2017 Themes to Watch

EARNINGS GROWTH

Earnings are the driver of the equity markets over the long term. Over the past couple of years, stagnant earnings growth played a major role in the equity market's failure to advance. Subsequently, positive earnings growth in the third quarter of 2016 played a role in the uptrend in stock prices.

J. Michael Gibbs, *Managing Director of Equity Portfolio & Technical Strategy,* and **Joey Madere**, *Senior Portfolio Analyst, Equity Portfolio & Technical Strategy,* share thoughts on earnings before and after the U.S. presidential election.

"... we still see healthy growth in the years ahead, especially if fiscal reform transpires."

CURRENT EARNINGS ESTIMATES

Post-election, stocks rallied further fueled by investor enthusiasm that earnings will surge even higher in the coming years due to fiscal stimulus. Although our estimates are below current consensus forecasts, we still see healthy growth in the years ahead, especially if fiscal reform transpires.

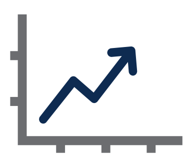
SINCE 1954
S&P 500 EARNINGS UP **6.2%** CAGR*

S&P 500 PRICE INDEX UP **7.4%** CAGR*

Prior to the election, we were comfortable with the consensus estimate for sales growth in 2017 of 5%; however we used more conservative margin assumptions due to our expectations of rising interest rates and wages. The result was a base case earnings estimate of $128 in 2017 (8% growth from 2016)**. This was also in line with the downward trend in consensus earnings revisions that has taken place in recent years, which would likely bring the consensus earnings estimate of $131 closer to our more conservative assumptions.

Post-election, our conviction that these estimates will be met has increased, as the odds of earnings growth picking up have improved on the heels of anticipated fiscal stimulus. However, until these policies come closer to being passed, we are holding our $128 earnings estimate steady.

PRIOR TO ELECTION
2017 RAYMOND JAMES CONSENSUS ESTIMATE FOR SALES GROWTH **5%**



2017 RAYMOND JAMES BASE CASE EARNINGS ESTIMATE **$128**

8% GROWTH FROM 2016

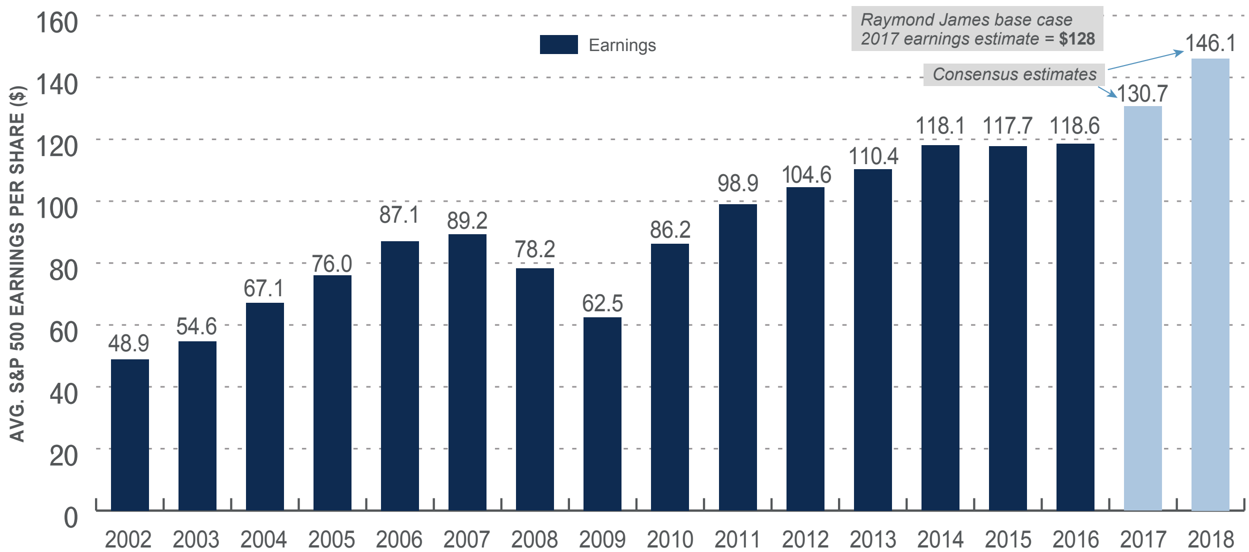
POST-ELECTION
2017 RAYMOND JAMES BASE CASE EARNINGS ESTIMATE **$128** HOLDING STEADY FOR NOW

TAX REFORM CONSIDERATIONS

We feel that cutting the U.S. corporate tax rate to 20% has the potential to boost S&P 500 earnings by an additional 6% to 7%. Please note that although the statutory U.S. corporate tax rate is currently 35%, the S&P 500's effective tax rate is roughly 27% as tax-savvy companies have used accounting rules to their advantage. A tax reduction to 20% may not be possible given the negative impact such a large reduction could have on the deficit and debt levels. If the tax rate declines to 25%, the benefit is approximately 3%.

* Compound Annual Growth Rate
** The earnings estimate of $128 is the earnings per share of all of the companies represented by one share of the index.

EARNINGS PER SHARE



Source: FactSet, Raymond James Equity Portfolio & Technical Strategy

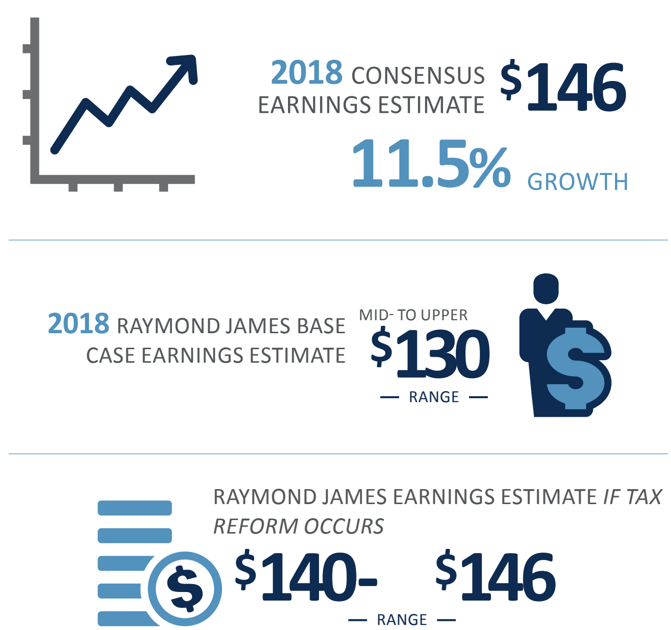
Also, a favorable repatriation tax (assumed 10%) would likely result in a large amount of the estimated $2.4 trillion in overseas cash coming back to the U.S. While that cash can be used on capital expenditures and reducing debt, it is also likely that a portion would be spent in the near future on mergers and acquisitions, stock buybacks, dividend increases and other shareholder-friendly actions. In our estimate, we see that potential increases in share buybacks from the repatriated cash could improve earnings by an additional 1% to 2.5%. The limitations of our calculations regarding lower tax rates and repatriated cash should not be minimized given the many unknowns. Other possible changes, such as interest deductibility and depreciation, could alter our estimates substantially. With tax reform being the more likely outcome, as opposed to easy-to-implement tax cuts, the process may take some time.

INFRASTRUCTURE AND OTHER UNKNOWNS

Increased infrastructure spending, another potential boost to the economy under the Trump administration, is often a slow process as well. Therefore, the increase to earnings will likely not be fully felt until 2018. It is also important to note that a stronger U.S. dollar would be a headwind to earnings, as would tighter trade policies; so there remain downside concerns as well.

A LOOK AHEAD AT EARNINGS

For 2018, the consensus estimate for earnings is $146 (11.5% growth), however we conservatively estimate 2018 earnings in the mid to upper $130 area. Similar to our 2017 earnings estimates, our 2018 estimates are also held back (relative to consensus) due to elevated profit margins, the likelihood of rising interest rates and wages, and the tendency for forward estimates to be revised lower over time. If tax reform does occur, earnings could reach the $140 to $146 area in 2018. In this scenario, applying a P/E of 19x (vs. 20x currently) would result in the S&P 500 reaching a level in the upper 2,600s to mid 2,700s (or 10% to 15% above current levels over the next two years). Because of this, (and due to lofty valuations) the timing and size of actual fiscal policies will be a key influence on earnings growth and market movements in the coming years.



Investing involves risk including the possible loss of capital. Past performance may not be indicative of future results. The S&P 500 is an unmanaged index of 500 widely held stocks. An investment cannot be made directly in this index. The performance noted does not include fees or charges, which would reduce an investor's returns.

2017 Themes to Watch (cont.)

ECONOMIC GROWTH: FISCAL POLICY

The stock market rallied following the November election, largely on the belief that fiscal stimulus, in the form of tax cuts and a large-scale infrastructure spending package, would spur growth. However, achieving these goals is certain to be more difficult than was initially assumed.

Scott J. Brown, Ph.D., *Chief Economist, Equity Research*, provides some clarity around the complicated topic of policy change.

INFRASTRUCTURE SPENDING

Both presidential candidates proposed about a trillion dollars in added infrastructure spending. The difference was in how that would be paid for: tax increases (Clinton) or a public/private partnership (Trump). Democrats in Congress have long pushed for more infrastructure spending, but Republicans in the House are expected to resist adding to the federal budget deficit. Privatization could be a partial solution. While Europe has privately-owned airports, most Americans do not want to pay fees for using private roads and bridges, and a public/private partnership is unlikely to deliver funds to where they are most needed (water and sewage systems, for example).

> "Republicans could try to cut taxes through budget reconciliation, which would require only a simple majority but, in using this process, only one extra thing can be done per calendar year – Hence, tax cuts may be more likely to show up in 2018."

CHALLENGES OF TAX REFORM

Tax cuts seem simple enough. This is what Republicans do – and with one-party control of the White House and both chambers of Congress – this is a critical opportunity. However, broad tax reform, which is what the country needs, is extremely difficult. By law, tax legislation must originate in the House. However, a tax reform bill would require 60 votes in the Senate, and Republicans hold a 52 to 48 majority. Getting eight or more Democrats on board is possible, but the end result would likely be watered down. There are several tax issues embedded in the Affordable Care Act. Failure to repeal/replace the ACA means that true tax reform has become even more difficult. A simple lowering of business and individual tax rates is possible, but on a much smaller scale than was expected earlier.

Tax cuts do not pay for themselves and would have to be offset through elimination of deductions and cuts in spending. This is where things get sticky. One early proposal is to eliminate all deductions except for research and development, home mortgage interest payments and charitable deductions. The U.S. has one of the highest business tax rates in the world, but the effective rate (what firms actually pay) is a lot lower. The U.S. could develop an efficient and fair tax system, but it can't start from scratch. The greatest difficulty in tax reform is that no one wants to give up their deductions.

Cutting spending is also not so easy. You can't do anything about interest payments on the federal debt. If you want to increase defense spending and leave Medicare and Social Security untouched, there isn't enough left to cut. You could reduce nondefense discretionary spending to zero and the U.S. government would still run a deficit. Moreover, spending on entitlements is rising as the baby-boom generation moves into retirement. Something has to give.

Congress could institute a border adjustment tax (BAT), taxing imports, to make up about half of the revenue that is expected to be lost after business tax rates are reduced, but there will be enormous challenges. The Europe Union has indicated that it would make a case before the World Trade Organization if the U.S. imposes a BAT. U.S. businesses, especially manufacturing, use parts and supplies from around the world. Setting up the apparatus to collect BAT revenues will take time, and the transitional costs to firms would be huge (firms have already expressed concerns to Congress).

It seems fiscal stimulus is still possible, but the road is likely to be long and bumpy.

DISCLOSURE

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