The Road Ahead | Comerica

Peter Sorrentino, Chief Investment Officer, Comerica Asset Management Fourth Quarter 2017

Quarterly Commentary

2017 Wrap-Up

By any definition, 2017 was a good year for investors. Whether in fixed income or equities, there were rewards for all. The impact of global quantitative easing (QE) made itself known in the U.S. last year, as the Federal Reserve discovered it could push interest rates higher for shorter maturities, but not those on longer-dated obligations. The fluid nature of global capital won out, at least in 2017, as the lure of comparatively higher U.S. interest rates overwhelmed the three rate increases. The outcome for taxable bond holders was benign, as the need for coupon income kept sellers at bay. Municipal bond investors labored under a cloud of uncertainty for most of the year as the debate drama surrounding the tax legislation played out. Once that uncertainty passed, issuers queued up a large new issuance calendar, offering investors generous selection and yield. Evidence of potential valuation bubbles became increasingly apparent as the search for coupon income produced situations for which there is little economic defense. In the European bond market, negative interest rates, which have been a reality on sovereign debt for some time, emerged in the corporate market where we witnessed a three-year BBB-rated offering with a negative 0.026% yield. Interest rates in emerging and frontier markets slipped into mid-single digits, despite prevailing solvency, inflation and political risks.

For equity investors, this was not a bad outcome, as having the ten-year yield stubbornly moored just below 2.4% for most of the year allowed rising earnings to be telegraphed directly into stock prices. Last year was atypical for the path of earnings expectations as well. Generally, earnings expectations enter the year on the optimistic side only to be revised downward as the year progresses. In 2017, we experienced the reverse. Domestic optimism following the 2016 general election fed improvement in the labor market and consumer spending. External economic growth accelerated, adding to domestic activity with it as well. The combination of these factors resulted in upward earnings estimate revisions as solid economic data confirmed the increase in output. At the sector level, we experienced a range of drivers for price performance. In information technology, the knowns garnered much of the attention, such as Apple (+48%) and Microsoft (+41%), but behind the scenes, the lesser knowns, such as NVDA (+82%) and Micron (+88%), posted far larger gains and gave us an indication that the realm of artificial intelligence is attracting not only headlines, but investment.

By and large, the balance of the U.S. market generated roughly a 21% return, but again, beneath the surface it was anything but homogeneous. In the consumer discretionary sector, shares of Amazon (+56%) and Netflix (+55%) led the pace with even traditional consumer names like Home Depot and McDonald's adding 44%, but for former industry leaders Disney (+4.7%) and Starbucks (+5.4%), it was a disappointing year. Oddly enough, the one sector that exhibited pricing power last year posted the sole decline, as the energy stocks slipped a collective 4%. This despite the price of crude oil and coal climbing $4.48 per barrel and $5.25 per ton, respectively, in 2017.

2018 Outlook

Looking ahead to 2018, we anticipate topline revenue growth for the S&P 500® Index of around 6.5%, driven by accelerating growth abroad and a lingering storm-induced bump in domestic results. Profit margins, which troughed in the second quarter of 2017 at 10%, should improve to roughly 11.5% by the end of 2018, still well short of the cycle peak 12.5% margin in 2015, but a definite improvement.

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The result should be a near 11% increase in earnings, putting the 2018 earnings per share (eps) for the S&P 500® Index at about $145.97, up from the 2017 forecast of $131.59. The wild card for 2018 will be the actual flow through from the change in the corporate tax rate. Estimates of the actual cash impact range from $4.25 to $5.00 in incremental eps for the Standard & Poor's 500® Index. Using the mid-point of that range yields an adjusted eps of roughly $150 per share. This places the implied forward P/E ratio at just under 18 times, still considerably above the five- and ten-year average P/E ratio of 14. Our economic outlook calls for the U.S. economy to continue its transition to a late cycle environment marked by increase business spending on productivity and capital stock replacement. The result should be a general shift in market leadership to the more cyclical companies.

Among the features of the recently-passed tax legislation are the bias towards domestic versus multinational companies and the treatment of capital spending; these are characteristics most often found in smaller companies. These factors, and the extended valuation of the current market leadership, create conditions favorable for a domestic leadership rotation to small and mid-cap stocks. A late cycle economy also has historically favored industrials over consumers, financials over REIT's and utilities, and lastly, value over growth. Typically, the catalyst for the rotation has been rising interest rates, which failed to materialize in 2017 due to continued global QE, the impact of which should fade in 2018 as the European Union (EU) winds down its program. Internationally, growth in Western Europe and selected emerging markets is forecast to outpace U.S. domestic growth in 2018. Even with their higher 2017 return, these markets generally are still trading at valuation levels below that of domestic equities and remain attractive alternatives.

As a cautionary, we are monitoring the markets for signs of growing excess as the duration of monetary stimulus has led to asset valuation bubbles in numerous hard asset categories, from coastal real estate and fine art to last year's most egregious example – Bitcoin. For fixed income investors, the flat yield curve and compressed state of credit spreads presents the ability to shorten maturities and upgrade quality at a very nominal cost in coupon. In equities, trading down in valuation means trading up in asset quality and cash flow. Being defensive does not imply settling for less at this point in the economic cycle. At some point, volatility will return to the equity market, and in such periods, the value methodology has historically outperformed the growth approach.

Market Sector	Q1-2017	Q2-2017	Q3-2017	Q4-2017	2017
Energy	-6.68%	-12.61%	5.48%	6.02%	-1.01%
Material	5.86%	9.28%	5.56%	6.93%	23.84%
Cons Disc	8.45%	11.00%	0.50%	9.86%	22.98%
Cons Stpl	6.36%	8.03%	-1.75%	6.49%	12.49%
Health Care	8.37%	16.07%	3.14%	1.47%	22.08%
Financials	2.53%	6.88%	4.82%	8.59%	22.14%
Technology	12.57%	16.57%	8.00%	9.01%	38.96%
Industrial	4.56%	8.32%	4.24%	6.03%	21.01%
Utilities	6.49%	8.42%	2.10%	0.21%	12.11%

Source: Bloomberg

Source: All statistics herein obtained from Bloomberg.

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