CAMPBELL NEWMAN

DECEMBER 31, 2017

REFLECTIONS & PERCEPTIONS

LABORING AHEAD

U.S.-based stock averages again climbed into new all-time high territory in the fourth quarter 2017, with most indices ending the year near their peaks. For much of the quarter, market participants focused on the solid third quarter corporate earnings reports and what we would term as "more confident" commentary regarding business activity from managements, as well as a string of improving macroeconomic data releases. At the same time, they largely ignored the geopolitical tensions in Korea and the Middle East, Washington, D.C.'s dysfunction, a tightening Fed and a flattening yield curve. The signing of the tax bill on December 22 gave stock prices an added push as analysts began to contemplate the previously unexpected positive impact of a 21% corporate rate on 2018 earnings growth.

Wide participation by different market segments (style, size and sector) is a key indication of the health of any stock market uptrend, and strength was broad-based in the quarter. As seen in Table I, all investment styles reported positive absolute returns in the quarter, with only modest outperformance for growth over value and large caps over mid and small. Additionally, every one of the S&P 500's 11 economic sectors recorded a positive return in the period. Money flows were stronger in more economically sensitive issues, as expectations for a faster growth environment took hold. This is seen in the S&P 500 sectors which outperformed the Index's 6.64% return: Consumer Discretionary (9.82% return), Information Technology (9.01%), Financials (8.63%) and Materials (6.93%). The Energy sector continued to rally in the quarter as the price of oil recovered to approximately $60/bbl, but narrowly underperformed with a 6.02% return. Conversely, the quarter's worst performing (but still positive) sectors were Utilities (0.21%) and Health Care (1.47%).

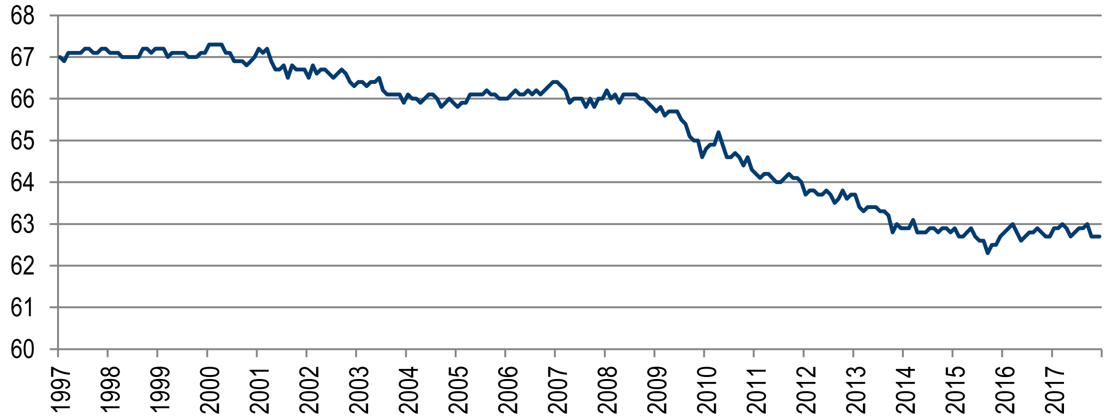
TABLE I: 4Q 2017 STYLE INDEX RETURNS

	VALUE	CORE	GROWTH
LARGE	5.3%	6.6%	7.9%
MID	5.5	6.1	6.8
SMALL	2.0	3.3	4.6

Source: FTSE Russell

One of the more important developments in 2017 was the emergence of a synchronous global economic expansion. In the U.S., economic data continue to show signs of improvement with recent reports regarding unemployment, industrial production, real estate sales and real personal income supportive of faster growth. As well, the Conference Board's Leading Economic Index (LEI) rose 0.4% in November to 130.9 (2010 = 100), following a 1.2% increase in October and a 0.1% increase in September. Propelled by improving financial indicators such as new orders in manufacturing and historically high consumer sentiment, a rising LEI Index portends solid economic growth into the first half of 2018.

CHART I: CIVILIAN LABOR FORCE PARTICIPATION RATE



Source: U.S. Bureau of Labor Statistics

The ongoing strength of job growth is especially noteworthy. Non-farm payrolls rose 148,000 in December 2017. That brought employment gains for the year to 2.1 million, the seventh straight year of increases exceeding 2 million. Hiring has increased for 87 straight months, the longest uninterrupted period of job expansion on record. All major industry sectors showed job growth in 2017, except retail. Growth in most sectors of the labor market increased at a similar rate in the third quarter 2017 (most recent data available) as they did in the first half of the year, showing no signs of a slowdown.

While sustained job growth is an unmistakable sign of improved economic vibrancy, wage gains have generally lagged previous expansions. According to the U.S. Bureau of Labor Statistics, weekly earnings have grown by approximately 1% since 2007 compared to the 40-year historical average of more than 1.5%. At the same time, wage growth might be too narrow of a view to gauge progress. The Employment Cost Index, a measure of compensation that considers benefits as well as cash pay, was up 2.5% in 2017 versus 2016, its fastest pace in two and half years. Finally, there is evidence corporations are beginning to pass along the expected tax savings to employees through higher compensation. Based on the announcements to date, it is estimated over 2 million workers have received a raise or bonus in response to December’s passage of the Tax Cuts and Jobs Act.

With a current unemployment rate of 4.1% versus 4.7% a year ago, the conditions for faster wage growth could be in the offing. Yet, wage inflation could also remain below the historical averages throughout this expansion. This is because many workers left the labor force following the financial crisis of 2007-2008, as seen in the Labor Force Participation Rate chart (Chart I). However, as the employment environment improves, some workers will move back into the job market, thereby increasing the pool of eligible workers and keeping wage growth in check.

The current consensus among economists is that the tax cuts will boost 2018 GDP by 0.4%. During the same period, another 2 million jobs are expected to be created in the U.S. Under this scenario, corporate earnings estimates are likely to trend higher than previously anticipated.

Low interest rates, low inflation, accelerating global growth and positive earnings surprises made 2017 a great environment for stocks. Our view is that, as the evidence stands today, the path of least resistance for the equity markets remains to the upside, in line with the direction of employment, wages, GDP and earnings. Of course, this outlook could be derailed by a multitude of factors, those that are top of mind and others few could imagine.

Also worth noting is, as bottom-up stock pickers, a view of the economic landscape is relevant to our process in that it helps us assess the environment our companies are selling into, which helps determine whether earnings estimates are achievable. We are now in January, and will know more in the following weeks as company managements discuss what they see in their markets for their businesses, and how the tax law changes will affect their earnings models.