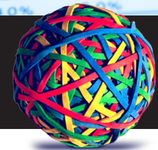
Q1 2017 EPS OUTLOOK

Successive Quarterly EPS Growth Projections Continue to Climb

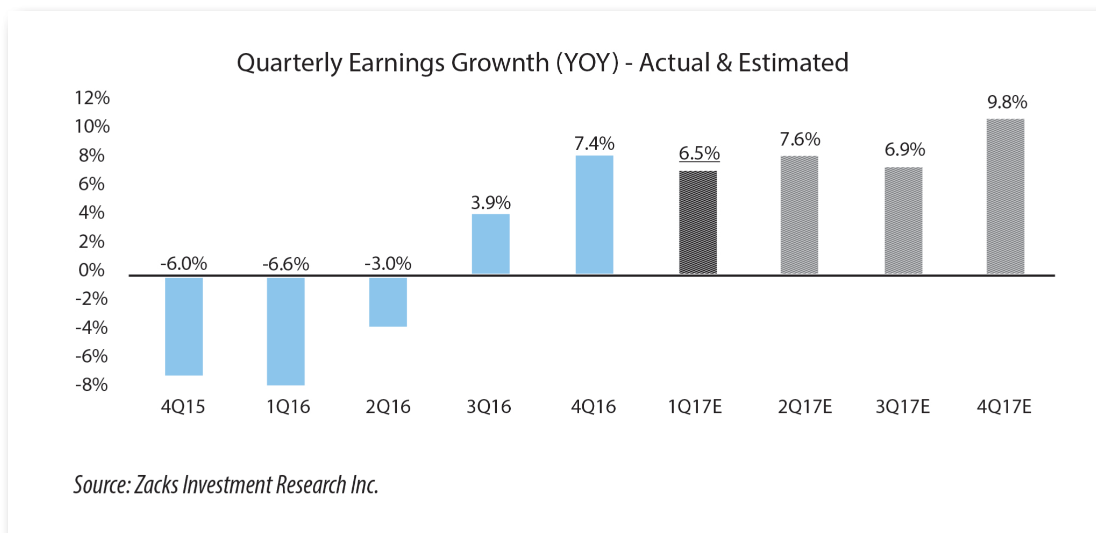
APRIL 2017 WHITE PAPERS

WEALTHMANAGEMENT



The first-quarter earnings reporting season is upon us. As of March 31, 2017, the consensus estimate for Q1 2017 S&P 500 operating EPS was $29.17, up 9.9% on a year-over-year basis (versus $26.54 in Q1 2016).

This advance would represent the third consecutive time the S&P 500 posted year-on-year EPS increases, after enduring four successive declines. In addition, these results should lead to a new all-time 12-month high of $120.32, eclipsing the prior high of $118.81 set in Q2 2015.



Source: Zacks Investment Research Inc.

FIRST QUATER EARNINGS CONTINUED ON P2

FIRST QUARTER EARNINGS CONTINUED

Furthermore, seven sectors are projected to see year-over-year increases, led by double-digit gains for financials, information technology, and materials. What's more, energy's recent trough was set in Q1 2016, with a loss of $0.35; yet Q1 2017 EPS is now seen at $3.07. Year-on-year EPS declines are expected to be reported by the consumer discretionary, industrials, telecom services and utilities sectors. Finally, despite the expected Q1 EPS increase, the S&P 500 trades are at a trailing 12-month operating P/E of 19.6X, or a 14% premium to its median since 1988.

What will be the driving forces behind Q1's results? The following comments by equity research analysts we follow concern the factors that likely affected EPS growth, including a 3% rise in the U.S. Dollar Index (Q1 2017 average vs. Q1 2016 average) and a 58% year-over-year surge in average quarterly WTI oil prices.

CONSUMER DISCRETIONARY

Most analysts have a relatively subdued outlook for Q1 EPS growth for this sector, which is expected to record a 4.0% decline. Results for the media and entertainment space will be likely pressured by continued investments in television programming and recent weakness in certain advertising categories, a potential slowdown at the international box office, and some difficult comparisons for high-margin content licensing revenues versus growth in subscriptions and affiliate fees.

Also, our outlook in part reflects likely margin pressures at traditional brick-and-mortar retail chains (versus online-based ones) amid a continued post-holiday inventory clearance and rationalization, and hurt by soft same-store sales trends and negative margin impact from rising online sales. We believe automotive margins will be hurt by lower U.S. industry sales volume, increased incentive spending, and investment in autonomous and mobility initiatives, offset by growth outside the U.S. and a favorable mix shift. Some lingering impact on

CONSUMER CONTINUED ON P3

CONSUMER DISCRETIONARY CONTINUED

health concerns and labor cost inflation could also weigh on some restaurants and/or hospitality companies, plus international expansion costs, including in Asia-Pacific and Europe.

Low-to-mid-teen revenue growth is expected in Q1 2017 for the homebuilders, driven by higher pricing and scarcity of new homes in most markets. Affordability and mortgage-loan approvals remain on the watch list but are not expected to be a problem for higher FICO-score households. Revenue growth will be driven by higher volume within the “start-up” home category, though less from “move-up” or “luxury” product segments. Despite rising labor and land costs, as well as narrowing gross margins, we believe that operating margins will benefit from lower SG&A expenses. Finally, industry metrics, including average selling prices, unit orders and deliveries, backlog volume, and value and community counts, should all show gains.

WT Wealth Management maintains an under-weight in this sector, as we believe that the sentiment of the US consumer/shopper has changed, and that this sector offers more risk than reward, compared to others available to us.

CONSUMER STAPLES

The consumer staples sector is expected to post a 2.9% rise in Q1 2017 EPS, as compared to a 9.9% increase estimated for the S&P 500 and the 3.7% growth this sector experienced in all of 2016. We believe key factors driving EPS growth underperformance in Q1 2017 for this sector are a shift in the Easter holiday into Q2 (from Q1 in 2016), unseasonably warm weather, decreased demand from low-income families due to a delay in receiving income-tax returns, persistent food deflation, demand pressures from higher year-over-year gasoline costs, and ongoing drug reimbursement pressures.

CONSUMER CONTINUED ON P4

CONSUMER STAPLES CONTINUED

However, we believe that growth was still achieved due to progress from ongoing cost savings initiatives and improved pricing power in a more favorable global economic environment. We also see overall demand benefiting as recent mergers, acquisitions and divestitures within the sector have led to improved exposure to wider margin products, faster growing categories, and an expansion in distribution, thereby supplementing greater scale advantages. Strong free cash-flow generation remains supportive of active share-repurchase programs, in our view, which provides additional EPS growth support.

WT Wealth Management maintains a market weight in this sector. We believe that many of the larger Consumer Staple names still have compelling yields, and that will aid in the attraction of capital and investor resources to this sector. We believe there is “inherent safety” in many of these names, especially in light of what may turn out to be less than anticipated GDP growth in the coming quarters.

ENERGY

The anticipated improvement in energy-operating EPS in Q1 2017 is deemed ‘not meaningful,’ or ‘NM,’ because going to a positive from a negative renders any percentage calculations meaningless. Maybe this improvement is best viewed in terms of a recovery. After all, the sector has turned the corner, and what had been negative EPS in Q1 2016 is now likely to be a modest gain in Q1 2017, in part because: (a) crude oil prices are considerably better this time around, and (b) energy companies have had a year to work on further cost-efficiency efforts.

The upstream space, which dominates the market cap of the S&P 500 energy value chain and benefits from higher crude prices, will be relatively better off, for West Texas Intermediate (WTI) averaged about $33 per barrel in Q1 2016 and should be in the high $40 or low $50-per-barrel range in Q1 2017. Customers are beginning to spend again, and consensus estimates point to a 16% recovery in upstream capex in 2017, which, if realized, should be the first uptick after two down years. And that new customer spending supports the drillers’ and oil services’ names.

ENERGY CONTINUED ON P5

ENERGY CONTINUED

Our wariness on energy stems from our concern that, while these changes are in a positive direction, they are insufficient to bring the sector back to its heydays in the 2011-2014 time frame, and valuations in many areas remain stretched. If we had to "pick" our favorite space within energy today, it would be in midstream – the pipeline space, where a 'Goldilocks' price for crude is enough to drive higher customer spending on projects, supported by a Trump administration that sees red wherever it finds red tape, but not so high that it kills demand.

WT Wealth Management maintains an under-weight in the energy sector, where we believe the risks greatly outweigh the rewards.

FINANCIALS

In the aggregate, the S&P 500 financials sector is projected to record the second-highest EPS gain in Q1 2017. This will be led by the investment banking & brokerage area, which is expected to record strong double-digit revenue growth from capital markets in both equity and fixed income trading areas, as investment banking got a boost in advisory fees for IPOs, and M&A provided continued growth in that market.

Wealth and asset management companies should show revenue gains, but not like those in Q4 2016, when the equity market rose strongly. Net interest income is expected to have risen along with higher rates, which benefit banks on deposits, as well as brokerage firms on investment accounts. Operating income margins are expected to have widened from higher revenues, because there were no major changes in key cost items, such as compensation. Because some discount brokers derive nearly half their revenue base from net interest income, a higher-rate environment will propel revenues by double digits. However, the newly initiated commission price war will affect some of the second-tier players.

Revenue growth is projected to be modest for life insurers, due to weak annuity sales amid regulatory uncertainty that should be offset by growth in headcount-driven products as a result of favorable labor market trends. Higher interest rates should drive net investment income and help to widen operating margins,

FINANCIALS CONTINUED ON P6

FINANCIALS CONTINUED

particularly on existing books of spreads-based businesses.

Many life insurers will continue to boost EPS growth through share buybacks, even though regulatory uncertainty related to the DOL fiduciary rule and SIFI designations continue to inject a degree of unpredictability into this group.

We expect top-line growth of 3-4% for the P/C insurers on 2-3% growth in premiums and higher rate-driven investment income. We expect operating margins to remain under some pressure from deterioration in underwriting results. However, things are not bad enough to spark a turn in pricing, so this group will likely continue to muddle along. Some of the more facile reinsurers may produce above-average results; the reinsurance space has been consolidating, which will help buoy valuations.

WT Wealth Management maintains an over-weight in the financial service and regional banking sector. Even if the Federal Reserve's goals of 3% rate increases in 2017 and 3% in 2018 miss the mark, we cannot believe that interest rates will not be higher in 6-12 months, which bodes well for financials and regional banks.

HEALTHCARE

The healthcare sector has experienced significant recent volatility, primarily due to the possible repeal and replacement of the Affordable Care Act (ACA). The withdrawal of the House Republicans' health care proposal, called the American Health Care Act, due to an insufficient amount of votes to pass the bill caused this sector even more volatility.

However, despite all of the "noise," the volatility has no immediate impact on the sector's current earnings. Q1 typically is a softer quarter for healthcare, mainly due to a reset of deductibles that result in lower physician visits, hence lower healthcare services and drug sales, etc. We do not anticipate any material change this year, which is reflected in the modest 0.4% earnings growth forecast.

We are encouraged by several positive clinical trial data readouts and recent drug approvals that should aid drug sales later this year and the next year. This is welcome news for the biotechnology and pharmaceutical industries, which are on the heels of only 22 new drugs approved in 2016 (45 and 41 new drugs were approved in 2015 and 2014, respectively). However, we still anticipate only flat-to-modest growth for the drug sector, as we see continued pricing pressure in the generic space and ongoing scrutiny on high drug prices for branded drugs, limiting sales growth. We look for improved earnings for the larger health insurers, as they significantly reduced their participation in the public healthcare exchanges that hurt profitability over the last two years.

WT Wealth Management currently maintains an over-weight in the healthcare sector. We believe that the imminent failure of the ACA and the increasing aging of the American population make this a compelling sector in the years ahead.

INDUSTRIALS

Q4 2016 EPS were relatively muted for most of the companies in the industrial sector. Standouts were in: (a) industrial machinery and tools, where demand was strong; (b) equipment rentals, where demand firmed up nicely; and (c) air freight and logistics, where demand was also strong, but costs increased faster.

The revenue outlook is relatively weak for defense companies. Defense budgets have not actually increased yet, but statements from the Trump administration indicate a likely improved revenue outlook over the next few years. The aerospace area remains strong, but backlogs have declined somewhat. EPS strength was driven by a work-down of current strong backlogs, which remain robust but were culled slightly.

Airlines saw the pricing environment strengthen but were more adversely affected by higher fuel costs. Oil has weakened some since the end of Q4 2016, however, which should help Q1 2017 results. Rails have seen improving commodity volumes in many areas off a weak base, especially in coal, which rebounded in Q4 2016. We believe that the EPS was good for this category in Q1 2017, aided by streamlined costs and better volumes.

Trucking remains challenged by industry overcapacity, which impacted Q4 EPS. Volumes improved, however, and the companies mostly beat EPS expectations. Finally, conglomerates remain hampered by their ties to energy, and, though oil prices have risen, project delays seem to continue. Revenue growth is expected to be in the low single digits at best, but we should see some acceleration in Q1 and the rest of 2017.

WT Wealth Management maintains an over-weight in the Industrial sector. We believe that the rewards outweigh the risks here, and that infrastructure and defense spending will see greater funding and benefits in the years ahead. We believe that this sector will not be free of volatility and will trade just as much on rhetoric and news as it does on fundamentals. So one will need discipline, a strong stomach, and patience to see the rewards.

INFORMATION TECHNOLOGY (IT)

According to consensus estimates, Q1 EPS for the S&P 500 technology sector should post the strongest growth, up 16.5% compared to the prior-year period. S&P 500 EPS is projected to rise 9.9%. We see the January-to-March period as relatively important for most technology companies, following the critical Q4, including consumers making purchases during the holiday shopping season and corporations spending what is left within technology budgets.

The U.S. dollar influences the financial results of S&P 500 IT sector companies, given their substantial exposure to foreign sales. Increases in the dollar versus international currencies make U.S. products and services relatively more expensive for purchase in other currencies. For 2015 (latest available), per S&P Dow Jones Indices, the technology sector generated 58% of revenues from international sources – the second most of the 10 economic sectors – compared with 44% for the S&P 500. The profits on non-U.S. revenues also tend to be relatively high, given generally lower tax obligations abroad.

Notably, in Q1 2017, after significant appreciation following the U.S. elections in November, the U.S. dollar fell against major global currencies, including the Euro and the Japanese Yen. We also believe that consumer and corporate confidence is relatively high, and may have aided purchases in Q1 2017.

WT Wealth Management maintains an over-weight in this sector, as technology sectors like IT are the railroads of 75 years when it comes to their importance and entrenchment in American culture.

MATERIALS

The materials sector is projected to record its third-highest Q1 EPS growth, at 13.5%. Chemical companies are benefiting from higher prices and rising global demand for their products.

Fertilizer and agricultural chemical companies are benefiting from rising corn prices, which in turn are boosting prices of seed, nitrogen, phosphates and potassium. Strong fertilizer demand in Brazil is helping as well. Higher oil prices are benefiting the commodity chemical-oriented companies, and we see continued strength in specialty chemical companies driven by rising demand and higher prices. Steel producers are benefiting from higher year-over-year steel prices and higher mill-utilization, driven by continued improvements in nonresidential construction demand. Partly offsetting the strength in steel producers, Freeport-McMoRan should weigh negatively on the group, given the unpredictable outcome of its Grasberg mine in Indonesia.

WT Wealth Management maintains a market-weight in the materials sector. Even with considerable bullish sentiment, we believe that many issues we are unable to predict, such as currency evaluations, could adversely affect the materials sector in the coming months.

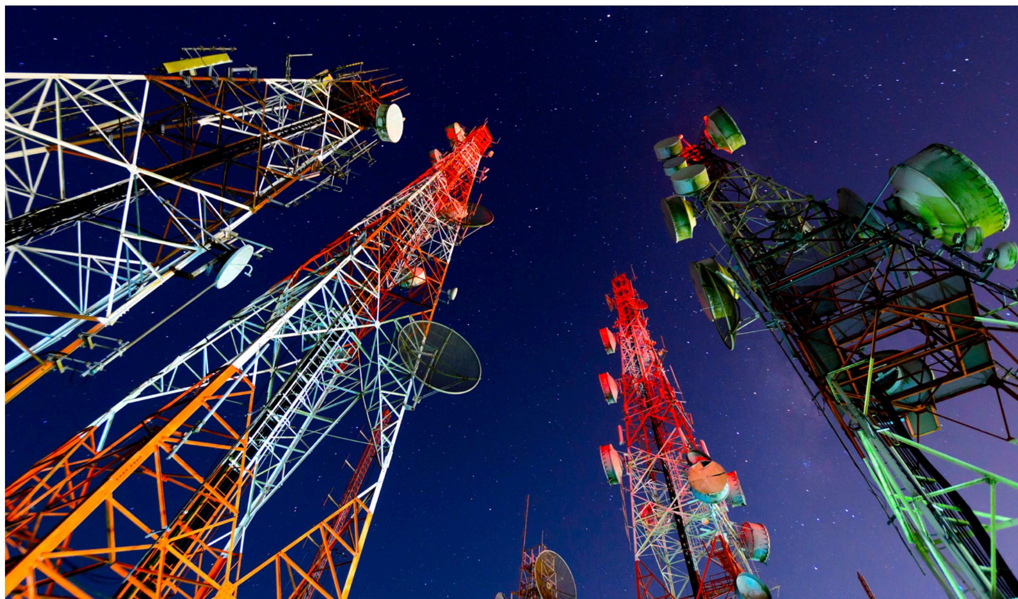
REAL ESTATE

Rental rates across most property types are expected to record low-to-mid single-digit growth year over year. Occupancy rates remain near all-time highs within industrial, multi-family and office markets but are easing in self-storage and hotel property types. Real estate investment growth is beginning to ease from higher levels in 2015 and 2016, and property acquisitions will remain well below normal levels, given competition from foreign buyers such as China. However, dividend growth is on track for 2017, with available cash and FFO growth.

Consensus estimates point to a below-market growth for the sector in Q1 EPS, particularly for retail REITS, as a rash of announced and planned retail store closings, coupled with the impact higher interest rates have on REIT stock performance, offset the positive factors of industrywide net absorption of space and favorable macro trends. However, we believe that a handful of these retail REITs, particularly those with Internet-resistant retail tenants, could surprise on the upside.

WT Wealth Management sees considerable risk in the real estate sector, despite somewhat bullish sentiment from many analysts. The headwind of rising interest rates, the death of brick-and-mortar retail, and the still-dubious sustainable GDP growth would lead us to look elsewhere other than real estate for capital appreciation and yield opportunities.

TELECOMMUNICATION SERVICES



The S&P 500 telecommunications services sector, according to S&P Capital IQ consensus estimates, is expected to generate a Q1 EPS decline of 2.1%. We expect revenue pressure to remain, given fierce competition from carriers. However, we believe that broadband growth and cost savings will preserve free cash-flow generation and support dividends. We note that AT&T and Verizon together comprise more than 90% of the S&P 500 Telecom Index.

TELECOMMUNICATION **CONTINUED ON P10**

TELECOMMUNICATION SERVICES CONTINUED

We see an ongoing consumer sentiment shift toward value-service providers, such as T-Mobile and Sprint, given their lower costs, unlimited data options, improving networks, and availability of leasing options. We note that both of these carriers once again likely outstripped their larger peers in postpaid phone subscriber gains in Q1.

However, the recent unlimited data plans both Verizon and AT&T announced in Q1 2017 could have negative implications on industry pricing for the remainder of the year. We believe that competition between the largest wireless providers will remain intense and will focus on expanding offerings in such areas as the connected car and over-the-top space.

In wireline, we expect continued access-line weakness but stable broadband subscriber gains. Competitive threats from cable and satellite providers should weigh on pricing and subscriber growth. However, we see continued cost-cutting, merger synergies, and business market improvements supporting free cash-flow. In light of that, smaller providers may cut/reduce existing attractive dividends, given a rising interest-rate environment, execution issues from recent acquisitions, and elusive growth prospects.

Finally, we see the telecommunications services sector being impacted by modest U.S. economic growth and still favorable, albeit rising, interest rates. For the S&P 500 Telecom space, we believe that free cash-flow generation from the bellwether telecom providers (AT&T and Verizon) will be enough to support an attractive dividend yield (over 4.5%) for the sector.

WT Wealth Management maintains a market-weight in the telecommunications sector. We are more bullish than many in this area and acknowledge that this could be an interesting and convoluted space, but just look around: hardly any Americans, or earthlings, are not intimately attached to their mobile phones – which we believe will ultimately lead to compelling opportunities within this space.

UTILITIES

Overall temperatures across the U.S. were slightly warmer in Q1 2017 than in the same period last year. However, it was much warmer in the Southern states. Since electric home and space heating is much more prevalent in the South, this should adversely affect electric demand and revenues.

However, in the densely populated Northeast, temperatures were in line with the national average. Oregon and Washington state were much colder than average, but, given a lack of S&P 500 utilities in those areas, we see little impact on the sector's Q1 2017 results. Partly offsetting the negative temperatures, we see customer growth and rate increases positively affecting revenues. Cost-reduction efforts and share repurchases should partly offset the slightly lower revenues, leading to a small decline in EPS.

WT Wealth Management had been very over-weighted in these sectors until we adopted the Trump-trade several days after the presidential election. We believed that stronger, more compelling opportunities were presented in many areas, including financials, technology, semi-conductors, and industrials. Today we have a market-weighting in the sector, and we still believe it is a good area for safe, compelling dividend yields.

CONCLUSION

So there you have it – the recovery from the 2015-16 EPS recession continues, as the S&P 500 is expected to report the first in a series of near-double-digit gains. Financials, information technology, and materials sectors are expected to show the greatest growth, while consumer discretionary, industrials, telecom services and utilities post year-over-year declines.

However, history implies that the final tally will be even better, as in each of the last 20 quarters actual EPS exceeded initial estimates and have done so by an average of 3.5 percentage points. Therefore, Q1 EPS growth may actually post a near-13.5% gain. This should assist in validating post-election optimism, which has pushed valuations to lofty levels.

We have been the first to acknowledge that the current rally and increase in equity valuations have all been on hope and promise. As of this writing, the Trump administration has not done anything other than boosting hope and optimism in the business-owner, and it is difficult to measure the impact on the hundreds of Obama-era regulations that have been squashed via executive order.

While we always refrain from being political, we do wish the new administration had tackled tax reform, spherically the re-repatriation of the hundreds of billions of dollars still parked overseas by American corporations. Ultimately, the lack of growth in this country over the past several years has been due to high tax rates, general unfriendliness in the business climate, and unwillingness of companies to invest domestically for a litany of reasons.

Overall, we still believe that this market has room to move, Q1 2017 earnings will meet expectations, and guidance will be encouraging but cautious. Earnings season will not be without volatility, but at WT Wealth Management we believe we own many of the best companies that have wide moats and huge market shares and have entrenched themselves so deeply into the American lifestyle they have become the "new" blue chips of today.

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DISCLOSURE **CONTINUED ON P12**

DISCLOSURE

factors as well as increased volatility and lower trading volume. Bonds, bond funds and bond ETFs will decrease in value as interest rates rise. A portion of a municipal bond fund's income may be subject to federal or state income taxes or the alternative minimum tax. Capital gains (short and long-term), if any, are subject to capital gains tax.

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