the Prudent Speculator

MARKET COMMENTARY MONDAY, JANUARY 15, 2018

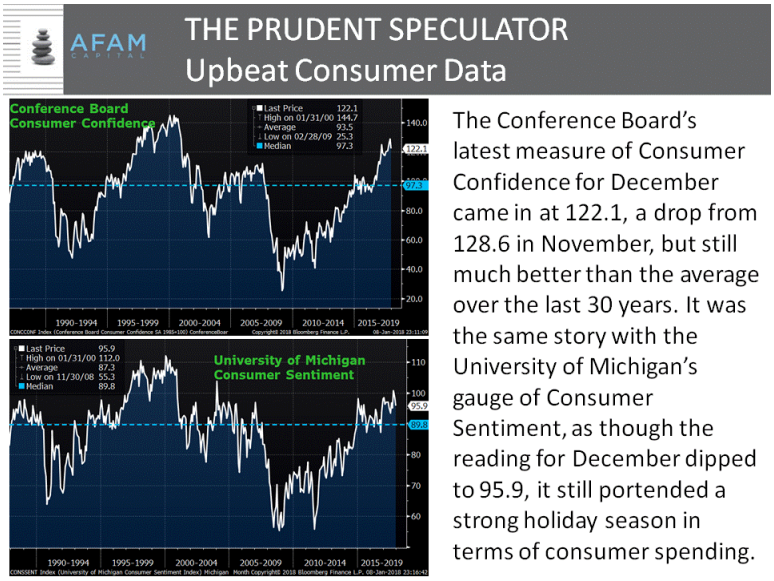
EXECUTIVE SUMMARY

Week #2 2018 - Rally Continues
Econ News - Favorable Statistics
Earnings Outlook - Tax Cuts Bolster EPS Estimates
Target Prices - New Listing Posted to theprudentspeculator.com
Fund Flows - Investors Still Love Bonds
Bonds Can Depreciate - German Bund & 10-Year U.S. Treasury Examples
Rising Bond Yields - Hardly Fatal for Equities
Company News - Updates on JPM, PNC, WFC, DAL, KSS, TGT, STX, SHPG & GILD

Market Review

What a week, capped off by the Minneapolis Miracle for your life-long-Vikings-fan Editor! The fantastic start to 2018 continued in week #2, with the S&P 500 and Russell 3000 tacking on another 1.61% and 1.64%, respectively. Happily, Value performed a smidge better than growth as the Russell 3000 Value index returned 1.65%, versus 1.63% for the Russell 3000 Growth index, while our broadly diversified portfolios managed to top all of those indexes over the last five days with gains generally north of 2.0%.

No doubt, solid economic statistics, be they on the mood of consumers,…



The Conference Board's latest measure of Consumer Confidence for December came in at 122.1, a drop from 128.6 in November, but still much better than the average over the last 30 years. It was the same story with the University of Michigan's gauge of Consumer Sentiment, as though the reading for December dipped to 95.9, it still portended a strong holiday season in terms of consumer spending.

…the employment situation,…

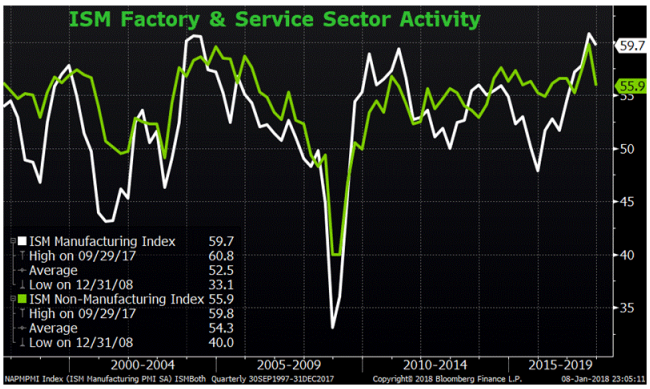
THE PRUDENT SPECULATOR
Strong Labor Situation

The Labor Department said that the unemployment rate remained at a 17-year low of 4.1% in December as the number of new non-farm payrolls created came in at a solid 148,000. And it would appear that the jobs picture will continue to be healthy, as the latest tally of weekly first-time filings for unemployment benefits came in at 261,000, not too far from the 30-year (monthly) low of 227,000 set last February.

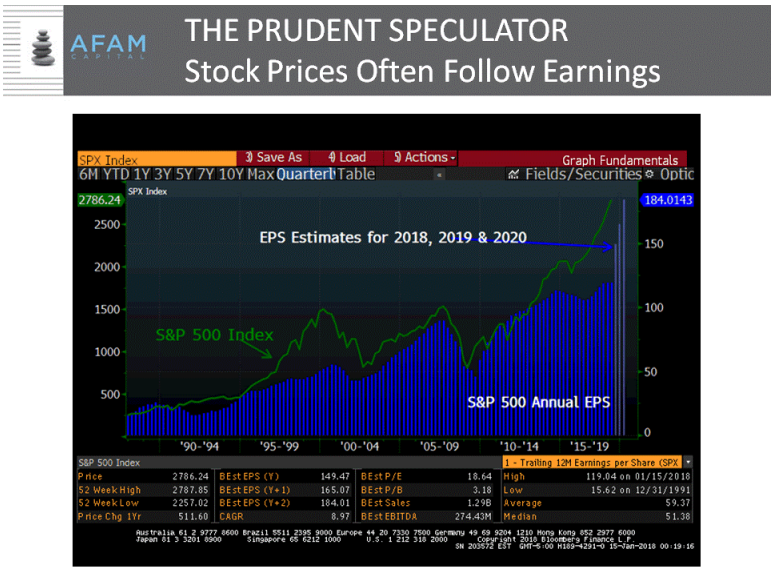
…or the outlook of purchasing managers in the factory and service sectors,…

THE PRUDENT SPECULATOR
Terrific ISM Numbers: Healthy Businesses

Though both the ISM Manufacturing and Non-Manufacturing indexes pulled back a bit in December, the measures of activity in the factory and service sectors remain healthy, well above their 20-year averages.



…have contributed to the favorable backdrop for stocks, but it is the ratcheting higher of earnings estimates following the passage of the Tax Cuts and Jobs Act that has provided the rocket fuel for the recent acceleration of the rally.



While we are not banking on the Bloomberg S&P earnings per share projection of more than $184 in the year 2020, and we respect that analyst estimates are often much too ambitious, we have given a sizable bump to many of our Target Prices, especially those of companies that are higher tax payers. Our latest listings have been posted to theprudentspeculator.com, but we are hanging tight to all of our holdings for the time being.

Of course, the big move up thus far in 2018 provides another reminder that the only problem with market timing is getting the timing right, something that many mutual fund and exchange traded fund (ETF) investors have again found out the hard way. Incredibly, per weekly data from the Investment Company Institute, interest in American stocks plummeted as the calendar turned, with a massive $22 billion of net redemptions from U.S. equity funds in the week ending January 3.

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THE PRUDENT SPECULATOR
Bonds Remain Stunningly Popular

While the move toward passive U.S. equity strategies has been massive over the past decade, data from the Investment Company Institute show that far more dollars have flowed out of domestic stock mutual funds/ETFs than have flowed in over the last three years. Foreign stocks and bonds have been the beneficiaries of the exodus.

Combined Estimated Long-Term Fund Flows and ETF Net Issuance
Millions of dollars

Week Ended	1/3/2018	12/27/2017	12/20/2017	12/13/2017	12/6/2017
Total Equity	-21,009	4,099	-1,584	6,809	8,621
Domestic	-22,065	1,208	-9,550	5,347	5,962
World	1,056	2,892	7,966	1,463	2,659
Hybrid	-327	-940	-2,122	-1,415	-2,139
Total Bond	7,570	4,109	1,599	5,015	6,160
Taxable	7,056	4,487	1,512	4,943	6,471
Municipal	515	-378	87	72	-311
Commodity	-305	-296	-434	5	421
Total	-14,071	6,972	-2,541	10,414	13,064

Source: Investment Company Institute

Investment Company Institute

Long-Term Mutual Fund and Exchange-Traded Fund (ETF) Flows

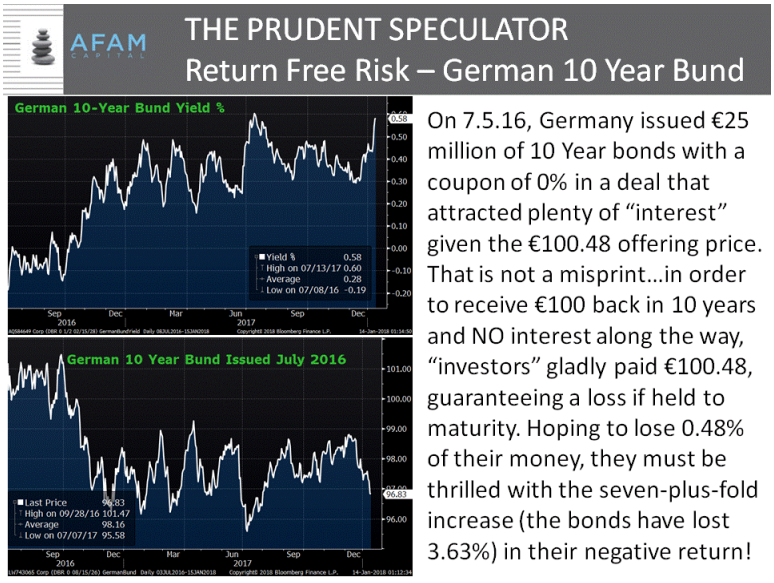
Millions, U.S. dollars

Period	Total LT MF and ETF	Equity			Hybrid	Bond			Commodity
		Total	Domestic	World		Total	Taxable	Municipal	
Since Dec 14	736,895	207,386	-232,245	439,634	-97,258	611,742	532,119	79,621	15,020
Since Dec 15	621,912	105,922	-129,096	235,020	-78,936	582,021	521,142	60,877	12,903
Since Dec 16	535,598	178,230	-59,613	237,845	-34,911	391,053	359,481	31,569	1,224

Note: Weekly fund flows are estimates based on reporting covering more than 98 percent of mutual fund and ETF assets, while actual monthly mutual fund net new cash flow and ETF net issuance data are collected and reported separately. Mutual fund data represent net new cash flow, which is new sales minus redemptions combined with net exchanges, while ETF data represent net issuance, which is gross issuance less gross redemptions. The primary difference is that net new cash flow excludes reinvested dividends and new issuance includes reinvested dividends. Data for mutual funds that invest primarily in other mutual funds and ETFs that invest primarily in other ETFs were excluded from the series.

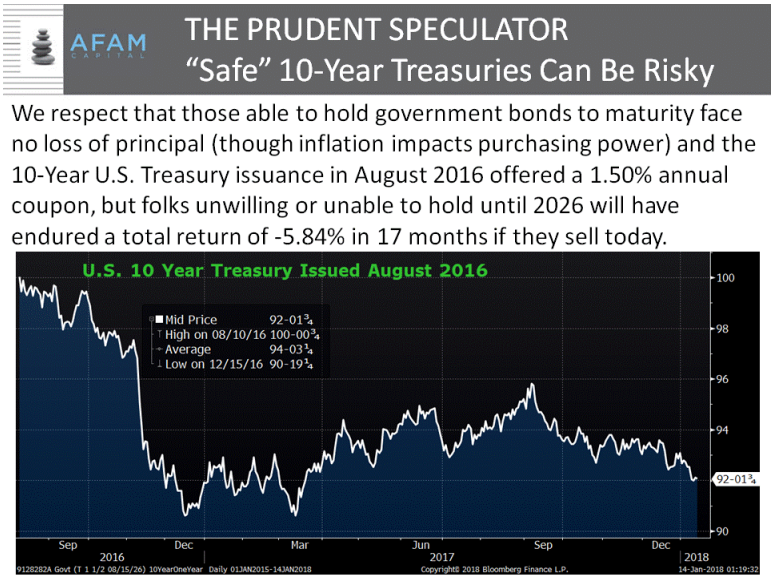
The disinterest in domestic equities is hardly a new condition, as folks have piled money into global stocks and taxable bonds. We understand the enthusiasm for the former, as we own more than a few foreign holdings, with several of our more recent recommendations of the five-letter, ticker-symbol-ending in “Y” variety, but we remain perplexed by the enthusiasm for bonds, given the extraordinarily low interest rate climate.

To be sure, fixed income investments historically have been far less volatile than stocks and overall returns generally have been positive throughout the 30+ year Bull Market in bonds, even as central bank debt buying has helped lead to some bizarre events, such as negative yields on German Bunds,…



On 7.5.16, Germany issued €25 million of 10 Year bonds with a coupon of 0% in a deal that attracted plenty of “interest” given the €100.48 offering price. That is not a misprint…in order to receive €100 back in 10 years and NO interest along the way, “investors” gladly paid €100.48, guaranteeing a loss if held to maturity. Hoping to lose 0.48% of their money, they must be thrilled with the seven-plus-fold increase (the bonds have lost 3.63%) in their negative return!

…but bonds are not without risk as even supposedly safe U.S. Treasuries have produced not-so-insignificant losses for those who bought in at the wrong time.



And, with the benchmark 10-Year U.S. Treasury seeing its yield spike above 2.5% last week, many in bond-land, including at least one prominent fixed-income fund manager, are thinking that the party may be ending, with a bond Bear Market now underway.

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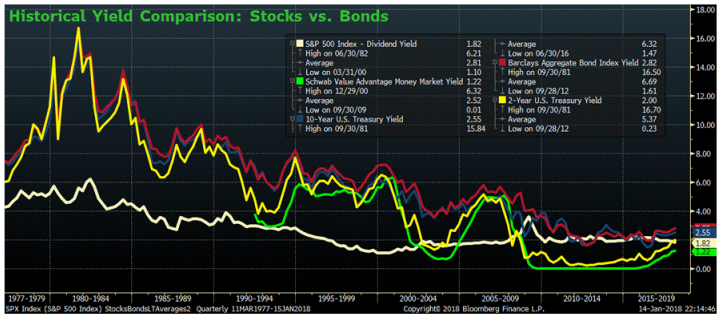
THE PRUDENT SPECULATOR
Income Options – Equities Very Attractive

Though the major market averages now trade at all-time highs, the payout on the S&P 500 (1.82%) is still rich when compared to yields on fixed income instruments, and when viewed against the historical averages since we began publishing *The Prudent Speculator* in 1977 for U.S. Treasuries, Money Market Funds and the Aggregate Bond Index.



While we would argue that all of the dollars that have gone into bonds in recent years may provide more tinder to stoke the equity market fire when and if those folks flee the red ink on their fixed income holdings, the move up in Treasury yields has many market pundits warning that stocks will soon come under selling pressure. Despite the continued attractiveness of dividend yields relative to the income available on competing instruments, the conventional wisdom suggests that investors will somehow decide that bonds are more compelling if interest rates rise (and their price declines). This makes sense in theory as the present value of the cash flows generated by companies in whose equities we own will decrease as interest rates increase, all else equal, but it has hardly been the case in practice that rising bond yields have proved detrimental to stocks.

For example, many folks thought the equity party would end when the Federal Reserve provided a hint back in 2013 that its massive bond buying program might be tapered…

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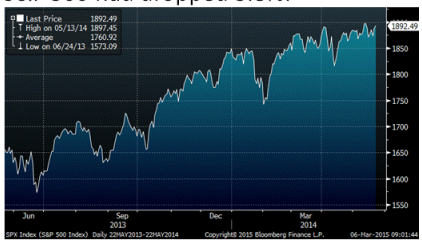
THE PRUDENT SPECULATOR
Taper Tantrum

On May 22, 2013, Ben Bernanke hinted that the Federal Reserve would soon begin to taper it's $85 billion per month in purchases of bonds and mortgage backed securities. One month later, the S&P 500 had dropped 3.8%.



Yet, one year later, the S&P 500 had recouped those losses and then some, rising 13.6% from May 22, 2013 to May 22, 2014, even though Janet Yellen's Fed actually started to taper by $10 billion per month in January 2014.

…while Janet Yellen & Co. actually initiated a series of increases in the Fed Funds rate back in December 2015.

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THE PRUDENT SPECULATOR
Fed Liftoff

On December 16, 2015, the Federal Reserve raised the Federal Funds rate by 25 basis points to 0.50%, the first increase ("Liftoff") in the benchmark interest rate since 2006. One month later, the S&P 500 had dropped nearly 8%.

Yet, two+ years later, the S&P 500 had recouped those losses and then some, rising 36.4% from Dec 15, 2015 to Jan 12, 2017, even though Janet Yellen's Fed actually hiked the Fed Funds rate four more times to 1.50%.

Certainly, both events provided a little short-term discomfort for the stock market, but each quickly gave way to significantly higher equity prices, something that should not have been a surprise for students of market history. Indeed, research shows that stocks (especially Value) have generated very good long-term returns following the previous 17 Fed rate-hiking cycles…

THE PRUDENT SPECULATOR
Fed Liftoff & Future Equity Returns

	Initial Effective	24 Months After Liftoff			36 Months After Liftoff			60 Months After Liftoff		
Start Date	Fed Funds Rate	S&P	Value	Growth	S&P	Value	Growth	S&P	Value	Growth
Dec 1954	1.28%	18.4%	15.6%	13.5%	7.7%	2.5%	3.8%	15.0%	17.0%	15.7%
Aug 1958	1.53%	12.9%	15.5%	18.3%	16.3%	18.8%	18.5%	12.3%	15.9%	10.5%
Aug 1961	2.00%	6.6%	11.7%	-0.5%	9.8%	14.5%	1.8%	5.9%	12.5%	3.7%
Nov 1964	3.52%	0.8%	8.5%	6.6%	7.0%	18.4%	19.3%	5.5%	15.0%	14.0%
Aug 1967	3.90%	4.2%	10.8%	7.2%	-1.3%	1.7%	-5.3%	6.9%	8.3%	6.7%
Apr 1971	4.15%	4.5%	-2.0%	-6.4%	-1.6%	-1.7%	-10.7%	3.2%	8.2%	-2.5%
Mar 1972	3.83%	-3.4%	-3.0%	-19.2%	-4.6%	-1.9%	-16.0%	2.1%	10.4%	-4.4%
Mar 1974	9.35%	9.3%	23.3%	9.1%	6.0%	20.3%	6.9%	6.4%	19.9%	10.8%
Feb 1977	4.68%	3.4%	15.1%	11.8%	10.0%	20.7%	19.1%	8.0%	17.5%	13.7%
Aug 1980	9.61%	4.3%	14.8%	0.1%	16.1%	28.8%	16.0%	14.5%	24.6%	10.3%
Jan 1982	13.22%	22.6%	37.9%	18.1%	20.1%	30.5%	15.1%	23.3%	28.9%	16.8%
May 1983	8.77%	13.1%	19.7%	0.0%	20.2%	23.5%	11.2%	14.5%	16.3%	5.2%
Apr 1987	6.37%	7.3%	11.1%	1.2%	8.3%	7.1%	3.2%	11.2%	11.0%	8.3%
Apr 1988	6.87%	16.5%	11.8%	12.2%	16.9%	10.7%	14.3%	14.7%	16.1%	11.9%
Feb 1994	3.25%	20.2%	15.4%	16.6%	22.2%	17.4%	15.5%	24.1%	16.0%	15.8%
Jun 1999	4.76%	-4.4%	16.2%	1.1%	-9.2%	8.8%	-8.1%	-2.2%	11.1%	0.3%
Jun 2004	1.03%	7.5%	17.8%	4.8%	11.7%	18.9%	8.8%	-2.2%	-1.0%	-1.7%
Averages:	5.18%	8.5%	14.1%	5.5%	9.2%	14.1%	6.7%	9.6%	14.6%	7.9%

	Initial Effective	24 Months After Rate Hike			36 Months After Rate Hike			60 Months After Rate Hike		
Start Date	Fed Funds Rate	S&P	Divs	No Divs	S&P	Divs	No Divs	S&P	Divs	No Divs
Dec 1954	1.28%	18.4%	16.9%	9.2%	7.7%	6.2%	-1.1%	15.0%	15.2%	12.4%
Aug 1958	1.53%	12.9%	14.2%	13.2%	16.3%	17.5%	12.8%	12.3%	13.5%	4.8%
Aug 1961	2.00%	6.6%	7.8%	-6.1%	9.8%	10.6%	-5.0%	5.9%	6.3%	3.9%
Nov 1964	3.52%	0.8%	0.7%	17.7%	7.0%	7.3%	35.2%	5.5%	5.7%	21.0%
Aug 1967	3.90%	4.2%	4.2%	6.0%	-1.3%	-1.4%	-14.1%	6.9%	6.6%	-2.0%
Apr 1971	4.15%	4.5%	2.4%	-19.1%	-1.6%	-2.4%	-18.0%	3.2%	4.0%	-6.0%
Mar 1972	3.83%	-3.4%	-3.9%	-25.0%	-4.6%	-4.3%	-21.4%	2.1%	3.9%	-6.3%
Mar 1974	9.35%	9.3%	11.7%	13.8%	6.0%	9.5%	8.6%	6.4%	9.6%	17.9%
Feb 1977	4.68%	3.4%	5.9%	24.7%	10.0%	12.6%	39.2%	8.0%	10.2%	23.4%
Aug 1980	9.61%	4.3%	5.3%	-6.3%	16.1%	17.5%	15.1%	14.5%	15.4%	5.5%
Jan 1982	13.22%	22.6%	23.0%	16.5%	20.1%	20.5%	9.8%	23.3%	23.4%	11.1%
May 1983	8.77%	13.1%	12.3%	-10.1%	20.2%	20.1%	2.4%	14.5%	13.9%	-1.0%
Apr 1987	6.37%	7.3%	7.6%	-0.4%	8.3%	8.0%	0.2%	11.2%	11.4%	5.5%
Apr 1988	6.87%	16.5%	15.3%	8.9%	16.9%	16.0%	10.8%	14.7%	14.8%	11.5%
Feb 1994	3.25%	20.2%	19.6%	18.3%	22.2%	21.7%	15.8%	24.1%	22.4%	20.5%
Jun 1999	4.76%	-4.4%	3.5%	-6.7%	-9.2%	-0.8%	-16.4%	-2.2%	3.0%	-4.6%
Jun 2004	1.03%	7.5%	8.9%	7.7%	11.7%	12.3%	12.1%	-2.2%	-2.0%	-0.5%
Averages:	5.18%	8.5%	9.1%	3.7%	9.2%	10.1%	5.1%	9.6%	10.4%	6.9%

Contrary to what many might think, stocks generally have performed admirably in the years following the initiation of a Fed rate-hiking cycle (i.e. Fed Liftoff). Even better, Value Stocks and Dividend Payers, like those that we have long favored, have enjoyed significant outperformance, on average, over the ensuing two years, three years and five years.

…and even dividend payers have done well concurrent with and subsequent to periods when the yield on the 10-Year Treasury has been rising.

THE PRUDENT SPECULATOR
Δ in 10-Year Treasury & Divs/No Divs

Concurrent Dividend-Paying Perf. & Change in 10-Year Treasury Rate

	Count	No Divs	Low 30	Mid 40	High 30	All Dividend
1-Month Drop	546	8.5%	10.4%	15.3%	17.9%	14.8%
1-Month Rise	537	9.0%	8.1%	6.0%	4.8%	6.4%
3-Month Drop	520	8.8%	9.9%	14.1%	15.9%	13.5%
3-Month Rise	559	8.6%	8.5%	7.2%	7.0%	7.7%
6-Month Drop	520	8.7%	9.0%	13.0%	14.5%	12.4%
6-Month Rise	553	8.6%	9.2%	8.1%	8.1%	8.6%
12-Month Drop	532	7.0%	8.4%	11.8%	12.7%	11.2%
12-Month Rise	529	10.0%	9.6%	8.9%	9.6%	9.5%

From 06.30.27 through 10.31.17. Concurrent annualized 12-month returns. SOURCE: Al Frank using data from Professor Robert J. Shiller and Professors Eugene F. Fama and Kenneth R. French

Subsequent Dividend-Paying Perf. & Change in 10-Year Treasury Rate

	Count	No Divs	Low 30	Mid 40	High 30	All Divs
1-Month Drop	539	9.8%	10.3%	12.7%	13.5%	12.4%
1-Month Rise	533	7.2%	7.7%	8.0%	8.7%	8.3%
3-Month Drop	516	11.5%	11.4%	13.3%	13.6%	13.0%
3-Month Rise	554	5.7%	6.8%	7.6%	8.8%	7.8%
6-Month Drop	520	10.7%	10.7%	12.7%	13.0%	12.3%
6-Month Rise	547	6.2%	7.2%	8.0%	9.2%	8.3%
12-Month Drop	532	9.1%	9.4%	10.7%	10.8%	10.5%
12-Month Rise	529	7.3%	8.0%	9.6%	11.0%	9.7%

From 06.30.27 through 10.31.17. Subsequent 12-month return. SOURCE: Al Frank using data from Professor Robert J. Shiller and Professors Eugene F. Fama and Kenneth R. French

While we realize that a rise in the 10-Year U.S. Treasury should make stocks less attractive, nearly 90 years of market data show that Dividend-Payers have performed admirably, on average, over the 12 months both concurrent with and subsequent to increases in the yield on the benchmark government bond.

That does not mean that equity prices will march steadily higher, so, despite our continued optimism for the long-term prospects of our broadly diversified portfolios of undervalued stocks, we offer the friendly reminder that the road ahead will not always be smooth. Indeed, 5% sell-offs, 10% correction and even 20% Bear Markets are very much normal occurrences on the long-term investment journey…

THE PRUDENT SPECULATOR
Volatility is Always Part of the Process

Advancing Markets

Minimum Rise %	Average Gain	Average # Days	Count	Frequency (in Years)	Last Start	Last End
20.0%	107.1%	906	26	3.5	3/9/2009	1/12/2018
17.5%	67.2%	578	37	2.4	10/3/2011	1/12/2018
15.0%	66.9%	561	43	2.1	10/3/2011	1/12/2018
12.5%	44.0%	331	70	1.3	2/11/2016	1/12/2018
10.0%	35.1%	249	103	0.9	2/11/2016	1/12/2018
7.5%	23.4%	147	152	0.6	2/11/2016	1/12/2018
5.0%	14.7%	72	294	0.3	6/27/2016	1/12/2018

Declining Markets

Minimum Decline %	Average Loss	Average # Days	Count	Frequency (in Years)	Last Start	Last End
-20.0%	-34.3%	371	25	3.5	1/6/2009	3/9/2009
-17.5%	-30.6%	225	36	2.5	4/29/2011	10/3/2011
-15.0%	-28.5%	195	42	2.1	4/29/2011	10/3/2011
-12.5%	-22.7%	140	69	1.3	5/21/2015	2/11/2016
-10.0%	-19.3%	103	102	0.9	11/3/2015	2/11/2016
-7.5%	-15.4%	66	151	0.6	11/3/2015	2/11/2016
-5.0%	-10.9%	37	293	0.4	6/23/2016	6/27/2016

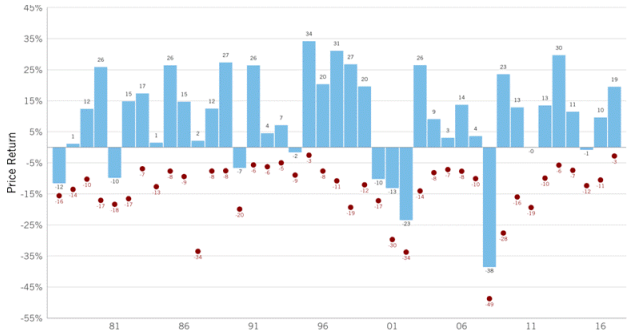
From 02.20.28 through 1.12.18. Price return series. We defined a Declining Market as an instance when stocks dropped the specified percentage or more without a recovery of equal magnitude, and an Advancing Market as in instance when stocks appreciated the specified percentage or more without a decline of equal magnitude. SOURCE: Al Frank using data from Bloomberg, Morningstar and Ibbotson Associates

Selloffs, downturns, pullbacks, corrections and even Bear Markets are events that equity investors always have had to endure on their way to the best long-term performance of any of the financial asset classes. On average, 10%+ setbacks occur every 10 months, which is about the same frequency as 10%+ rallies, but the magnitude of the gains historically has been far greater than the losses.

…even as they are often overlooked when viewed through a longer-term lens.

THE PRUDENT SPECULATOR
A Big Selloff Happens Almost Every Year

While the S&P 500 has enjoyed excellent long-term returns and endured a relatively small number of negative full years since the founding of *The Prudent Speculator* in 1977, there have been corrections of 10% or more in 24 of the 40 years.



From 12.31.76 through 12.29.17. Price returns do not include dividends. Intra-year drops refer to the largest drops between high and low close prices during a calendar year. 2016 return is year to date. SOURCE: Al Frank using data from Bloomberg

Stock Updates

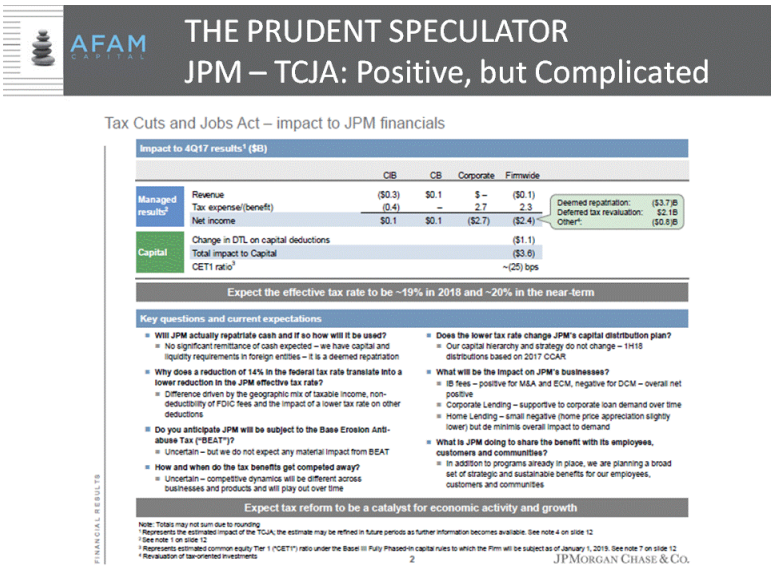
Fourth quarter earnings season will kick into high gear this week, but there were a handful of companies out with results last week. Jason Clark and Chris Quigley provide updates on four of those names as well as another five of our current recommendations that made headlines.

JPMorganChase (JPM - $112.67) reported favorable Q4 earnings last week, pushing shares of the blue-chip banking behemoth up more than 5% so far this year, following a strong 2017. JPM posted adjusted EPS of $1.74, versus consensus analyst estimates of $1.69. We believe Q4's results further substantiate why JPM should be a core financial stock holding for investors, as earnings growth outpaced peers and JPM continues to gain share across its businesses. There

has long been mention about JPM's “coiled spring” of EPS power, and we think the backdrop in 2018 and 2019 could unleash it.

JPM CEO Jamie Dimon commented: “2017 was a record year on many measures for JPMorgan Chase as we added clients and customers and delivered record EPS. We had healthy growth in Treasury Services, Securities Services and Investment Banking – we were #1 in IB fees globally, a record for the firm. Commercial Banking and Asset & Wealth Management generated record revenue and net income. The Commercial Bank earned a record $2.3 billion of IB revenue and continued to add bankers and offices and now has offices in each of the top 50 MSAs. In Asset & Wealth Management, loans and AUM were up, 9% and 15%, to record levels, and we brought in $68 billion of long-term net flows. Consumer & Community Banking – which now reaches 61 million households – grew core loans and deposits 9% each, and had record merchant processing volume of $1.2 trillion.”

Mr. Dimon added, “The company maintained its fortress balance sheet, discipline and client focus. Operating from this position of strength allowed us to extend credit and raise capital of $2.3 trillion for U.S. consumers, businesses and institutional clients, while returning $22 billion to shareholders…The enactment of tax reform in the fourth quarter is a significant positive outcome for the country. U.S. companies will be more competitive globally, which will ultimately benefit all Americans. The cumulative effect of retained and reinvested capital in the U.S. will help grow the economy, ultimately growing jobs and wages. We have always invested, even in difficult times, in our employees, customers and communities, and as a result of the tax plan we will be increasing and accelerating some of these investments.”



While we think that revised consensus analyst EPS estimates of $8.73 for 2018 might be too conservative, we note that JPM shares are currently trading for just 13 times this projection. We also expect the quarterly dividend of $0.56 per share to rise in the coming year (current dividend yield is 2.0%). With the continued progress, momentum and our expectations for a strong 2018, we have boosted our Target Price for JPM to $120.

PNC Financial Services (PNC - $151.84) saw its shares climb almost 5% last week after solid market moves and the bank’s reporting of adjusted EPS of $2.29, versus consensus analyst

estimates of $2.20. CEO William S. Demchak proclaimed, “By just about any measure, 2017 was a successful year for PNC.”

He added, “We grew loans and deposits and added customers across our businesses, continued to focus on expense management, and generated record fee income for the year, as well as in the fourth quarter. The year ended with a benefit from the new tax legislation, giving us increased flexibility as we continue to invest in our businesses, communities and our employees, which helps drive our Main Street banking model. We executed on our strategic priorities throughout the year, including our technology initiatives and the expansion of our middle market franchise into new markets. As we enter the new year, we believe we are firmly positioned to create long-term value for our shareholders.”

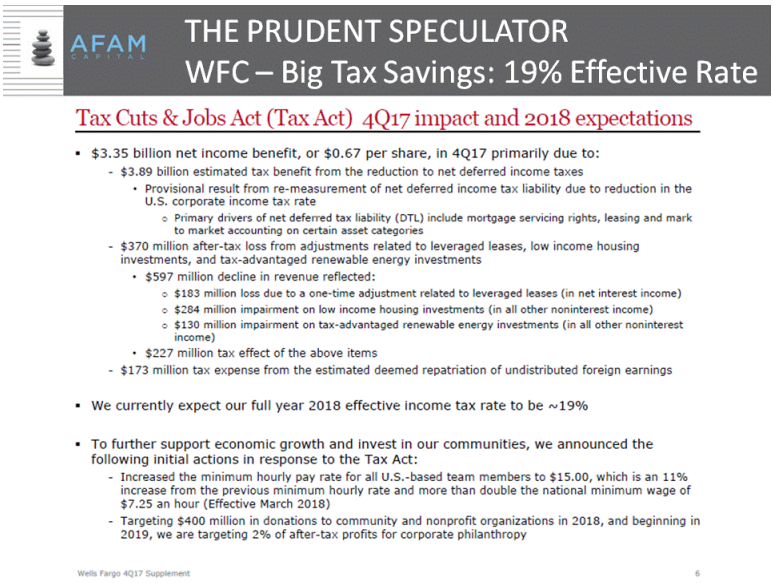
Analysts see total loan growth for 2018 of 4.9% and we think the firm’s asset management business will continue to add to the bottom line. We also expect PNC to continue improving its efficiency ratio in 2018 through a combination of revenue enhancements and expense discipline. While the full extent of tax reform is not yet understood by PNC itself, nor its numerous business and individual customers, we believe the stock is positioned to add to the 30% return it has seen over the last 12 months. That said, PNC shares currently trade for 15 times NTM earnings projections, while the dividend yield is 2.0%, so we do want to keep an eye on the stock, even as our Target Price has been raised to $159.

Wells Fargo (WFC - $62.55) saw positive returns in 2017, even as the year was filled with negative headlines and bad press. Despite the customer account scandal and change in top management, we think that WFC is making solid progress in the necessary changes to not only drive performance, but to also improve the internal culture and repair its reputation. The big domestic bank’s Q4 earnings release was full of noise with tax adjustments and benefits, as well as one-time adjustments for asset sales, write downs and litigation accruals. For the quarter, WFC said it realized EPS of $1.16, versus $0.96 a year ago and $0.83 in Q3 2017.

CEO Tim Sloan said, “In 2017 we continued executing on our plan to build a better bank for the future, and I'm proud of the hard work and dedication of our team members to put our customers first as we transform Wells Fargo. Over the past year we have invested billions of dollars into our business and capabilities including risk management, accelerated the pace of innovation, increased our commitment to communities, enhanced team member benefits, and continued to execute on our business strategies to provide long-term value to our shareholders. The progress we made over the past year was evident in the fourth quarter in higher deposits, loan growth particularly in commercial loans, increased debit and credit card transactions, and record client assets under management in Wealth and Investment Management. While we faced challenges in 2017, we are a much better company today than we were a year ago, and I am confident that this year Wells Fargo will be even better.”

CFO John Shrewsberry added, “Wells Fargo reported $6.2 billion of net income in the fourth quarter, which included a net benefit from the Tax Cuts & Jobs Act and a gain on the sale of Wells Fargo Insurance Services, partially offset by litigation accruals. Compared with the third quarter we grew both loans and deposits, and our credit performance, liquidity and capital remained exceptionally strong. We returned a record $14.5 billion to shareholders through common stock dividends and net share repurchases in 2017, up 16%, and returning more capital to shareholders remains a priority. We've made progress on our efficiency initiatives and remain committed to our target of $2 billion of expense reductions by the end of 2018, which are being used to support our investments in the business, and an additional $2 billion by the end of

2019. In addition, by the beginning of 2019 we expect the amortization of core deposit intangible expense ($769 million in 2018) and the FDIC special assessment to be complete."



WFC shares are trading at less than 13 times NTM earnings expectations, and offer a dividend yield of 2.5%. While there are still plenty of improvements needed, we think there is solid opportunity as management drives expenses lower and cleans up last year's reputational mess. Our Target Price for WFC has been raised to $69.

Shares of **Delta Air Lines** (DAL - $59.83) climbed nearly 7% last week, after the Atlanta-based air carrier reported Q4 2017 results that exceeded analyst expectations. DAL earned $0.96 per share on $10.2 billion of revenue, compared with analyst estimates of $0.88 and $10.1 billion, respectively. Delta also raised its full-year 2018 EPS forecast to a range of $6.35 to $6.70 per share (previously $5.35 to $5.70 per share) on the basis of U.S. tax law changes and "improved cost trajectory."

CEO Ed Bastian said, "While higher fuel prices help create greater stability for the industry over the long run, in the short term it does take time for our business to recalibrate and recover those costs through our revenues. But with a solid demand environment and economic backdrop, combined with the flexibility that we've built into our business, we feel well positioned to address this higher fuel environment. I'd like to detail our path to strengthen our company and grow earnings in 2018: First, we have to keep our top line growing. We're targeting a 4% to 6% revenue increase while maintaining prudent 2% to 3% system capacity growth. We're currently seeing the best revenue momentum we've had in five years, and the December quarter was the first time all entities were positive since early 2013. Second, we'll leverage our international opportunities by our own growth as well as through our partner relationships. Third, we must change the trajectory on unit cost and deliver on our 0% to 2% non-fuel CASM growth guide for the year. And finally, we are focused on making technology, an improving source of competitive advantage."

We like that DAL is keeping capacity growth in check (too much capacity is akin to a retailer having too much inventory) and is continuing to seek out high-value business travelers. Delta noted that the outlook for business travel in 2018 is the best in at least three years. We still see

DAL as attractively valued with a forward P/E ratio below 10 and a dividend yield that is just north of 2.0%. With the capacity growth outlook modest and orders on the books for hundreds of new planes, we think that DAL is in a solid position to push fare prices and ancillary fees higher, while benefitting from still-low fuel, maintenance and interest costs. Our Target Price for DAL has been elevated to $78.

Shares of **Kohl's** (KSS - $63.87) jumped more than 12% last week after the department-store retailer pre-announced strong holiday traffic, increased fiscal full-year guidance, shared additional upbeat news at an investor conference and received a few analyst upgrades. Kohl's revealed a 6.9% November/December same store sales increase for the holiday period, well above estimates and better than peers Macy's (+1.1%) and J.C. Penney's (+3.4%). KSS also raised its adjusted EPS guidance by 9% at the mid-point to $3.98 to $4.08 from $3.60 to $3.80.

Chairman and CEO Kevin Mansell, said, "We are very pleased with our Holiday period sales, which were consistently strong through November and December. All lines of business and all regions reported positive comp sales. As expected, growth in digital demand accelerated significantly in the Holiday period from the year-to-date trend. In addition, we experienced positive sales in our stores driven by stronger traffic. I'd like to thank every Kohl's associate across the organization for their commitment to delivering an outstanding Holiday experience for our customers."

At an investor conference later in the week, management reiterated that higher store and digital traffic were a priority and that they were willing to think outside the box like their ongoing trial with Amazon (package pickup and return). Speculation is that the company might consider renting excess square footage to grocers and convenience stores. Management also said that it continues to look for ways to control and cut costs, as well as increase productivity and that it was on pace for its $250 million annual savings. The company intends to improve productivity by lowering its square footage, cutting inventory by 10% in its standard and small stores, shrinking the footprint by selling or leasing excess space, and rolling out smaller stores (35K square feet). Additionally, the firm announced that its strategy continues to be guided by its four key pillars: specifically leveraging technology to upgrade the store experience, a focus on product (including speed to market), greater personalization via marketing and maximizing its loyalty programs.

Kohl's guided to 2017 gross margin improvement, implying a Q4 gross margin increase. We see this as positive as it says to us that the company didn't have to "buy" the sales increase via major discounting. Additionally, the update to guidance doesn't include any benefit to the January tax rate, and we note that KSS has reported an effective tax rate above 36% for the last four quarters.

Even though Kohl's has been on the move, up almost 50% since mid November, we still think there is upside to come with benefits from tax-cuts, improved traffic, investment in digital sales, cost cutting, inventory control and optimal space usage. KSS shares yield 3.4%, and we have lifted our Target Price to $67.

General merchandise discount store chain **Target** (TGT – $76.80) increased its fiscal 2019 guidance and raised Q4 2018 guidance in response to U.S. tax reform. Target, a high-tax-rate payer, expects to earn between $5.15 and $5.45 per share (prev. $4.40 to $4.60 per share) in fiscal 2019 and $1.30 to $1.40 per share in Q4 2018 (prev. $1.05 to $1.25 per share). Shares rose more than 15%.

"We are very pleased with our holiday season performance, which reflects the progress we've made against our strategy throughout the year," said CEO Brian Cornell. "We've positioned our stores at the center of a continually expanding suite of convenient fulfillment options and made significant investments in our team, which enabled our stores to fulfill 70 percent of all digital orders in the November/December period. As we look ahead to 2018, we will build on the foundation we established this year by launching additional exclusive brands, enhancing our digital capabilities, opening approximately 30 small-format stores and tripling the size of our remodel program to more than 325 stores. We will also remain focused on rapidly scaling up new fulfillment options including Same Day Delivery, which will be enabled by our acquisition of Shipt, and our recently launched Drive Up service."

We are encouraged by the benefits from the tax break and think that Target has turned a corner in its fight against **Wal-Mart Stores** (WMT - $100.87) and Amazon. Target is scheduled to report results for the final quarter of fiscal 2018 on March 8. TGT shares trade for 15.6 times forward earnings and offer a dividend yield of 3.2%, and our Target Price has been raised to $86.

Shares of hard disk drive maker **Seagate Technology PLC** (STX – $51.26) surged last week after an article on Seeking Alpha, a crowd-sourced financial content aggregator, suggested that the company may own shares of Ripple, a settlement system. While Ripple functions well enough as a payment processor, its real value comes from its 61% ownership of a native cryptocurrency called XRP (ripples). According to the Seeking Alpha post, Seagate Technology invested in Ripple via a Series A funding round in 2015 ($28 million) and in a Series B round ($55 million) a year later. The stake has not been confirmed by Seagate or Ripple, but it's possibly worth as much as $7.8 billion (with a b!). Following the news, Seagate's market capitalization climbed 'only' about $2 billion, indicating a healthy dose of skepticism surrounding the stake and uncertainty of its value.

More importantly, we would argue, and pushing shares even higher, STX reported better-than-expected preliminary fiscal Q2 2018 results. Seagate expects revenue of $2.9 billion with non-GAAP gross margin around 30%. STX ended Q2 with $2.6 billion in cash and equivalents. "Our revenue growth and strong portfolio profitability in the December quarter reflect solid demand for high-capacity mass-storage solutions, particularly for our cloud-based environments," said CEO Dave Mosley. "Availability of our cloud and edge portfolio remains constrained with broad-based customer demand globally and we are looking forward to planning discussions with a significant number of customers at CES (Consumer Electronics Show in Las Vegas) this week."

An ongoing concern of ours has been that STX was getting left behind in the SSD (NAND) drive race by rival Western Digital. Those worries largely have been allayed, as the company began its previously announced long-term NAND supply deal with Toshiba Memory. The deal will give STX a stable supply of NAND and allow the SSD line to grow, free of concerns that the proverbial supply chain "rug" could be yanked out from under them. While we aren't thinking that the Ripple stake is material (especially considering it's strictly a rumor at this time), we are certainly intrigued. With or without the stake, we like STX's strong cash flow and solid balance sheet. Equally important, we believe that STX's solid dividend yield of 4.9% and attractive valuation, including a price-to-forward earnings ratio of 11.5, are very good reasons to remain patient with the stock. Our Target Price has been hiked to $55.

Shares of **Shire PLC** (SHPG – $147.55) fell more than 5% last week following the company's lowering of guidance and organizational shakeup, announced at the annual JPMorgan Health

Care Conference in London. SHPG expects revenue by 2020 to reach $17 billion to $18 billion, down from a previous target of $20 billion.

On the topic of the reorganization, Shire CEO Flemming Orskov said, “By the end of 2017, we basically had two very distinct businesses that also internally are operated very differently. One business where the main target origins in about eight countries outside the U.S. plus the U.S. is a very distinct group of psychiatrists, some neurologists, a very small group of primary care physicians, out of hospital business largely dependent on the U.S. And then, you have a Rare Disease business which is a more equally split U.S.-international business, rapid growth outside the U.S. as well, more growing to hospital – more hospital-based. So, what do you do on those situations, and we basically had made us a decision, having looked at every opportunity we have internally and externally. We think that the next best step is to operationally separate these two businesses without having the cost go up on us.”

Mr. Orskov said of the overall business, “If you look at innovation, you look at the pipeline, you look at the impact, the medicines, the portfolio, the answer is always the same: we are the leader in rare diseases. We have 23,000 employees in 75 countries. We grow fast around the globe and we have also fast growth in some of the countries that are going to be the leaders in future in pharmaceuticals like China and Japan. We have seven franchises now, five of which have over $1 billion in revenue, all growing rapidly. And we have two emerging franchises also growing very rapidly. When I say biotech, it is biotech. More than 65% of our sales today are derived from biologics. But we thrive through innovation. We have 40 programs in clinical development, 15 programs in Phase 3. I challenge you to find many large or small companies with such a pipeline. But we never ignore the fact that this growth only comes through relentless focus on meeting the unmet needs of our patients.”

He continued, “One way of meeting that is increased focus on personalization. We know that a lot is happening at the interface of health and technology, and we're also here at the forefront. We just got myPKFiT approved in the U.S. as a personalized system, IT system, to basically minimize the bleeding in patient. We see that as the future, we see that as the future in devices and we see that in the future in many other areas patients are looking for personalized self-controlled solutions.”

Mr. Orskov concluded, “2018 affords us a phenomenal opportunity to take our expertise, our focus on execution and innovation, to two independent divisions. We will start reporting on them separately in the first quarter of 2018. And then, in the second half, we'll give you further update once we've divisionalized what some other future opportunities are, potentially including separate listing. We will continue our rapid debt pay-down and target of going to below 2.5 times by the end of 2018. We expect 2018to be a growth year despite some challenges, despite we have to get the very positive news of Covington coming onboard and some extra depreciation, increased competition, but we also have things going our way with some positive tailwinds.”

We believe the decline in the stock price didn’t fit the crime, as recent quarterly results have been solid, including attractive growth from its Immunology business. We think that splitting the businesses makes sense and note that Shire remains ahead of schedule to deliver at least $700 million in cost synergies from its Baxalta integration by Year 3, while generating solid cash flow and reducing debt. Shares trade for just 9.4 times NTM earnings. SHPG remains one of our favorites, as we mentioned in our *18 Stocks for 2018* report, with a revised Target Price of $250.

Biopharmaceutical giant **Gilead Sciences** (GILD – $79.02) also attended the JPMorgan Health Care Conference in London last week, with management offering enthusiasm for HIV therapies and seeing stabilization in hepatitis C therapy pricing.

CEO John Milligan said, “Today, if you look at Gilead, I think it has exhibited exceptional scientific leadership particularly in HIV, liver disease and our newest area, cellular therapy. Through the years, we've been able to reach millions of patients, literally millions of patients through our Access Programs in HIV where we have over 10 million people who now have access to our therapies, to ourselves and to our partners. We've treated over 1.6 million people with chronic HCV curing the vast majority of them. And we have a presence in 38 countries directly, but cover the globe through our partnerships so that we can have these medicines that are so important broadly available. And we're positioned for growth. We have a very strong balance sheet.”

Mr. Milligan continued, “We achieved that through extreme operational excellence. We had over 13 U.S. NDA approvals and we launched four of the top 10 pharmaceutical products based on first year sales, including our most recent HIV launch of Genvoya, which achieved over $1.3 billion in its first full 12 months on the market. We have industry-leading operating margins which are greater than 50%, and that has of course resulted in very strong cash flows over the years. During that time, we returned 57% of free cash flow to our shareholders. We initiated a dividend program and then increased that dividend annually for two years, and we've reduced our share count by approximately 14%.”

For the upcoming five years, Mr. Milligan said that he expects continued innovation in HIV and to benefit from a “complete portfolio” of hepatitis C products. He said of liver disease therapies, “Over 1.6 million people have been treated for HCV, again with a vast majority of those cured, including if we look at some of the real-world rates of Harvoni where we have the most extensive data set, we have real-world cure rates in different data sets between 94% and 98%. Epclusa interestingly is becoming a more important drug for lots of patients and doctors because it works across all different genotypes. It's 12 weeks of therapy regardless of the stage of liver disease and has become very popular, and we're now generating data long term with Epclusa in real-world use as well. In clinical studies, of course, it behaved very, very well with all rates in the high 90 percentage.”

He continued, “We are seeing a market that, as we emerge into 2018, is going to be lower than it has been in the past for a number of reasons, one of which is pricing has come down over the course of the years with the entrants of different competitors to market. But as we enter 2018, we can say that the pricing has become stable. So, for 2018 and beyond, we think the market prices will be stable. We think that the market share will be split between two companies and we'll see how we battle out between ourselves and our competitor AbbVie. And a more predictable, but slightly declining patient flow into the future.”

Mr. Milligan concluded, “We are clearly positioned as a leader across all our core therapeutic areas with very important molecules and very important data sets coming out, which will help position us for further growth in the future. We have incredible financial strength to continue to build our pipeline, not only internally but through additional M&A and external partnership. We have been very active in bringing new technology, new molecules and new capabilities to Gilead. We have this incredible science driven culture that allows us I think to make very good choices and to drive innovation to an incredible extent, you've seen that through our HIV innovation and our HCV innovation and now our cellular therapy innovation. And we have this

continued focus on operational excellence. So we will continue to focus hard to bring new products to market, to bring value to shareholders, and to return capital to shareholders in a very focused way."

We are pleased that hepatitis pricing is stabilizing, as it accounts for more than a third of GILD's total revenue, and are encouraged by the company's breakthroughs in HIV therapy, while the recent Kite Pharma acquisition looks promising. Gilead reports Q4 earnings results on February 6. GILD shares trade for less than 12 times fiscal 2018 earnings estimates and yield 2.6%. We continue to be fans of GILD and have moved our Target Price up to $124.

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