

MARKET COMMENTARY MONDAY, DECEMBER 25, 2017

EXECUTIVE SUMMARY

Week in Review – Value Wins the 5-Day Race
 Miracle of Compounding – Dow 50000 by 2030
 Tax Bill Passes – Good News for Corporate America
 Sentiment – AAll Bullishness Running High
 Fund Flows – Contrarians Still Have Little to Worry About
 Santa Claus Rally – Favorable Time of the Year
 Company News – Updates on CCL, FDX & NKE

Market Review

Merry Christmas! Given the Holiday, we offer a shorter missive following a solid week for the equity markets in general and a very good five days for Value-oriented strategies in particular. While the S&P 500 gained 0.30% last week, with the Russell 3000 rising 0.41%, Growth stocks trailed for a change in the relative performance race. The Russell 3000 Value index climbed 0.70%, compared to a 0.12% advance for the Russell 3000 Growth index.

And, lest those numbers elicit a ho-hum in response, we note that the former works out to a 43.7% return if it were repeated over each of the 52 weeks of the year. Even the latter produces a 6.4% return when annualized, illustrating again the oft-discussed Miracle of Compounding.



It is amazing how relative modest yearly return numbers can lead to substantial growth when time and simple math are applied. For example, Dow 50000 by the year 2030 would be achieved with annual price gains for the index of 5.6%...which is merely the historical average.

Miracle of Compounding - Dow 50000 by 2030
 (Initial Value of Dow Jones Industrial Average = 24754, December 2017)

	Inflation 3.0%	Intermediate Gov't Bonds TR 5.1%	Dow Jones Industrial Average Price Return 6.6%	Corporate Bonds TR 8.0%	S&P 500 TR 10.0%	Fama/French Dividend Stocks TR 10.9%	Fama/French Value Stocks TR 13.3%
Dec-17	24,754	24,754	24,754	24,754	24,754	24,754	24,754
Dec-18	25,497	26,016	26,140	26,239	27,229	27,353	28,046
Dec-19	26,262	27,343	27,604	27,814	29,952	30,225	31,776
Dec-20	27,049	28,738	29,150	29,482	32,948	33,399	36,003
Dec-21	27,861	30,203	30,782	31,251	36,242	36,906	40,791
Dec-22	28,697	31,744	32,506	33,126	39,867	40,781	46,216
Dec-23	29,558	33,363	34,326	35,114	43,853	45,063	52,363
Dec-24	30,444	35,064	36,249	37,221	48,239	49,794	59,327
Dec-25	31,358	36,853	38,279	39,454	53,062	55,023	67,218
Dec-26	32,298	38,732	40,422	41,821	58,369	60,800	76,158
Dec-27	33,267	40,707	42,686	44,331	64,206	67,184	86,287
Dec-30	36,352	47,259	50,266	52,799	85,458	90,647	125,497
Dec-32	38,566	52,202	56,054	59,324	103,404	110,683	161,099
Dec-37	44,708	66,942	73,608	79,389	166,533	182,344	300,776

Compounded at average annualized rates that have been the historical returns on each investment from June 1927 to August 2017. Source: AI Frank using data from Morningstar, Bloomberg and Professor's Eugene F. Fama & Kenneth R. French. Past performance not a guarantee of future performance.

No doubt, the big news of the week was the signing of the Tax Cuts and Jobs Act, with its reduction in the corporate income tax rate to 21% from 35%. To be sure, the calculations are not as simple as increasing EPS by 21.5% (0.79% divided by 0.65%; i.e. companies keeping 79% of what they earn, instead of 65%), given that the effective tax rates across Corporate America are all over the map. Still, it is likely that many publicly traded companies will see a solid boost to their after-tax income.

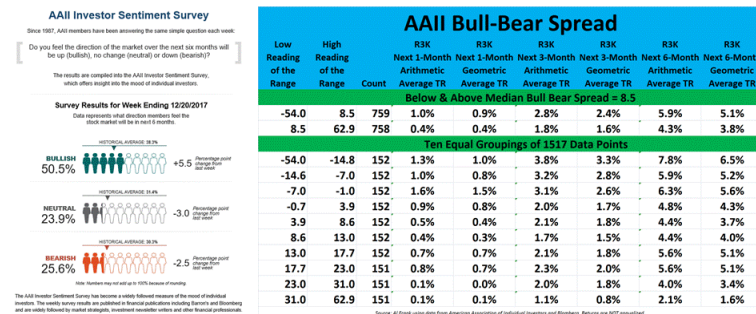
Of course, what businesses choose to do with the extra dollars in their coffers remains to be seen – thus far, we have heard from five of our companies, with *The Wall Street Journal* writing:

Boeing (BA – \$295.10) saying the new law “boosts Boeing’s competitiveness,” announced it will move up an additional \$300 million of investments, dedicating \$100 million to corporate giving; \$100 million for worker development; and \$100 million to enhance the company’s facilities... **AT&T** (T – \$38.94) said it will increase its U.S. investments next year by \$1 billion, plus pay a \$1,000 bonus to some 200,000 employees. **Comcast** (CMCSA – \$40.78) CEO Brian Roberts, explicitly citing tax reform and the FCC’s decision to end net-neutrality, pledged a \$1,000 bonus to about 100,000 employees and vowed to invest “well in excess” of \$50 billion over five years... **Wells Fargo** (WFC – \$61.55) and **Fifth Third Bancorp**(FITB – \$30.84) said they would increase their minimum wage to \$15 an hour, with Fifth Third also throwing in a \$1,000 bonus for 3,000 hourly workers.

And, we would think dividend increases, share buybacks and heightened merger and acquisition activity would also be high on executive team agendas, which is probably a good part of the reason why investor optimism rose again last week. Indeed, the number of Bulls in the latest American Association of Individual Investors Survey jumped above 50%, with AAI explaining, “Optimism among individual investors about the short-term direction of stock prices is at its highest level in nearly two years, rising to unusually high level.”

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AAII Sentiment – Contrarian Indicator

Warren Buffett states, “Be greedy when others are fearful and fearful when others are greedy,” and the weekly AAI Bull-Bear Spread and subsequent performance supports the Oracle of Omaha’s assertion...at least on the “others are fearful” argument. Of course, the latest +24.9 reading would argue that a little near-term caution may be in order.



While the AAI data certainly raises a contrarian eyebrow, we also heard via CNBC.com, “As Congress voted on the tax bill this week, investors pulled \$14.5 billion from equities funds and ETFs, the fourth largest on record and the most since the weeks after Brexit, according to Bank of America Merrill Lynch...Bond funds saw their biggest outflows in a year, with high-yield funds losing \$5.3 billion in an eighth week of losses...The BofAML strategists said the trades in the week ended Wednesday did not translate into ‘Trump trade,’ with funds exiting financials, small-caps and value funds, all sectors that should benefit from lower taxes.”

The BofAML fund data is a bit more recent than the latest numbers from the Investment Company Institute, but ICI has actually been reporting a bit of renewed interest in U.S. stock mutual and exchange traded funds. Of course, it will take many months of net inflows into

domestic equities before we could even begin to think that folks actually again were becoming enchanted with the asset class,...

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Interest in Bonds Remains Off the Charts

The latest numbers from Investment Company Institute show that investors have started to show a little interest in U.S. stock mutual funds/ETFs, but the love for bond mutual funds/ETFs remains rampant. Believe it or not, since the start of 2015, a net \$211 billion has actually fled U.S. equities and a net \$565 billion has piled into fixed income.

Combined Estimated Long-Term Fund Flows and ETF Net Issuance						Investment Company Institute					
Millions of dollars						Long-Term Mutual Fund and Exchange-Traded Fund (ETF) Flows					
Week Ended	12/13/2017	12/6/2017	11/29/2017	11/21/2017	11/15/2017	Month	Stocks	Bonds	Month	Stocks	Bonds
Total Equity	6,815	8,612	3,129	5,026	-54	January-15	-34,465	17,535	July-16	292	33,575
Domestic	5,336	5,961	-645	1,166	-4,214	February-15	-5,547	30,321	August-16	-9,956	30,858
World	1,480	2,652	3,775	3,860	4,160	March-15	-1,494	4,905	September-16	-5,713	24,669
Hybrid	-1,415	-2,139	-652	-500	-359	April-15	-34,681	11,027	October-16	-23,109	13,855
Total Bond	5,018	6,156	6,537	6,900	1,468	May-15	-17,287	5,010	November-16	22,993	-13,288
Taxable	4,947	6,468	6,366	6,162	839	June-15	-7,023	6,324	December-16	18,859	-4,142
Municipal	71	-312	171	737	630	July-15	-14,864	-1,255	January-17	4,966	31,061
Commodity	5	421	-295	-39	136	August-15	-18,569	-18,122	February-17	17,530	34,026
Total	10,423	13,051	8,719	11,386	1,191	September-15	-4,725	-10,849	March-17	8,906	36,632
Source: Investment Company Institute						October-15	-807	15,397	April-17	-8,370	22,116
						November-15	654	-5,573	May-17	-10,816	33,128
						December-15	476	-25,043	June-17	-8,022	29,420
						January-16	-27,222	7,686	July-17	-12,386	29,164
						February-16	-9,108	11,915	August-17	-18,937	26,418
						March-16	7,711	29,296	September-17	-9,636	36,476
						April-16	-12,610	22,114	October-17	3,211	38,818
						May-16	-14,252	16,925	November-17	-2,561	27,766
						June-16	-15,530	16,623	Totals:	-210,998	564,788

...the lack of investor euphoria a reason that the recent rally could carry further.

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Santa Claus Rally

As the end of 2014 and 2015 will attest, past returns do not guarantee future returns, but we are now in a seasonally strong seven-day period.



That said, we know that prices move in both directions, so despite our unwavering enthusiasm for the long-term prospects of our broadly diversified portfolios of undervalued stocks, we are always braced for downside volatility, especially as it will be a few weeks before Q4 earnings reporting season kicks into high gear.

Stock Updates

Speaking of earnings, Jason Clark and Chris Quigley take a look at three of our companies that were out with quarterly results last week...

Carnival (CCL – \$66.35) reported fiscal Q4 2017 results last week that topped analyst estimates. The cruise line operator said its adjusted EPS was \$0.63, versus consensus expectations of \$0.51. Revenue for the period of \$4.26 billion came in above forecasts calling for \$4.15 billion. CEO Arnold Donald noted, “We exceeded the high end of our original full year 2017 guidance by \$0.22 per share, achieving record cash from operations of \$5.3 billion and another adjusted earnings per share record despite a significant drag from fuel and currency. Our full year performance was led by over 4.5% growth in ticket prices while overcoming a variety of headwinds, affirming that our core strategy, which is anchored in delivering exceptional guest experiences, driving demand through marketing programs to increase cruise consideration, and introducing new more efficient ships through measured capacity growth all while leveraging our scale, can deliver consistent earnings improvements.”

Looking ahead, Mr. Donald commented, “Despite booking disruptions from this year’s multiple hurricanes, we are still heading into 2018 with a stronger base of business and higher prices than last year. We have numerous efforts underway to keep the momentum going in 2018 and beyond, from our innovative approaches to increase consideration for cruising, including our recently announced partnership with Univision, to the further roll-out of our state-of-the-art revenue management system. In 2018 we also look forward to the delivery of four new cutting-edge ships, Carnival Horizon, Seabourn Ovation, AIDAnova, and Nieuw Statendam to further our strategic fleet enhancement program.”

Based on current booking trends, along with expected higher fuel prices, the company expects full year 2018 adjusted earnings per share to be in the range of \$4.00 to \$4.30, compared to 2017 adjusted earnings per share of \$3.82. Mr. Donald concluded, “We remain on track to achieve double digit return on invested capital in 2018. We are committed to the continued distribution of cash to shareholders through increasing dividends, currently totaling \$1.3 billion annually, and ongoing share repurchases, which have exceeded \$3 billion since late 2015.”

We continue to maintain our long-term optimism on CCL and the overall cruise industry space, given favorable demographic trends and the fact that there are still meaningful growth opportunities in emerging economies and the likes of China, which are encouraging for global revenue diversification and the ability to rapidly reach a new customer base. CCL shares sport a 2.7% dividend yield and trade for less than 16 times estimated earnings. Our Target Price has sailed ahead to \$84.

Shares of **FedEx** (FDX – \$250.02) added to the terrific yearly gain on Wednesday, reaching all-time highs, after the package and freight delivery service reported that fiscal Q2 2018 results were better than analysts had expected. FDX earned an adjusted \$3.18 per share, versus the consensus of \$2.89, and had revenue totaling \$16.3 billion, versus a projected \$15.7 billion. The earnings beat was largely driven by a lower-than-expected tax rate. FDX’s effective rate was 32.0% for the quarter, compared to 35.1% for the same period last year, thanks to a foreign dividend paid to FDX. We note that FDX’s tax rate fluctuates by a few percentage points every quarter.

FDX expects to benefit handsomely from the now-signed tax reform in Washington. CEO Fred Smith said, “We’re encouraged by the Tax Cuts and Jobs Act legislation advancing in Congress at this very moment. This legislation offers pro-growth, pro-business tax reform solutions that will power the economy, increase business investment, expand job opportunities and enhance incomes and improve U.S. competitiveness.”

CFO Alan Graf added, “U.S. GDP could increase materially next year as a result of the U.S. tax reform. If this occurs, we would likely increase capital expenditures and hiring to accommodate the additional volumes triggered from this incremental GDP growth. If the Tax Cuts and Job Act is enacted as set forth in the Joint Conference Report, we estimate our earnings per share could increase by \$4.40 to \$5.50 per diluted share for FY 2018 before mark-to-market year-end pension accounting adjustments, primarily due to the revaluation of our net deferred tax liabilities. This range also includes an estimated \$0.85 to \$1 per diluted share due to a lower tax rate on fiscal 2018 earnings for last five months of fiscal 2018. As we have stated many times in the past, we would like to see a level playing field for corporate taxes. This tax reform bill will go a long way in making U.S.-based corporations more competitive globally.”

Mr. Graf continued, “We have delivered great service levels again this peak, thanks to our careful forecasting and planning that results from working closely with our customers to manage record-setting seasonal volumes and also thanks to the dedication of hundreds of thousands of team members all over the world that make this happen.”

Chief Market Officer Raj Subramaniam said, “We see moderate growth in the global economy. Our U.S. forecast is up slightly on solid current momentum. Consumer confidence is at a 17-year high and solid PMI readings show the industrial sector is expanding. Passage of U.S. tax reform could add materially to next year’s U.S. GDP forecast. Globally, our world GDP forecast for this year and the next reflects the best growth since 2011 with a synchronized global upturn supporting trade volume growth. We also have a unique strategy for peak pricing this year, where we are not applying an additional peak surcharge to all residential packages, only oversized packages or packages that require additional handling. This strategy was different from others in the marketplace, but we felt it is important to be mindful of our small and medium customers. Obviously, peak is not over but we have seen very good traction with the small and medium customers and we will continue to monitor and measure to inform our pricing decisions for the next year’s peak season.”

FDX expects a decrease in tax rate to between 33% and 34% for fiscal 2018 (previously 33% – 36%), resulting in boosted fiscal 2018 adjusted EPS guidance between \$12.70 and \$13.30 (previously \$12.00 – \$12.80). Thus far, we are pleased that the ongoing Amazon threat has not hampered FedEx’s growth plan and like that the new tax policy helps high-tax payers like FedEx even more. Interestingly, analysts have only modestly hiked 2018 price and earnings targets. We continue to be fond of FedEx’s strong balance sheet, modest dividend yield and position as an industry leader. As things presently stand, FDX trades at approximately 17.2 times the next-12-months earnings estimate and our increased Target Price is now \$309.

Nike (NKE – \$63.29), a worldwide leader in footwear and sports apparel, earned \$0.46 per share in fiscal Q2 2018 (vs. \$0.40 est.). NKE had sales of \$8.55 billion, versus the \$8.40 billion

estimate. Revenue was up 3% year-over-year on a constant currency basis, while gross margin contracted 120 basis points to 43%. International revenue grew to 59.2% of the total. Nike believes that it's building a sustainable long-term growth platform in North America, and expects sales abroad will continue to rise through investments in developing markets and China. Although the results came in ahead of estimates, NKE shares fell more than 2% on Friday on analyst concerns that a sales slump in North America may persist into the fiscal third quarter. Even after the tumble, shares have gained about 25% (including dividends) this year.

CEO Mark Parker believes that Nike's digital push and top athlete sponsorships give the company a unique advantage in the battle to keep brick-and-mortar sales relevant: "Though our Consumer Direct Offense, we're identifying which consumer opportunities have the most upside and we're investing in those areas to fuel growth. We're focused on unleashing a relentless flow of innovation at a scale that our industry has never seen, bringing Nike closer to the consumer in key cities and delivering with speed and using the power of digital to go deep and broad by rewarding our most active NikePlus members, while expanding that community to hundreds of millions. We're entering the second half of the year with a wave of new products and concepts. Consumers want fresh, innovative products and they want choice."

Nike's basketball products remains popular with customers: "We've created a lot of opportunities for creative story telling around the game's greatest athletes. In the next several weeks alone, we'll deliver the next version of the industry's biggest signature shoe with the Kyrie 4. We'll build on the incredible first year of Paul George's shoe with the PG 2 and we'll introduce an all new Flyknit construction with Kobe's next performance design. The Jordan brand will launch its first signature shoe with reigning MVP, Russell Westbrook. We're also thrilled to expand our relationship with Giannis Antetokounmpo as we bring his unique personality to life through new signature product and storytelling next year. In Apparel, we're leveraging our complete portfolio to realize its massive potential. This spring and summer we'll push the edges in performance for the biggest sports moments like the NBA all-star game, the tennis majors and 2018 World Cup."

NKE shares have been on a tear since September, benefitting from strong holiday spending estimates and "red hot" product launches, with less contraction expected in the second half of the fiscal year. Management reports that momentum is building, especially with many significant product launches in Q3, and targets scaling them in Q4. Still, management left its 2018 EPS growth estimate in the "mid-single digit range" unchanged. As always, the company will also have to continue to navigate currency headwinds and the ebbs and flows of product input costs. We think product customization will help prop up margins and we believe that Nike remains a best-of-breed company, even though the company's valuation isn't exactly cheap anymore. We like that Nike sports an excellent balance sheet and our Target Price for high-quality NKE has been bumped to \$69.

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