MARKET COMMENTARY MONDAY, MAY 28, 2018

May 28, 2018

EXECUTIVE SUMMARY

TPS 620 – June Issue Coming Friday Evening
Corporate Profits – Earnings Have Been Very Good
Econ News – Mixed Recent Data, But Generally Positive Overall
Fed Minutes – More Likely to Let Inflation Run Modestly Above 2%
Myth Debunking – Rising/Falling Interest Rates Definitely Bad/Good for Stocks
Valuations – Inexpensive Newsletter Portfolio Metrics
Stock News – Updates on FITB, KSS, TGT, LOW, WSM, MDT, MCK & FL

Market Review

Happy Memorial Day! Work is underway on the June edition of *The Prudent Speculator*. If all goes according to plan, we will email *TPS 620* late on Friday, June 1. This month, we will offer our regular quarterly Earnings Scorecard, which recaps a spectacular Q1 reporting season across Corporate America. Indeed, according to calculations from data provider Bloomberg, 78.6% of the S&P 500 members that have announced results thus far have exceeded EPS expectations, compared to only 15.3% that have trailed consensus analyst forecasts. Those numbers compare very favorably to the respective Beat/Miss stats of 73.2% and 19.8% for Q1 2017.

Looking ahead, Standard & Poor's now projects that earnings per share for the S&P 500 will jump from $124.51 in 2018 to $157.24 this year to $174.47 in 2019, with comparable estimates from Bloomberg. Not surprisingly, with healthy earnings growth likely, even as analysts are often too rosy in their forecasts, we remain optimistic about the long-term prospects for equities,...

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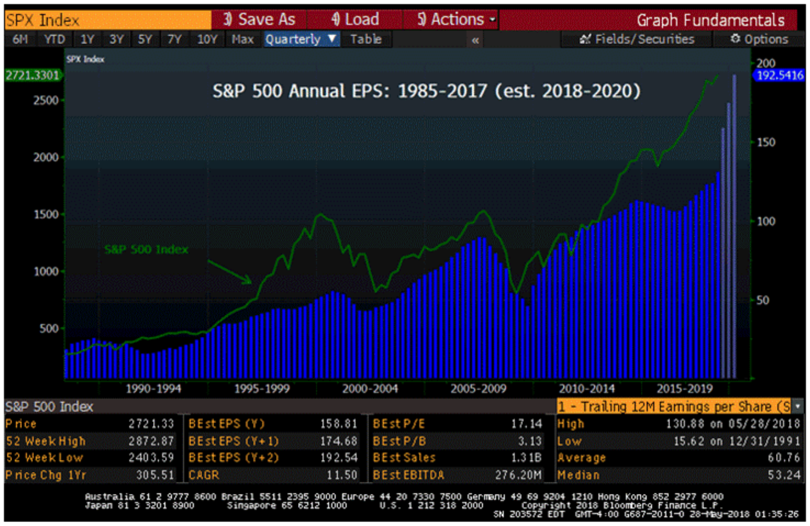
Stock Prices Often Follow Earnings

Market history shows that sustained market downturns usually coincide with a recession in corporate profits. No guarantees, of course, but the outlook for earnings, especially given the recent tax cuts, is favorable.



...conceding that recent economic statistics have not always been grand,...

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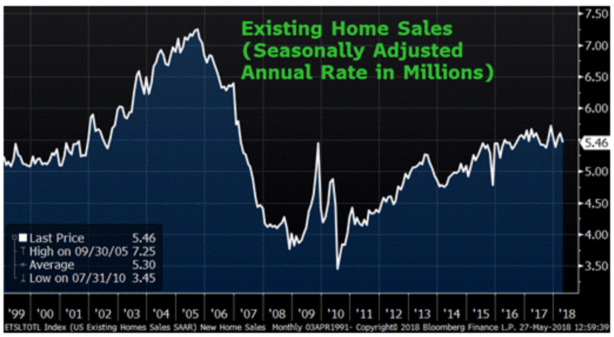
Mixed Econ Data



Though a big drop in volatile aircraft demand led to a 1.7% dip in overall orders for durable goods, the Commerce Department said that core (ex. Transportation) capital goods orders rose a better-than-expected 1.0% in April. Meanwhile, sales of existing homes for April were somewhat disappointing as the not-so-bad 5.46 million pace trailed estimates of 5.60 million, no doubt impacted by rising prices and interest rates.

…though the preponderance of the evidence suggests a relatively positive outlook for U.S. GDP growth.

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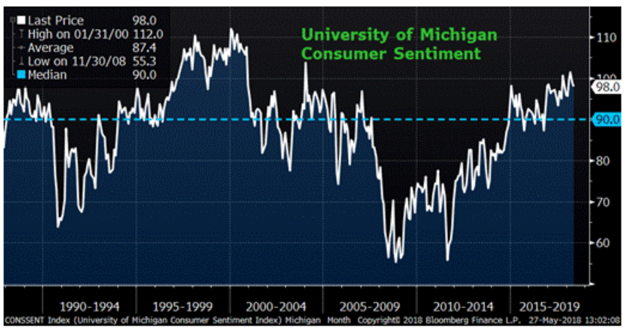
Consumers Have Reason to be Upbeat



The jobs picture remains robust as first-time claims for unemployment benefits continue to reside at near-record lows, with the latest weekly tally coming in at 234,000, far below the long-term average. And though the University of Michigan's gauge of Consumer Sentiment for May dipped to a weaker-than-expected 98.0, the number was still healthy and well above the median level over the last 30 years.

Such was generally the view expressed by the Federal Open Market Committee earlier this month, with the Minutes of the latest Fed Meeting released last week including: "In their discussion of the economic situation and the outlook, meeting participants agreed that information received since the FOMC met in March indicated that the labor market had continued to strengthen and that economic activity had been rising at a moderate rate. Job gains had been strong, on average, in recent months, and the unemployment rate had stayed low. Recent data suggested that growth of household spending had moderated from its strong fourth-quarter pace, while business fixed investment had continued to grow strongly."

More importantly for short-term-oriented market participants, the Fed's attitude seemingly became a little more dovish (i.e. less inclined to raise interest rates at a rapid pace), given the perception that Jerome Powell & Co. might let inflation run above the important 2.0% level for a period of time. The minutes included, "A few participants commented that recent news on inflation, against a background of continued prospects for a solid pace of economic growth, supported the view that inflation on a 12-month basis would likely move slightly above the Committee's 2% objective for a time. It was also noted that a temporary period of inflation modestly above 2% would be consistent with the Committee's symmetric inflation objective and could be helpful in anchoring longer-run inflation expectations at a level consistent with that objective."

No doubt, drama related to North Korea, tariffs and oil prices also played a major role, but the Fed Minutes helped to ignite a big rally in U.S. Treasuries, with the yield on the benchmark 10-Year skidding from 3.06% a week ago to 2.93% today. Perhaps surprisingly to some, given all of the commentary from pundits who insist that stock prices are dependent on interest rates,...

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Interest Rates and Stocks

Despite a significant drop back below 3.0% on the 10-Year U.S. Treasury yield in the week ended 5.25.18, stock prices did not jump higher, continuing to throw more cold water on the argument that falling/rising interest rates definitely must be good/bad for equities

...the equity markets did not soar in response to the big drop in the 10-Year yield. On the contrary, stocks endured renewed intraday volatility in response to headlines out of Washington, Asia and the Middle East, with a supposed flight to safety boosting Treasuries. Nevertheless, the major stock market averages managed modest appreciation on the week, with the S&P 500 advancing 0.33% and the Russell 3000 index gaining 0.30%. Value underperformed Growth again last week, with the Russell 3000 Value index sinking 0.17% compared to a 0.73% increase for the Russell 3000 Growth index, though our portfolios generally ended in the green for the five days.

The equity futures for Tuesday's trading were a bit higher as these comments were penned, thanks to seemingly positive developments in Asia, but we remain braced for additional volatility, even as nothing has occurred to alter our faith in the long-term prospects of our broadly diversified portfolios of undervalued stocks. As we have said in recent missives, we still think investor sentiment is far from optimistic, interest rates are still very low by historical standards, corporate profits are poised to enjoy significant growth this year and next, the global economies are showing modest to moderate growth and equity valuations are far more reasonable after this year's churning.

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THE PRUDENT SPECULATOR Newsletter Portfolio Metrics

CURRENT PORTFOLIO AND INDEX VALUATIONS

Name	Price to Earnings Ratio	Price to Fwd. Earnings Ratio	Price to Sales Ratio	Price to Book Ratio	Dividend Yield
TPS Portfolio	15.8	13.0	1.2	1.9	2.7
Select Value	16.8	13.5	1.3	2.1	2.3
Select Dividend	16.4	13.4	1.1	2.1	3.0
Select Focused Dividend	14.3	12.0	0.9	2.1	3.3
Select Focused Value	14.8	12.8	1.3	2.3	2.7
Select SMID Dividend	18.0	14.0	0.7	1.8	2.5
Russell 3000	22.3	17.9	2.0	3.1	1.8
Russell 3000 Growth	26.8	21.3	2.8	6.5	1.2
Russell 3000 Value	18.8	15.2	1.6	2.0	2.5
Russell 2000	46.2	26.3	1.3	2.4	1.3
Russell 2000 Growth	71.4	34.2	1.7	4.4	0.7
Russell 2000 Value	33.2	20.9	1.1	1.6	1.9
Russell 1000	21.3	17.4	2.1	3.2	1.9
Russell 1000 Growth	25.4	20.7	2.9	6.8	1.3
Russell 1000 Value	18.1	14.8	1.6	2.0	2.5
S&P 500 Index	20.8	17.1	2.2	3.3	1.9
S&P 500 Growth Index	24.6	20.2	3.6	6.0	1.3
S&P 500 Value Index	17.6	14.6	1.5	2.2	2.6
S&P 500 Pure Value Index	15.0	12.2	0.6	1.4	3.3

As of 05.27.18. Weights based on model portfolios. Harmonic mean used to calculate the portfolio price metrics. Companies with negative earnings are excluded from the P/E and Estimated P/E calculations. SOURCE: AFAM Capital using data from Bloomberg Finance L.P.

Stock Updates

Chris Quigley provides updates on 8 of our recommendations that were in the news last week…

Shares of **Fifth Third Bancorp** (FITB – $31.36) dropped more than 6% last week after the regional banking leader reported that it would merge with Chicago-based MB Financial. The transaction is valued at approximately $4.7 billion. If approved by shareholders, MB Financial shareholders would receive $54.20 of total consideration, consisting of 1.45 FITB shares and $5.54 in cash. According to the press release, the merger will "result in a total Chicago deposit market share of 6.5%, ranking the combined company fourth in total deposits and second in estimated retail deposits among the nearly 200 banks in the marketplace. Additionally, the combined company will have a 20% share of middle market relationships in Chicago, ranking it second."

"There were no other potential partners of the same caliber as MB Financial in the Chicago market, and we are very pleased to reach an agreement to merge our companies. We view MB Financial as a unique partner in our efforts to build scale in this strategically important market. Customers of both banks will benefit from greater convenience and the complementary capabilities that our banks, together, can offer," said FITB CEO Greg D. Carmichael.

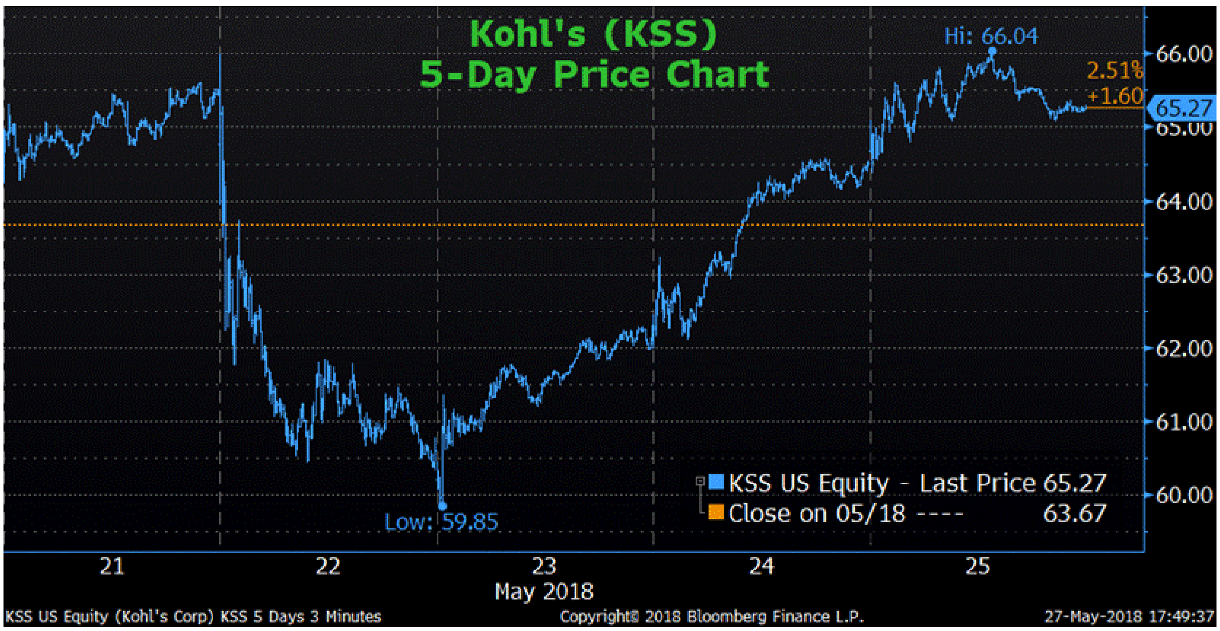
"In addition to its strategic importance, this merger is expected to drive significant financial benefits. We expect our investment to generate an IRR of approximately 18.5% and to be accretive to our operating EPS in the first year, with accretion of nearly 7% in the second year, once cost savings are fully realized. Furthermore, we not only expect the merger to accelerate our progress towards our NorthStar financial targets but also raise them above our previous guidance," Mr. Carmichael added.

While we like that the deal will give FITB a significant increase in footprint in the Chicago area and has potential for synergies (including "significant" branch overlap), we think that the price paid is on the rich side. MB Financial's fundamental metrics are more expensive than those of FITB. For example, MB Financial's forward P/E is 17.5 times (vs. FITB's 12.6 times) and yield is 1.9% (vs. FITB's 2.0% yield). We do like that the deal should quickly be accretive to FITB's earnings, even as we know that there are always integration risks in any merger. When all was said and done, we chose to trim our Target Price for FITB by a buck to $40.

Family-oriented department store operator **Kohl's** (KSS – $65.27) earned $0.64 per share in fiscal Q1 2019 (vs. $0.50 est.). KSS had sales of $4.2 billion (vs. $4.0 billion est.). While the earnings were terrific (albeit with some easy year-over-year comps) and earnings guidance was raised to $5.05 to $5.50 per share for 2018 (from $4.95 to $5.45), shares initially rose 5% after hours, then tumbled 7.4% the following day on management's comments that included possible headwinds in the back half of the year. Happily, the plunge didn't stick and shares finished the week up 2.5%. We would imagine that the folks that dumped their stock in the $60 range on Tuesday or Wednesday were none too pleased to see Friday's $65+ close!

THE PRUDENT SPECULATOR
KSS – Patience at Work Again

Fascinating how short-sighted folks ignored an earnings beat and increased guidance from department-store retailer Kohl's, instead focusing on an innocuous calendar-related "headwind" comment from management. Happily, the negative reaction was very short-lived.



As is sometimes the case, the headlines don't match up with the context of the full quote. We think that's the case here. In response to an analyst question about the back half of the year and the holiday season, CFO Bruce Besanko said, "In regards to the guidance question, obviously, we've increased the guidance. The sales number, though, we increased the guidance in large part because of the gross margin outperformance in the first quarter, though we're still early in the year, but the comp sales for the annual basis is still the flat to 2% higher for the year. And as I just said, the retail calendar shift favorably impacting the first half and negatively impacting (headwind) the second half. And then, just one more comment on this guidance, obviously the gross margin beat was pretty good in the first quarter. So, we've taken effect of that and obviously updated the guidance from a margin perspective to 15 basis points to 20 basis points." While Mr. Besanko's reply could be interpreted a number of ways, we don't think that it deserved the share price to plunge more than 7%, a conclusion reached pretty quickly by investors who almost immediately bid KSS shares higher.

In any event, we think Kohl's has some good things in the pipeline, including strong expected digital growth due to new customer features including Buy Online Ship to Store (BOSS), building out a sixth e-commerce fulfillment center and launching a new loyalty program. While KSS has been forced to evolve to ward off other e-commerce giants, and continues to work through this process, we have been pleased with the firm's progress. We remain fond of the company's solid free cash flow generation and think that investments it is making in its online business, smaller store concepts and loyalty program will eventually pay off. In our eyes, KSS is still attractively undervalued, now trading for just 11.9 times forward earnings estimates and yielding 3.7%. Our Target Price for KSS has been elevated to $76.

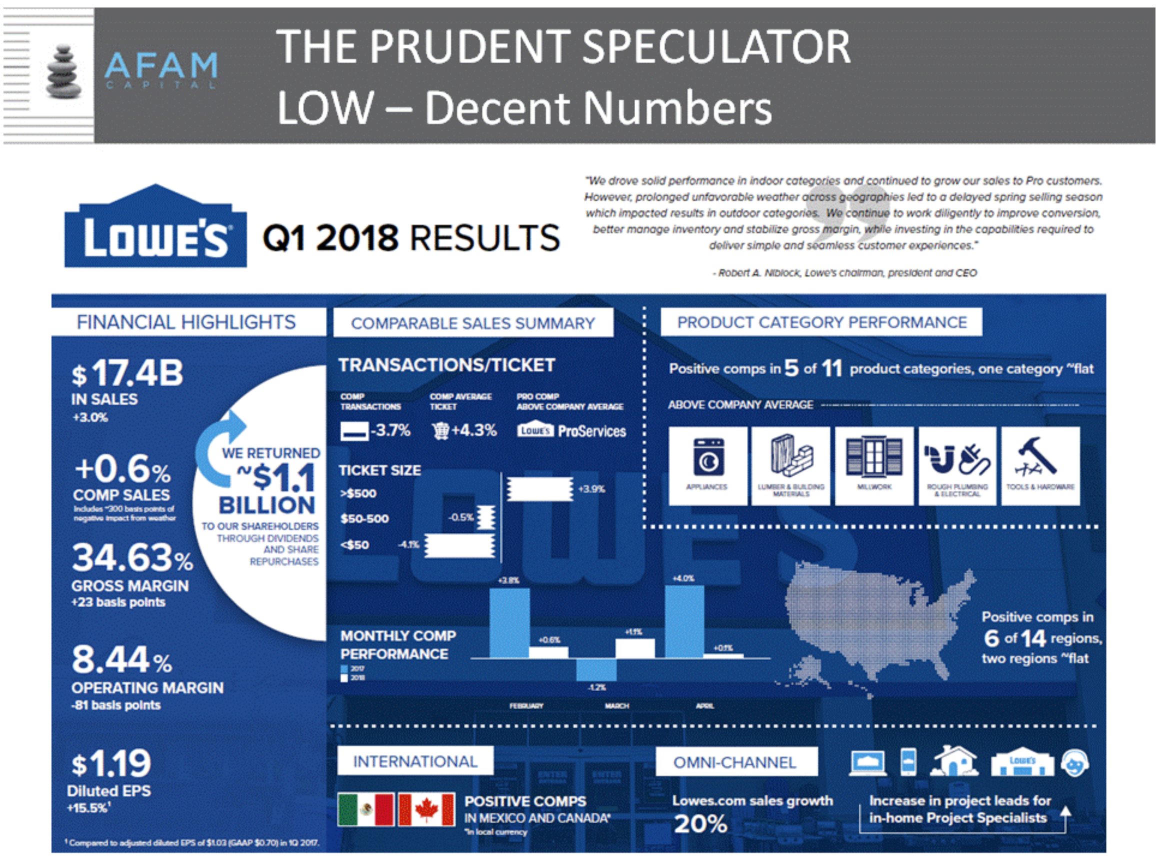
General merchandise discount store chain **Target** (TGT – $71.21) earned $1.32 per share in fiscal Q1 2019 (vs. $1.39 est.). TGT had sales of $16.6 billion, matching the analyst consensus estimate. Shares tumbled 5.7% following the announcement.

CEO Brian Cornell said, "Our traffic growth of 3.7% is the strongest we've seen in more than 10 years, reflecting healthy increases in both our stores and digital channels. Comparable sales growth of 3% was consistent with our guidance, driven by strength in home, household essentials and food and beverage. This demonstrates the benefits of maintaining a balanced portfolio, as strength in these categories offset the impact of a late spring on our temperature sensitive categories, which have accelerated dramatically as we entered the second quarter."

Despite being greeted initially with a frosty reception, the small store format is working very well for TGT. CFO John Mulligan explained, "We opened seven new locations in the first quarter, including one large format location and six small formats in metro areas like Los Angeles, Boston and Chicago. We're really pleased with the financial performance of these new small format stores and even happier with how they grow. We have dozens of small formats that have been opened for more than a year and as a group, they continue to comp in high single-digits in the first quarter. When we look at what's driving our traffic growth, we can't isolate a single driver. It's the combination of all the changes we've been making that have changed the trajectory. In fact, we continue to see the benefit of our 2015 sale of the pharmacy business to CVS, as script counts in our store pharmacies increased 8% in the first quarter. While the progress feels great, we are not about to slow down."

The retailer returned $800 million to shareholders in the quarter via share repurchases and dividends, and expects to make $3.5 billion of capital expenditures for the full year. While we expect there to be no shortage of competitive headwinds in the future, we think that Target's strong balance sheet, small stores and large investments in its multi-channel sales network should help solidify its foundation for the future. TGT shares trade for 13.3 times forward earnings and offer a dividend yield of 3.5%. Our Target Price now stands at $85.

Home improvement retailer **Lowe's Cos** (LOW – $96.69) posted earnings per share of $1.19, versus the $1.22 estimate in fiscal Q1 2019. LOW had sales of $17.4 billion (vs. $17.5 billion est.). Those numbers were evidently not as bad as pessimistic analysts were looking for and shares rose more than 10% with the added news that the company had hired Marvin Ellison as CEO, a well-regarded industry veteran whose most recent appointment was as the CEO of JC Penney. While the departure of current CEO Robert Niblock was expected, analysts seemed pleasantly surprised with the choice of replacement. Shares tacked on an additional gain after news broke on Thursday that billionaire hedge fund investor Bill Ackman took a $1 billion position in the company.



On Wednesday's conference call with investors, Mr. Niblock said, "In the first quarter, we experienced a delayed spring selling season due to prolonged unfavorable weather across geographies that impacted outdoor categories. As a result, we delivered first quarter comparable sales growth of 0.6%, driven by a 4.3% increase in comp average ticket. However, spring has finally arrived and comps in May are double-digit positive. Looking ahead to the rest of the year, we expect that solid macroeconomic fundamentals, such as strong employment and income gains, will sustain home improvement market expansion and that the home improvement industry is poised to grow its share of overall consumer spending. Housing is expected to remain a positive driver, as demand in excess of supply drives home price appreciation and we continue to see household formation improvement over the past year, which should persist amid steady job gains. We'll continue to focus on and invest our resources in what is most relevant to engaging customers in the moments that matter and improving the capabilities our employees need to better serve customers. In doing so, we will strengthen our competitiveness, positioning us to continue capitalizing on home improvement demand."

Management expects revenue growth around 5% with full-year earnings per share between $5.40 and $5.50, an increase from the previously issued guidance. We think that a favorable macroeconomic backdrop should continue to bolster the home improvement industry, Lowe's included, for the foreseeable future. LOW trades at 17.3 times forward EPS estimates with a yield of 1.7%. Our Target Price has been raised to $118.

Home goods retailer **Williams-Sonoma** (WSM – $53.10) earned $0.67 per share in fiscal Q1 2019 (vs. $0.58 est.). WSM had sales of $1.20 billion (vs. $1.16 billion est.). Shares traded higher by 5.7% following the announcement, though they were up as much as 15% in early trading on Thursday. Although WSM's results showed progress, it wasn't enough to appease some analysts, who penned research notes that took a lot of wind from the stock's sails. Notably, Baird analyst Peter Benedict wrote that he is "reluctant to chase the stock" and has concerns over long-term margins. We disagree.

CEO Laura Alber said, "We achieved strong results against our guidance range across all metrics, with our e-commerce revenues outpacing to almost 54% of our total revenue. These results speak to the power of our multi-channel model, distinctive brand portfolio and world-class customer service heritage, all of which are our company's competitive strengths. Based on a strong start to the year, we are raising our full-year revenue guidance by $20 million and our EPS by $0.03 [$4.15 to $4.25 per share]."

Ms. Alber continued, "We're pleased with our start to fiscal 2018. In addition to driving topline and EPS growth, our customer satisfaction continues to improve, our customer counts continue to increase and our inventory growth is declining as we continue to drive efficiencies throughout our business. Customers are at the center of everything we do and we remain firmly focused on delivering both the inspiration and superior service to transform their houses into homes. We are very optimistic about our growth prospects ahead and we look forward to updating you on our progress next quarter."

WSM has seen a substantial boost from the reduction in corporate tax rate. The company paid 23.8% in Q1, compared with 34.5% in Q1 last year, a 16% gain in terms of EPS. Certainly, increasing competition from Amazon and margin pressure aren't new risk factors for the company, and they explain a large part of the reason that the stock is trading at a bargain price by our view, but we continue to smile upon the investments in technology and in WSM's online presence, and believe those features when paired with exceptional customer service differentiate WSM's brands from the rest of the retail world. With a recent bump in dividend to $0.43 per quarter, shares now yield 3.2%. Trading for just 12.5 times estimated earnings, our Target Price for WSM has been hiked to $77.

Health care equipment developer and manufacturer **Medtronic PLC** (MDT – $86.30) posted earnings per share of $1.42, versus the $1.38 estimate in fiscal Q4 2018. MDT had revenue of $8.1 billion, versus the $8.0 billion estimate. Given the solid quarter, shares traded higher by about 2%.

Chairman and CEO Omar Ishrak offered the following positive comments on fiscal 2018, "The second half of the year was particularly strong, overcoming several first-half challenges, including an IT disruption, multiple hurricanes, fires in Santa Rosa and supply constraints in Diabetes. Despite all of this, we recovered well and came in at the high end of both the revenue and the EPS guidance we established at the start of the year. We also continued to drive margin expansion, reduced debt leverage and returned$4.3 billion to shareholders. We made significant progress against each of our growth strategies. In therapy innovation, we executed a number of meaningful product launches and advanced a pipeline of increasingly groundbreaking medical technology, recreating new markets, disrupting existing markets and leading in several of the fastest-growth markets in med tech."

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MDT – Excellent Quarter

"Looking at the picture ahead, for fiscal year 2019, we expect organic revenue growth to be in the range of 4% to 4.5%. By business group, we expect CVG (Cardiac and Vascular Group), MITG (Minimally Invasive Therapies Group) and RTG (Restorative Therapies Group) to grow 4% plus or minus, with CVG likely on the minus side, given the anniversary of major product launches in Coronary & Structural Heart; and MITG and RTG to be more in line with the 4%. We expect Diabetes to grow in the low double digit, with a stronger first half off of low comparisons," Mr. Ishrak stated.

We believe that MDT continues to offer appealing long-term returns and continue to think that the acquisition of Covidien a few years ago has produced a stronger and more appealing company. Pairing MDT's diversified product portfolio aimed at a wide range of chronic diseases with Covidien's breadth of products for acute care in hospitals has strengthened the firm's position as a key partner for its hospital customers, which boosts our optimism about the long-term growth prospects. We remain fans of Medtronic's diverse portfolio, as when certain product lines wane, new offerings are seemingly always rolled out to help offset slowdowns and foster growth. With domestic demographic trends in its favor, we like its products and pipeline, including treatments for atrial fibrillation, aortic stenosis and various neurological disorders. MDT yields 2.1% and trades at less than 17 times NTM adjusted EPS projections. Our Target Price for MDT has been lifted to $103.

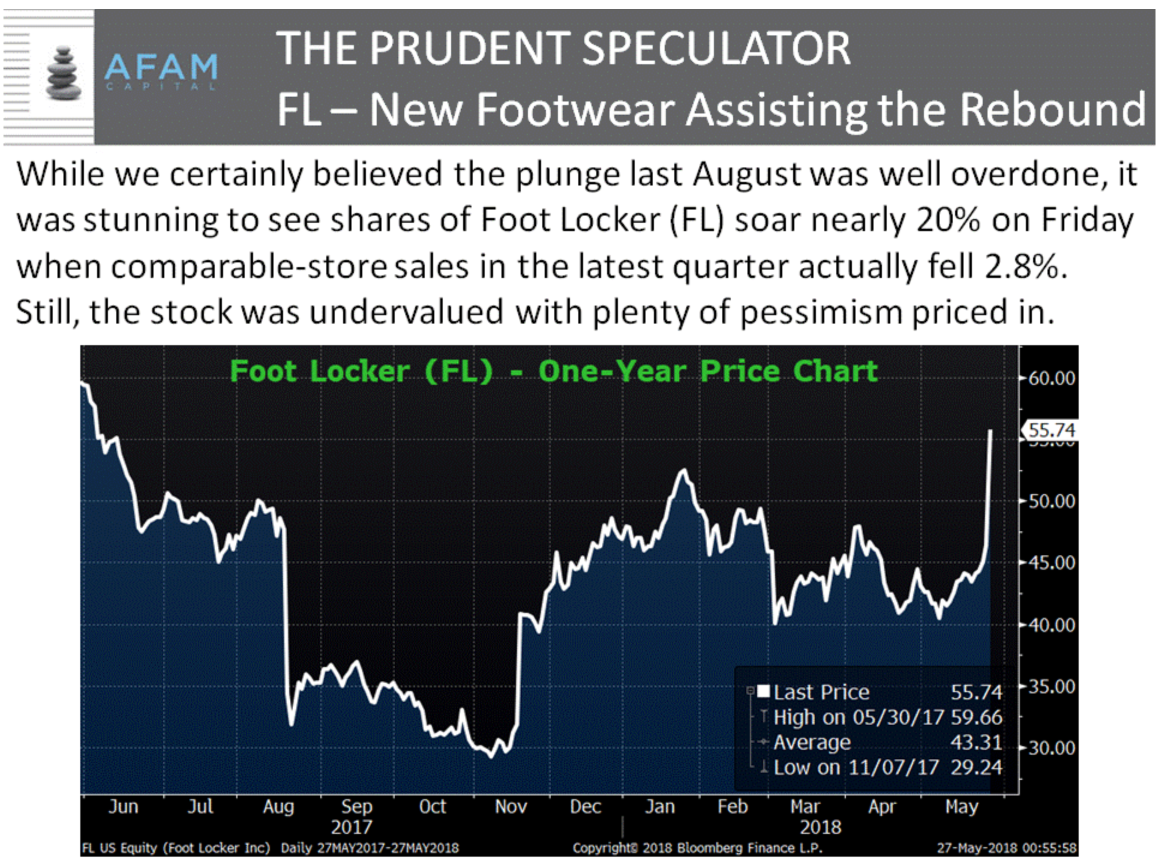
Health care distributor **McKesson** (MCK – $145.81) earned $3.49 per share in fiscal Q4 2018 (vs. $3.56 est.). MCK had sales of $51.6 billion (vs. $51.4 billion est.). After the earnings miss, shares slipped 1.9%, and management's reaffirmation of previous EPS guidance ($13.00 to $13.80 per share) seemed to go unnoticed. In addition, MCK announced an additional $4 billion buyback, which is significant given that the total value of MCK as of Friday's close was 'only' $29.5 billion.

McKesson CEO John Hammergren said, "Our outlook reflects a competitive but more stable market environment and effective capital allocation, while including the anticipated headwinds in our European and Canadian businesses. I would also remind you that our multiyear strategic growth initiative is not expected to materially impact our financial results in the coming year. We are in the preliminary phase of implementing the strategic growth initiative and efforts are well under way across the organization. We'll provide more details on our progress as well as our growth initiatives at our Investor Day, which is scheduled for the end of June."

He continued, "I'm pleased with our fourth quarter results, which were driven by solid execution across multiple businesses. And for the year, we were able to deliver results that were largely in line with our expectations outlined at the beginning of the year. We bring new value to health systems' customer relationships and renewed our extended contracts with all of our major independent buying groups in the past 18 months. We've recorded the first full-year of operations of Change Healthcare, a scaled healthcare information technology business which began integrating the combined businesses, realizing targeted cost synergies and preparing for our future initial public offering."

With the company's many irons in the fire and (thus far) successfully bringing the fight to Amazon, we continue to see MCK 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. MCK trades for less than 11 times NTM earnings estimates and our Target Price actually has been bumped up to $213.

Shoe and apparel retailer **Foot Locker** (FL – $55.74) earned $1.45 per share in fiscal Q1 2019 (vs. $1.25 est.). FL had sales of $2.03 billion (vs. $1.96 billion est.). The big beat sent shares surging 19.9% in Friday's trading, even as same-store sales actually dropped 2.8% during the period. Of course, the investment community was expecting a bigger dip in stores open more than a year, illustrating that plenty of bad news had already been discounted by the inexpensive stock price.



"The flow of premium product continues to improve, with increasing breadth and depth in the most sought after styles from our key vendors," said FL CEO Richard Johnson. "This led to first quarter results which were above our expectations. With the strength of our strategic vendor partnerships and our central position in youth culture, we continue to believe that we are poised to inflect to positive comparable-store sales growth as we progress through the year."

Mr. Johnson continued, "The dramatic shifts influencing the expectations and behaviors of our customers continued to affect our business in the fourth quarter, just as they have throughout 2017. That said, we remained a highly profitable company in 2017, even though our sales and profit results were not what we planned for going into the year. Looking ahead, with the product and other strategic initiatives we have underway, we believe we are positioned well, both organizationally and financially, to successfully transform our business to continue inspiring and serving an exceptionally dynamic youth culture, for generations to come."

Foot Locker spent $112 million to buy back 2.6 million shares during the quarter. FL also reported $1.029 billion of cash on its balance sheet and said it opened 11 new stores, relocated or remodeled 43 stores and closed 37 stores in the quarter, bringing the total store count to 3,284. Excluding exchange rates, the company saw a 7.1% reduction in inventory, which leaves it in a position to "flow in fresh and exciting product throughout the balance of the year." After being punished at seemingly every possible Amazon-related turn over the past year, we were pleased to see Foot Locker get its day in the sun. We think that the company's solid cash position, online presence and inventory management give us plenty of reasons to continue to hold the stock. Our Target Price has been boosted to $78.