October 23, 2017

The Hurricane Head-Fake

Reading Through One-Time Earnings Items

- **Earnings’ Hurricane Blip.** With 17% of the S&P 500 having reported 3Q earnings thus far, Y/Y growth remains modestly positive at 1.7% but is lower than initial expectations of 3.0%. Expectations are for a rebound from this slow growth to 11.4% in the 4Q and a continuation of that growth in the beginning of 2018.

- **Insurers Leads the Downside, Due to One-Time Impact from Hurricanes.** Blended earnings growth estimates suggest the insurance industry is primed for a -67% hit on earnings Y/Y due to a deluge of claims from the hurricane season.

- **Energy Leads the Upside on Easy Comps, Followed by Technology.** Of the eleven sectors in the S&P 500, energy is leading the charge with blended earnings growth of 199% on back of easier year-ago comparables. Information technology is also primed for a solid quarter, with blended earnings growth of 8.8%.

- **Forward Expectations May Be Lofty.** Excluding this industry’s impact, S&P 500 earnings growth would still be near 5%, a good deal short of the near-10% estimates currently provided by analysts. Odds are these expectations will need to be revised down either during this earnings season or in the coming months.

**Our Take:** Excluding the hurricane impact, U.S. earnings growth continues but appears sub-par.

With Politics, One Step at a Time

- **Budget Resolution Resolves, Sets Stage for Tax Reform.** The tax reform-critical Senate budget resolution was adopted last Thursday, unlocking a shortcut that facilitates the passage of tax reform with only GOP votes.

- **Tax Reform Evolves.** The proposed tax plan includes provisions that will limit the deductibility of interest, while allowing for the expensing of capital investment. In theory, this will encourage companies to pursue business growth rather than borrowing, which some firms previously used to pay dividends and buy back stock. Recent Fed commentary indicated a short-term stimulus en lieu of systemic reform may be “harmful”.

- **Delayed and Dismayed on Trade.** After being brought to a standstill by rising economic nationalism, North American Free Trade Agreement (NAFTA) negotiations have been pushed into Q1 2018. Increasing barriers to cross-border trade can potentially disrupt supply chains across the continent and create winners and losers.

**Our Take:** In spite of the slow pace of legislative reform, the market continues its expansion.

Race for Fed Chair in the Home Stretch

- **Powell the Leading Candidate for Next Fed Chair.** Fed Governor Jerome Powell, Steve Mnuchin favorite, leads the pack with a 56% probability of winning Trump’s nomination for Chair of the Federal Reserve, according to online political prediction market PredictIt.org. This is consistent with recent reports that Trump’s advisors are leaning toward him or Taylor. He is likely to provide continuity and favor gradual rate hikes.

- **Taylor Closely Behind as the Hawkish Choice.** John Taylor, professor of economics at Stanford, has seen his odds increase to 18% on PredictIt, occupying second place. His chances have been rising in the past few weeks, especially as recent reports suggest Trump advisors are leaning toward him or Powell. Taylor is widely viewed as someone likely to take a more hawkish stance, hiking rates.

- **Yellen and Warsh Round Out the Field.** Current Fed Chair Janet Yellen and former investment banker Kevin Warsh, with his social connections to President Trump, are the remaining candidates considered to be in contention. The likelihood of their nominations have slipped to 16% and 12%, respectively.

**Our Take:** As the Fed Chair decision approaches, odds favor the Fed remaining on a gradual tightening path.
Chart of the Week:

**Modest Earnings Growth in the Longer-Term Trend of Expansion**

S&P 500 Earnings Growth (Year-over-Year)

*The Q3 2017 figure is a blended earnings growth figure, which includes actual results from companies that have reported already and forecasted results for companies that have not yet reported. Growth figures for 2017 Q4 and onward are analyst forecasts.*

**Dates of interest:**
- **10/23:** U.S. Chicago Fed Index, Eurozone Consumer Confidence, Japan Markit Mfg PMI (Flash)
- **10/24:** U.S. Markit Mfg & Svc PMIs (Flash) & Richmond Fed Index, Eurozone Markit Mfg & Svc PMIs (Flash), Germany Markit Mfg & Svc PMIs (Flash)
- **10/25:** U.S. New Home Sales, Durable Goods & MBA Mortgage Apps, Germany Ifo Sentiment
- **10/26:** U.S. Initial Claims, Building Permits & Kansas City Fed Index, ECB rate decision, Germany GfK Consumer Confidence, and Japan CPI
- **10/27:** U.S. Q3 GDP (Preliminary) & Michigan Sentiment

*The S&P 500 Earnings Growth chart is sourced from Glenmede, FactSet as of 10/20/2017.

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