July 24, 2018
Intrinsic Value Team
Todd Asset Management

Disbelieving

Todd Asset Management US Market Commentary

	2Q 2018	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	3.4%	2.7%	14.4%	11.9%	13.4%	13.2%	10.2%
Russell 1000 Value	1.2%	-1.7%	6.8%	8.3%	10.3%	11.3%	8.5%

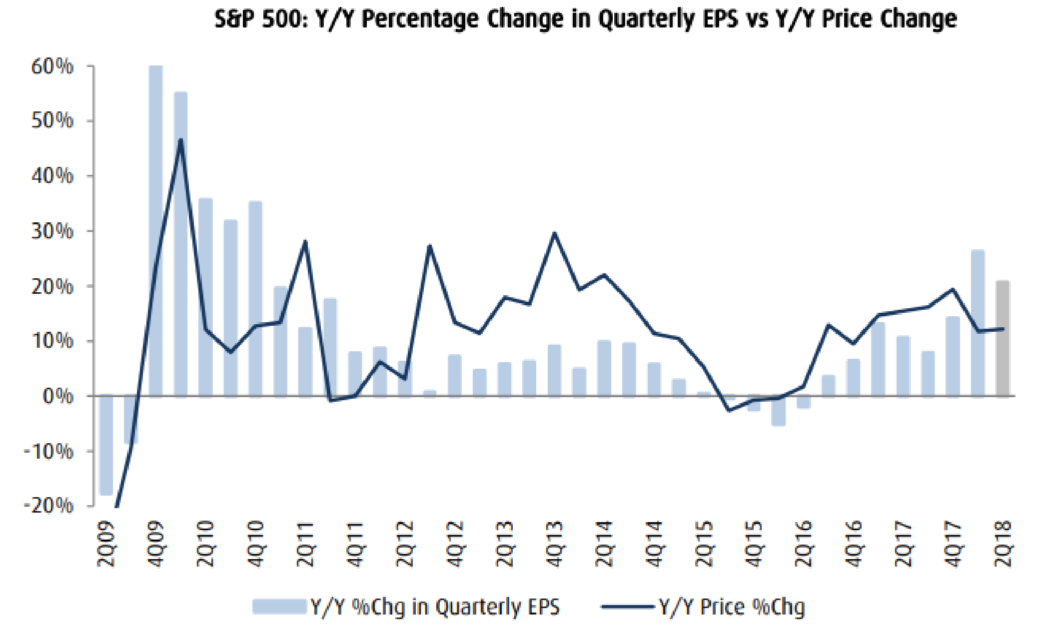
More positive economic news has come out over the past several months than the 2.6% first half gain in the S&P would lead you to believe. Economists suggest that Q2 GDP could be as high as 4%. Tax reform is being implemented and reduced withholdings means employees have higher take home pay. Earnings growth and revisions to analyst estimates of earnings have both been strong. EPS growth is running at the highest level (20% +) since 2010 for the S&P 500, but the market is only slightly higher than it was at the beginning of the year. Our sense is that there is a lot of disbelieving going on, and investors have not been willing to bid up stocks in light of other fears that are occupying their attention. We believe this is a consolidation phase in the market. As concerns start to lessen, we would expect better action later in the year.

So what are the concerns investors are wrestling with? Well, Geopolitics certainly played a role. Earlier this year, North Korea was a major concern. The June 12 meeting between President Trump and Kim Jong-Un seems to have allayed those fears for now. Other concerns were brewing in the quarter. Investors worried about trade wars as the US started imposing tariffs on steel, aluminum and Chinese products. Tariffs have been threatened for German cars and (at least) another $200B of Chinese exports. NAFTA negotiations are ongoing, and may or may not yield an agreement. As the quarter progressed, it became apparent that there was turmoil in the UK government surrounding the Brexit negotiations. Additionally, Italy and Mexico elected populist leaders, leaving investors concerned for the future direction of those governments.

Additionally, first quarter economic results were a little soft for some of our trading partners. These concerns lead bond yields lower worldwide after their spike in the first quarter. Despite that, the Federal Reserve remains intent on raising rates. During a single week in the middle of June, the Federal Reserve raised rates, the European Central Bank promised to end their quantitative easing program. We believe the decline in bond yields despite the central banks indicating shift to tighter policies indicate that markets do not believe the economies are in self-sustaining recoveries yet. Investors seem to believe that as central banks exit the unusual measures they have adopted since the crisis, markets and economies will not be able to hold up. The catch is that Central banks would not be exiting these policies unless they believed the economies would continue growing.

So with those concerns noted, what went right in the quarter? First, earnings and sales growth were spectacular for the S&P 500. As you can see from the attached chart from Brian Belski of BMO Capital Markets, S&P earnings grew the fastest that we have seen since coming out of the Great Recession in 2010.

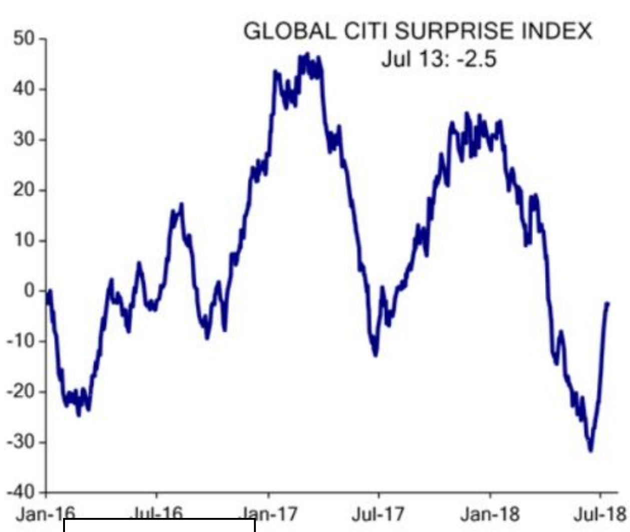
Despite that, the year over year price change decelerated. That is another sign of the market disbelieving fundamentals.



Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

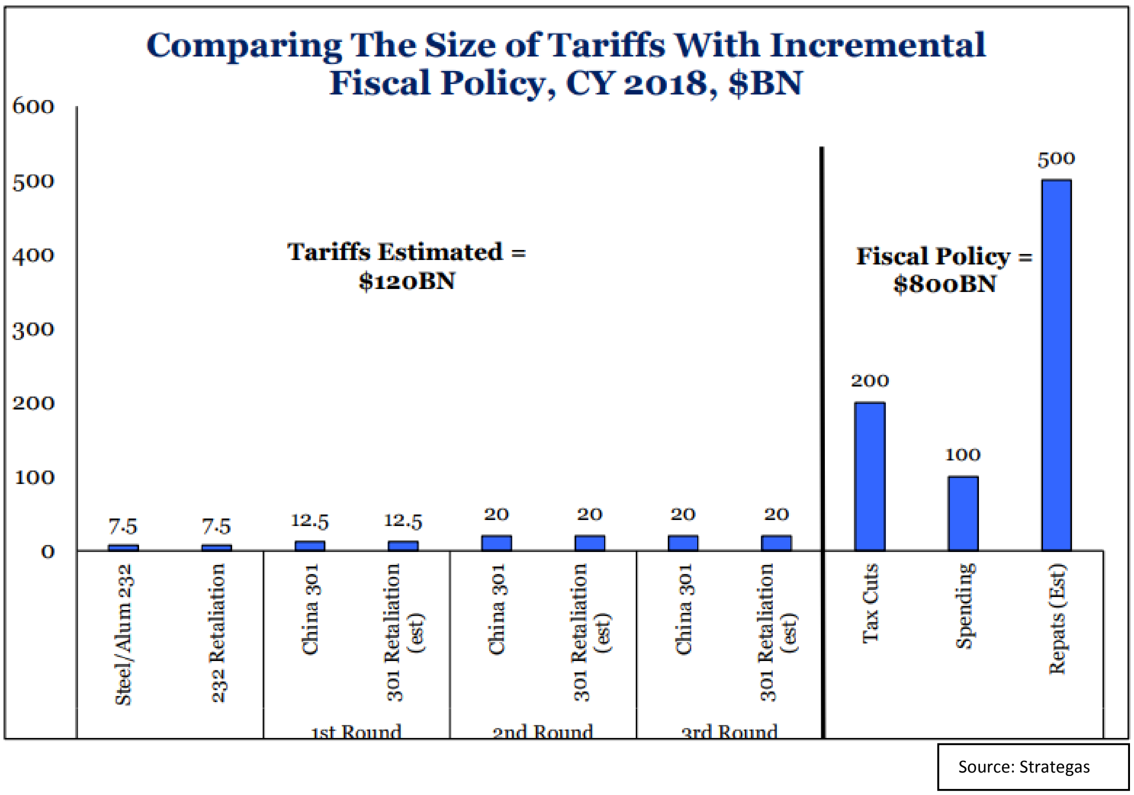
Inflation remains low. Despite having extraordinarily strong employment reports, wage inflation is only up 2.7% year over year where during other cycles you might have expected it to be up 4% with this low level of unemployment. Anecdotally, our clients that run manufacturing businesses say that even with the tight labor markets, their wage growth remains under control.

While there may have been a slowdown in the first quarter, it appears that the second quarter is showing a rebound. Analysts expect that US GDP growth may have topped 4% during the period, though we will only officially find out in late July. We also see that Citigroup's global economic surprise index (a measure of whether the economy is expanding faster or slower than expected) is staging a recovery from depressed levels of the first half. The chart to the left suggests this recovery may have some time to go, which should be supportive of stocks as the market gets comfortable that worldwide economies can withstand the geopolitical uncertainties we laid out earlier.



Source: Evercore ISI

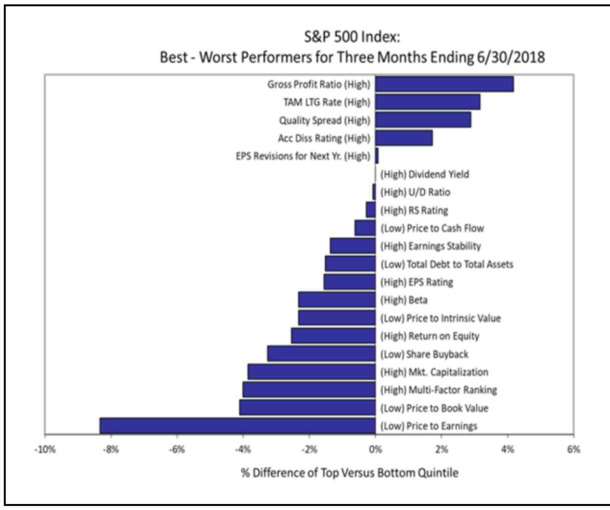
The economic recovery being experienced in the US should have some legs to it. Consumer confidence is near Post Financial Crisis highs and the impact of US tax cuts and repatriation is still working its way through the economy. Concerns about the trade tariffs seem overblown when you look at them in concert with the size of the fiscal stimulus. Looking at the chart below, from Dan Clifton of Strategas, you can see that the size of the tax cut and repatriation dwarfs the impact of tariffs in the US.

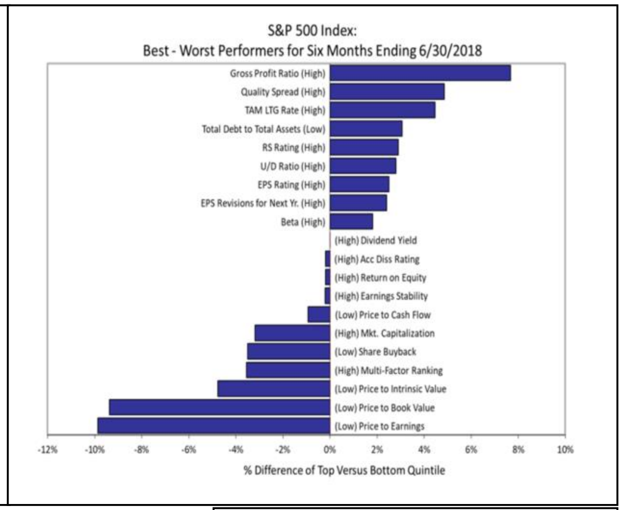


Markets may not react to the fundamentals until we get through the summer. Midterm Elections are coming up for the US in November, and history tells us that until markets sense which party wins, strong gains are not likely. There is also the uncertainty of what is likely to develop with the trade spat that is currently going on. One thing we would note is that in International Economics, you rarely come to difficult decisions without playing a game of "chicken". The game is on now between China and the US. We still think that probabilities favor a negotiated settlement, but there is a long way to go between here and there. In the meanwhile, the US economy is accelerating and valuations are better now than they were for most of the past four years.

TODD
ASSET MANAGEMENT LLC

Factor Analysis





Source: Todd Asset Management, Bloomberg

We present our customary factor analysis for the past quarter and year to date period above. We would make a couple of points that might be of interest:

- The number of factors that worked over the past three months narrowed to emphasize growth and quality. Our sense is with all of the uncertainties we mentioned above, that the market is experiencing a mini-2016 like loss of confidence. We anticipate the list of factors that are working should broaden out later this year as concerns are addressed.
- Quality and growth have both worked well since the beginning of the year, though the factors that worked well narrowed significantly into the second quarter.
- Value, shareholder return and our Multi-factor model have not worked as well while investors are still infatuated with the assured growth they perceive in the technology stocks.

Sectors reflected this as well, as the Energy, Technology and Consumer Discretionary sectors lead the markets during the quarter. Energy was up in sympathy with oil prices and our exposure helped performance. Tech and Consumer Discretionary are both dominated by the FANG stocks. Amazon and Netflix are two of the largest stocks in the Discretionary sector, While Facebook, Microsoft, Alphabet (Google) and Apple dominate the technology sector. The laggards were the Industrial and Financial sectors. Trade concerns have investors worried the industrials could slip up, and rates declining impacted investor perceptions of growth prospects for the banks.

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S&P 500 Sector Performance Q2 2018

Groups (11)	Return
S&P 500 ECO SECTORS IDX	2.93%
11) S&P 500 ENERGY INDEX	12.69%
12) S&P 500 CONS DISCRET IDX	7.84%
13) S&P 500 INFO TECH INDEX	6.75%
14) S&P 500 REAL ESTATE IDX	5.13%
15) S&P 500 UTILITIES INDEX	2.80%
16) S&P 500 HEALTH CARE IDX	2.66%
17) S&P 500 MATERIALS INDEX	2.05%
18) S&P 500 TELECOM SERV IDX	-2.33%
19) S&P 500 CONS STAPLES IDX	-2.34%
20) S&P 500 FINANCIALS INDEX	-3.58%
21) S&P 500 INDUSTRIALS IDX	-3.66%

Source: Bloomberg

Outlook

Markets are wrestling with many factors and confidence appears limited despite the fact that the S&P is trading near the highs of the year. Investors are rushing into a crowded trade in the FANG stocks (Facebook, Amazon, Netflix and Google). These stocks have been the leadership for some time, and by some measures have accounted for more than two thirds of the markets gains this year. Uncertainty about economic growth is the cause of this concentration of performance. As the year progresses, we believe investors will regain some comfort that the economy will continue to grow despite the noise we are getting from Washington. As that comfort grows, we anticipate markets should act better, and investors should be willing to venture beyond the FANG stocks and look for value in other parts of the market.

As always, if you need any additional information, please feel free to contact any of us.

Curt Scott, CFA
Jack White, CFA
Jack Holden CFA
Shaun Siers, CFA

7/24/18
S&P 500 – 2,820
Russell 1000 Value – 1,217

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

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S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.