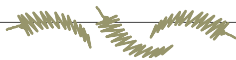
C Y P R E S S
ASSET MANAGEMENT, INC.



MARKET COMMENTARY **January, 2018**

Over the past year, equity markets worldwide have made strong gains, in spite of a worrisome geopolitical environment, fueled by accelerating and broad based global growth. The S&P 500 Index advanced almost 22% in 2017 (total return), and has now turned in 14 consecutive months of positive total returns, the longest such streak ever. Of note, in prior years of 20% plus returns, the S&P 500 has averaged +11% in the subsequent year and has been positive 70% of the time.

The global recovery that began midway into 2016 has continued to strengthen. Growth is accelerating in Europe, Japan, China, India and the U.S. Financial conditions are supportive of markets and monetary policy remains generally accommodative and biased to growth. The Federal Reserve is on a well communicated path of measured rate hikes and gradual normalization of monetary policy. We believe economic growth may well surpass expectations in 2018, potentially complicating the Goldilocks environment and Fed policy. After 4 years of slow but steady 2% GDP growth, real growth could potentially exceed 3% in the U.S. this year. Even with faster growth, however, we expect inflation to remain subdued.

In the short term, the welcome cyclical pick up in economic activity should continue to provide a boost to global commodity prices. And relatively stronger oil and commodity prices should in turn positively reinforce global spending and investment. From a broader perspective, however, technology and other disruptive forces are exerting a powerful and structural deflationary influence.

Global Economic Outlook & S&P Earnings - January 2018 (S&P 500 @ 2,700)

	2013	2014	2015	2016	2017e	2018e
Global Real GDP Growth (y/y rate)	3.3%	3.4%	3.1%	3.0%	*3.6%*	***3.8%***
U.S.	2.2	2.4	2.4	1.6	*2.3*	***2.7***
Euro Area	-0.4	0.8	1.5	1.8	*2.2*	***2.0***
Japan	1.5	0.0	0.6	1.0	*1.6*	***1.5***
Developing Asia	6.6	6.4	6.2	6.2	*6.4*	***6.5***
China	7.7	7.3	6.9	6.7	*6.8*	***6.6***
Latin America	2.5	1.0	-0.5	-1.2	*1.4*	***2.2***
Emerging Market & Developing Economies	4.7	4.6	4.2	4.1	*4.7*	***4.9***
S&P 500 Aggregate EPS	109	118	117	118	*131*	***150***
Earnings (y/y rate)	12.6%	8.3%	-0.8%	0.9%	*11.1%*	***16.1%***
PE Ratio						***18***

Sources: IMF, ISI Group, BAML

Disruptive technology and innovation is arguably the most significant factor in the economy and markets today. Shale oil, electric vehicles and autonomous transportation, the "Amazon effect" across consumer and retail markets, social media and generational driven brand and media disintermediation, the rise of artificial intelligence in the work place, "over the top" delivery of content and entertainment are all examples of disruption and creative destruction. In each instance the supply of something is expanding and price is contracting. While we cannot rule out a spike in inflation, these deflationary forces should keep commodity prices, wages, and even interest rates below historical norms.

Market Outlook

Nine years into the current bull market, there is no readily discernable indication that it should come to an end. Investment fundamentals are actually improving. The strong global economic backdrop, healthy earnings growth, regulatory relief, and now tax reform and repatriation of stranded overseas cash are all major positives for equities.

Corporate earnings are now forecast to increase by about 15% in 2018 (this compares to a 7% consensus forecast just 3 months ago), with roughly half of that coming from tax reform. The biggest impact is a lowering of the corporate tax rate from 35% to 21%, but the benefits of bringing home cash held overseas will also be significant. U.S. corporations hold an estimated $2 trillion in cash and investments outside the U.S. (where it had been held and essentially stranded to avoid a disproportionally higher U.S. corporate tax rate).

We expect companies to take advantage of the 15% (or lower) repatriation rate and to bring back to the U.S. nearly all of their international cash. Most likely uses include share buy backs, dividend increases, capital investment, acquisitions and some boost to employment.

There is also a longer-term benefit to tax reform and a more "level" and territorial corporate tax system. In the past, too much corporate spending has been tax driven foreign investment that did not prove productive. Tax reform along with continued regulatory relief and reform should help U.S. corporations focus on productive investments, creating value, and putting money to its best use.

Some will argue that the tax cuts are a one-time boost to profits, and otherwise merely "pull forward" GDP growth. We believe the impact will be more lasting and dynamic, and can lead to better capital management, increased investment in the U.S., higher returns and profit growth.

The prospective price to earnings multiple for the S&P 500 is about 18, moderately higher than a year ago and roughly 7% above the long-term average. We believe valuation levels are still reasonable given the favorable economic backdrop (low rates, low inflation, balanced global growth) and earnings outlook.

Potential threats to the market include a spike in inflation, a Fed that tightens too aggressively, investor euphoria, and of course geopolitical risks like the North Korean nuclear standoff.

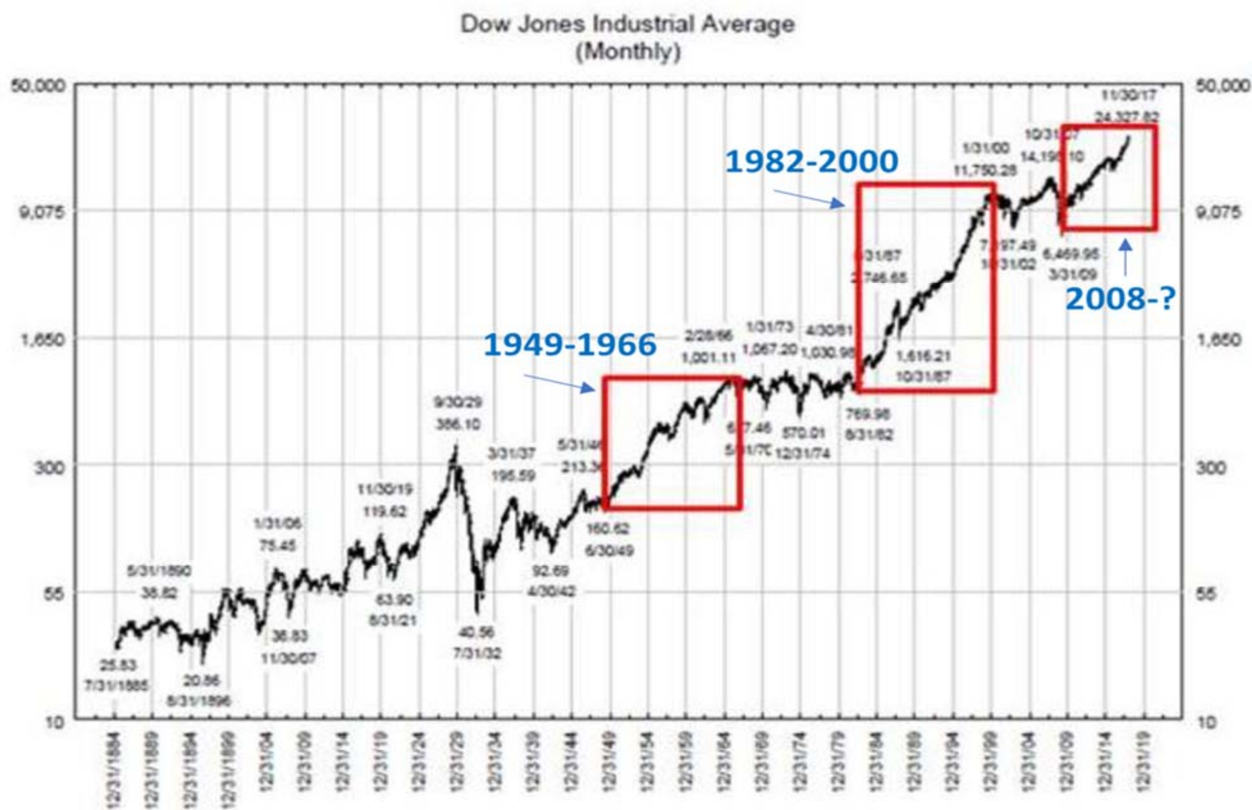
As discussed above, while a spike in inflation would throw a scare into the markets and complicate the Fed's cautious approach, we view this as a low probability event. It may indeed be different this time, but the S&P 500 typically trends higher during Fed tightening cycles, and peaks after the last rate hike. We do expect the Fed to hike rates at lease twice in 2018, and for the Fed to be data-driven and remain patient in raising rates and normalizing monetary policy.

Investors are certainly more optimistic and the mood has clearly brightened along with the improved global outlook, but euphoria has thus far largely been confined to the realm of bitcoin. Fund flows into equities were negative through 2017 and remain subdued in contrast to the continued positive flow of funds into bonds. A lot of cash and a lot of investors remain on the sideline, reluctant to enter the market after years of gains. The current IPO market (new public stock offerings) is not frothy or even particularly vibrant, in contrast to what we saw in the late 1990's and mid-2000's.

Certainly the S&P 500 could have a 10% correction. Since 2010 there have been 18 downturns in the market of greater than 5%, four of which were greater than 10%. In the post-World War II period, we have experienced two lengthy "generational" bull markets, 1949-1966 and 1982-2000. A strong case can be made that we are in the midst of a third. While we can expect corrections along the way, and some will be significant, the market remains in fundamentally good shape.

Market performance in 2018 boils down to whether stocks can hang on to most of their current P/E ratio. Given the combination of an extraordinarily favorable environment for business in the U.S. today with a strong and balanced global recovery still in its early innings, the environment should remain supportive of equities.

Secular Bull Markets (1949-1966, 1982-2000, 2008-?)



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