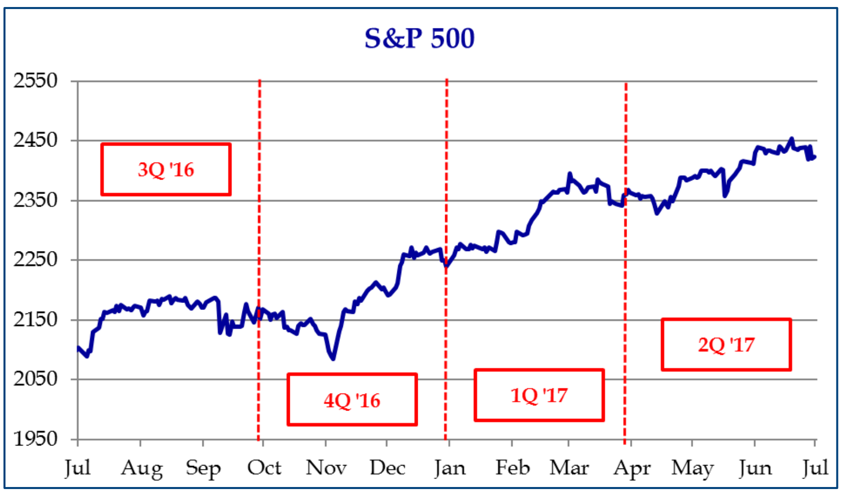
KINGS POINT
CAPITAL MANAGEMENT LLC

What Is Dragging the Market to New Highs?

Many people believe the continuing bull market for U.S. equities is the most unloved in history. Part of the reason stems from almost seven years of subpar economic growth versus the historical average of +3% GDP. This environment is reflected through the sluggish recovery in job growth and real personal income. As such, the substantial rise in the equity market is more reflective of declining interest rates and a moderate earnings recovery, rather than a substantial upswing to the economy. This, coupled with investors' focus on the need for yield, helped to drive additional funds into equities rather than into traditional fixed income assets. As this bull market continues to grind higher, investor skepticism grows. Nevertheless, we continue to view this market as fairly priced and likely to move somewhat higher as the year progresses.

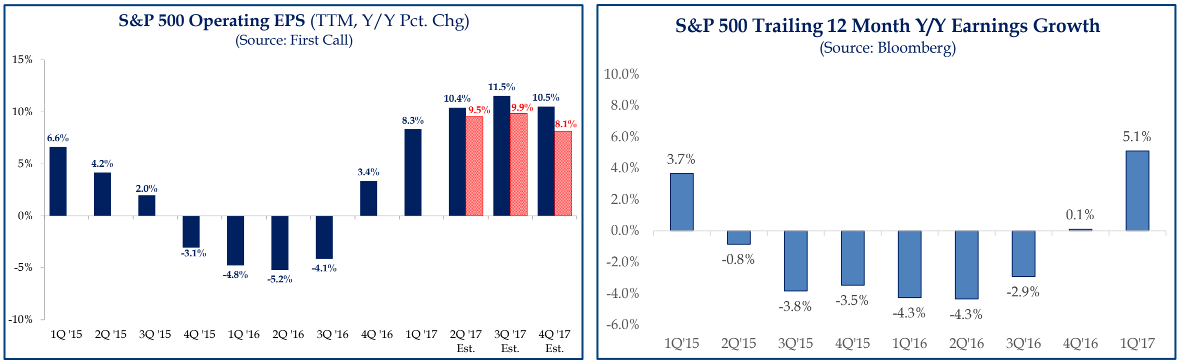
Chart I



Source: Strategas

Three factors, which we believe are critical to understanding any bull market, help explain our view. These are corporate profit growth, interest rates and valuation. Let's examine each one.

Corporate Profits:



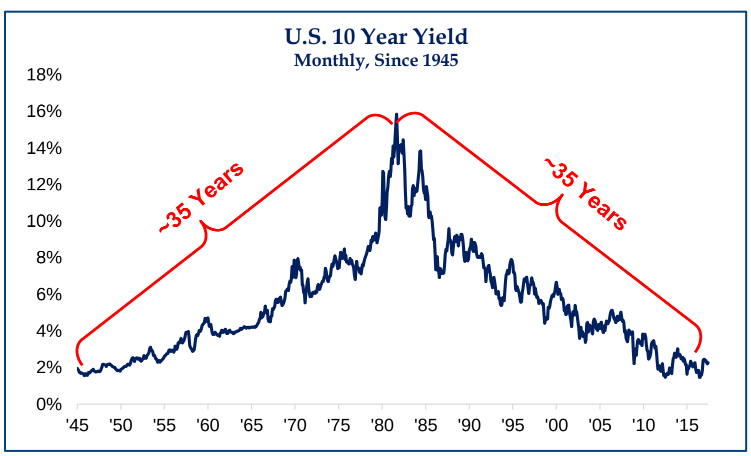
Source: Strategas

Probably the most important variable to any long-term bull market trend is corporate profit growth. While earnings (profit) growth for the S&P 500 has been "flattish" the last two years, growth is accelerating in 2017 and should extend into 2018. General expectations are that profits will rise from 5-8% in 2017. More importantly, if Congress passes any tax reform measures this year, it could further boost corporate profit growth. For companies with a high domestic tax rate, the impact could be considerable. Additionally, global economic growth now seems to be accelerating. This should result in higher corporate profits in Europe and Asia over the next 12-18 months.

Interest Rates:

For most investors, one to three years is a long-term investment trend. However, in economics, that is barely a trend at all.

Chart IV

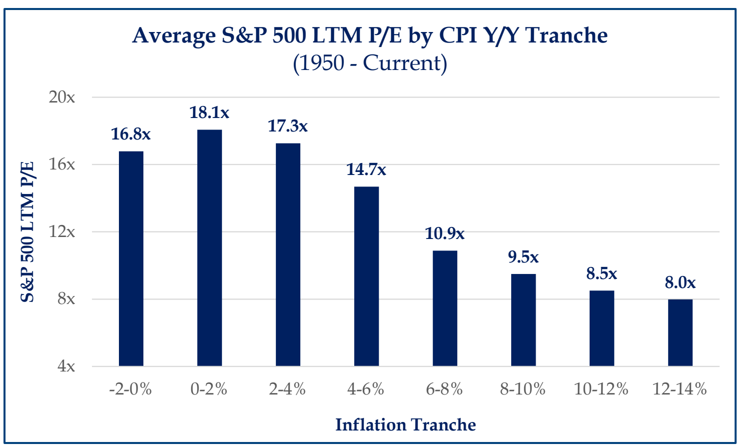


Source: Strategas

As the above chart demonstrates, critical economic variables (inflation, GDP, CPI, personal income and spending) are directionally impactful over longer cycles. As you can see, we are currently at the bottom of a 35-year downtrend. How fast interest rates recover is difficult to determine. Suffice to say, the Federal Reserve is indicating at least one additional rate increase this year. Additionally, the Fed is discussing deleveraging its balance sheet by selling bonds previously purchased to depress longer term interest rates. In any environment, trying to forecast the process is always risky. Most experts have made incorrect projections over the past few years. Currently, if GDP growth remains at 2% or better in the U.S. and 3% or more for the global economy, it is likely that interest rates would move higher over time. The "wild card," as mentioned previously, is how quickly and to what extent the Fed implements a program to deliver. The faster the implementation, the more likely rates will increase at a faster pace. While other factors including corporate profit growth, inflation and employment trends will remain important, the speed at which interest rates increase and the absolute level of rates could cause equity valuations to recede from its current level of 19X earnings. At the moment, the Federal Reserve is emphasizing a go-slow attitude toward raising interest rates and deleveraging. Thus, as long as GDP growth remains around 2-3%, we would expect any rise in interest rates to be modest.

Valuation:

Chart V



Source: Strategas

As mentioned above, equity valuation tends to be a residual of other factors; most notably corporate profits, inflation, and interest rates. For a consistent level of corporate profits, a lower level of interest rates and inflation tend to support a higher P/E (price to earnings) multiple. Over long periods of time, the P/E ratio for the U.S. equity market tends to average 16-17X earnings. Currently, the multiple is 19X trailing 12-month earnings and 17-18X projected earnings. Given the improving corporate profit outlook, full employment and sub 2% inflation, the market is close to fair value.

Should interest rates spike and/or inflation move above 2%, we would expect a contraction in P/E multiples. Even under a best-case scenario we expect the market to no more than hold current valuations. Thus, any meaningful move upward would have to reflect good corporate profit growth or the implementation of a stimulative tax policy.

While we have not discussed the impact of global commodity costs on inflation, the current weakness has a negative impact. Oil prices have sharply declined from peak levels and appear to be unable to move above $50 any time soon. This has also added to the low inflation scenario. In addition, wage pressures (as reflected in the latest nonfarm payroll report) continue to remain at subdued levels. Without rising pressures from either commodity costs or wages, inflation should remain subdued. As a result, we see the rising trend in interest rates or a Fed policy error as potential valuation headwinds (outside of any global geopolitical event). Should Congress implement a beneficial tax program, as mentioned previously, it could continue to push the market to even higher levels.

PORTFOLIO UPDATE

Recently, we added Avery Dennison (AVY) to our equity portfolio. The company meets or exceeds all our financial criteria for strong management and strong operational growth. AVY is also in a good position to benefit from exploding e-commerce trends for online purchasing of many consumer products. We have enclosed a summary of the company for your review.

OUTLOOK FOR THE SECOND HALF OF 2017

As mentioned previously, there are a number of critical variables that will determine the short-term direction for the equity markets. Fed policy, inflation levels and the direction of interest rates are all important inputs. However, corporate profits over the next few quarters, all else being equal, are critical to maintaining the current positive trajectory. While a market correction is possible, our view is that it would be a healthy adjustment in this extended bull market. As such, we will try to take advantage of any pullbacks to add attractive companies when possible.

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Company:	Avery Dennison	**Price:**	$87.79
Ticker:	AVY	**Market Cap:**	$7.7B
Date:	6/20/2017	**Beta:**	1.20

Avery Dennison (AVY)

About the Company: Avery Dennison produces pressure-sensitive materials, tags, labels and other converted products. The company's business segments include Label and Graphic Materials (69% of 2016 sales), Retail Branding and Information Solutions (24%), and Industrial and Healthcare Materials (7%). The company's label and graphic materials business includes pressure-sensitive labels, packaging materials, and reflective materials (i.e., soda/beer labels, street signs, food packaging). The company's retail business includes graphic tickets, tags and labels, and radio-frequency identification tags (i.e., apparel labels and security tags). The company's industrial and healthcare business includes pressure-sensitive tapes for general industrial and healthcare purposes (noise dampening tapes, window sealing, diaper closures, surgical patches, etc.). Avery Dennison's geographic revenue breakdown is: 40% U.S., 34% Western Europe, 18% Asia (ex-Japan) and 8% Eastern Europe, Middle East and Northern Africa.

Why We Like AVY: We are attracted to Avery Dennison's category dominance, strong organic revenue growth, high ROIC (17%), and substantial exposure to high-growth ecommerce categories. Recently, AVY has been shifting its portfolio to increase exposure to high-growth secular trends such as ecommerce/omni-channel and a growing emerging market middle class. The company has multiple levers to achieve management's goal for +4.5% organic revenue CAGR through 2021. Avery Dennison's radio-frequency identification (RFID) is growing by over 20% y/y driven by growth in ecommerce apparel retail. Brick and mortar omni-channel retailers use Avery's RFID tags to improve inventory accuracy to 99+% while reducing shrink and labor costs. Avery has significant exposure to the emerging markets (30% of AVY sales are to EM). Avery is the leader in labels in emerging markets with roughly 4X the market share of the next closest competitor. The labels industry in emerging markets is projected to grow at a 5-7% CAGR.

Avery generates substantial free cash flow ($408m of FCF, 5.3% FCF yield). The company is generous to shareholders when it comes to capital allocation. AVY returned an average of 101% of free cash flow to shareholders through dividends, share repurchases and debt-paydown in the last three years. The company has increased its dividend per share by an average of 12% for the last five years (currently 2.1% dividend yield).

Valuation & Expectations: On their Q1 2017 earnings call on April 26, management raised their EPS guidance for fiscal 2017 to $4.50-$4.65. At their investor day on March 8, 2017 management provided fiscal 2021 targets of +4% organic sales CAGR, +11% operating margin (from 9.9% currently), and +17% return on capital. On valuation, AVY trades at a 19X forward P/E and 11X EV/EBITDA NTM. This is slightly above the peer group median P/E of 17X and EV/EBITDA of 9X. We believe AVY merits its premium valuation because of the company's best-in-class product offering and above average growth rate.

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