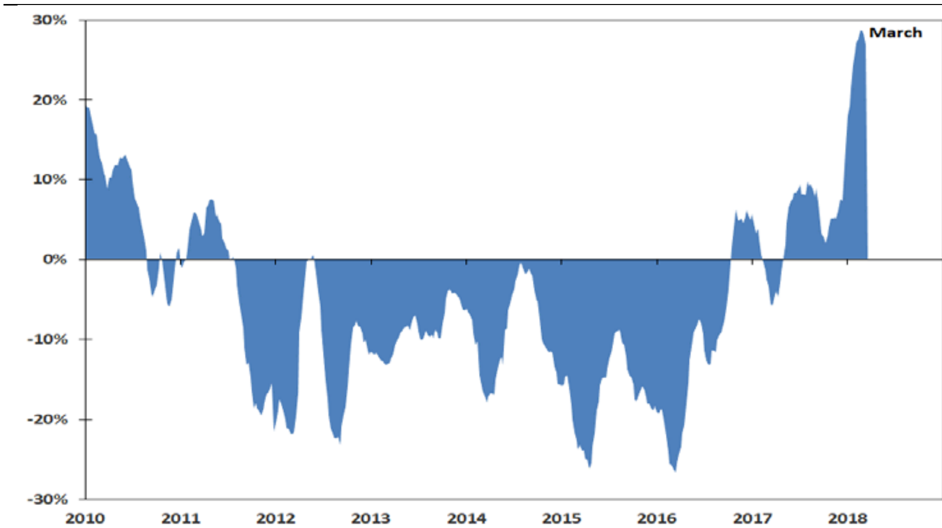
Figure 3: Sector Weightings of the S&P 500



Source: S&P

Significantly, earnings estimates continue to rise. Figure 4 illustrates that, on a weekly basis, the current period of net estimate increases that began in spring 2017 is the *most extended* in a decade. The *number* of positive revisions is also noteworthy, with upward estimate revisions exceeding downward revisions by the widest margin since 2010.

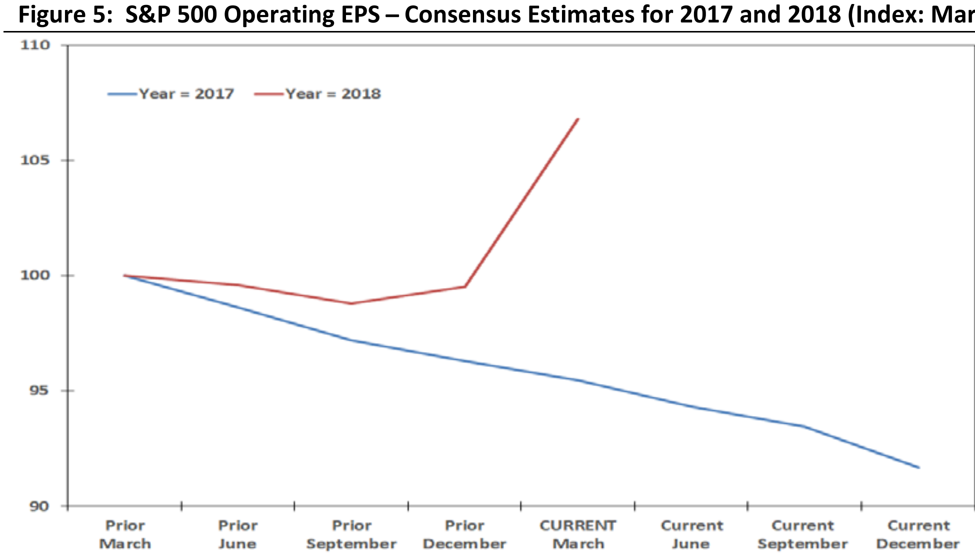
Figure 4: Percentage of Net Estimate Revisions within the S&P 500
 # estimates up minus down as % of total # of estimates. Three-month moving average of weekly data



Source: Thomson Reuters

Not surprisingly, the consensus estimate for 2018 S&P 500 operating EPS has continued to increase — Figure 5. This is quite unusual because the typical pattern — seen in 2017 — is for the consensus earnings estimate to *decline* steadily with the progression of time.

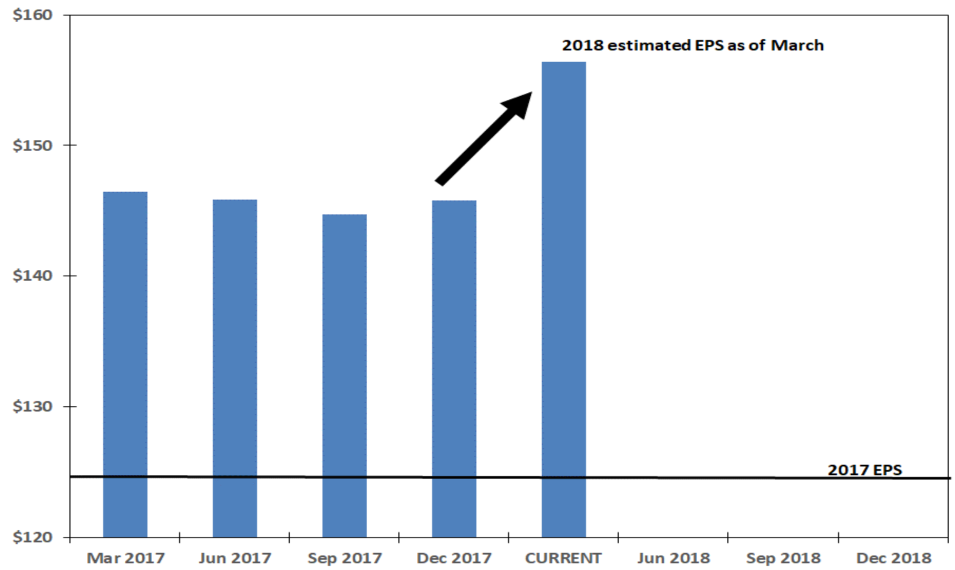
Figure 5: S&P 500 Operating EPS – Consensus Estimates for 2017 and 2018 (Index: March = 100)



Source: S&P

In fact, Figure 6 illustrates that the current estimate of 2018 S&P 500 EPS is now 7% above its level just three months ago.

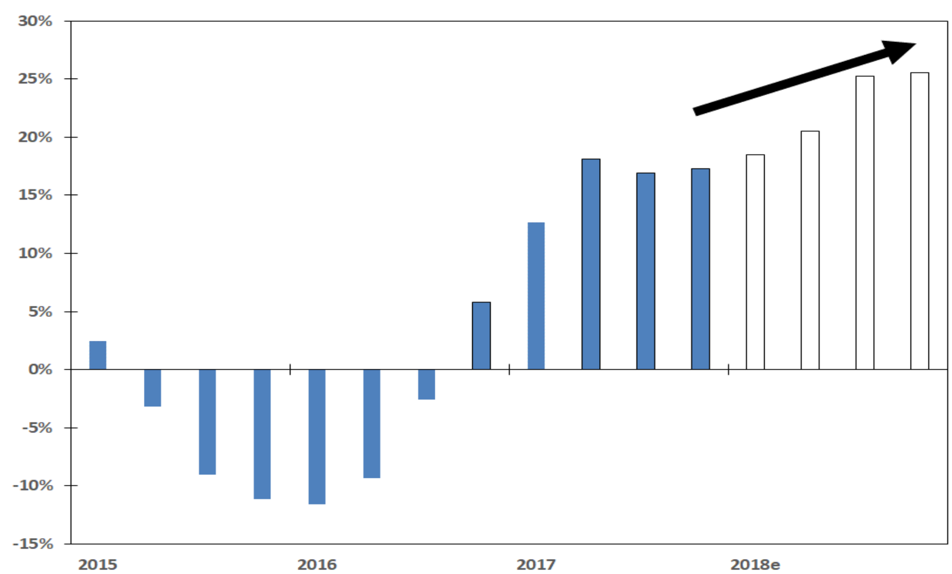
Figure 6: S&P 500 Operating EPS — Consensus Estimate for 2017 and 2018



Source: S&P

Reflecting the above, the consensus forecast is for the profit growth of S&P 500 companies to accelerate throughout 2018 — Figure 7.

Figure 7: S&P 500 Operating EPS: Year-to-Year Percentage Change Quarterly

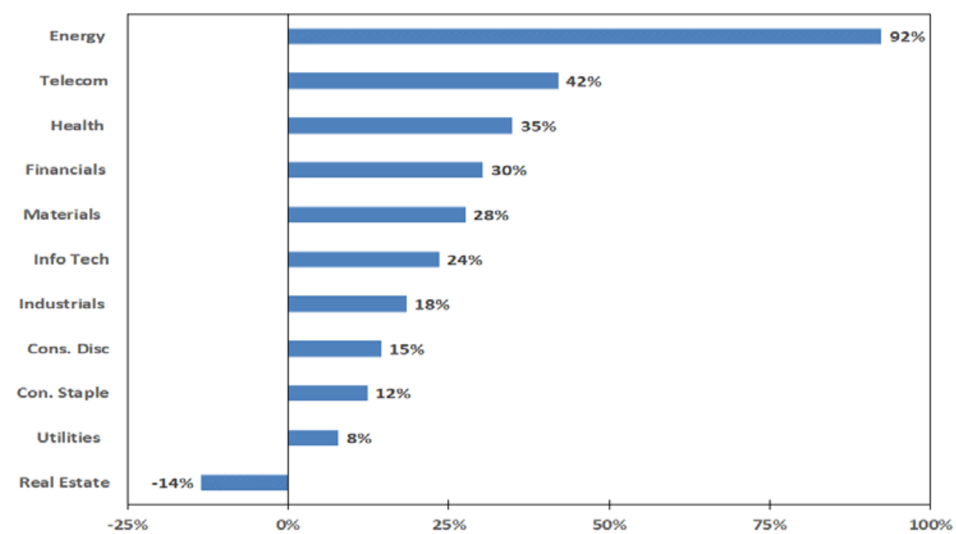


Source: S&P

Broad-based Sector Strength

Strength in corporate profitability is broad-based, with nine of the eleven sectors in the S&P 500 currently forecast to post double-digit earnings gains this year (the two exceptions being the relatively small Real Estate and Utilities sectors) — Figure 8.

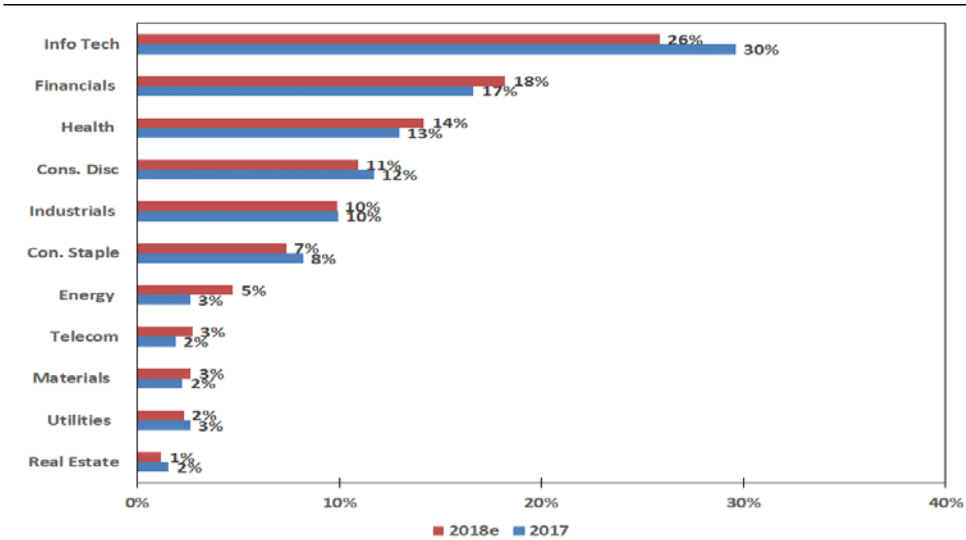
Figure 8: Consensus Expectation for 2018 Earnings Growth in S&P 500 Sectors



Source: S&P

Importantly, as Figure 3 illustrated, some sectors such as Information Technology have a much bigger weight in the S&P 500 than others, so that earnings growth in those sectors (24% for IT) has much more significance than earnings gains in others e.g., Telecom (42%) — Figure 9.

Figure 9: Sector Contribution to S&P 500 Operating Earnings (Bars sum to 100%)

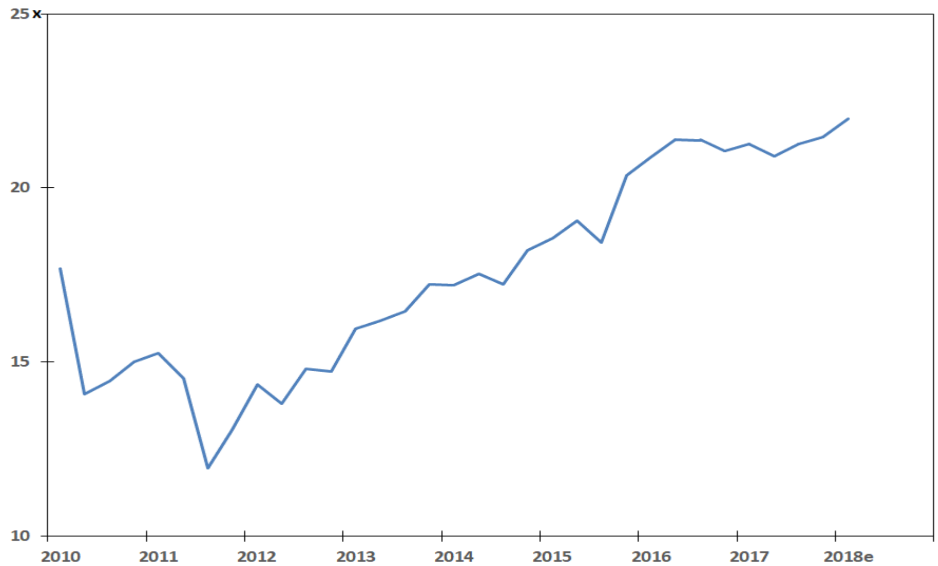


Source: S&P

Risks to the Outlook: An ESG Perspective

With valuations elevated — Figure 10 — there are risks to the equity outlook.

Figure 10: S&P 500 Price-to-Earnings Multiple



Source: S&P

Some of the risks that have been highlighted include:

- More interest rate increases by the Federal Reserve than are currently expected.
- Wage pressures driven, in part, by a very tight labor market.
- Trade tensions. The U.S. has announced tariffs on steel and aluminum, leading to concerns that these are the opening shots in what will turn out to be a global trade war.
- Geopolitical conflict. Although U.S. relations with North Korea appear to be improving, tensions with Russia seem to be ratcheting up.
- Domestic political upheaval. Turnover in the U.S. government has not weighed on markets to date, but further turmoil could lead to concerns about the ability of the administration to govern effectively.

Below we take a different perspective, and consider risks that might arise from environmental, social or governance (ESG) factors. Specifically, our focus is on ESG risks that have the potential to impact the earnings outlook of two key sectors during 2018.

Information Technology

Figure 9 illustrated that the IT sector was by far the largest contributor to S&P 500 profits in 2017 (30% contribution), and is expected to maintain that position in 2018 (26% contribution). As outlined below, there are a number of potential ESG risks on the horizon for the sector, especially with regard to corporate governance.

For a start, Europe has a history of clamping down on technology companies with practices that are perceived to be abusive; new regulations to be introduced in May will govern the way personal data is collected. The General Data Protection Regulation (GDPR) aims to strengthen data protection for EU citizens, and applies to any company that collects data from EU residents, including firms based outside of Europe.

The regulations restrict what types of personal data tech companies can collect, store and use across the 28-member European Union. The rules include the so-called "right to be forgotten," so that individuals can ask companies to remove certain online data about them. If companies do not comply with the provisions of the GDPR, they could face fines totaling 4% of their annual revenue.

The issue of data privacy is currently a hot topic. In mid-March, Facebook became embroiled in controversy about external data-mining that harvested users' private information, which was allegedly used for political purposes.

In addition, there is a growing risk that governments and regulators will conclude that some of the world's tech giants need to be broken up. Some observers have pointed to the emergence of "web trusts" in the technology services industry. Alphabet is one of the companies at the epicenter of antitrust concerns; its Google division has an 81% global market share in desktop and mobile search. Much like former monopolies — such as those in oil (Standard Oil) or telecommunications (Bell System) — Google's dominant market position has caught the attention of regulators. The company faces ongoing antitrust investigations in Europe, Israel, South Korea, India and Japan.

Financials

After IT, the Financials sector was the second largest contributor to S&P 500 profits in 2017 (18% contribution), and it is expected to maintain that number two position in 2018 (17% contribution). Here, too, governance issues present potential risks. Indeed, following the 2007-09 global financial crisis, Larry Fink, CEO of Blackrock, was quoted as saying "I actually don't think risk management failed. I think corporate governance failed…"

A decade after the federal government rescued faltering financial firms, the Senate recently voted to pass legislation that would relax restrictions on large parts of the banking industry, thereby moving Congress closer to passing the first rewrite of the Dodd-Frank reform law.

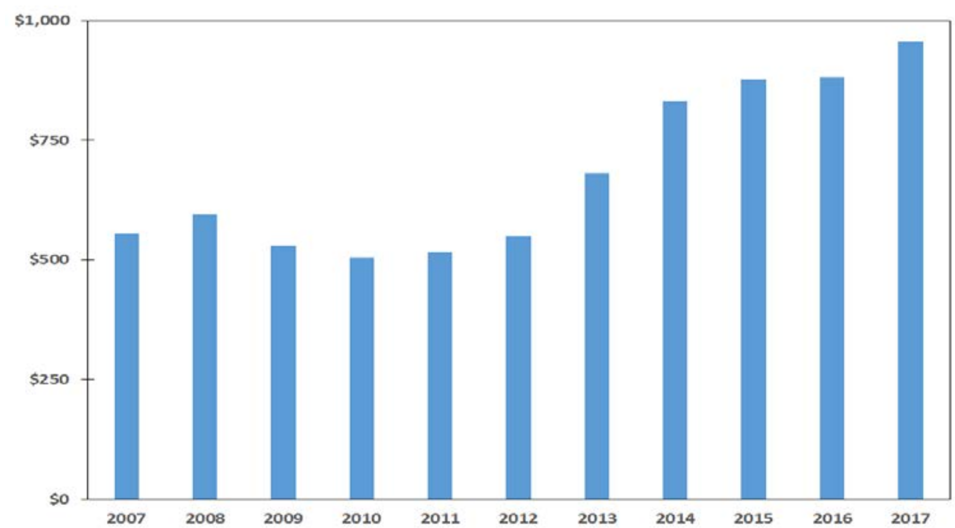
The Senate legislation would raise to $250 billion from $50 billion the asset threshold for banks to be designated as systemically important financial institutions, a status that subjects them to stricter Federal Reserve supervision. That would free American Express Co., BB&T Corp., KeyCorp and other companies from the scrutiny associated with being deemed too big to fail. It would also exempt banks with less than $10 billion in assets from rules banning proprietary trading.

The Senate vote shifts attention to the House of Representatives, where members will have to pass their own version of the bill if the current legislation is to be changed. The White House issued a statement within minutes of the bill clearing the Senate that said President Trump supports it and would sign it into law.

Critics say this legislation would be a dangerous rollback of financial regulations intended to prevent another meltdown. A March Congressional Budget Office report[1] that analyzed the bill concluded that it could increase the likelihood of failure for a bank.

Although it would likely take some time for legislation of this kind to be enacted, the fact is that the amount of risk-taking in the U.S. financial sector has increased significantly in recent years. Figure 11 illustrates that the value of loans to highly indebted companies has almost doubled since the post-crisis low in 2010.

Figure 11: Loans to Highly Indebted Companies Outstanding in the U.S.



Source: S&P / LSTA

2018 Equity Outlook Unchanged

While acknowledging the risks outlined above, our 2018 equity outlook remains unchanged. We continue to believe that strength in corporate profits will offset any pressures on P/E multiples, so that stock prices are likely to end 2018 with gains of 5-10%.

[1] Congressional Budget Office Cost Estimate, March 5, 2018

Michael Geraghty is the Equity Strategist at Cornerstone Capital Group. He has over three decades of experience in the financial services industry. Michael has worked as an investment strategist at a number of leading firms. At PaineWebber (1988 – 2000), he was a Senior Vice President and member of an Institutional Investor ranked U.S. Portfolio Strategy team. At UBS (2000 – 2003), he was an Executive Director and senior member of the global equity strategy team responsible for regional and sector allocations. At Citi Investment Research & Analysis (2004 – 2012), Michael was the global themes strategist; Citi was ranked #1 for Thematic Research in the 2011 Extel survey. Michael holds a Master's degree in Economics and a Masters of Business Administration in Finance from Columbia University. michael.geraghty@cornerstonecapinc.com

Important disclosures