ALGER

COMMENTARY

Market Update

Spring 2017

CORPORATE PROFITS SUPPORT EQUITY PERFORMANCE

A variety of commentators have proposed various reasons for why the equity bull market has continued this year. In this commentary, however, we maintain that a powerful combination of accelerating economic growth and encouraging corporate fundamentals has been the primary driver and could continue to support equities.

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Economic Strength

Some commentators attribute recent equity performance to the U.S. presidential election. Others say it has been momentum trading. If it were either of those factors, the recent correction following growing concerns over Washington's ability to pass meaningful legislation would have been more severe. Rather, we believe the primary factor behind strong equity performance has been robust economic growth. Consider the following:

- Consumer and business confidence have risen sharply and are at or near their highest levels in a decade.
- Corporate profits and wage growth have been accelerating.
- The Conference Board's Leading Economic Index is at a record high (see Figure 1).

Economic strength is not limited to the U.S. Indeed, 2017 may be the first time since 2010 that all G-20 countries simultaneously experience economic growth, driving improving corporate fundamentals. The most recent reporting season saw S&P 500 sales and earnings per share (EPS) grow at very solid mid- and high-single digit rates, respectively. This reporting period marks the first time in nearly two years that the index has grown its earnings for two consecutive quarters, which has supported equity markets. A further example of fundamentals driving recent stock gains is that the Information Technology and Health Care sectors, which have had the strongest earnings seasons relative to expectations, have been the best performers year to date.

Figure 1:

Economic Fundamentals are Strong

Source: FactSet and the Conference Board

Inspired by Change, Driven by Growth.

Our view has consistently been that the economic recovery would be longer and stronger than expected, but also slower in pace due to the severity and nature of the 2008/2009 bear market and recession. While improving economic conditions are likely to make the Federal Reserve more aggressive in its tightening, we don't believe that monetary policy changes will derail the expansion. We note that the U.S. does not typically enter into a recession until about three years after material Fed tightening, which we maintain is just starting now.

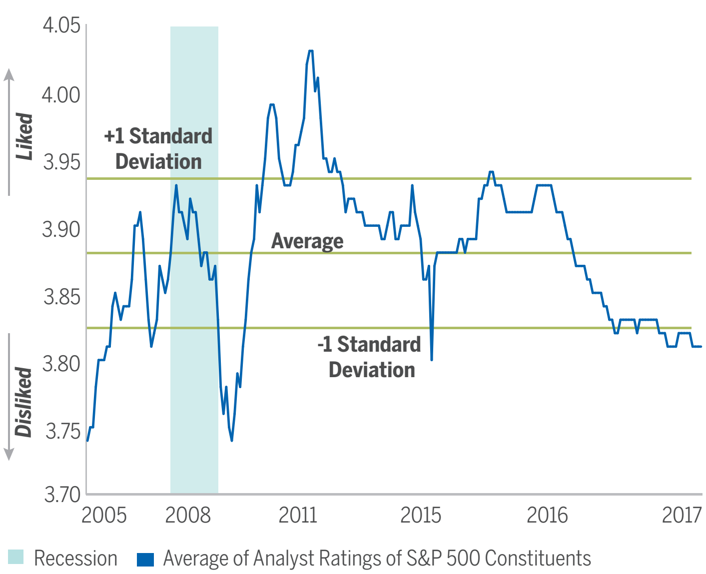
Rising equity valuations concern some investors, but growth sectors such as Information Technology and Health Care are trading in-line or at a discount to their 20-year median price-to-earnings (P/E) ratios.[1] It is also reasonable to argue that with extremely low interest rates, equity multiples should be higher than their current levels.

Skepticism Versus Euphoria

In the face of new market highs for equities, many commentators are calling for a market correction, with the average analyst rating for S&P 500 companies being approximately one standard deviation below the average over the past decade (see Figure 2). If bull markets begin in despair and end in euphoria as we believe, then the equity market still has room to run, particularly given strong fundamentals.

Figure 2

Analyst Sentiment is Relatively Low

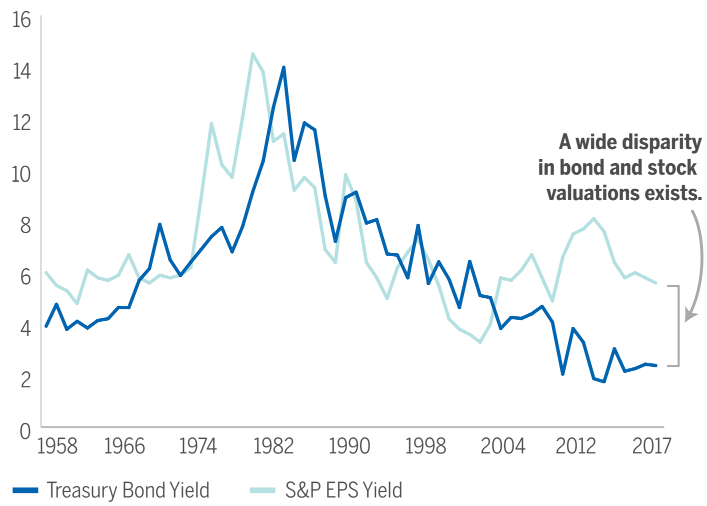


5 = "Most Liked" / 1 = "Most Disliked" Based on First Call Average Analyst Ratings

Source: Fundstrat

Figure 3

Equity Valuations are Attractive



Source: Fundstrat

One asset class where we see euphoria, however, is fixed income. Over the past decade, U.S. bond mutual funds and ETFs (taxable and municipal) have attracted over $1.6 trillion more in assets than their equity counterparts. This craving for fixed income exists despite the expensive valuations of bonds. Treasury bond yields are normally tightly linked to nominal GDP growth (both averaged 6.5% over the past 50 years), but current 10-year yields are more than two percentage points below next year's estimated nominal GDP growth. Keep in mind that a one percentage point increase in interest rates should theoretically cause an 8% decline in the price of a 10-year bond. A historically wide disparity, meanwhile, exists between equity and bond valuations (see Figure 3). When considering the wide disparity, two scenarios are possible: fixed income yields will rise and bond returns will be very disappointing or equity yields will fall (i.e. P/E ratios will rise) and stock returns will be strong. Either way, equities would outperform.

The Catalyst for Change

So what will drive the Great Rotation from bonds to equities? Policy changes. The past several years have been marked by monetary stimulus and quantitative easing. This was good for bonds as the Fed targeted a 0% Fed Funds rate and also bought long-term bonds to drive down interest rates. The Fed's actions drove a massive bond bull market. But it's likely that fiscal stimulus will replace monetary stimulus, with bond purchases being replaced with tax cuts and

[1] As of February, 28, 2017, the S&P 500 Health Care sector P/E was six percent below its 20-year median and the Information Technology sector P/E was at its 20-year median while nearly every other sector traded at a premium, according to data from FactSet.

government spending, which will drive budget deficits and increased government borrowing. This, combined with modestly increasing inflation, should pressure bond prices.

To us, equities and growth stocks in particular look very attractive relative to other assets such as fixed income and real estate. Consider that the expected real return for a U.S. 10-year Treasury bond is under 0.5% and yields for real estate are low-to mid-single digits, having declined by nearly half during the past two decades.[2] By contrast, equities provide access to some of the world's greatest technology companies that have higher free cash flow yields, double-digit earnings growth, and strong barriers to entry. To us, it's not a close race.

This Great Rotation to equities from bonds also has implications for active investing. Over the past few years, investors have favored bond-like equities (including those with weak fundamentals) as an alternative to low-yielding fixed income securities. This behavior weighed on active managers who focus on identifying strong businesses rather than pursuing dividend quality. The fact is that rising interest rates have typically been associated with active investing outperforming passive and we believe that may be the case going forward. We are optimistic that we have seen the cyclical lows in interest rates and active investing.

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Navigating the Ship Forward

While we think that the economic expansion can continue, we believe that a good captain does not simply look at calm waters and expect smooth sailing; rather, it is prudent to be prepared for all weather conditions. As bottom-up focused growth investors, we concentrate on building a boat or investment portfolio that we believe can sail through whatever conditions lie ahead. Instead of changing course based on which way economic winds are blowing (e.g. rotating to cyclical stocks when the economy is strong or to defensive stocks when it appears to be weakening), we focus on finding companies that can take market share and grow in both good and bad times.

Our research and experience shows that there are always areas of the economy that are growing, irrespective of where we are in market or economic cycles.

The best risk management we know of is to understand our companies as well or better than anyone else, feel confident in their growth under multiple scenarios, and let the strength of their management teams and competitive advantages create value for our clients. Our research and experience shows that there are always areas of the economy that are growing, irrespective of where we are in market or economic cycles. For example, during the Global Financial Crisis that occurred from the second quarter of 2008 until the second quarter of 2011, U.S. GDP was somewhat flat, but U.S. internet advertising and e-commerce grew over 30%. Companies that exploited that growth generated strong returns with Amazon.com, Inc.'s stock price, for example, soaring from $73 to $204 over this time frame.

Innovation is Strong

We see many areas that seem poised to grow regardless of economic conditions. They range from established growth industries such as cloud computing and the mobile internet to emerging technologies such as artificial intelligence (AI).

We believe the following factors will support rapid growth of AI:

- Hardware improvements.
- Algorithm development.
- Storage efficiency.

Those factors are driving a revolution in what computers and robots can do including how they interact with us. It has long been established that technology is increasing at an ever faster rate, as popularized by Moore's Law,[3] but recent advances in the fundamentals that drive AI are simply astounding. For example, CPU deep learning performance has increased by 65 times in four years.[4] These types of technological leaps are allowing computers to actually learn on their own—an AI program named Libratus, developed at Carnegie Mellon, recently beat some of the world's best poker players. The truly incredible thing is not that it won, but that it *taught itself and developed its own strategy*.

AI will change many industries. In health care, doctors struggle to keep up with technology given the thousands of

[2] Treasury bond returns are based on Inflation-Protected Securities yields and real estate yields are based on the National Council of Real Estate Investment Fiduciaries' (NCREIF) average implied capitalization rate of 4.5%.

[3] Moore's law describes the growth of technology and is based on an observation by Intel co-founder Gordon Moore who determined that the number of transistors per square inch on integrated circuits was doubling every year.

[4] Source: NVIDIA. Data represents advancement from Kepler to Pascal architecture.

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medical studies that are published each day. Yet, in one experiment, not only did IBM's AI supercomputer, Watson, recommend the same treatments for cancer patients as oncologists 99% of the time, but incredibly it also found additional treatment options that physicians had not identified in 30% of the cases, potentially giving patients new hope.

In transportation, cars are learning to drive themselves much more safely with Google, for instance, achieving an error rate of 2 per 10,000 miles driven in 2016, a huge 75% drop from the previous year.[5]

Some AI applications are already in use. It is estimated that 35% of Amazon's current sales are generated with its AI-curated personal recommendations. According to a UBS survey, nearly 90% of large U.S. companies have a cognitive computing project underway and 20% expect machine learning to have a business impact within a year.

The huge computing power needed to drive these projects forward will be aided by services or platforms such as those from Google, Amazon, and Microsoft.

Conclusion

Finding areas of growth and companies that we believe will benefit from them, no matter what the environment, is our passion and expertise. Regardless of economic conditions, we believe our time-tested philosophy of focusing on Positive Dynamic Change has strong potential for producing attractive results for our clients and partners.

Sincerely,

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Chief Investment Officer

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[5]Source: Autonomous Vehicle Disengagement Reports, 2016. State of California Department of Motor Vehicles.