MARKET COMMENTARY MONDAY, JANUARY 22, 2018

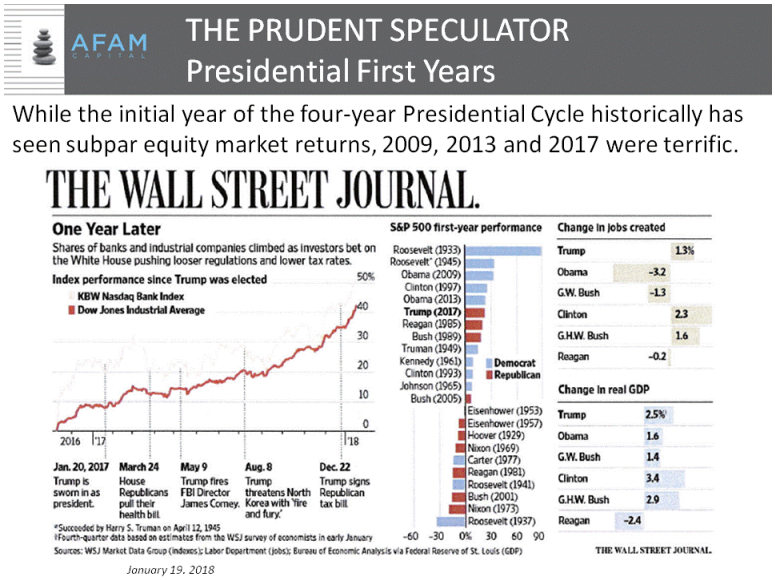
EXECUTIVE SUMMARY

Week #3 2018 – Decent Gains
Trump's First Year – Terrific Advance
Sentiment – Talk is Bullish, But Bonds Still Getting Lots of Love
Fixed Income Perspective – Treasuries Can Drop in Price
Government Shutdown – Historical Equity Market Returns
Q4 Earnings – 77.4% Beating the Street
EPS Estimates – 2018 and 2019 Expectations on the Rise
Company News – Updates on KSS, IBM, QCOM, BBT, GS, SYF, GT, BK & MRK

Market Review

While volatility picked up a bit, it was another nice week for U.S. stocks with the major market averages closing at all-time highs on Friday. For the four-day trading week, the Russell 3000 tacked on 0.82% and the S&P 500 gained 0.88%, with Growth again leading the performance race. The Russell 3000 Growth index rose 1.11%, compared to a 0.52% advance for the Russell 3000 Value index, but given supposed investor concerns about a looming government shutdown, not to mention the big rally already turned in over the first two weeks of the year, we have to be satisfied with what has transpired thus far in 2018.

This is especially true, given that 2017 was a terrific year, defying many a market pundit who thought that the surprising results of the 2016 Presidential Election would lead to a big market downturn. Obviously, we know that anything can happen going forward and we are always braced for the inevitable selloffs, but the first year of the Trump Presidency provided another illustration that the secret to success in stocks is not to get scared out of them.



And speaking of fear, there do not appear to be many frightened folks as investor optimism has been running high, with the latest Bull/Bear Sentiment Survey showing a 54.1% tally of those

who were Bullish on stocks for the next six months, versus only 21.4% who were Bearish. The averages dating back to 1987 are 38.3% Bulls and 30.3% Bears, so AAII is something to keep an eye on, even as history shows it a far better contrarian indicator when pessimism is rampant.

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THE PRUDENT SPECULATOR
AAII – Another Reason to Favor Value

Equities have enjoyed gains just about every way the historical market data is sliced and diced, but the latest extreme +32.7 AAII Bull-Bear Sentiment reading is one of the rare conditions that has led to negative returns, on average, one, three and six months out…for Growth Stocks. The dreaded decile 10 has still been solidly positive for Value, with a very wide six-month gap vs. Growth.

AAII Bull-Bear Spread & Russell 3000 Value Returns

Decile	Low Reading of the Range	High Reading of the Range	Count	R3KV Next 1-Month Arithmetic Average TR	R3KV Next 1-Month Geometric Average TR	R3KV Next 3-Month Arithmetic Average TR	R3KV Next 3-Month Geometric Average TR	R3KV Next 6-Month Arithmetic Average TR	R3KV Next 6-Month Geometric Average TR
Below & Above Median Bull Bear Spread = 8.5									
BELOW MEDIAN	-54.0	8.5	808	0.9%	0.8%	2.7%	2.3%	5.8%	5.0%
ABOVE MEDIAN	8.5	62.9	779	0.8%	0.7%	2.6%	2.4%	5.3%	4.9%
Ten Equal Groupings of 1517 Data Points									
1	-54.0	-14.3	159	0.6%	0.4%	3.1%	2.5%	6.8%	5.4%
2	-14.3	-7.0	163	1.2%	1.1%	3.7%	3.4%	7.0%	6.4%
3	-6.8	-1.0	157	1.5%	1.4%	2.9%	2.5%	6.2%	5.4%
4	-0.7	3.4	156	0.9%	0.8%	2.2%	1.9%	5.1%	4.7%
5	3.4	8.0	162	0.4%	0.3%	1.9%	1.6%	4.0%	3.4%
6	8.1	12.8	155	0.5%	0.4%	1.5%	1.3%	4.2%	3.6%
7	12.8	17.0	163	1.1%	1.1%	3.1%	2.9%	6.0%	5.6%
8	17.0	22.7	154	0.9%	0.8%	2.3%	2.1%	5.6%	5.1%
9	22.9	30.8	159	0.7%	0.6%	2.9%	2.7%	5.6%	5.1%
10	30.8	61.7	158	0.7%	0.7%	2.6%	2.4%	4.8%	4.5%

From 07.30.87 through 01.05.18. Unannualized. SOURCE: Al Frank using data from American Association of Individual Investors and Bloomberg

AAII Bull-Bear Spread & Russell 3000 Growth Returns

Decile	Low Reading of the Range	High Reading of the Range	Count	R3KG Next 1-Month Arithmetic Average TR	R3KG Next 1-Month Geometric Average TR	R3KG Next 3-Month Arithmetic Average TR	R3KG Next 3-Month Geometric Average TR	R3KG Next 6-Month Arithmetic Average TR	R3KG Next 6-Month Geometric Average TR
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9	22.9	30.8	159	0.2%	0.1%	1.5%	1.1%	3.6%	2.7%
10	30.8	61.7	158	-0.2%	-0.3%	-0.1%	-0.5%	-0.3%	-1.3%

From 07.30.87 through 01.05.18. Unannualized. SOURCE: Al Frank using data from American Association of Individual Investors and Bloomberg

Of course, while investors proclaim that they are optimistic, they have not really been putting their money where the mouths are as data from Bank of America Merrill Lynch show that their clients have been net sellers of stocks for quite a while,…

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THE PRUDENT SPECULATOR
Net Selling of U.S. Equities

Table 1: BofAML clients' cumulative net buying (selling) of US equities by year ($mn)

Sector	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008
Consumer Discretionary	(815)	(14,600)	(6,584)	(3,137)	(4,427)	(6,271)	(3,520)	2,180	(1,470)	(660)	(5,297)
Consumer Staples	65	(4,976)	(1,997)	1,072	(5,228)	(3,895)	(6,731)	(4,426)	(3,412)	(3,260)	(7,334)
ETFs	2,250	57,133	23,551	28,158	34,363	12,139	18,684	6,597	8,432	5,702	7,935
Energy	(66)	(5,712)	(5,054)	(1,230)	(4,074)	(3,288)	(5,323)	(933)	(4,290)	(1,970)	(8,694)
Financials	(534)	155	(4,726)	(858)	(5,408)	(4,983)	(2,248)	(1,730)	(4,734)	4,784	(2,257)
Health Care	120	(12,796)	(12,525)	(5,490)	(5,517)	(4,101)	(829)	2,243	(3,991)	(1,888)	(6,115)
Industrials	(248)	(10,502)	(10,507)	(3,036)	786	(2,110)	(1,699)	(653)	(1,576)	(91)	(6,736)
Information Technology	383	(6,603)	(8,518)	1,193	(3,128)	(2,703)	(1,217)	2,730	1,475	(4,355)	(6,177)
Materials	231	(2,678)	(2,418)	(3,479)	(1,229)	(3,664)	(3,045)	(1,783)	(1,270)	(413)	(1,068)
Real Estate	(329)	(4,155)	(366)								
Telecommunication Services	(80)	(806)	1,028	596	3,223	1,743	(204)	690	(517)	365	(273)
Utilities	(386)	(2,968)	(942)	156	(636)	425	(808)	732	(893)	(461)	(1,622)
Client											
Hedge Funds	998	(2,164)	(2,957)	(2,434)	(4,683)	(3,417)	(2,085)	(5,695)	(4,456)	6,418	(1,223)
ex. ETFs	(470)	(3,852)	(4,894)	(5,944)	(8,933)	(822)	(2,723)	(3,590)	(3,607)	7,568	(1,556)
Inatitutional	(1,087)	(52,717)	(49,137)	(26,153)	(18,235)	(32,792)	2,668	1,493	(13,755)	6,088	(15,150)
ex. ETFs	(566)	(60,771)	(52,225)	(19,309)	(25,640)	(29,542)	(4,693)	1,725	(15,002)	7,823	(16,713)
Pension Funds	(17)	(149)	106	58	347	(1,271)	(115)	(354)	566	1,261	388
ex. ETFs	(12)	341	695	223	(161)	(763)	(476)	212	219	169	337
Retail	(429)	7,787	(13,983)	1,764	(13,205)	(18,800)	(39,973)	(23,049)	(25,999)	(23,361)	(21,266)
ex. ETFs	(1,732)	(39,604)	(34,366)	(29,728)	(35,914)	(34,997)	(50,657)	(31,983)	(34,033)	(31,949)	(27,305)
Corporates	1,108	38,587	37,019	40,767	44,850	39,401	32,449	32,897	31,964	8,609	N/A
Size											
Large cap	116	(4,151)	(20,314)	665	4,815	(16,887)	(10,081)	4,480	(9,505)	(3,755)	(33,155)
ex. ETFs	(1,501)	(45,223)	(35,414)	(9,903)	(13,568)	(15,814)	(17,812)	5,284	(10,483)	(3,820)	(34,028)
Mid cap	284	(2,004)	(6,543)	9,329	3,991	2,151	3,050	237	(2,845)	301	(3,074)
ex. ETFs	62	(12,476)	(11,340)	(1,441)	(6,010)	(4,742)	(3,851)	(3,819)	(6,363)	(1,159)	(7,356)
Small cap	189	(2,351)	(2,202)	3,950	(80)	(872)	90	928	103	1,207	(1,410)
ex. ETFs	(221)	(7,941)	(5,856)	(2,870)	(6,060)	(5,402)	(3,961)	(2,416)	(3,830)	(2,970)	(4,187)
Total	944	2,916	(33,274)	11,613	5,380	(21,136)	(7,919)	4,492	(11,659)	(2,758)	(50,817)
Single stocks only	(1,660)	(65,640)	(52,610)	(14,214)	(25,638)	(28,848)	(25,625)	(951)	(20,677)	(7,949)	(45,573)

Source: : Bank of America Merrill Lynch Note: Data on Real Estate since 8/31/16. Financials Includes Real Estate prior to 8/31/16.

As of January 17, 2018

…validating the numbers on mutual and exchange traded funds compiled by Investment Company Institute and Morningstar that show net outflows out of domestic equities and massive net inflows into bond funds.

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THE PRUDENT SPECULATOR
Long Love Affair with ~~U.S. Stocks~~ Bonds

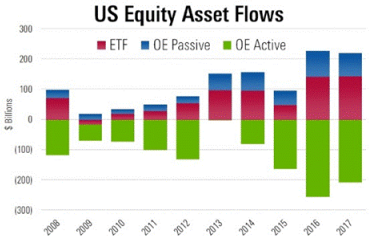
Investment Company Institute

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

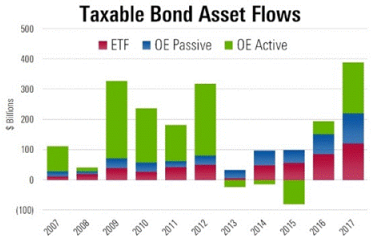
Millions, U.S. dollars

Period	Total LT MF and ETF	Equity			Hybrid	Bond			Commodity
		Total	Domestic	World		Total	Taxable	Municipal	
2015+2016+2017	736,895	207,386	-232,245	439,634	-97,258	611,742	532,119	79,621	15,020
2016+2017	621,912	105,922	-129,096	235,020	-78,936	582,021	521,142	60,877	12,903
2017	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.



Source: Morningstar



Source: Morningstar

Certainly, we do not expect a stampede out of bonds, but we would argue that a further equity rally could be fueled by more than a few dollars seeking greener pastures as we seriously doubt that those who have fled over the years to the perceived safety of fixed income will be happy with losses, even if they are minor, on their investments.

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THE PRUDENT SPECULATOR
Red Ink in Bond Land

We respect that those able to hold government bonds to maturity face no loss of principal (though inflation impacts purchasing power), but the current 10-Year U.S. Treasury Note has shown a negative total return of 2.05% so far in 2018, with the yield jumping from 2.41% to 2.66%.

To be sure, we do not think interest rates will soar, but we would argue that there is quite a bit of room for rate increases (and bond price declines) before equities would lose their current attractiveness relative to fixed income.

THE PRUDENT SPECULATOR
Fed Model: Favorable Earnings Yield

The so-called Fed Model suggests that the yield on 10-Year Treasuries should be similar to the S&P 500 Earnings Yield, which is the inverse of the P/E ratio. If the 10-Year is greater than the S&P Earnings Yield, a market is overvalued and if the reverse is true, as it is today, a market is undervalued. Though some argue that the Fed Model is no longer an effective tool, we like today's relatively generous earnings yield of 4.3%.

We shall see if the actual Washington shutdown that began on Saturday morning finally leads to a round of profit-taking (the equity futures were showing modest losses on Sunday night), but history suggests that long-term-oriented investors shouldn't lose any sleep over the event,…

THE PRUDENT SPECULATOR
Washington Closed for Business

After a Senate spending bill failed to advance late on January 19, 2018, the federal government shut down due mainly to disagreements over immigration policy. Incredibly, a Washington closure has occurred 18 times since 1976, but equities have taken these events in stride.

U.S. Government Shutdown Dates		S&P Start Value	S&P End Value	Event Gain/Loss	12 Months Later	36 Months Later	60 Months Later	Event End thru Present
9/30/1976	10/11/1976	105.24	101.64	-3%	-7%	3%	19%	2687%
9/30/1977	10/13/1977	96.53	93.46	-3%	12%	41%	46%	2942%
10/31/1977	11/9/1977	92.34	92.98	1%	2%	39%	54%	2830%
11/30/1977	12/9/1977	94.83	93.65	-1%	3%	39%	49%	2904%
9/30/1978	10/18/1978	102.54	100.49	-2%	3%	19%	67%	2783%
9/30/1979	10/12/1979	109.32	104.49	-4%	25%	29%	57%	2612%
11/20/1981	11/23/1981	121.71	121.60	0%	9%	37%	102%	2147%
9/30/1982	10/2/1982	120.42	121.97	1%	36%	51%	169%	2044%
12/17/1982	12/21/1982	137.49	138.61	1%	18%	52%	80%	1877%
11/10/1983	11/14/1983	164.41	166.58	1%	0%	47%	61%	1602%
9/30/1984	10/3/1984	166.10	162.44	-2%	13%	102%	118%	1638%
10/3/1984	10/5/1984	162.44	162.68	0%	13%	102%	119%	1626%
10/16/1986	10/18/1986	239.53	238.84	0%	18%	43%	64%	1080%
12/18/1987	12/20/1987	249.16	249.16	0%	11%	32%	77%	1015%
10/5/1990	10/9/1990	311.50	305.10	-2%	24%	51%	90%	827%
11/13/1995	11/19/1995	592.30	600.07	1%	24%	92%	128%	368%
12/15/1995	1/6/1996	616.34	616.71	0%	21%	106%	111%	367%
9/30/2013	10/17/2013	1,681.55	1,733.15	3%	9%	23%	62%	61%
Price Changes Only - Does Not Include Dividends			**Averages:**	**-1%**	**13%**	**50%**	**82%**	**1745%**

Source: Al Frank using data from Bloomberg and https://www.washingtonpost.com/news/wonk/wp/2013/09/25/here-is-every-previous-government-shutdown-why-they-happened-and-how-they-ended/?utm_term=.a0877913da76

…especially given the health of corporate profits. Fourth quarter earnings season is still very young, but thus far the results have been very favorable, with Bloomberg calculating that 77.4% of the 53 S&P 500 companies that have announced results have topped expectations, compared to 11.3% that have trailed projections and 11.3% that have matched estimates. Those numbers compare very favorably to the 65.7%/22.9%/11.4% Beat/Miss/Match figures for the full S&P 500 in the Q4 2016 earnings season. Keeping in mind that a sustained market downturn has often been accompanied by an earnings recession, we are pleased to see EPS estimates for 2018 and 2019 moving higher.

History shows that stock prices generally have followed earnings, so it is nice to see actual and projected EPS moving up, even as earnings forecasts often turn out to be too optimistic. Happily, the number of companies exceeding expectations in 2017 has been better than the average earnings-beat rate over the last 5 years.

S&P 500 Earnings Per Share

Quanter Ended	Bottom Up Operating EPS 3 Month	Bottom Up Operating EPS 12 Month
ESTIMATES		
12/31/2019	$44.18	$166.37
9/30/2019	$42.55	$161.91
6/30/2019	$40.97	$157.92
3/31/2019	$38.67	$154.12
12/31/2018	$39.72	$150.57
9/30/2018	$38.56	$144.95
6/30/2018	$37.17	$137.72
3/31/2018	$35.12	$131.06
12/31/2017	$34.10	$124.76
ACTUAL		
9/30/2017	$31.33	$118.56
6/30/2017	$30.51	$115.92
3/31/2017	$28.82	$111.11
12/31/2016	$27.90	$106.26
9/30/2016	$28.69	$101.42
6/30/2016	$25.70	$98.17
3/31/2016	$23.97	$98.61
12/31/2015	$23.06	$100.45
9/30/2015	$25.44	$104.14
6/30/2015	$26.14	$108.30
3/31/2015	$25.81	$111.50
12/31/2014	$26.75	$113.01

Source: Standard & Poor's. As of 1.18.18

S&P 500 Quarterly Earnings Comparisons

	BEAT	MISSED	MET		BEAT	MISSED	MET
Q3 2017	72.4%	19.3%	8.2%	Q4 2014	68.6%	21.0%	10.4%
Q2 2017	70.2%	20.1%	9.7%	Q3 2014	73.7%	17.2%	9.0%
Q1 2017	74.0%	18.9%	7.2%	Q2 2014	65.7%	21.2%	13.0%
Q4 2016	67.3%	22.0%	10.8%	Q1 2014	67.1%	22.6%	10.2%
Q3 2016	70.5%	21.1%	8.4%	Q4 2013	63.9%	25.3%	10.8%
Q2 2016	70.2%	20.9%	8.9%	Q3 2013	66.1%	23.2%	10.6%
Q1 2016	72.3%	20.6%	7.0%	Q2 2013	65.4%	26.8%	7.8%
Q4 2015	68.8%	21.6%	9.7%	Q1 2013	65.9%	25.9%	8.2%
Q3 2015	67.9%	23.0%	9.0%	Q4 2012	64.8%	24.8%	10.4%
Q2 2015	69.8%	22.0%	8.3%	Q3 2012	63.3%	23.7%	13.0%
Q1 2015	67.7%	22.9%	9.4%	AVERAGE	68.4%	22.1%	9.5%

Source: Standard & Poor's and Bloomberg

Stock Updates

We continue to hold tight to all of our stocks, including department-store retailer **Kohl's** (KSS – $67.54), where increasing earnings estimates have compelled us to boost our Target Price to $71. Jason Clark and Chris Quigley provide updates on five of our names that were out with results last week, as well as another three of our current recommendations that made headlines.

After a strong start to 2018 for the stock, investors were not impressed with the Q4 results for **Int'l Business Machines** (IBM – $162.37), sending shares south by 4%. Despite beating estimates on the top- and bottom-lines and increasing revenue year-over-year for the first time in 23 quarters, Big Blue shares were punished for what many viewed as a sub-par gross margin of 49.5% (vs. 50.8% est.). IBM earned $5.18 per share ($5.17 est.) on revenue of $22.5 billion ($22.1 billion est.). IBM also said it took a one-time charge of $5.5 billion related to U.S. tax reform.

Outgoing CFO Martin Schroeter said, "Back in July, we planted the flag for our businesses, and we pointed to an improved trajectory in the second half. Now, as we look back on the year, we did, in fact, significantly improve the trajectory in our revenue and our gross margin performance. We did this by ramping up our cloud and as-a-service offerings by continuing to reinvent our Systems brands, by driving a higher level of software transactional revenue and by improving consulting performance. This was our first full quarter with the z14, and with pervasive encryption and the ability to address new technologies like blockchain, we're adding new clients and new workloads to the platform. We also invested nearly $1 billion in capital expenditures and generated $6.8 billion of free cash flow. With that free cash flow performance, we've returned almost $10 billion to shareholders, including dividends of $5.5billion and $4.3 billion in gross share repurchases. We bought back over 27 million shares, reducing our

average share count by just over 2%. At the end of the year, we had $3.8 billion remaining in our buyback authorization."

Incoming CFO Jim Kavanaugh offered the 2018 outlook, "We have a strong start to our new z14 and are introducing POWER9systems and have the most competitive storage offerings in some time. And across our businesses, our strategic imperatives revenue was up at a double-digit rate to $36.5 billion for the year, which is now 46% of our revenue. So when you take all of this together, we're entering 2018 with a stronger revenue profile than a year ago. Our 2018 rate will reflect the implementation of tax reform, which includes a lower U.S. corporate tax rate, offset by the broader tax base, and reduce foreign tax credit utilization. This translates to an ongoing operating rate for 2018 of 16%, plus or minus 2 points, which is a 4 point headwind year-to-year. Putting it all together, we expect to deliver operating earnings per share of at least $13.80. I want to briefly comment on two other items with respect to our earnings per share expectations."

Mr. Kavanaugh will replace Mr. Schroeter, with the transition underway. Mr. Kavanaugh has worked at IBM for more than two decades, serving as Controller between 2008 and 2015, followed by two years as SVP of Transformation and Operations and most recently as SVP of Finance and Operations. Mr. Schroeter continues on at IBM, replacing Bruno Di Leo as the VP of Global Markets.

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THE PRUDENT SPECULATOR
IBM – Growing Strategic Imperatives

A Cognitive Solutions & Cloud Platform Company

4

- Strategic Imperatives revenue up 11% in 2017, led by cloud (+24%) and security (+54%)
- Cloud revenue of $17B in 2017 – public, private, hybrid
- Embedding cloud and AI capabilities to build new platforms and solutions, while reinventing existing ones
- Extending innovation leadership in key areas, including AI, cloud, security, blockchain, quantum

FY17

$37B *Strategic Imperatives Revenue*

46% *of IBM Revenue*

Strategic Imperatives Revenue	4Q17	Yr/Yr
Total	**$11.1**	**14%**
Analytics	$6.1	6%
Cloud	$5.5	27%
aaS annual run rate	*$10.3*	*18%*
Mobile	$1.3	21%
Security	$1.5	127%
Social	$0.2	(14%)

Revenue growth rates @CC, $ in billions
Overlap in Strategic Imperatives revenue primarily reflects solutions delivered via cloud

IBM

Despite the sell-off, IBM shares are still up 5.8% year-to-date, and we think that momentum can continue if the company is able to continue executing on its Strategic Imperatives, including its fast-growing Cloud business. Also, Watson continues to expand its deployments, with Health Care, Internet of Things and Financial Services being among the most popular applications. And there is excitement surrounding IBM's foray into blockchain (https://www.ibm.com/blockchain/), a technology that has garnered plenty of media attention in relation to the explosion of cryptocurrencies.

We understand that investor focus likely will remain on overall top-line growth, but we think that Strategic Imperatives provides a long-term catalyst to a very inexpensive stock. IBM trades for a very low 11.7 times forward earnings per share, while the dividend yield is now 3.7%. Our Target Price remains $197.

The drama at **Qualcomm** (QCOM – $68.04) trudges on, as the chip designer continues on its year-long battle with regulators to merge with NXP Semiconductors NV (NXPI), while facing takeover pressure from Broadcom. In its battle for independence, QCOM turned to its stockholders on Tuesday, issuing a multi-page plea to investors to vote to keep its current board of directors (who have rebuffed Broadcom approaches on multiple occasions). The letter (https://www.qualcomm.com/news/releases/2018/01/16/qualcomm-sends-letter-stockholders-and-files-investor-presentation) noted, including the capitalization, "QUALCOMM HAS SIGNIFICANT BUSINESS MOMENTUM AND THE RIGHT STRATEGY TO CREATE BOTH NEAR-TERM AND LONG-TERM STOCKHOLDER VALUE – FAR GREATER VALUE THAN BROADCOM'S DRAMATICALLY UNDERVALUED PROPOSAL."

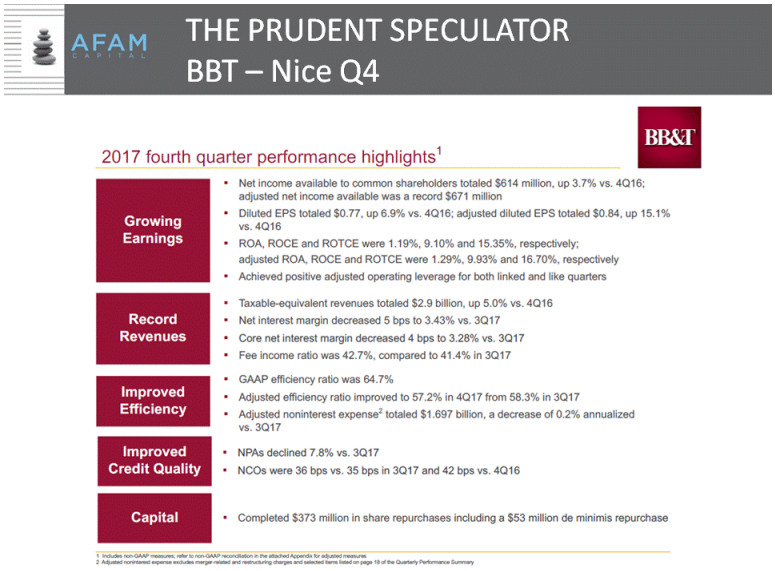
Qualcomm's Board said that it rejected Broadcom's advances due to the undervalued offer, regulatory uncertainty, no "transformative opportunity" in 5G, long deal completion time and an offer that's designed to benefit only Broadcom stakeholders. Equally important, QCOM also included fiscal 2019 guidance in the open letter, saying that it expects adjusted EPS of $6.75 to $7.50 per share (the adjustment includes NXPI benefits) or unadjusted (standalone) EPS of $4.47 to $5.22 per share. Those numbers were better than what analysts had been projecting.

Happily, Qualcomm CEO Steve Mollenkopf had an update on the QCOM/NXPI tie-up for investors on Thursday, "We are pleased that both the European Commission and the Korean Fair Trade Commission have granted authorization of the NXP acquisition, and we are optimistic that China will expeditiously grant its clearance. Acquiring NXP is complementary to Qualcomm's global portfolio, providing tremendous scale in automotive, IoT, security and networking and will greatly accelerate our ability to execute and create value in new and adjacent opportunities."

While the public battle makes for nice fodder for CNBC, we think that Qualcomm inching closer to closing the NXPI deal is the important news. Though it's abating, we have some concern that the longer the NXP regulators take, the higher the chance that NXP shareholders push back and demand a bigger price tag for their shares. Of course, were Broadcom to raise its bid and address some of the regulatory issues associated therewith, we might be more receptive to Qualcomm holding actual takeover talks instead of fighting the battle via press release. Our Target Price for QCOM has been increased to $76.

Shares of financial services company **BB&T Corp** (BBT – $54.80) rose by more than 3% last week on the heels of a positive Q4 financial results release. Core 4Q EPS came in at $0.84, versus consensus Street estimates of $0.79. Overall, we thought management's 2018 guidance was supportive of higher forward EPS estimates driven by expectations for further efficiency improvements and greater clarity on the expense outlook and a potential inflection point in loan growth. Additionally, we like management's stated focus on deploying excess capital, via organic growth initiatives and dividend increases.

"We had a very strong fourth quarter with record revenues and good expense control," explained CEO Kelly S. King. "Taxable-equivalent revenues were $2.9 billion, up 7.4% annualized compared to last quarter. We expect to have strong revenue growth in 2018…Total expenses for the quarter were $1.9 billion and our GAAP efficiency was 64.7%, primarily due to expenses incurred in connection with the passage of tax reform. Our adjusted efficiency ratio of 57.2% reflects significant progress in our optimization efforts."



Mr. King continued, "While average total loans were essentially flat compared with last quarter, core loans increased an annualized 3.9%, which excludes prime auto, residential mortgage and PCI loans that decreased as planned. Our credit quality is very strong, as nonperforming assets improved and loans 90 days or more past due and net charge-offs were relatively stable at very low levels."

We like that BBT continues to experience a strong adoption rate of its customizable digital banking platform. We are also fans of the company's relatively conservative loan underwriting and its efforts to diversify its revenue stream. While shares are off to a terrific start (up more than 10%) in 2018, we see additional upside potential on the back of a solid economy, rising interest rates, cost controls and benefits from tax reform. BBT yields 2.4% and trades at 14 times 2018 consensus earnings estimates. Our Target Price has been lifted to $62.

Despite a big sell-off following the announcement of Q4 results, shares of **Goldman Sachs** (GS – $256.12) bounced back and closed the week slightly higher than they started. While the Wall Street titan continued to deal with brisk headwinds in its Fixed Income, Currency and Commodity trading business, GS turned in a bottom-line beat (excluding tax legislation) that was more than 15% higher than investors were expecting. Goldman said those adjusted EPS came in at $5.68, versus a $4.90 analyst projection.

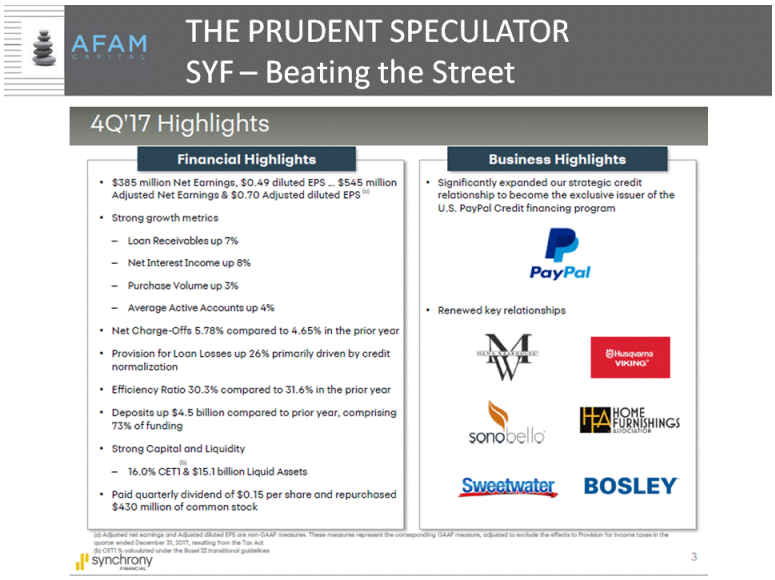
The firm also said it ranked first in worldwide announced and completed mergers and acquisitions for 2017, with its investment banking division producing its second highest annual net revenue number ever ($7.37 billion). Also during 2017, Investment Management generated

record net revenue of $6.22 billion, including record management and other fees. Assets under supervision increased 8% from 2016 to a record $1.49 trillion, with net inflows in long-term assets under supervision of $42 billion. Goldman also advanced its online consumer lending and deposit platform, Marcus: by Goldman Sachs, originating over $2 billion of loans and growing online deposits by over $5 billion.

“Last year, we delivered higher revenue and stronger pre-tax margins despite a challenging environment for our market-making businesses,” said GS CEO Lloyd C. Blankfein. “With the global economy poised to accelerate, new U.S. tax legislation providing tailwinds and a leading franchise across our businesses, we are well positioned to serve our clients and make significant progress on the growth plan we outlined in September.”

Looking to 2018, we view the revenue outlook as mostly favorable given rising GDP growth, a higher Investment Banking pipeline, internal growth initiatives, tax reform benefits and relatively easy trading comparable numbers. While expenses were larger than expected in Q4, we believe Goldman is locked in on keeping them under control, as well as managing its capital. Management guided to a 2018 tax rate of approximately 24%. We continue to be long-term fans of GS and are constructive on the name given the prospects for stronger revenue growth, operating leverage, potential de-regulatory policies and a potentially higher earnings multiple than the current forward P/E of less than 12. Our Target Price for GS has been boosted to $286.

Shares of **Synchrony Financial** (SYF – $38.47) briefly fell in pre-market and early-trading on Friday after the consumer financial company released its Q4 financial results, but they turned positive not long after, finishing the day up more than 3%. For Q4, SYF said it generated adjusted EPS of $0.70, versus consensus analyst estimates of $0.64. Loan receivables expanded by $6 billion, or 7%, while deposits grew over $4 billion, or 9%, compared to the same period a year ago.



SYF CEO Margaret Keane explained, “Substantial progress was made on our strategic priorities not only in the fourth quarter, but throughout 2017. Our business continues to deliver organic

growth, leveraging innovative marketing, promotions, and value propositions. We are making investments in our robust data, analytics and digital capabilities, further enhancing the experience of our partners and cardholders. And we are supporting our business with continued growth in our direct deposit platform. We accomplished all of this while maintaining a strong balance sheet and returning capital to shareholders through growth and the execution of our capital plan. Synchrony Financial continues to be well positioned for long-term growth and we look forward to driving further value for our partners, cardholders, and shareholders in 2018."

While Synchrony reported a beat on the top and bottom-lines, investors early in the day sold the stock on concerns that the company expects a net charge-off rate of 5.5% to 5.8% in 2018, due to normalization and timing of recent portfolio acquisitions. The turnabout then came during and after management's call, where they shared generally positive commentary, particularly around credit normalization. All in all, we think that management smartly inserted constructive conservatism into the 2018 outlook, leaving room to surprise on the upside, especially given the firm's acquisition of PayPal's U.S. consumer credit receivables portfolio and being named the exclusive issuer of PayPal Credit online consumer financing program.

The company's balance sheet remained strong with total liquidity (liquid assets and undrawn credit facilities) of $21 billion, or 22% of total assets. The estimated Common Equity Tier 1 ratio under Basel III subject to transition provisions was 16.0% and the estimated fully phased-in Common Equity Tier 1 ratio under Basel III was 15.8%. In addition, SYF shares trade at 11.4 times NTM estimates and yield 1.6%. With continued progress and operational momentum, our belief that credit concerns are manageable, solid deposit growth, new partnerships and gradually increasing interest rates, we smell a long-term recipe for success. Thus, we have adjusted our Target Price upward to $51.

Shares of **Goodyear Tire & Rubber** (GT – $34.99) were inflated by 3% last week after the company raised its outlook on account of U.S. tax changes. At the Deutsche Bank Global Auto Industry Conference in Detroit, CEO Rich Kramer said, "We clearly see the mobility landscape changing and we see that certainly through both technology and through consumers. But as we look at the market, we break it down into four very simple buckets. The first is fleets, shared miles. You see vehicle miles, traveled shared mobility is going to increase. The second element is autonomous vehicles. The third element is just connectivity. Connectivity is the enabler of everything. I think the numbers would say connected cars in 2015 were something like 13% that goes up to something like 75% by 2030. So, connectivity is going to be key whether it is cars talking to each other, cars talking to the grid, cars talking to other infrastructure, whatever that might be, cars talking to people through our phones, connectivity is something that's going to enable this. And finally, the trend toward electric. The rapid gains in technology that we're seeing are also very real. So, we see this trend moving forward, compare that or compound that with the regulatory concerns out there in various countries around the world. This is a trend as well that we see coming. These are things that we see will create significant opportunities for Goodyear."

Mr. Kramer continued, "As we think about the tax law change, our current estimate is about a $230 million one-time charge related to the revaluation of our deferred tax assets. As we look at

our outlook for 2018 – and again we'll go into more detail on this on our fourth quarter call – is a result of tax reform. We're looking at a global book tax rate now of about 20% to 25% with cash taxes continued at around 15%. We also don't expect now to pay taxes in the U.S., any significant taxes now to 2025 which is up from 2020, so a positive for us from that perspective. And relative to raw materials, we see a tailwind for the year of about $75 million at spot rates today, but that's sort of a tail of two halves again, we see headwinds in the first half… about $105 million headwind as we start the year, and those tailwinds then will come in the back half of the year. So we still have that hangover of raw materials coming into the first quarter. And building on the strong finish that we've had to 2017, we're expecting now segment operating income of about $1.8 billion to $1.9 billion driven by volume and cost savings. But I have to point out that number also includes about $50 million to $70 million of a reclassification of pension expense under a new accounting standard where it comes out of segment operating income and it goes into other expense."

While overall vehicle demand remains strong, we think that GT should be more sensitive to overall miles traveled than to new sales, given the company's two-pronged market exposure. We feel that strong employment, rising wages and moderate fuel prices are conducive to folks traveling more and therefore creating more wear and tear on tires (spurring replacements). We think that Goodyear should gain from higher long-term demand in emerging markets, and management remains focused on reducing expenses, improving cash flow and strengthening the balance sheet. GT trades below 10 times estimated earnings and the quarterly dividend was recently increased to $0.14 per share (yields 1.6%). Our Target Price has been driven higher to $51.

It was a roller-coaster ride, but when all was said and done, shares of **Bank of New York Mellon** (BK – $56.61) fell more than 2% last week, as the financial giant reported Q4 financial results. Adjusted earnings per share came in at $0.91, which was largely in line with consensus analyst estimates. Assets under custody/administration reached a record $33.3 trillion, reflecting higher market values, net new business and the favorable impact of a weaker U.S. dollar. The company had $1.9 trillion directly under management at the end of Q4, which was also a record. During 2017, BK repurchased 55 million of its common shares for $2.7 billion and paid $901 million in dividends.

"Our fourth quarter results were impacted by new tax legislation and actions that we took to strengthen our firm for the longer term. Aside from these items, our results were favorably impacted by strong equity markets and the underlying businesses continued to show modest growth in revenues and profits," commented BK CEO Charles W. Scharf.

"We saw strength in asset servicing along with growth in collateral management and clearing services – areas where we see continued client demand. Additionally, our investment management business performed well due to an uplift from global equity markets, net inflows and improved investment performance fees, resulting from good investment performance, especially in fixed income," Mr. Scharf continued.

All seemed well with the commentary until Mr. Scharf added, "The actions that resulted in the severance and other charges during the quarter are part of an ongoing review of our

performance. We expect this review to be completed by our March 8th Investor Day where we intend to provide a comprehensive update of the review and have a broader discussion about our firm…In addition, we have thought how best to use the ongoing benefit from lower taxes and we believe that we have a responsibility to our employees to share the benefit, as well as to invest as much as we intelligently can to build the company for the future so we can serve our clients, communities, and shareholders for the long term. At this point, we are anticipating that the impact of the lower tax rate would be almost entirely offset by actions that we will take to reinvest this benefit in our employees and our business."

AFAM CAPITAL

THE PRUDENT SPECULATOR
BK – Reinvesting Tax Savings

Estimated U.S. Tax Legislation Impact[1]

US Tax Cuts and Job Act Impact ($ in millions)	Total Revenue	Income Taxes	Net Income
Remeasurement of net deferred tax liabilities[2]	$ —	$ 1,191	$ 1,191
Repatriation tax	—	(723)	(723)
Other items	(4)	(39)	(43)
Renewable energy investments	(279)	281	2
	$ (283)	$ 710	$ 427

- Increased net income by an estimated $427 million
- Regulatory capital decreased by $551 million driven by the repatriation tax, offset by the tax benefit related to the remeasurement of certain deferred tax liabilities
- U.S. tax legislation on renewable energy investments was de minimis to net income; pre-tax accounting resulted in a reduction of $279 million recorded in investments and other income which was offset by the tax benefit from remeasurement of associated deferred tax liabilities

Commentary

- New U.S. tax legislation is expected to stimulate economic activity which should be positive for business
- Effective tax rate for 2018 expected to be approximately 21%
- Base Erosion Anti-abuse Tax ("BEAT") not expected to have an impact in 2018. Impact beyond 2018 uncertain, but currently expect it to be immaterial
- Capital and liquidity requirements for our Non-U.S. entities currently expected to limit amount of funds that will be repatriated
- Capital distribution plans for the first half of 2018 not impacted; the remainder of the year's buybacks is subject to the CCAR process

[1] Our estimate of the impact of U.S. tax legislation is based on certain assumptions and our current interpretation of the Tax Cuts and Jobs Act, and may change, possibly materially, as we refine our analysis and as further information becomes available.
[2] Excluding deferred tax liabilities related to energy investments.

Fourth Quarter 2017 – Financial Highlights BNY MELLON

While we believe that the quarter was a little messy, short-sighted investors were evidently disappointed that BK would not be returning the tax savings to shareholders. No doubt, we understand that many are not in the stock for its long-term prospects, but we do not mind that management is putting the tax dollars into significant digital investments, employee rewards and other initiatives that should pay off down the road.

We continue to like that BK is fairly well capitalized and has a management team that is committed to cost containment and driving growth for the future. BK shares are currently trading at less than 14 times NTM adjusted earnings expectations. Our Target Price has been nudged up to $63.

Shares of **Merck** (MRK – $61.28) rose almost 5% last week after the pharma giant released interim data for its Keytruda Phase 3 lung cancer study that showed, "Merck's anti-PD-1 therapy (Keytruda®), in combination with pemetrexed (Alimta®) and cisplatin or carboplatin, for the first-line treatment of patients with metastatic non-squamous non-small cell lung cancer (NSCLC), met its dual primary endpoints of overall survival (OS) and progression-free survival (PFS)." The news was welcomed by investors, as there had been skepticism that the drug combination worked after European regulators pulled a Keytruda regulatory application and delayed another clinical trial in October.

“KEYNOTE-189 showed significant improvement in overall survival and progression-free survival for patients receiving KEYTRUDA in the first-line setting in combination with traditional chemotherapy, compared with those receiving chemotherapy alone,” said Dr. Roger M. Perlmutter, president, Merck Research Laboratories. “We are deeply grateful to the KEYNOTE-189 patients and investigators for their important contributions to this landmark study, and we look forward to presenting the data in the near future.”

We are encouraged by the cancer therapy study results, and believe the strength in Merck’s immuno-oncology platform and in its Animal Health business, along with the potential of its pipeline, should more than offset patent losses and branded competition. After the jump, shares of MRK trade at less than 16 times NTM earnings and offer a dividend yield of 3.1%. True, there are plenty of competitive pressures in addition to growth opportunities, but we still like high-quality MRK and have bumped up our Target Price to $75.