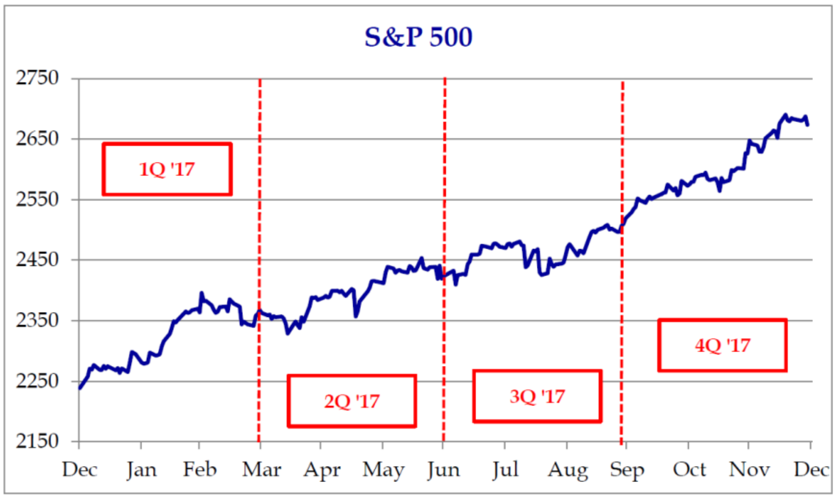
KINGS POINT
CAPITAL MANAGEMENT LLC

2018 OUTLOOK

NERVOUS BULL MEETS NERVOUS BEAR

The global equity markets rallied throughout 2017 with one of the lowest degrees of volatility ever recorded. With the S&P 500 index increasing 22%, the gains extended the bull market into a ninth consecutive year. As of December 2017, the bull market is now the second longest in duration (106 months) and the third largest in advances (up 295%).

Chart I – 2017 Growth



Source: Strategas

To put this equity advance in further perspective, it is important to understand that this bull market began on the heels of one of the greatest bear markets of all time. The U.S. stock market has only fallen 20% or more six times since 1926. Three of the six times occurred in the Great Depression era of the 1930s. With a 37% decline in the S&P 500 in 2008, it is not surprising that the rebound would be both strong and lengthy. The seeds of this current great bull market are many:

❖ The Federal Reserve aggressively moved to quantitative easing and has dramatically reduced interest rates during this current bull market. The duration and aggressive leverage used by the Fed is unprecedented.

- U.S. economic growth recovered at a sub-par rate of expansion versus historical stronger recovery patterns. GDP growth averaged about 2% versus a more normal recovery of 3% or more during this current bull market.

- Inflation and wage growth remained very subdued over the last eight years.

- Equity valuations have almost doubled from the trough reached in 2009.

- Corporate profits rebounded sharply over the same period of time.

- Investor sentiment has remained subdued. Many observers call this bull market one of the most unloved of all times. Thus, speculative excesses have not surfaced as of yet.

2018 OUTLOOK – THE CAUTIOUS BULL

As we enter 2018, investors are faced with an acceleration of many positive factors. First and foremost is a synchronized global economic expansion. We are seeing an improvement in GDP in the U.S., Europe and Asia. Interestingly, China has continued to play an important role in driving higher GDP growth. The Chinese economy reaccelerated last year, and this increase is supporting growth in many regions.

Along with accelerating global economic activity, we are also seeing accelerating earnings growth for most corporations. This rising revenue and earnings trend has just been turbo-charged by the U.S. Congress passing a huge tax reduction for U.S. corporations and to a lesser degree, individuals. The acceleration in revenue and earnings growth is occurring with a (so far) benign rise in inflation and interest rates. These two variables probably carry the key to how well the equity markets will perform in 2018. With the U.S. and global economies accelerating concurrent with consumer and corporations getting an additional benefit of tax reductions, interest rates are likely to move higher throughout the year. If wage rates begin to accelerate as well, we would expect to see inflation move up to the Federal Reserve target of 2%.

The long-term interest rate cycle is a classic bell-shaped curve. The trough occurred in mid-2016, and then moved upward as the Fed began to raise interest rates.

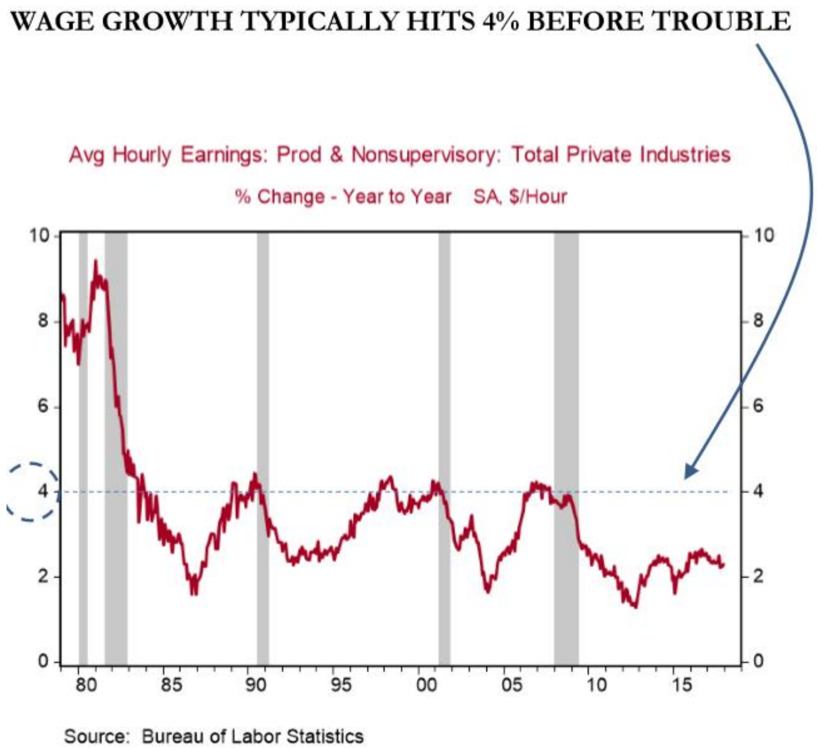
Chart II – Ten Year Yield

Source: Strategas

Importantly, the peak in the 10-year yield occurred in the inflation-fueled latter half of the 1970s. The impetus was the two Arab oil crises when oil prices rose well over 200% in a short span of time. This led to wage and price controls in the U.S., which exacerbated the subsequent rise of inflation when the controls were lifted. Interest rates rose substantially higher, particularly during the Volker period when the Fed strategy was to increase rates until the inflation spiral was broken. If we eliminate the period of the late 1970s to the mid-1980s, the more normal peak to the curve would approximate 7-8%. As such, one would expect a more normal average rate of approximately 4% during cycles in which GDP growth nears 3%. Thus, with the 10-year currently at ~2.6% (and some expectations of perhaps 3% by the end of 2018), interest rate increases could become a slight headwind in the coming months, rather than a major red-flag of concern for equity markets at this juncture.

Inflation is largely fueled by wage increases and full employment. Needless to say, we are close to full employment with the unemployment rate holding at 4.1%. Job growth of ~200,000 or more monthly has become a trend in recent months. If the labor market continues to tighten, one would expect wage growth to accelerate in the U.S. While most investors fret over the absolute level of wage growth, we are more concerned with the pace of increase or percentage change as this will be a better gauge for inflation trends.

<u>Chart III – Inflation Chart</u>



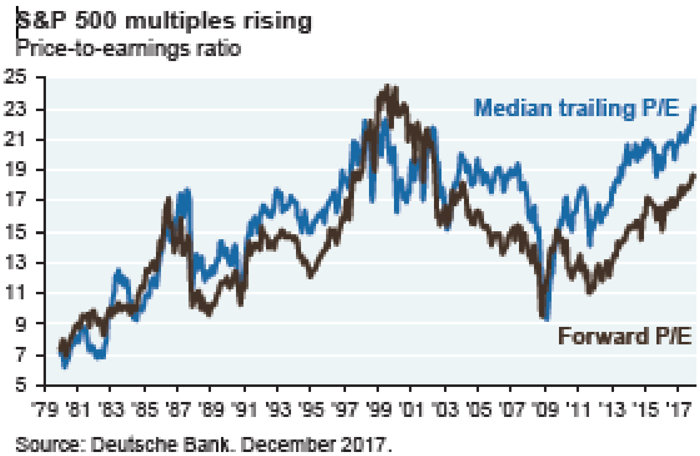
Source: Strategas

As the above chart indicates, average hourly earnings growth remains under 4%. The 4% rate has usually occurred just prior to a recession (Chart III). Thus, wage inflation seems well contained and has room to rise. At this juncture, rising inflation rates are still considered more a headwind to the equity market than a bear market red flag.

<u>ITS ALL ABOUT VALUATION NOW</u>

With corporate profits accelerating in 2018, fueled by the twin engines of strong economic growth and lower tax rates, many observers believe S&P 500 earnings could reach $140-$165 a share this year. The current S&P 500 earnings forecast for 2017 is about $131 a share. Thus, the market is now selling at a P/E of approximately 21 times 2017 estimates and about 19 times a $145 a share target (up 11%) for 2018.

Chart IV – JP Morgan Valuation



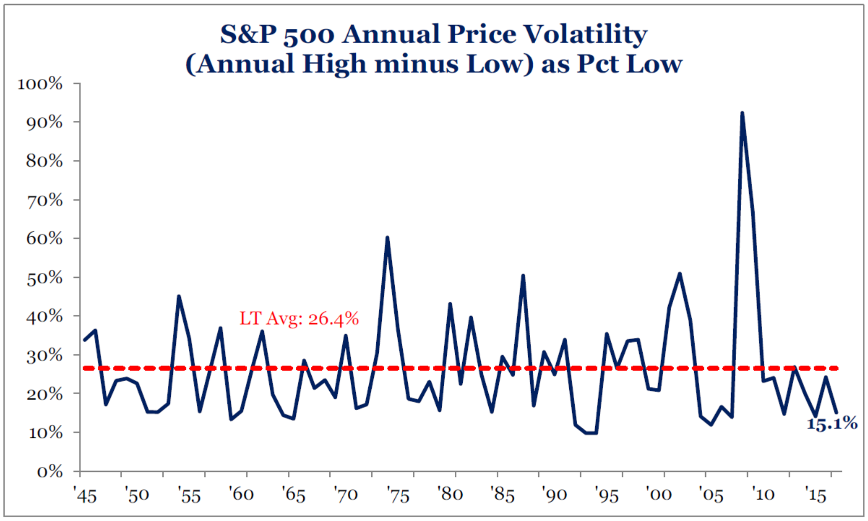
Source: JP Morgan

Over long periods of time, the market P/E has averaged 16 times earnings. Valuations have expanded in recent years due in large part to disproportionally low interest rates and inflation. As these two variables begin to revert higher, P/E expansion may be more limited. Thus, equity market valuations may be more constrained despite accelerating corporate profit growth.

With this in mind, we remain cautiously bullish and expect the market will likely generate a 5-10% return this year as corporate profit growth of 10+% is discounted by a relatively stable valuation.

VOLATILITY AND THE SHIFTING BACK TO NORMAL ECONOMIC TRENDS

Chart V – Volatility Chart



Source: Strategas

As the above chart demonstrates, the S&P 500 has been in a low volatility environment for the last five years. Part of the reason reflects the massive liquidity the Fed has created through quantitative easing. This process has tended to inflate most asset prices. However, the trends that have created this virtuous cycle are now reversing. The Fed is moving toward selling bonds (almost a quantitative tightening) to reduce its balance sheet leverage after years of huge bond buying. The economy is now accelerating to a nearly 3% GDP after years of subpar 2% growth. Interest rates are steadily climbing, and inflation is beginning to show signs of life. Over the next 3–5 years, we expect the U.S. economy to return to more normal patterns of growth. It is rare to see a rapid mean reversion in economics and, as such, a 3-5 year timeline is probably more likely. We point this out to underscore that stock market volatility should also return to a more normal pattern in the future. More importantly, we believe a higher level of volatility will lead to more market corrections, and thus more opportunity for active investing during 2018. Investors may view a market correction as a start of a bear market since volatility has been so low in recent years. However, at this juncture, we believe it should be viewed as a return to more normal market volatility. Notwithstanding our belief that certain pockets of the market are currently over extended, we remain constructive and would take a market pullback as an opportunity to strengthen the portfolio.

As the global economy improves and interest rates rise, we see a number of investment opportunities. However, as mentioned, we are also focused on retaining some degree of sensitivity to the changing financial environment. Should interest rates, inflation or economic growth move too rapidly, we will be sensitive to protecting our capital base.

Please contact our offices with any questions.

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