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CORPORATE BEIGE BOOK:
BETTER SENTIMENT AND LOTS OF TAX TALK

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KEY TAKEAWAYS

Our analysis of fourth quarter 2016 earnings conference call transcripts indicates sentiment among corporate executives continued to improve as 2016 ended and 2017 began.

Policy was a popular topic, as taxes, infrastructure, and regulation saw big jumps in the number of mentions. Currency and China also continued to garner a lot of attention.

Solid fourth quarter 2016 results and improved sentiment from corporate executives support our expectation for mid-to-high single digit earnings growth for the S&P 500* in 2017.

It should come as little surprise that sentiment among corporate executives improved during the fourth quarter of 2016. We saw relatively more use of strong and positive words compared with weak and negative words in our analysis of earnings conference call transcripts. Talk of recession remains virtually non-existent, supported by solid economic data of late. Significant discussions of taxes also came as no surprise given market participants' focus on corporate tax reform and the possible border adjustment tax. Finally, currency and China continued to garner a lot of attention, while energy and Brexit faded. Note that our analysis covers fourth quarter 2016 earnings calls that took place from mid-January through the first three weeks of February.

ANOTHER IMPROVEMENT IN MANAGEMENT TONE

When we count positive and negative words from earnings call transcripts, we see that sentiment among corporate executives continued its impressive streak of improvement in the fourth quarter of 2016. The total overall use of strong and weak words declined quarter over quarter, but the use of strong and positive words (e.g., "strong," "robust," "solid," "improving," "good") fell much less than the use

FOURTH QUARTER 2016 EARNINGS SEASON

Fourth quarter earnings season has not been a blowout by any stretch, but growth has been solid at near 8%, putting the earnings recession further in the rear view mirror. Potential policies out of Washington, D.C. have dominated discussions, but there have been many other items of note, including resilient guidance, strong profit margins, and particularly strong results relative to expectations for the financials, industrials and technology sectors. Please see our February 21, 2017 *Weekly Market Commentary* for some of our key earnings season observations.

*We expect mid-single-digit returns for the S&P 500 in 2017 consistent with historical mid-to-late economic cycle performance. We expect S&P500 gains to be driven by: 1) a pickup in U.S. economic growth partially due to fiscal stimulus; 2) mid- to high-single-digit earnings gains as corporate America emerges from its year-long earnings recession; and 3) an expansion in bank lending; and 4) a stable price-to-earnings ratio of 18–19.

of weak words (e.g., "weak," "soft," "difficult," "challenging"), pushing the differential between strong and weak words higher, which we refer to as our Corporate Beige Book Barometer [Figure 1].

The differential between strong and weak words in our analysis rose 15% to 789 in the fourth quarter of 2016, after a more than 20% increase in the third quarter of 2016. The improved sentiment is even more apparent when looking at the ratio of strong to weak words, which jumped from 2.6 in the third quarter to 3.8 in the fourth quarter [Figure 2].

We are encouraged that this analysis generally reflects the improved conditions in corporate America that we have observed in the economic data, in the reported earnings and revenue numbers, and anecdotally in the enthusiasm around pro-growth policies from Washington, D.C.

POLICY TALK DOMINATES

After little policy talk from corporate executives during 2016's third quarter earnings reporting season (roughly mid-October 2016 through mid-to-late November 2016), much of which occurred before Election Day, we saw a huge spike in policy discussions in fourth quarter conference calls. The policy focus for executives, analysts, and investors is evident in the sharp increase in the use of the word "tax" (or "taxes") as shown in Figure 3. We highlighted the increased attention on tax reform in our *Weekly Market Commentary* two weeks ago that revealed tax policy getting more mentions than any other policy topic (source: FactSet).

On a related note, we were surprised that the controversial border adjustment tax did not get more attention, although it did go from receiving no mentions in our sampled transcripts in the third quarter to a few dozen in the fourth quarter. Other key policy topics included trade, which saw a big jump in mentions in the quarter (32 to 91), regulation (7 to 36), and infrastructure (20 to 34).

WHAT IS THE CORPORATE BEIGE BOOK?

We use earnings conference call transcripts to gauge overall sentiment of corporate management teams, much like we have done with the Federal Reserve's (Fed) Beige Book to create our Beige Book Barometer (the Fed's Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Fed districts). To create our Corporate Beige Book, we count the number of strong words (or variations of "strong") and the number of weak words (or variations of "weak") and calculate the difference between the two. (Examples of strong words include "robust," "solid," and "optimistic;" examples of weak words include "soft," "fragile," and "pessimistic.") We can then compare that differential to prior quarters to make comparisons over time. Although not every single call transcript is analyzed, we believe the trends observed provide valuable insights.

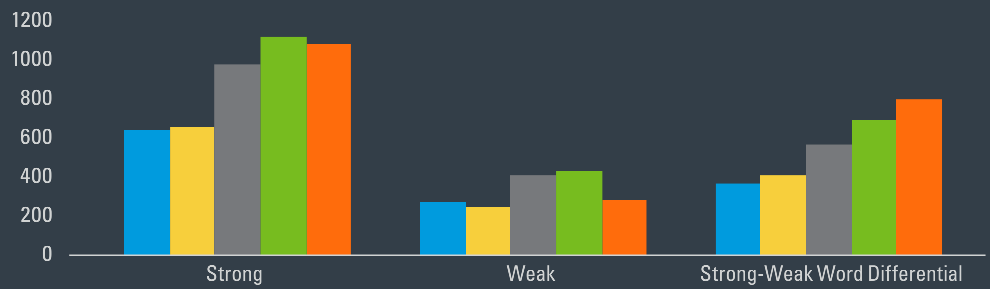
Here are some executives' comments on tax reform, including a mention of the border adjustment tax:

- *"From our perspective, we believe that any type of corporate tax reform would be positive for us, because as you know, in the agricultural sector, being a U.S. domiciled company, we pay the highest tax rates in the industry."* (Agriculture)
- *"We strongly support comprehensive corporate tax reform. Lower corporate tax rates will encourage investment, create jobs, and make the U.S. a more competitive country."* (Transportation logistics)
- *"Any relief on corporate taxes would be a benefit, subject to any of the other provisions that may get put out there such as the border adjustment tax that you alluded to. So, a lot of kind of ambiguity out there, and we really won't know more until later in the year when some of this comes into clear focus."* (Building materials)

Corporate Beige Book

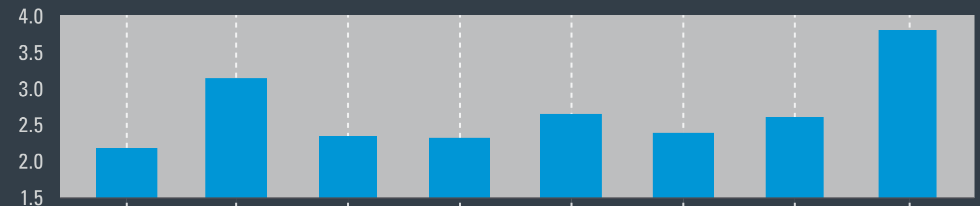
1 Corporate Sentiment Continued to Improve in Q4

● Q4 2015 ● Q1 2016 ● Q2 2016 ● Q3 2016 ● Q4 2016



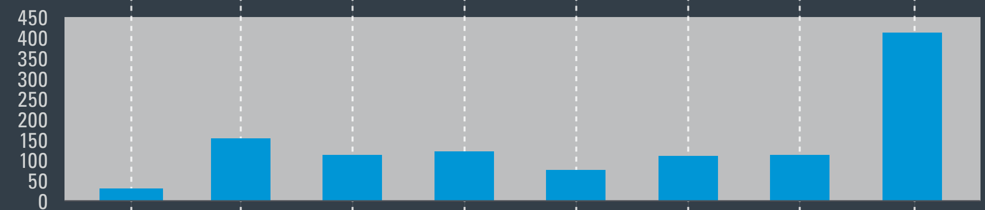
2 We Saw a Big Jump in the Ratio of Strong vs. Weak Words

Ratio of strong vs. weak words



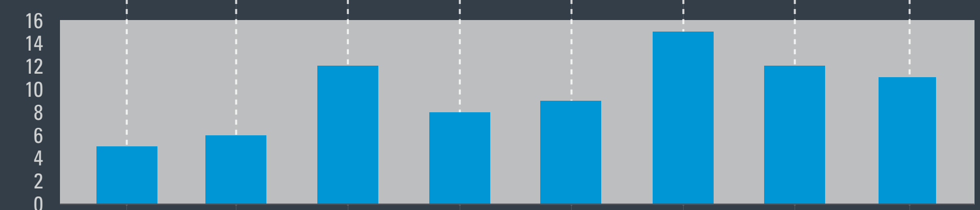
3 Policy Talk Evident by the Increase in Mentions for Taxes

Number of tax mentions



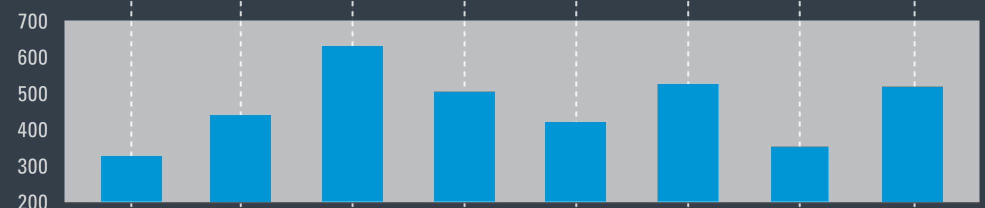
4 Recession Talk Still Nonexistent

Number of recession mentions



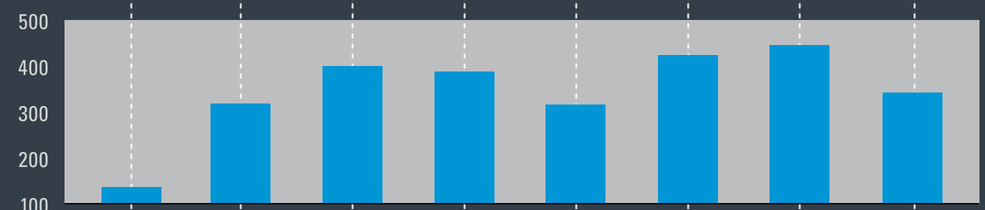
5 Recent Dollar Strength Coincides with More Currency Attention

Number of currency mentions



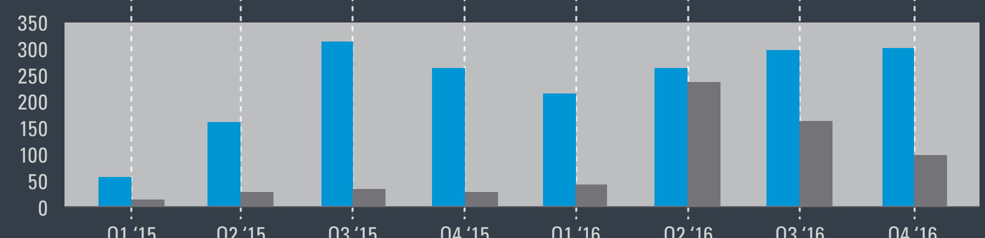
6 Oil Stability Has Led to Less Attention on Energy

Number of energy mentions



7 Brexit Quiets Down While China Remains in Focus

● China Mentions ● U.K. Mentions



Source: LPL Research, Bloomberg, FactSet 03/03/17

Data represent number of mentions during fourth quarter 2016 earnings conference calls for companies that have reported as of 02/23/17.

- *"As you know, approximately 65% of our revenues are derived from the U.S. and therefore, we pay a significant amount of U.S. corporate taxes. If there is a reduction in the corporate tax rate, we would expect to benefit from it."* (Industrial equipment)

Here are some executives' comments on trade:

- *"Obviously, there are still many questions about the future of NAFTA and the trade relationship between the U.S. and Mexico. While we've gotten some indication of the direction of the new administration through the nomination of most of the key trade policymakers, we still don't have definitive answers to several of those questions. What we do know is that the President's team has indicated that there will be a process for reshaping of America's trade policies which could include updating NAFTA."* (Railroad)
- *"I think clarity sooner rather than later would be particularly helpful and would be on a lot of discussions. That's really what they are at the moment, discussions around trade policies as they relate to both Mexico and China, and some of the other trade partners that we have. So in our view the sooner that gets cleared up and resolved, I actually think there could be a further uptick."* (Industrial equipment)

Comments on infrastructure:

- *"[With regard to infrastructure] … whether it be some kind of infrastructure private-public partnership credit program, whether it's some kind of a grant program, there is a whole bunch of different permutations then to what could unfold. But I'd say step one corporate tax reform, this is just my opinion. Step two, infrastructure, and you'll see it coming out of the administration what they choose to prioritize and then our focus will follow suit."* (Railroad)
- *"We believe the case for infrastructure development is clear. A world-class infrastructure is the backbone of a modern healthy U.S. economy. In addition, reduction of Federal regulations will also make the U.S. economy more vibrant."* (Transportation logistics provider)

And comments on deregulation:

- *"There is this broad desire to roll back regulations, but I don't know that we know of anything that is specific. We plan to spend time in Washington here in the first quarter and hopefully by April, may have a bit better read on that, but we've looked at, which is a broader corporate issue, we've looked at the tax reform proposals and we're quite excited about that on the corporate front, but that's just about income tax."* (Airline)
- *"First, in an overall sense, I've been very pleased with the agenda that the Trump administration has. We have seen an avalanche of regulation over the last decade, and putting a much more balanced cost/benefit framework of that is quite positive for our business, for the country, job creation, and a lot of things."* (Oil and gas)
- *"In addition, reduction of Federal regulations will also make the U.S. economy more vibrant." (Transportation logistics)*

TALK OF U.S. RECESSION NONEXISTENT

Corporate executives generally try to stay away from the "R" word (recession) when talking with investors, confirmed by the small number of mentions of the word in the fourth quarter of 2016 (11) [Figure 4]. The average number of times the word recession was mentioned during earnings calls over the past eight quarters at less than 10 has been surprisingly low, and several of those were related to overseas economies. We think these data points, along with our assessment of leading economic indicators, continue to point to low recession odds in 2017.

DOLLAR BUMP PUTS IT BACK IN THE SPOTLIGHT

The number of mentions currency received during fourth quarter 2016 earnings calls jumped 47% from the third quarter of 2016, [Figure 5], though the number of mentions still trailed the peak during the U.S. dollar surge of 2015. Several factors have contributed to the increasing attention. First, the dollar was very strong in the fourth quarter of 2016 with a 7% rise based on the DXY U.S. Dollar Index. After a dip in January 2017, the dollar regained strength in February as Fed rate hike expectations accelerated, rekindling fears of currency-driven earnings weakness and commodity price declines (historically, commodity prices and the U.S. dollar tend to move in opposite directions). In addition, the possibility of a border adjustment tax, which could be very bullish for the dollar if enacted (we remain skeptical) likely put some upward pressure on the dollar.

As we noted in our *Outlook 2017: Gauging Market Milestones* publication, we expect U.S. dollar gains to be relatively modest this year.

HIGHER PRICES PUT OIL ON THE BACK BURNER

Oil's rise from the February 2016 lows in the mid-$20s to its current price in the mid-$50s has eased concerns about the negative impact of low prices on energy and energy-sensitive companies, reflected in the drop in the number of mentions the topic received on fourth quarter 2016 earnings conference calls [Figure 6]. Energy notably produced a year-over-year increase in earnings in the fourth quarter of 2016 for the first time in two years.

CHINA STILL A FOCUS; BREXIT, NOT SO MUCH

In June and July of 2016, the U.K. was the primary geographic focus for corporate executives following the unexpected vote in favor of Brexit (i.e., the vote for the U.K. to leave the European Union). Since then, the U.K. economy's resilience and strength in global equity markets (and certainty the shift in attention toward U.S. elections and Trump's policies) have seemingly left executives comfortable with the risks and investors and analysts less interested in the topic. Accordingly, as shown in Figure 7, U.K. mentions collapsed in the fourth quarter, falling 40%. Among those that did mention Brexit, few cited it as a near-term risk and even fewer cited it as a reason for fourth quarter weakness.

Meanwhile, despite relative stability in the data and markets during the fourth quarter of 2016, China continues to get a lot of attention because of the potential for more protectionist trade policy. China will likely continue to garner significant attention in the months ahead as Trump's trade policies take shape, while China's economic stability, at least for now, is encouraging. A significant majority of the executives' comments about China cited favorable business conditions.

CONCLUSION

Our Corporate Beige Book suggests that corporate executives have become more and more confident in the macroeconomic outlook in recent months, due in part to prospects for pro-growth policy including tax reform from the Trump administration. Solid fourth quarter results and the improved sentiment from corporate executives support our expectation for mid-to-high single digit earnings growth in 2017. For more of our thoughts on fourth quarter earnings season, please see our February 21, 2017 *Weekly Market Commentary*. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

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International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

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