the Prudent Speculator

MARKET COMMENTARY MONDAY, FEBRUARY 5, 2018

EXECUTIVE SUMMARY

Week #5 2018 – Rally Reverses Sharply
Market History – Sizable One-Day Tumbles Have Happened Before
Secret to Success – Don't Trust Everything You Read: Getting Even on the Dow
10-Year Yield Has More than Doubled Since July 2016 – Stocks Have Enjoyed a Big Rally
Econ Update – Favorable Statistics Have Increased Inflation Worries
Interest Rates – Likely to Remain Very Low By Historical Standards
Rising Inflation – Value Wins the Returns Race
Down Under 25 – *Forbes Australia Cruise* Bargains
Company News – Updates on ETN, XOM, STX, SIEGY, MSFT, AMGN, T, MAN, MDC, HMC, AAPL & MCK

Market Review

Greetings from Auckland, New Zealand, where your Editor is transiting on his way to Perth, Australia and the start of the *29th Forbes Cruise for Investors*. While the journey has been long thus far, with no Wi-Fi over the Pacific, it might have been nice to have been airborne a day or so earlier, so as to have missed the ugliness in the equity markets on Friday. In a sobering reminder that stock prices can move in both directions, the Dow Jones Industrial Average plunged more than 665 points (2.54%) on the last trading session of the week, while the S&P 500 skidded 2.14%. And, the week as a whole was awful, with the Dow tumbling 4.11%, the S&P 500 sinking 3.82% and the Russell 3000 dropping 3.78%.

Not surprisingly, the massive point drop on the Dow (the largest one-day move since December 2008) brought out plenty of superlatives from the financial press, even as the percentage magnitude of the change has been seen 16 times previously just since the end off 2009,…

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THE PRUDENT SPECULATOR
Outsized DJIA Single Day Price Moves

Volatility has been subdued of late, but since 1927 there have been 370+ times each when the Dow has lost/gained 2.54%+ in a day.

	1920's	1930's	1940's	1950's	1960's	1970's	1980's	1990's	2000's	2010's	Totals
Years Ending in 0		24	7	5	1	2	1	5	6	5	56
Years Ending in 1		47	3	1	1	0	0	1	6	7	66
Years Ending in 2		55	0	0	2	0	1	0	10	0	68
Years Ending in 3		27	2	0	1	4	0	0	2	0	36
Years Ending in 4		8	0	0	0	5	0	0	0	0	13
Years Ending in 5		2	0	2	0	1	0	0	0	3	8
Years Ending in 6		4	10	0	0	0	2	2	0	1	19
Years Ending in 7		20	3	0	0	0	10	2	5	0	40
Years Ending in 8	5	12	2	1	0	0	3	8	24	1	56
Years Ending in 9	25	6	0	0	0	1	1	1	12		46
Totals	30	205	27	9	5	13	18	19	65	17	408

From 12.31.27 though 2.2.18. Days of index price return drops of more than 2.54%. SOURCE: Al Frank using data from Bloomberg

	1920's	1930's	1940's	1950's	1960's	1970's	1980's	1990's	2000's	2010's	Totals
Years Ending in 0		11	4	1	0	4	1	4	5	5	35
Years Ending in 1		30	1	0	0	1	0	3	7	8	50
Years Ending in 2		50	0	0	4	0	9	0	16	0	79
Years Ending in 3		38	0	0	1	5	1	0	5	0	50
Years Ending in 4		7	0	0	0	11	4	0	0	0	22
Years Ending in 5		2	0	0	0	3	1	0	0	1	7
Years Ending in 6		0	5	0	1	0	0	0	0	0	6
Years Ending in 7		8	0	2	0	0	13	5	1	0	29
Years Ending in 8	3	21	0	0	0	3	4	5	23	0	59
Years Ending in 9	16	4	0	0	0	0	1	1	13		35
Totals	19	171	10	3	6	27	34	18	70	14	372

From 12.31.27 though 2.2.18. Days of index price return gains of more than 2.54%. SOURCE: Al Frank using data from Bloomberg

…while the single-day decline of the broader market, as measured by the S&P 500, has been endured nearly 700 times previously over the last 90 years. Looked at another way, given that there have been 22,629 market days since the start of 1928, more than 3% of all trading sessions have suffered a loss equal to or greater than what was witnessed on Friday. Happily, there have also been 638 days where the S&P 500 gained more than 2.14%, with far more winning sessions overall no matter the magnitude.

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THE PRUDENT SPECULATOR
Outsized S&P 500 Single Day Price Moves

Volatility has been subdued of late, but since 1927 there have been 600+ times each when the S&P 500 has lost/gained 2.12%+ in a day.

	1920's	1930's	1940's	1950's	1960's	1970's	1980's	1990's	2000's	2010's	Totals
Years Ending in 0		30	11	7	1	4	6	7	13	10	89
Years Ending in 1		50	4	1	0	0	2	2	13	16	88
Years Ending in 2		66	2	0	5	0	5	0	27	3	108
Years Ending in 3		39	4	2	1	4	1	1	5	2	59
Years Ending in 4		22	1	1	0	14	0	1	0	1	40
Years Ending in 5		6	5	5	0	2	0	0	0	4	22
Years Ending in 6		9	13	0	2	0	5	3	0	5	37
Years Ending in 7		32	5	4	0	0	18	5	10	0	74
Years Ending in 8	4	25	7	1	0	0	3	11	38	1	90
Years Ending in 9	28	19	3	0	0	1	2	7	25		85
Totals	32	298	55	21	9	25	42	37	131	42	692

From 12.31.27 though 2.2.18. Days of S&P 500 price return drops of more than 2.121%. SOURCE: Al Frank using data from Bloomberg

	1920's	1930's	1940's	1950's	1960's	1970's	1980's	1990's	2000's	2010's	Totals
Years Ending in 0		17	7	2	0	6	3	5	18	10	68
Years Ending in 1		32	2	0	0	1	3	6	12	13	69
Years Ending in 2		60	3	0	6	0	10	0	21	2	102
Years Ending in 3		49	2	1	1	6	3	0	10	2	74
Years Ending in 4		23	1	0	0	13	6	1	0	1	45
Years Ending in 5		12	1	5	0	6	1	0	0	3	28
Years Ending in 6		7	10	1	2	0	2	0	2	3	27
Years Ending in 7		16	2	3	0	0	18	7	6	0	52
Years Ending in 8	1	43	2	0	1	3	9	8	30	0	97
Years Ending in 9	18	16	1	0	0	0	2	13	26		76
Totals	19	275	31	12	10	35	57	40	125	34	638

From 12.31.27 though 2.2.18. Days of S&P 500 price return gains of more than 2.121%. SOURCE: Al Frank using data from Bloomberg

Certainly, we are not suggesting that folks should ignore the pain endured by their portfolios, and we recognize that the traffic has been flowing only in the northerly direction for quite some time, but we offer the perspective that volatility is not an unusual aspect of the investment process. Indeed, the drop from the highs set on January 26 hasn't even made it onto the list of 294 previous setbacks of at least 5% for the S&P 500,…

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THE PRUDENT SPECULATOR
Ups & Downs but Equities Win

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.

Advancing Markets

Minimum Rise %	Average Gain	Average # Days	Count	Frequency (in Years)	Last Start	Last End
20.0%	107.6%	907	26	3.5	3/9/2009	1/26/2018
17.5%	67.4%	579	37	2.4	10/3/2011	1/26/2018
15.0%	67.1%	562	43	2.1	10/3/2011	1/26/2018
12.5%	44.0%	331	70	1.3	2/11/2016	1/26/2018
10.0%	35.2%	249	103	0.9	2/11/2016	1/26/2018
7.5%	23.4%	147	152	0.6	2/11/2016	1/26/2018
5.0%	14.7%	72	294	0.3	6/27/2016	1/26/2018

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 1.26.18. 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

LONG-TERM RETURNS

	Annualized Return	Standard Deviation
Value Stocks	13.4%	26.0%
Growth Stocks	9.4%	21.4%
Dividend Paying Stocks	10.6%	18.1%
Non-Dividend Paying Stocks	8.8%	29.6%
Long-Term Corporate Bonds	6.1%	7.5%
Long-Term Gov't Bonds	5.5%	8.5%
Intermediate Gov't Bonds	5.1%	4.4%
Treasury Bills	3.4%	0.9%
Inflation	3.0%	1.8%

From 06.30.27 through 12.31.17. Growth stocks = 50% small growth and 50% large growth returns rebalanced monthly. Value stocks = 50% small value and 50% large value returns rebalanced monthly. Dividend payers = 30% top of dividend payers, 40% of middle dividend payers, and 30% bottom of dividend payers rebalanced monthly. Non-dividend payers = stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index. SOURCE: Al Frank using data from Professors Eugene F. Fama and Kenneth R. French and Ibbotson Associates

…with the 10.6% to 13.4% annualized returns for Dividend-Payers and Value Stocks illustrating the ample rewards for putting up with the sometimes disconcerting gyrations of the equity markets. Of course, it is periods like the present that investors need to remember that the secret to success in stocks is not to get scared out of them, especially as big downturns spark all sorts of sensationalistic media headlines.

Like clockwork, this weekend our good friends at *Marketwatch.com* served up a column warning that there have been "long periods of misery when the market remained in a downward spiral or moved sideways." The author informed readers, "It took 25 years for the market to recover from the 1929 stock-market crash,…

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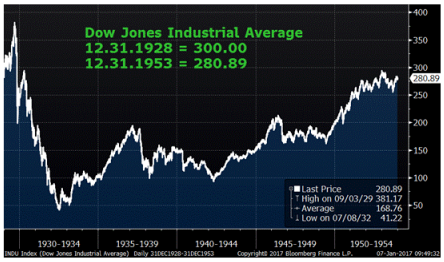
THE PRUDENT SPECULATOR
Dow Went Nowhere: 1929 to 1954

Illustrating that index values tell only part of the story, the Dow Jones Industrial Average actually lost ground over a 25-year time span from the beginning of 1929 to the beginning of 1954, yet the total return on stocks ranged from 4.02% to 8.32% per annum, with the S&P 500's annualized return coming in at a respectable 6.07%. The reason for the difference between the price-return-only Dow measure and the actual returns investors might have earned is dividends and their reinvestment.



Annualized Total Returns	
25 Years	
12.31.28 - 12.31.53	
FF Value	8.32%
FF Growth	5.64%
FF Divs	6.03%
FF No Divs	4.02%
S&P 500	6.07%

Source: Data compiled by Professors Fama & French and https://dqydj.com/sp-500-return-calculator/

…and 16 years for stocks to bounce back from the combined effect of the Vietnam War, the 1973 oil shock and the resignation of President Richard Nixon."

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THE PRUDENT SPECULATOR
Dow Went Nowhere: 1966 to 1982

Incredibly, the Dow Jones Industrial Average actually lost ground over a 16-year time span from the beginning of 1966 to the beginning of 1982, yet the total return on Value stocks was a superb 13.39% per annum. Obviously, stock picking mattered as the S&P 500's annualized return was *only* 5.97%, though Non-Dividend Payers outperformed Dividend Payers by more than one% per year. Despite losing nearly 10% of its price, the Dow's total return during the period was 3.94% per annum.

Annualized Total Returns	
16 Years	
12.31.65 - 12.31.81	
FF Value	13.39%
FF Growth	7.35%
FF Divs	7.29%
FF No Divs	8.44%
S&P 500	5.97%

Source: Data compiled by Professors Fama & French and https://dqydj.com/sp-500-return-calculator/

Yes, the Dow Jones Industrial Average showed no price appreciation over those periods, but the S&P 500 managed TOTAL returns of 6% or so PER ANNUM during both those supposed dismal spans. The reason for the gigantic gap in performance is dividends and their reinvestment. Alas, it would seem that many journalists do not grasp the concept of total return, though we respect that one would actually have had to reinvest their dividends to enjoy the solid equity market gains.

Of course, leaving dividends out of the equation and focusing solely on capital appreciation is a fatal mistake when evaluating the merits of equities, just as it would be to leave bond coupons or interest payments out of the fixed income conversation. On that subject, Morningstar's *SBBI Annual Yearbook* shows that Long-Term Gov't Bonds have had total capital appreciation (i.e. ignoring the income and its reinvestment component of total return) over the last 90 years of 36.9%, while Intermediate Term Gov't Bonds have had capital appreciation of 68.3%. Those figures are NOT annualized and encompass nine decades, meaning that if one measured bonds like many seem to measure stocks, there would be no way they could ever be held.

And speaking of bonds, a spike in interest rates received the lion's share of the blame for last week's carnage as the yield on the 10-Year U.S. Treasury soared to 2.84% on Friday afternoon, up sharply from 2.66% a week earlier. Certainly, we recognize that higher rates should arguably make stocks less appealing, but investors did not seem to mind a week ago that the yield on the 10-Year had nearly doubled from 1.38% on July 8, 2016.

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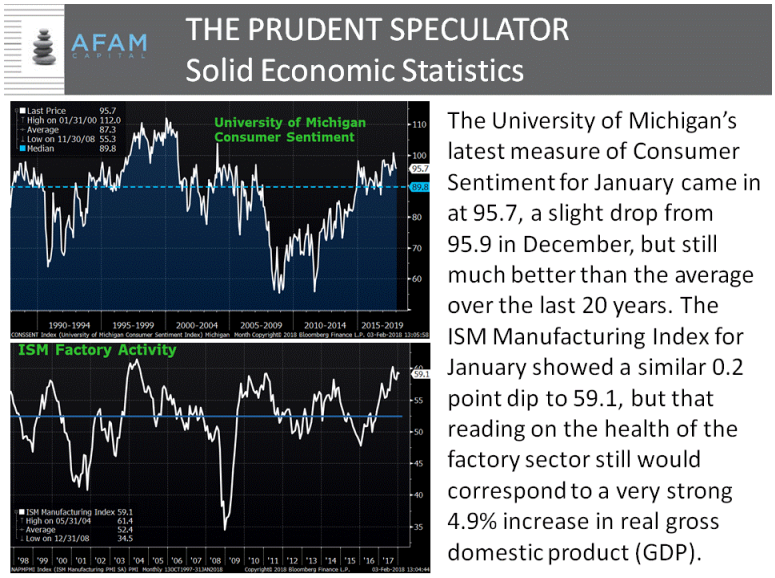
THE PRUDENT SPECULATOR
Rising Rates are Bad for Stocks?

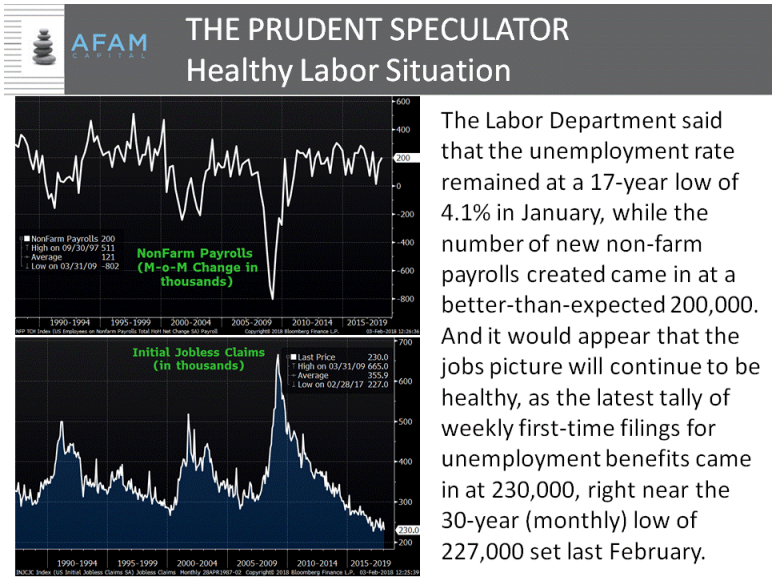
While the jump in yield on the 10-Year U.S. Treasury to 2.84% at the end of last week from 2.66% the week prior was the culprit for the big tumble in stocks, the S&P 500 has soared from 2130 on July 8, 2016, despite a more-than-doubling in the 10-Year yield over the same period.

The main reason for the increase in rates had heretofore not been a problem is that they were rising on more favorable economic data. Hard to complain about a healthier domestic economy, given the boost it provides to corporate profits, and we were happy to see a continuation last week of the release of generally positive numbers,…



The University of Michigan's latest measure of Consumer Sentiment for January came in at 95.7, a slight drop from 95.9 in December, but still much better than the average over the last 20 years. The ISM Manufacturing Index for January showed a similar 0.2 point dip to 59.1, but that reading on the health of the factory sector still would correspond to a very strong 4.9% increase in real gross domestic product (GDP).

…including statistics on the all-important jobs picture.

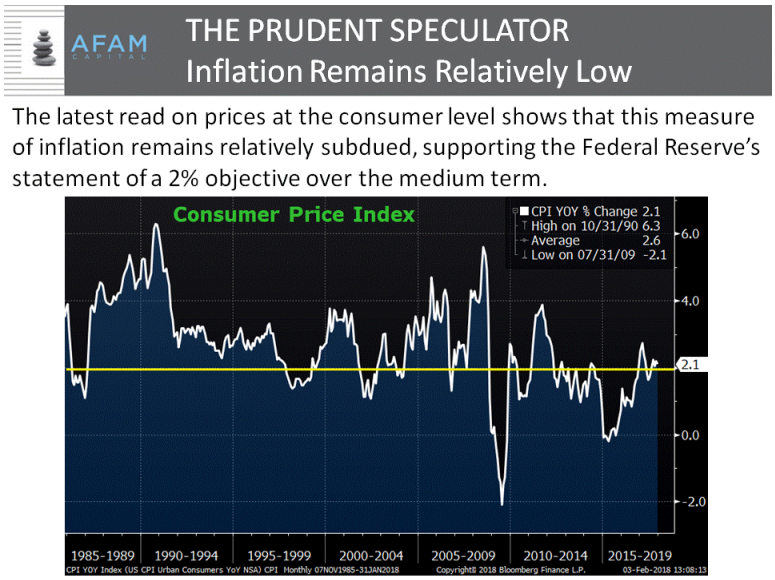


The Labor Department said that the unemployment rate remained at a 17-year low of 4.1% in January, while the number of new non-farm payrolls created came in at a better-than-expected 200,000. And it would appear that the jobs picture will continue to be healthy, as the latest tally of weekly first-time filings for unemployment benefits came in at 230,000, right near the 30-year (monthly) low of 227,000 set last February.

To be sure, many are now worried that interest rates will rise faster, given that wage growth for January jumped 2.9%, the largest year-over-year increase since June 2009. While good for workers, higher employment costs have heightened worries about inflation, even as some of the increase in compensation was due to the one-time bonuses doled out by many companies in response to the cut in corporate taxes.

That said, we do note that the Federal Reserve was also more upbeat in the statement that accompanied last week's decision to maintain the Federal Funds rate at 1.25% to 1.50%. Outgoing Fed Chair Janet Yellen & Co. said, "Information received since the Federal Open Market Committee met in December indicates that the labor market has continued to strengthen and that economic activity has been rising at a solid rate. Gains in employment, household

spending, and business fixed investment have been solid, and the unemployment rate has stayed low. On a 12-month basis, both overall inflation and inflation for items other than food and energy have continued to run below 2 percent. Market-based measures of inflation compensation have increased in recent months but remain low; survey-based measures of longer-term inflation expectations are little changed, on balance."



Of course, San Francisco Fed President John Williams, a voting-member of the Federal Reserve's interest-rate committee, suggested in a speech on Friday that the U.S. central bank should remain on a course of gradual rate hikes this year. He added, "For the moment, I don't see signs of an economy going into overdrive or a bubble about to burst, so I have not adjusted my views of appropriate monetary policy." Mr. Williams concluded, "I expect continued moderate growth, with no Herculean leap forward."

The futures market still seems in general agreement with the Fed (two to three rate hikes this year),…

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THE PRUDENT SPECULATOR
Futures: One, Two or Three Hikes in 2018

Though some are starting to fear a faster pace, we do not expect much change in the plan for a gradual boosting of interest rates, following the transition to Jerome Powell as Fed Chair. The odds now suggest a 31.8% chance of two and a 34.9% chance of three increases in the Fed Funds rate in 2018, though 21.9% is now the probability of four or more hikes.

99) Export Data — World Interest Rate Probability

United States — Instrument: Futures: Fed Funds - Effective — Fed Effective Rate 1.42

1) Overview | 2) Future Implied Probability

Current Implied Probabilities — 3) Add/Remove Rates

Dates: Meeting / Calculation — Calculated 02/02/2018 — Based on rate 1.25-1.50

Meeting	Hike Prob	Cut Prob	1.25-1.5	1.5-1.75	1.75-2	2-2.25	2.25-2.5	2.5-2.75	2.75-3
03/21/2018	92.8%	0.0%	7.2%	92.8%	0.0%	0.0%	0.0%	0.0%	0.0%
05/02/2018	93.2%	0.0%	6.8%	88.6%	4.6%	0.0%	0.0%	0.0%	0.0%
06/13/2018	97.6%	0.0%	2.4%	35.9%	58.7%	3.0%	0.0%	0.0%	0.0%
08/01/2018	98.0%	0.0%	2.0%	30.1%	54.8%	12.6%	0.5%	0.0%	0.0%
09/26/2018	98.8%	0.0%	1.2%	18.7%	44.7%	29.8%	5.4%	0.2%	0.0%
11/08/2018	99.1%	0.0%	0.9%	15.1%	39.4%	32.8%	10.4%	1.3%	0.0%
12/19/2018	99.3%	0.0%	0.7%	10.7%	31.8%	34.9%	17.4%	4.1%	0.4%
01/30/2019	99.4%	0.0%	0.6%	9.5%	29.2%	34.5%	19.5%	5.8%	0.9%

Source: Bloomberg

…which stated last week, "The Committee expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

That last comment is important for investors to keep in mind as interest rates remain extraordinarily low by historical standards,…

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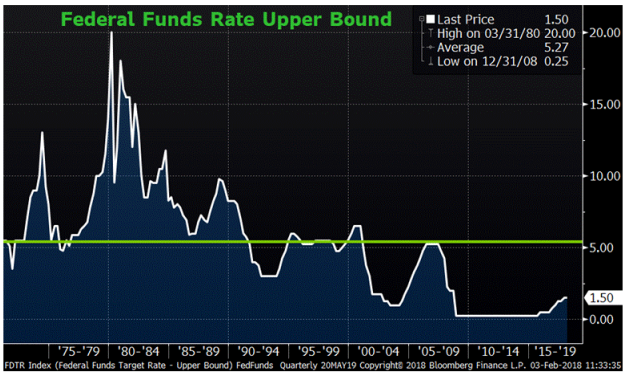
THE PRUDENT SPECULATOR
Lots Of Hikes Needed To Reach "Normal"

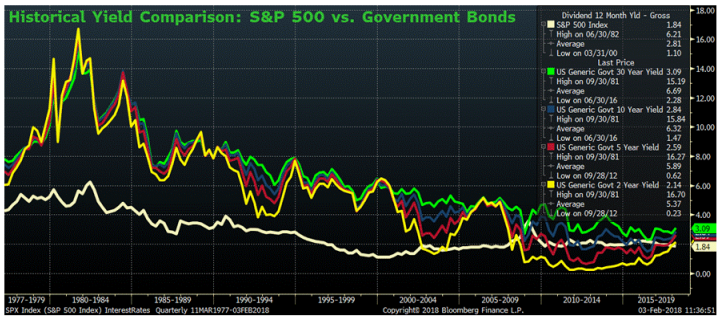
Folks should not be too worried about additional interest rate hikes, given that Janet Yellen & Co. presently project that the long-run target for the Fed Funds rate is 2.8%, well below the long-term 5.27% average.



…which continues to be a strong support of equity prices by our way of thinking, both in terms of the income produced versus competing investments…

THE PRUDENT SPECULATOR
Income Options – Equities Very Attractive

Though the major market averages now trade near all-time highs, the payout on the S&P 500 (1.84%) is still generous when compared to yields on fixed income instruments, and when viewed against the historical averages since the launch of *The Prudent Speculator* in 1977 for U.S. Treasuries, Money Market Funds and the Aggregate Bond Index.



…and even in regard to valuation.

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 4.4%.

And, for those who truly fear the inflation bogeyman, we think healthy perspective can be provided by looking at the historical evidence of equity returns and changes in the inflation rate.

THE PRUDENT SPECULATOR
Δ in Inflation & Value/Growth

Concurrent Stock Performance & Change in Inflation Rate

	Count	Value	Growth	Small	Large
Less than 2.7%	549	15.3%	13.4%	16.2%	12.7%
More than 2.7%	530	11.4%	5.0%	8.1%	7.0%
3-Month Drop	590	15.4%	12.3%	14.8%	12.4%
3-Month Rise	485	11.0%	5.5%	9.0%	6.9%
6-Month Drop	562	16.2%	12.4%	15.6%	12.3%
6-Month Rise	507	10.2%	5.5%	8.2%	7.1%
12-Month Drop	544	14.5%	10.2%	12.8%	11.1%
12-Month Rise	513	12.0%	7.8%	11.1%	8.2%

From 12.31.27 through 12.31.17. Concurrent annualized 12-month returns. SOURCE: Al Frank using data from Bloomberg and Professors Eugene F. Fama and Kenneth R. French

Subsequent Stock Performance. & Change in Inflation Rate

	Count	Value	Growth	Small	Large
Less than 2.7%	551	11.6%	9.6%	11.1%	9.8%
More than 2.7%	530	15.0%	8.4%	12.9%	9.6%
3-Month Drop	585	14.5%	9.7%	13.2%	10.6%
3-Month Rise	481	11.7%	7.9%	10.5%	8.4%
6-Month Drop	561	14.8%	9.6%	13.1%	10.9%
6-Month Rise	502	11.4%	8.1%	10.7%	8.1%
12-Month Drop	544	15.3%	10.0%	13.5%	11.5%
12-Month Rise	513	11.0%	7.6%	10.6%	7.3%

From 12.31.27 through 12.31.17. Subsequent 12-month return. SOURCE: Al Frank using data from Bloomberg and Professors Eugene F. Fama and Kenneth R. French

A stronger economy and tax cuts have some folks thinking that inflation will pick up in 2018 and beyond…which is fine by us. After all, Value stocks, on average, have seen a sizable return advantage over Growth, both concurrent with and subsequent to an increase in the inflation rate, with the performance gap widest when inflation is higher.

All of the above is not meant to say that equities will resume their climb this week, especially as there has not exactly been a lot of pain suffered by stock market investors in 2018, given how well the major market averages performed over the first four weeks of the year,…

THE PRUDENT SPECULATOR
Stock Returns Versus Bond Returns

Returns Race

2018 YTD Return %	2017 Return %	2016 Return %	Since 10-Yr Yield Low (7.8.16) %	Bloomberg Symbol	Index
Stock Indexes					
3.34	28.11	16.50	45.97	INDU Index	Dow Jones Industrial Average
4.94	29.73	8.97	48.76	CCMP Index	NASDAQ Composite Index
3.26	21.68	12.04	33.59	RIY Index	Russell 1000 Index
0.84	14.63	21.28	34.16	RTY Index	Russell 2000 Index
3.07	21.12	12.72	33.63	RAY Index	Russell 3000 Index
3.44	21.82	11.95	33.79	SPX Index	S&P 500 Index
4.58	30.21	7.07	40.75	RLG Index	Russell 1000 Growth Index
1.92	13.64	17.33	26.62	RLV Index	Russell 1000 Value Index
2.03	22.14	11.28	37.13	RUO Index	Russell 2000 Growth Index
-0.45	7.82	31.72	31.09	RUJ Index	Russell 2000 Value Index
4.38	29.58	7.38	40.47	RAG Index	Russell 3000 Growth Index
1.74	13.17	18.38	26.97	RAV Index	Russell 3000 Value Index
4.85	27.43	6.89	37.75	SGX Index	S&P 500 Growth Index
1.97	15.35	17.39	28.67	SVX Index	S&P 500 Value Index
Largest Bond Funds					
-1.71	3.57	0.79	-1.88	VBTIX Equity	Vanguard Tot Bd Mkt Idx-Inst
-1.72	3.53	0.75	-1.95	VTBIX Equity	Vanguard Tot Bnd Mkt Ii-Inv
-0.58	8.17	0.82	11.58	PONAX Equity	Pimco Income Fund-A
-0.60	2.39	0.81	-0.28	VTABX Equity	Vanguard Total Intl Bnd-Adm
-1.60	3.10	0.76	-1.30	MWTRX Equity	Mtrpltn Wst Ttl Rtrn Bnd-M
-1.35	5.13	0.73	1.23	PTTRX Equity	Pimco Total Return Fund-Inst
-0.42	7.36	0.63	11.09	PIMINIA Equity	Pimco Gis-Income Fund-Ins Ac
-0.44	2.02	-0.01	1.01	VFSTX Equity	Vanguard S/T Invest Grd-Inv
-1.37	4.53	0.21	-0.78	VWITX Equity	Vanguard Intm Trm T/E-Inv
-0.73	4.36	0.63	3.31	DODIX Equity	Dodge & Cox Income
-1.21	3.79	0.51	1.21	DBLTX Equity	Doubleline Ttl Rtrn Bnd-I
-0.43	1.89	0.07	1.86	LDLAX Equity	Lord Abbett Shrt Dur Inc-C

Source: Bloomberg. As of 2.2.18. 10-Year Treasury Yield Low (1.38%) was July 8, 2016.

It is tough to complain about big equity market returns, especially given what bonds have done, even as Value's recent struggles relative to Growth have continued into 2018. Of course, it is also fascinating, given all of the hand-wringing over higher interest rates, to look at the performance of stocks and bonds since the yield on the 10-Year U.S. Treasury hit an all-time low of 1.36% on July 8, 2016!

…while the contrarian in us didn't like the report last week from Bank of America Merrill Lynch that there were massive inflows into U.S. stock funds over the first four weeks of the year. As we like to say, the only problem with market timing is getting the timing right!

Still, for those who share our long-term, three-to-five-year time horizon, we continue to see no reason to alter our enthusiasm for our broadly diversified portfolios of undervalued stocks, and we would advise those who have been sitting on the sidelines waiting for a pullback to take advantage of the downturn. Though we like all of our 100+ recommendations, your Editor put

together a list for the *Forbes Cruise* audience of 25 inexpensive *TPS* companies that have seen their share prices decline by more than 3% this year.

AFAM CAPITAL

THE PRUDENT SPECULATOR
Down (in 2018) Under Bargains

Down Under 2018

Symbol	Common Stock	2018 YTD TR %	2.2.18 Price	Target Price	Sector	P/E	P/S	P/TBV	EV/ EBITDA	FCF Yld	Debt/ TE (%)	Div Yld	Mkt Cap
AAPL	Apple	-5.2	$160.50	$202.36	Technology Hardware	16.5	3.4	6.2	8.8	6.4	79%	1.6%	814,379
ABX	Barrick Gold	-5.0	$13.74	$23.87	Materials	18.6	1.9	2.0	4.3	5.1	79%	0.9%	16,029
AEO	American Eagle	-6.6	$17.56	$21.80	Retailing	15.8	0.8	2.8	6.5	5.1	0%	2.8%	3,114
ALK	Alaska Air Group	-12.2	$64.56	$104.10	Transportation	9.7	1.0	4.8	5.4	6.6	138%	2.0%	7,944
ALL	Allstate	-6.5	$97.94	$110.35	Insurance	14.4	nmf	2.0	nmf	nmf	nmf	1.5%	35,258
ANH	Anworth Mort	-11.8	$4.80	$6.44	Diversified Financials	9.1	nmf	0.8	nmf	nmf	nmf	12.5%	471
ARII	American Railcar	-8.3	$38.19	$51.73	Capital Goods	13.9	1.4	1.3	7.5	-5.8	95%	4.2%	729
DLR	Digital Realty	-5.4	$107.71	$129.26	Real Estate	18.0	nmf	4.0	nmf	nmf	nmf	3.5%	22,387
DOC	Physicians Realty	-9.6	$16.05	$23.81	Real Estate	15.3	nmf	1.2	nmf	nmf	nmf	5.7%	2,876
DSW	DSW Inc	-8.5	$19.60	$29.85	Retailing	14.5	0.6	1.7	5.6	11.9	0%	4.1%	1,568
HFC	HollyFrontier	-9.4	$46.40	$57.86	Energy	28.5	0.6	3.8	10.0	8.0	103%	2.8%	8,225
JBL	Jabil Inc	-3.7	$25.28	$42.92	Technology Hardware	11.3	0.2	3.2	5.0	6.1	121%	1.3%	4,430
JNPR	Juniper Networks	-7.9	$26.26	$37.13	Technology Hardware	12.4	2.0	6.8	8.3	11.1	147%	2.7%	9,846
KIM	Kimco Realty	-18.1	$14.87	$24.39	Real Estate	9.6	nmf	nmf	18.3	nmf	nmf	7.5%	6,329
KMB	Kimberly-Clark	-3.7	$116.21	$145.09	Home & Personal Prods	18.7	2.2	nmf	11.9	5.2	nmf	3.4%	40,878
MET	MetLife	-5.1	$47.56	$70.20	Insurance	9.4	nmf	1.1	nmf	nmf	nmf	3.4%	50,047
REG	Regency Centers	-13.1	$60.12	$89.74	Real Estate	16.7	nmf	1.8	nmf	nmf	nmf	3.5%	10,237
SFL	Ship Finance Int'l	-3.9	$14.90	$17.07	Energy	12.3	3.6	1.3	11.2	6.9	113%	9.4%	1,393
SHPG	Shire PLC	-10.3	$139.19	$249.78	Pharma, Biotech	9.5	2.9	nmf	13.8	7.3	nmf	0.7%	42,223
SYMC	Symantec	-3.7	$27.02	$34.79	Software & Services	18.0	3.5	nmf	35.1	5.5	nmf	1.1%	16,794
TNP	Tsakos Energy	-9.0	$3.56	$7.95	Energy	32.4	0.6	0.2	8.7	nmf	119%	5.6%	302
TPC	Tutor Perini	-5.5	$23.95	$37.31	Capital Goods	12.4	0.2	1.3	8.0	0.5	90%	0.0%	1,192
TRN	Trinity Industries	-10.0	$33.59	$42.39	Capital Goods	22.4	1.3	1.6	9.0	1.7	102%	1.5%	5,098
TSN	Tyson Foods	-8.1	$74.49	$86.02	Food, Beverage	14.0	0.8	nmf	10.7	5.6	nmf	1.6%	29,742
WSM	Williams-Sonoma	-3.3	$49.63	$71.19	Retailing	14.1	0.8	3.6	6.5	7.1	0%	3.1%	4,178

As of 2.2.18. nmf=Not meaningful. TBV = Tangible book value. EV/EBITDA = Enterprise value to earnings before interest, taxes, depreciation and amortization. FCF Yield = Free Cash Flow Yield

The big selloff last week the catalyst, we suspect that many may be looking to move money off of the sidelines, and the 25 *TPS* names presented here are all off in percentage this year by more than the Russell 3000 index is up.

Alas, we know that when Wall Street holds a sale, many choose not to shop, and the not-so-pretty end to Friday's trading has us thinking that Monday may see more selling, but we would think reticent investors should be buoyed by the generally favorable fourth quarter earnings reporting season. After all, data provider Bloomberg calculates that 76.9% of the 251 S&P 500 companies that have announced results have topped expectations, compared to 14.3% that have trailed projections and 8.8% 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.

Stock Updates

Speaking of earnings, Jason Clark and Chris Quigley provide updates on a dozen of our names that were out with quarterly results last week…

Despite pulling back on Friday, shares of diversified industrial manufacturer **Eaton** (ETN – $85.09) are off to a great start in 2018. Eaton reported Q4 financial results last week that outpaced investor expectations, posting adjusted EPS of $1.29, versus a $1.24 consensus estimate, on revenue of $5.21 billion, versus forecasts of $5.1 billion.

ETN CEO Craig Arnold explained, "We had a strong fourth quarter, with revenues above the high end of our guidance range, and net income and adjusted earnings per share, excluding the impact of the new U.S. tax bill, at the high end of our guidance range. Coming into the quarter, we expected organic sales would be up between 3% and 4% and currency translation would add 1.5% growth. Our organic sales ended up growing 5%, and positive currency translation impacted sales 2%. The 5% organic growth was our highest quarterly rate of growth during 2017. The impact of the new U.S. tax bill was income of $62 million in the fourth quarter. Marking our deferred tax assets and liabilities to the lower tax rate created $79 million of

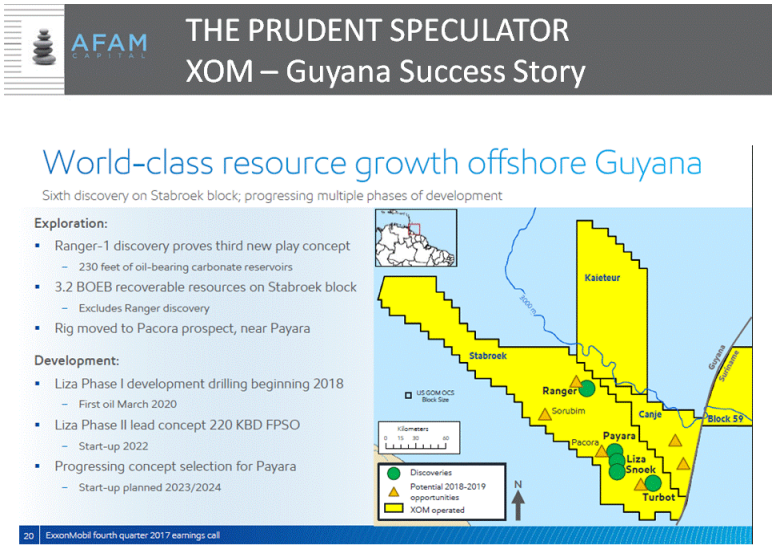
income, which was offset by a $17 million charge for the mandatory repatriation tax… Operating cash flow in the fourth quarter was $879 million. We continued to return substantial cash to our shareholders, repurchasing $61 million of our shares in the quarter, making our full year repurchases a total of $850 million, 2.5% of our shares outstanding at the beginning of the year."

Moving forward, Mr. Arnold said, "Our orders in the fourth quarter grew rapidly in every segment…Looking at 2018, we expect our organic revenues to grow approximately 4%. We anticipate segment margins to be between 16.3% and 16.9%, a significant step up from 15.8% in 2017. We expect 2018 net income and adjusted earnings per share to be between $5.00 and $5.20, representing at the midpoint a 10% increase over 2017, excluding the gain on the Cummins JV and the income arising from the new tax bill in 2017. We anticipate net income and adjusted earnings per share for the first quarter of 2018 to be between $1.00 and $1.10."

While we believe there is some more potential upside for Eaton shares and like the venture with **Cummins** (CMI – $184.31), we recognize that our position in the stock is elevated in size for some accounts, so we might be willing to trim our stake should we find another industrial name that offers a favorable risk/reward profile. Of course, we have bumped up our Target Price to $92 as ETN currently yields 2.8% and trades at 16.5 times NTM earnings projections.

Shares of integrated oil giant **Exxon Mobil** (XOM – $84.53) fell more than 5% Friday after the company reported Q4 financial results that fell short of consensus analyst estimates. XOM had adjusted EPS of $0.88, versus forecasts of $1.03, on revenue of $66.5 billion (versus estimates of $72.2 billion). Despite the impact of rising oil prices during the last quarter, which had boosted the company's lagging share price, XOM was hurt by falling production as well as weakness in its refining operations and at its chemicals unit.

"The impact of tax reform on our earnings reflects the magnitude of our historic investment in the U.S. and strengthens our commitment to further grow our business here," said CEO Darren W. Woods. "We're planning to invest over $50 billion in the U.S. over the next five years to increase production of profitable volumes and enhance our integrated portfolio, which is supported by the improved business climate created by tax reform." That in mind, and despite the messy quarter, we believe XOM has plenty of upside ahead of it with many positive drivers for improving capital efficiency, margin expansion and growth, led by its oil fields in Guyana.



Thus, we think the selloff was overdone, and given our belief that the long-term global-energy story is still intact, we are more than comfortable with our XOM position. We continue to like that XOM is well-run and that management is focused on operating fundamentals. Exxon generates strong cash flow from operations and is comfortably able to cover the investments in the business and dividend payments. Additionally, XOM is the only energy player with a Aaa credit rating (issued by Moody's) and its fortress balance sheet and capital discipline gives it the financial flexibility to selectively invest in higher-value products and potentially acquire assets at a discount. We are constructive on XOM's cost-control initiatives and the value that its upstream and downstream operations achieve due to a high level of integration. We also like the research and investment in reliable alternative energy sources for the future. XOM yields 3.6%. All things considered, our Target Price for XOM now stands at $100.

Hard disk drive maker **Seagate Technology PLC** (STX – $51.77) earned $1.48 per share in fiscal Q2 2018 (vs. $1.40 est.). STX had sales of $2.9 billion, matching the consensus estimate. Shares rose slightly following the announcement, though perhaps that's not surprising considering that the stock is up more than 23% this year, due in part to mid-January's rumors that suggested STX may own shares of Ripple, which has been caught up in the cryptocurrency frenzy.

Seagate CFO Dave Morton indicated that the company has a stake in Ripple, "A few years ago, we made an investment in Ripple, a company driving technology innovation for distributed ledger and blockchain use cases. We believe the proliferation of these companies will create tremendous amounts of data, require higher levels of data integrity, and will alleviate friction and global financial operations and other important use cases that require the transfer of value with improved agility and transparency. While recent attention is on the valuation of the XRP crypto assets, we believe Ripple has a real and robust blockchain technology platform, and defined and validated use case for XRP, and a leading management team."

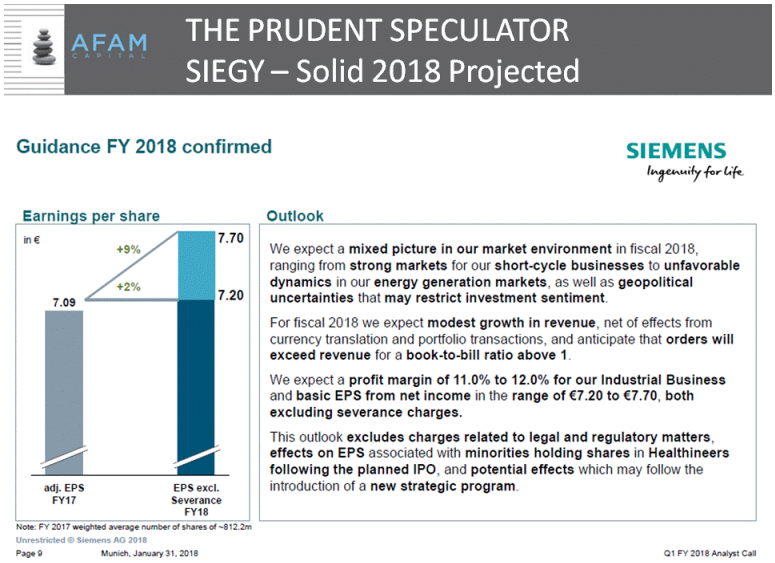
Looking at more important matters, CEO Dave Mosely said, “For the March quarter, we anticipate year-over-year exabyte growth with continued strong demand in cloud storage as supply remains tight in our highest capacity solutions. For the other markets we serve, we anticipate normal, sequential, seasonal demand declines. As a result of the strong cloud demand and seasonality in our other markets, we expect total revenues to be down 5% to 7% sequentially from the December quarter. This represents lower sequential revenue declines than the last few years and year-over-year revenue growth for Seagate. We expect gross margins to be sequentially in line with the December quarter’s gross margins and continue to be within our 29% to 33% long-term range. Non-GAAP operating expenses will be down sequentially 2% to 3%, with further cost-containment measures as we continue to manage our operating expenses tightly, targeting approximately $375 million per quarter by the end of fiscal 2018.”

As we noted last month, 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, which management said puts STX in a position to have “a broad offering of flash-based products that are ready to scale and grow across multiple markets.” We also like STX’s strong cash flow and solid balance sheet. We believe that STX’s solid dividend yield of 4.9% and attractive valuation, including a price-to-forward earnings ratio of 10.3, are very good reasons to continue to hold the stock. On account of the strong results and outlook, we have raised our Target Price to $60.

Engineering and manufacturing giant **Siemens AG** (SIEGY – $71.13) earned $1.55 per share in fiscal Q1 2018 (vs. $1.26 est.). SIEGY had sales of $23.3 billion (vs. $25.1 billion est.). Siemens benefitted from solid Industrial Business margins, despite significant foreign exchange headwinds and a drop in Power and Gas. The company also reported a 22% year-over-year increase in free cash flow, a book-to-bill ratio of 1.13 and organic order growth around 7%. While the shares initially moved higher following the announcement, they ended up cratering by the end of the week as a result of the broader market decline.

Of course, business conditions still look quite favorable. CEO Joe Kaeser commented, “The growth momentum of the global environment seems to be strong in most economies. And our investment in key businesses and sectors is paying off. Our focus on digitalization and innovation shows clear results. The Digital Factory division leads the way into what we call Industrie 4.0.”

Mr. Kaeser continued, “Looking ahead, we do expect the macroeconomic environment to remain positive. Downside risks are rather attached to continued geopolitical tension in the area like Russia, the Middle East, and the Korean Peninsula. Also, diverging definition of what free and fair trade may as well pose risks to the global business going forward. Furthermore, the structural challenges in the fossil power generation market will continue. We have initiated and will take decisive steps to adjust our capacities accordingly. Meanwhile, the dialogue with the employee representative shave also started in Germany.”



We like Siemens' worldwide footprint, diversified business portfolio and strong emphasis on the digitization of infrastructure. The merger with Gamesa (wind power) has kept managers busy, while the upcoming IPO of Healthineers (management states that it is on track to list the health-care business in the first half of calendar year 2018, depending on market conditions) should result in a more focused company once the dust settles. SIEGY also expects that U.S. tax reform will result in a tax rate at the "low end" of the 27% to 33% guidance window. The German 'blue-chip' trades for 16.0 times earnings and yields 2.1% after foreign taxes. Our Target Price has been boosted to $93.

Computing giant **Microsoft** (MSFT – $91.78) reported earnings per share of $0.96, versus the $0.86 estimate in fiscal Q2 2018. MSFT had sales of $28.9 billion, versus the $28.4 billion estimate. Shares dipped following the announcement (and were slammed on Friday), though we note that the stock has risen almost 50% over the past year and 275% (including reinvested dividends) over the past five years. MSFT benefitted from strong demand for Intelligent Cloud products (segment revenue was $7.8 billion vs. $7.5 billion est.) and Personal Computing revenue (segment revenue was $12.2 billion vs. $12.0 billion est.).

CEO Satya Nadella said, "Every CEO I talk to is keen to start their transformation journey by empowering their employees and creating a modern workplace. They want productivity and collaboration tools that deliver continuous innovation and do so securely. Spectre and Meltdown are the latest instances in an increasingly complex threat environment. Our investments to make Windows 10 the most secure, always up-to-date operating system enabled us to move quickly to protect customers in the face of these threats, for protecting customers will continue to be a top priority. Our continued commitment to operational security and advanced technology is one reason customers like BP, Goodyear, PayPal are choosing Microsoft 365.Mastercard chose Microsoft 365 to empower employees and inspire teamwork with integrated apps like Teams, Yammer and SharePoint. We're infusing AI across Microsoft 365 with the simple goal of helping people do their best work. Insights in Excel is a new service that uses machine learning to detect and highlight patterns. Translator brings 60 languages to Word. We are helping people

be more productive on the go on any platform with real-time co-authoring in Office apps on iOS, Android and now the Mac."

Mr. Nadella continued, "I want to reflect on a topic that is at the forefront of every customer conversation that I have. In an era where there is rapid transformation driven by digital technology, customers are looking for a trusted partner, someone with a business model that is aligned with their long-term interests, deep technical innovation and an understanding of the responsibility that goes along with this innovation. This perhaps is one of our key differentiators. Internally, we have a saying, Microsoft runs on trust. And we strive to earn it every day with all of the constituents we serve."

CFO Amy Hood offered guidance, "Assuming current rates remain stable, we expect FX to increase revenue growth by 2 points, COGS by 1 point and operating expenses by 1 point. With positive IT spend signals, a strengthening commercial PC market and growing customer demand for hybrid cloud services, we expect our commercial business to remain strong as we drive annuity growth, expand our installed base and execute well on renewals. We expect commercial unearned revenue to be down approximately 2% to 3% sequentially, in line with historic seasonality. And our Q3 expiry base will return to year-over-year growth, impacting commercial bookings growth."

Ms. Hood also noted that, aside from the massive benefit from the repatriation of cash held outside the U.S., the new U.S. tax rules will not help Microsoft much going forward, "Based on our current understanding of the recently enacted tax law, we now expect our effective tax rate for H2 to be 16%, plus or minus 2 points. For FY 2019, we expect our full year effective tax rate to be slightly below the new U.S. corporate rate of 21% due to the impact of tax law provisions effective for us July 1, 2018. We will continue to have quarterly variability based on the mix of service and license revenue, geographic mix of revenue and the timing of equity vests."

While the stock has been on a tear and positive operational momentum seems unlikely to abate in the near term, we expect to hold this high-quality name a while longer, though we wouldn't rule out taking some of our terrific gains off the table as it has swelled even more since our last Market Commentary update. MSFT's valuation, including a price-to-forward earnings ratio of 24.4, isn't cheap by some measures, yet we remain attracted to the solid dividend yield near 1.8% and terrific balance sheet. Analysts, for their part, expect the company's growth rate of at least 8% for each of the next three years, with earnings growing from $3.08 in fiscal 2017 (reported) to an estimated $4.50 in 2020. Our Target Price for MSFT has been hiked again to $100.

Despite the big market-wide sell-off on Friday, shares of **Amgen** (AMGN – $187.01) ended the day higher, following the biotech giant's Q4 and full-year 2017 earnings release. For the quarter, the company reported adjusted EPS of $2.89 on revenue of $5.8 billion. Both the top- and bottom-line fell a bit short of consensus analyst estimates. Free cash flow for Q4 came in at $2.9 billion and for the full year grew 9% to $10.5 billion, driven by higher operating income and favorable changes in working capital. At year end, Amgen's cash and investments totaled $41.7 billion.

"With strong volume-driven growth for our recently launched products and a promising new product pipeline, we are well positioned for future growth," proclaimed CEO Robert A. Bradway. "We expect several developments to provide an additional boost for these products, most notably the recent inclusion of cardiovascular outcomes data in the Repatha® (evolocumab) prescribing information." Management announced that it expects 2018 total revenue guidance of $21.8 billion to $22.8 billion and adjusted EPS of $12.60 to $13.70.

Given that the outlook wasn't as strong as some investors hoped, reaction in the after-hours on Thursday was hardly favorable with the stock price tumbling more than $5, before enthusiasm over the company's big buyback announcements took hold. In addition to repurchasing 4.5 million shares of common stock at a total cost of $0.8 billion in Q4, for all of 2017, Amgen bought back 18.5 million shares for $3.1 billion. And the company just authorized an additional $10 billion of share repurchases, on top of a $4.4 billion existing buyback plan.

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AMGN – Strong Drug Pipeline

KEY PIPELINE MILESTONES

Clinical Program	Indication	Projected Milestones
KYPROLIS®	Relapsed or refractory multiple myeloma	EU regulatory review (ENDEAVOR OS data) Regulatory reviews (ASPIRE OS data)
BLINCYTO®	Acute lymphoblastic leukemia	EU regulatory review (TOWER OS data) Regulatory reviews (MRD-positive)
XGEVA®	Prevention of SREs in multiple myeloma	EU regulatory review
Prolia®	Glucocorticoid-induced osteoporosis	U.S. regulatory review
EVENITY™* (romosozumab)	Postmenopausal osteoporosis	U.S. regulatory resubmission EU regulatory review
Aimovig™† (erenumab)	Migraine prevention	U.S. regulatory review
ABP 710 biosimilar infliximab (Remicade®)	Inflammation	Phase 3 data
ABP 980 biosimilar trastuzumab (Herceptin®)	Oncology	Regulatory reviews

MRD = minimal residual disease; Aimovig™ and EVENITY™ trade names provisionally approved by FDA; *Developed in collaboration with UCB globally, as well as our joint venture partner Astellas in Japan; †Developed in collaboration with Novartis

Provided February 1, 2018, as part of an oral presentation and is qualified by such, contains forward-looking statements, actual results may vary materially; Amgen disclaims any duty to update.

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AMGEN

Although the noise level surrounding drug pricing is starting to rise again, we like the pipeline of new products and we are pleased with the operational progress AMGN has been making, so we believe the long-term potential for the stock remains very attractive. We are also partial to Amgen's strong free cash flow generation, solid financial footing and willingness to return capital to shareholders via dividend increases (the yield is currently 2.8%) and repurchases. Still, our Target Price for AMGN has been trimmed to $223.

Integrated telecom services firm **AT&T** (T – $38.07) earned $0.78 per share in fiscal Q4 2017 (vs. $0.65 est.). T had sales of $41.7 billion (vs. $41.2 billion est.). While revenue was essentially flat year-over-year, AT&T said the U.S. tax rule changes were the catalyst behind the strong Q4 and annual results, explaining that $0.13 per share was added to earnings, and "our ability to fully expense capital spending in the fourth quarter generated most of this benefit." Shares jumped more than 4% following the announcement, before retreating on Friday.

AT&T CEO Randall Stephenson explained, "On a standalone basis, excluding Time Warner, we expect adjusted EPS in the $3.50 range. As I said, inclusive of the items previously discussed.

We also expect organic growth in the low single digits, driven by continued profitability improvement in Mexico, wireless service revenues growing in the second half of the year, cost structure benefits from virtualization and automation and those offset by continued transformation of our video business and legacy services. Free cash flow growth will be strong. We're expecting about $21 billion of free cash flow for the full year, which approximates our expected adjusted net income. And we expect capital spending to approach $25 billion or about $23 billion net of expected FirstNet reimbursements, that includes the $1 billion of an incremental tax reform investment. That's it in a nutshell. We ended the year with an exclamation point, thanks to customer growth, tax reform and FirstNet. And we're very excited about the year ahead."

While Mr. Stephenson remarked to analysts that he was "obviously surprised" at the government's attempt to block AT&T's acquisition of Time Warner, we are less surprised. We respect that the regulators will argue that the marriage will adversely affect customers and pricing, reduce competition and limit the available choices for Internet service, so we have excluded the benefits of Time Warner until a chance of success becomes clearer. Our Target Price has jumped to $49 for the standalone AT&T. Whether the deal goes through or it is denied by regulators (the breakup fee from AT&T's perspective is a paltry (for a deal of this magnitude) $500 million), we remain fans of T, especially given the current P/E ratio of 11 and the hefty dividend yield of 5.3%.

ManpowerGroup (MAN – $122.50) posted adjusted earnings per share of $2.11, versus the $2.06 estimate investors were looking for in Q4. The staffing solutions company also benefited from the recently passed U.S. Tax Reform, with the actual Q4 EPS number hitting $3.22. Revenue came in at $5.64 billion, versus the $5.54 billion that was expected. Despite the solid release and a Q1 EPS forecast (in the range of $1.60 to $1.68, which includes a positive impact of tax reform of $0.20 and a positive impact from foreign currency of $0.15) that was 10% better than consensus analyst forecasts, MAN shares fell more than 7% on Friday in the global equity market rout.

MAN CEO Jonas Prising commented, “We are very pleased with our strong performance in the fourth quarter, with improved revenue growth and good profitability. These strong quarterly results capped off the full year 2017 where we delivered strong top line growth and profit performance…The war for talent is intensifying globally, and our clients are focused on finding the best talent and building their organizational agility, while individuals are interested in opportunities that build their skills and advance their careers. We have anticipated these market trends, and as we start 2018, we are confident that our superior global footprint, our extensive portfolio of workforce solutions and our great people put us in a formidable position to continue to create value for our clients and candidates.”

We continue to like MAN’s broad geographic footprint, wide range of offerings, good expense management and solid balance sheet. It is also good to finally see currency headwinds becoming tailwinds, and coupled with the momentum in its businesses and benefits from tax reform, the first part of 2018 is setting up to be very good. MAN shares currently trade at a forward P/E ratio of 13.5, and we have elevated our Target Price to $145.

Despite reporting solid Q4 financials, shares of homebuilder **MDC Holdings** (MDC – $32.01) fell more than 6% last week as investors sold in reaction to the yield on the benchmark 10-Year U.S. Treasury jumping above 2.8%. While the quarter was impacted by the re-measurement of deferred tax assets, MDC turned in adjusted EPS of $0.43 on revenue of $704 million. We were pleased to see gross margins expand and for business backlog to hit $1.6 billion (16% higher than at the end of 2016).

MDC CEO Larry A. Mizel added, “Our strong performance in the 2017 full year is evidenced not only by double-digit percentage increases for home sale revenues and net income, but also by the steps we took to strengthen our financial position, enhance shareholder value, and prepare for future growth. During the year, we added $150 million to our senior notes due January 2043, bringing the total amount outstanding to $500 million. In doing so, we pushed our average senior note maturity to almost 15 years, a strong advantage as interest rates start to rise. In addition, we expanded the capacity under our unsecured line of credit from $550 million to $700 million and extended its maturity to December 2022. We ended the year with liquidity of $1.25 billion, an increase of nearly 40% over the prior year, which provides us with additional resources to fund our future growth. Already, our plans for expansion are well underway, as shown by the nearly 10,400 lots we approved during 2017 for purchase, which was more than double our total in 2016.”

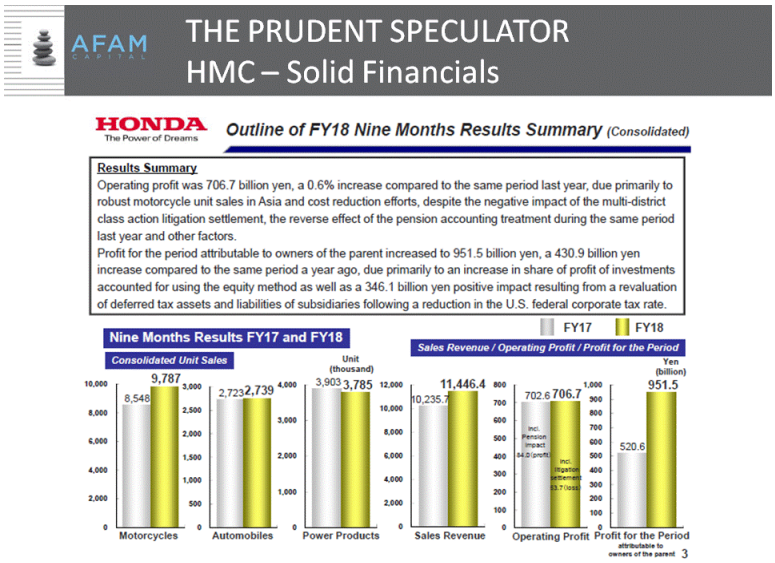
Mr. Mizel concluded, “We ended the year on a strong note, with fourth quarter net home orders surging 23% year-over-year. We believe the robust demand is not only the result of solid economic fundamentals, but also our focus on affordable product. At the center of our emphasis on affordability is our SeasonsTM collection, which accounted for 15% of our fourth quarter net orders. Because of our strong sales performance, our yearend backlog value is 16% higher than a year ago, setting the stage for growth in 2018. Given our positive outlook and strong financial position, we enhanced our industry-leading dividend program with an 8% stock dividend in the fourth quarter and a 20% increase in our cash dividend declared at the start of the 2018 first

quarter, reflecting our confidence in the prospects for growth against the backdrop of solid industry conditions."

We continue to like MDC and think that the selloff in the stock last week was overdone. While interest rates could move higher in the coming months, we remain at rate levels that are very low on the historical spectrum. Additionally, the U.S. economy continues to show improvement, with a solid outlook for employment, consumer confidence and wage inflation for its prospective customers. MDC sports a broad geographic footprint, boasts successful cost control initiatives and maintains a solid balance sheet, with ample liquidity that the company continues to smartly tap as it acquires land in attractive markets across the country. MDC trades for less than 11 times NTM adjusted earnings and yields 3.8%. Our Target Price has been nudged up to $50.

Honda Motor (HMC – $36.16) reported well-received fiscal Q3 earnings and raised its profit forecast for the third time this year as U.S. tax cuts and demand for SUV's in China helped boost financial performance. China vehicle sales reached a record and sales of the CR-V in the U.S. surged. Consolidated profit for the Japanese automaker in the quarter totaled JPY 570.2 billion, an increase of 237.8% from the same period last year, helped mightily by the impact of U.S. tax cuts. Consolidated revenue for the quarter amounted to JPY 3,957.1 billion, an increase of 13.0% from the same period last year, due primarily to increased sales in all business operations.

Two encouraging points emerged from 3Q results. The improved sales mix associated with higher U.S. light truck sales had a bigger impact than most expected and increased sales in China, where capacity utilization is high, also provided a greater-than-projected boost.



We continue to like the geographically diverse revenue stream and are encouraged by Honda's progress in emerging markets (including India and China) and modest opportunity for growth in North America. Our calculation of HMC's trailing-12-month operating EPS (excluding the big tax benefit) work out to around $4.18, putting the current P/E ratio at less than 9. With the stock

also trading below book value and the dividend (which is likely to move up) yield standing around 2.1%, we have increased our Target Price to $44.

Technology hardware designer and manufacturer **Apple** (AAPL – $160.50) earned $3.89 per share in fiscal Q1 2018 (vs. $3.84 est.). AAPL had sales of $88.3 billion, versus the $87.3 billion estimate. Apple reported challenges in the quarter, including lower-than-expected iPhone X sales, amid a backlash for limiting performance of older iPhones and for 'No Service' issues on iPhone 7 smartphones. Shares ultimately fell 4.3% on Friday given the big market-wide selloff, but they had a wild after-hours session on Thursday afternoon, trading as low as $162.54 and as high as $174.27 as investors seemed to struggle to parse the results.

CEO Tim Cook, ever positive, said, "We're thrilled to report Apple's biggest quarter ever, which set new all-time records in both revenue and earnings. We generated revenue of $88.3 billion, which is above the high end of our guidance range, and it is up almost $10 billion or 13% over the previous all-time record we set a year ago. It's also our fifth consecutive quarter of accelerating revenue growth, with double-digit growth in each of our geographic segments around the world."

CFO Luca Maestri reminded investors of the gigantic cash pile and tax reform-related changes, "We ended the quarter with $285.1 billion in cash plus marketable securities, a sequential increase of $16.2 billion. $269 billion of this cash or 94% of the total was outside the United States. We issued $7 billion in debt during the quarter, bringing us to $110 billion in term debt and $12 billion in commercial paper outstanding for a total net cash position of $163 billion at the end of the quarter. We also returned $14.5 billion to investors during the quarter. We paid $3.3 billion in dividends and equivalents and spent $5.1 billion on repurchases of 30.2 million Apple shares through open market transactions. Turning to taxes: Due to the recently enacted legislation in the U.S., we estimate making a corporate income tax payment of approximately $38 billion to the U.S. government on our cumulative past foreign earnings. This amount is very similar to what we have been accruing on those earnings in our financial results through fiscal year 2017. Including the $38 billion payment, we will have paid over $110 billion of corporate income tax on our total domestic and foreign earnings during the last 10 years for a cash tax rate of about 26%.Our tax rate of 25.8% for the December quarter was close to our guidance of 25.5% as the lower U.S. statutory rate from the new legislation was effectively offset by the remeasurement of deferred tax balances."

We like that Apple continues to expand in emerging markets, while domestically, Apple Watch has been selling well (over 50% growth in revenue in units for the fourth quarter in a row and strong double-digit growth in every geographic segment). We continue to be happy with Tim Cook's leadership; and with the stock's performance since Steve Jobs' passing. We are pleased that the admittedly expensive iPhone X is selling well – though we find the investor disappointment curious considering Apple sold *only* 77.3 million iPhones in total for the quarter. That's a lot of iPhones! We are fans of Apple's strong product line, diversified geographic revenue, fortress balance sheet (including the aforementioned mountain of cash) and solid dividend yield of 1.6%. Our Target Price has been increased to $202.

Health care distributor **McKesson** (MCK – $159.21) earned $3.41 per share in fiscal Q3 2018 (vs. $2.95 est.). MCK had revenue of $53.6 billion, versus the $52.0 billion estimate. Shares rose early in the week, then plunged on Amazon rumors (see below), recovered somewhat and then fell again following the Amazon earnings report into the weekend. McKesson's adjusted EPS excludes a $1.78 one-time tax benefit related to the U.S. tax policy changes. MCK benefitted in fiscal Q3 from a lower share count, organic growth across multiple operating segments and incremental profit contribution from acquisitions.

Amazon, which everyone nowadays presumes is not a giant river, once again scared an entire sector of Wall Street after news came across the wires that Amazon (Jeff Bezos), Berkshire Hathaway (Warren Buffet) and **JPMorgan Chase** (JPM – $114.28) (Jamie Dimon) were partnering "on ways to address healthcare for their U.S. employees, with the aim of improving employee satisfaction and reducing costs." If this sounds familiar, it is. We heard rumors that Amazon was lurking in the pharmacy space (or similar) in May 2017, September 2017, October 2017 and November 2017. The only difference now is that Mr. Bezos confirmed the rumors, and pulled in two major partners. The press release had quotes from all three executives:

"The ballooning costs of healthcare act as a hungry tapeworm on the American economy. Our group does not come to this problem with answers. But we also do not accept it as inevitable. Rather, we share the belief that putting our collective resources behind the country's best talent can, in time, check the rise in health costs while concurrently enhancing patient satisfaction and outcomes," said Mr. Buffett.

"The healthcare system is complex, and we enter into this challenge open-eyed about the degree of difficulty," said Mr. Bezos. "Hard as it might be, reducing healthcare's burden on the economy while improving outcomes for employees and their families would be worth the effort. Success is going to require talented experts, a beginner's mind, and a long-term orientation."

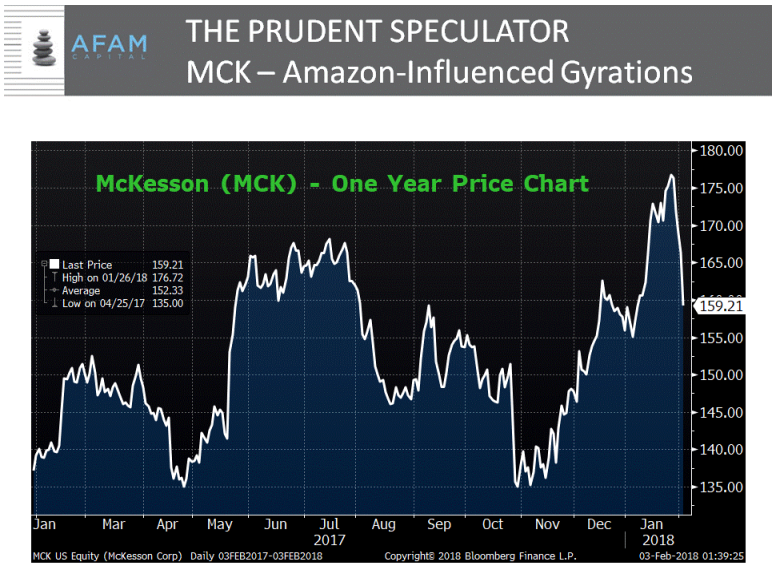
"Our people want transparency, knowledge and control when it comes to managing their healthcare," said Mr. Dimon. "The three of our companies have extraordinary resources, and our goal is to create solutions that benefit our U.S. employees, their families and, potentially, all Americans."

Certainly, this is not the first foray of individual companies into health care or pharmacy. Top of the examples list is Kaiser Permanente, one of the largest and most famous integrated managed care consortiums, which started as a pact between industrial magnate Henry J. Kaiser and Dr. Sidney Garfield, a young physician unable to find work after finishing residency at L.A. County-U.S.C. Medical Center. Mr. Kaiser wanted to find a way to lower his health care costs; and he did with Dr. Garfield's help. **Caterpillar** (CAT – $157.49), the construction equipment maker, also has its own pharmacy benefit manager (PBM).

While those two examples are far from a comprehensive list, we note that both Kaiser and Caterpillar have been successful in their lowering costs, but costs continue to rise in the aggregate and we think McKesson CEO John Hammergren made very pertinent points last quarter when he addressed the Amazon concerns with analysts, "To some extent, we were Amazon before it was cool to be Amazon. Now, if you think about our business model, largely it

is an online order relationship. From an order processing perspective, it is very well functioning that has been in place for a long time, next-day delivery and a complete process from a logistics perspective. But it's also supported by field salespeople, return goods management, sometimes private trucking, and certainly things like controlled substance management, billions of dollars of inventory, and very significant back-office operations that reconcile the significant delta in various pricing strategies that our manufacturer partners, both in medical supplies as well as in pharmaceuticals, rely upon with us in partnership. So, I would say, in some ways, it's very similar to what Amazon would do maybe logistically. But if you actually think about what's behind the scenes in terms of us taking credit risk, in terms of us processing invoices and processing returns, and then processing pricing on a regular basis, it's quite significant and more nuanced, perhaps, than it would appear on the surface."

He continued, "Clearly, we are also heavily focused on trying to make sure that our customers have the right tools and capabilities to help them with all of their requirements in terms of patient relationships to make it more than just a transaction and make it a healthcare experience supported by a professional pharmacist that really understands the nuances of drug-to-drug interaction, understands what it means to dispense things like opioids and other products, and understands certainly the regulatory framework and the larger clinical issues that may be facing the patients that they're working with every day. So, the easiest thing to talk about in the world of wholesaling is the logistics function. But I would say that that's probably the simplest part of our business. And clearly, we try to excel in myriad of other areas that we think differentiate us. Having said all of that, we don't take the entry of any competitor lightly and we continue to evolve our strategy so that our value to both the manufacturer and to our customers is unique and superior."



No doubt, Amazon's heath care solution eventually could be a formidable competitor, but we see MCK (along with the other health care and drug distribution companies we own) as still being able to capitalize on continued pharmaceutical spending in the U.S. that is projected to grow robustly in the coming years, considering the aging of our population. We believe that the

important role McKesson plays in getting medical supplies and medicines from manufacturers to pharmacies, clinics, hospitals and patients remains a vital link that we think is not easily replicated. We reprise what one industry watcher said during the last bout of rumors, “Amazon has built its business dealing with first-party payment—the consumer. It’s a very different business when the consumer is sharing the cost with a third party.” Finally, we note that the aforementioned Mr. Dimon was busy working the phones since the news broke, reassuring his health-care-industry investment-banking clients that JPMorgan has no intention of competing with them. MCK trades for 12.0 times NTM earnings estimates and our Target Price actually has been bumped up to $216.