Asset Management

SPECIAL REPORT: 4Q 2017 EARNINGS WRAP UP

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Good growth, despite difficult comparables

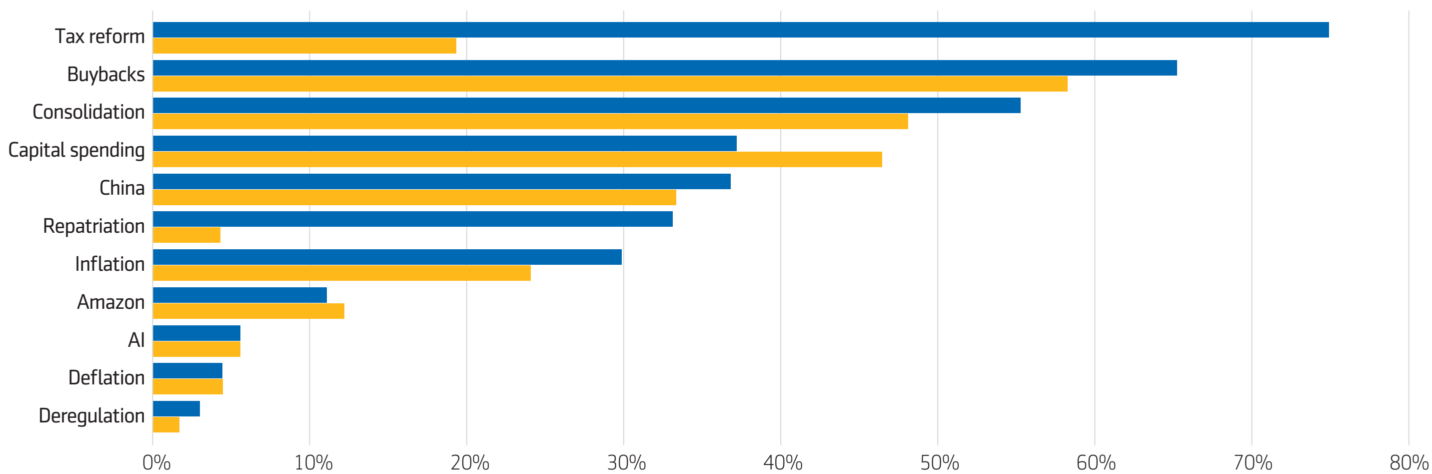
Exhibit1: Sector results relative to expectations – A fixed income perspective

Negative	Modest negative	Neutral/mixed	Modest positive	Positive
	Consumer Non-Cyclical	Transportation	Manufacturing	Basic Materials
		Consumer Cyclical	Construction/Real Estate	Technology
		Energy	Healthcare	
			Communications	
			Energy	
			Non-European Banks	
			Insurance	
			Other Finance	

After quarters-upon-quarters of improving growth, it becomes increasingly difficult for companies to continue posting accelerating growth rates when compared to prior periods. Yet, earnings and revenue results were robust in the fourth quarter. Year-over-year, S&P 500 revenues grew 8% and earnings per share (EPS) improved by 14%. At a high level, the growth was relatively well spread out across the sectors, with some topline softness for utilities, telecom and financials. Energy, materials and information technology all experienced double digit growth. While there was some concern going into the quarter that consensus levels were aggressive given below-average adjustments to the downside as the reporting period approached, overall EPS estimates still came in 4% above expectations, which is a similar level to the past few quarters. Additional information can be found in Appendix I and II.

Exhibit 2 illustrates the most relevant key terms referenced in S&P 500 members' earnings calls. While other important topics were discussed, tax reform and related topics were clearly the primary focus.

Exhibit 2: Percent of S&P 500 companies referencing topic on earnings calls



Source: Aegon AM US Credit Research Team, Bloomberg

Tax reform

Management teams are focusing on:

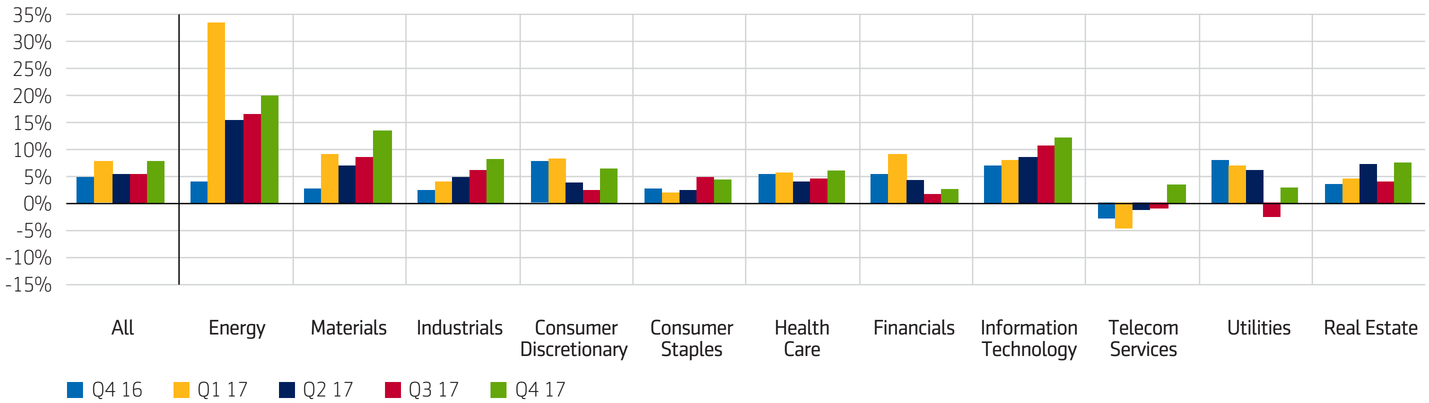
1. The immediate effect of tax-related items on the balance sheet, typically resulting in one-time, non-cash adjustments for affected companies, including necessary current charges to reflect foreign earnings.
2. The anticipated impact of the new, lower tax rate for 2018.
3. The longer-term benefit of the cash flow generated from those firms receiving tax savings and how to spend these proceeds.
4. Repatriating overseas profits.

What to do with the money?

- **Distribute it to shareholders:** Equity investors, through dividend increases and share buybacks, appear to be one of the larger beneficiaries from tax reform. While this may shift down the road, several firms were comfortable increasing these distributions for the current period while they await further clarity and have time to evaluate other options.
- **Invest it in the business:** Interestingly, despite all of the discussion on savings from tax reform, as well as the increased ability to deduct capital expenditures over the near-term, the percentage of firms referencing CapEx and related terms this quarter actually decreased relative to the third quarter. Regardless, the tone was constructive and overall, it appears companies are considering investing in the business as often as they are considering distributing cash to shareholders. Across the broad market, discussion indicated flat-to-slightly-higher capital spending plans in the years ahead as companies re-evaluate breakevens on projects under the new tax regime, recover from depressed levels of investment, and take advantage of the strong economic environment. While comments included more traditional buildouts, such as new facilities and expansions, investment in new technology was also an important component. There was also increased optimism from firms that will most directly benefit from higher capital spending such as financials, manufacturing, and technology.
- **Make acquisitions:** With consolidation being a key discussion topic for many quarters, it wasn't surprising to hear companies mention that this could be a potential use of cash. That said, acquisition plans take time and given how quickly the tax bill came together, most management teams were not prepared to discuss this topic in any level of detail this quarter. More clarity is likely to emerge over the coming quarters.
- **Pass it along to employees:** One-time employee bonuses made headlines at the end of 2017 and into 2018, however, when looking into the details, the behavior wasn't as widespread as it may have seemed. Yes, certain companies did take these actions and some firms provided longer term perks such as an increased 401(k) contribution matching or wage increases, but overall these activities were relatively limited.
- **Reduce debt:** Companies with higher interest expense levels in relation to their earnings are facing the potential for increased tax bills due to limitations on interest expense deduction caps. This primarily affects lower-quality issuers. In addition, companies are looking at their overall financing strategy given the potential for higher interest rates. While this isn't a direct result of tax reform (although it could be down the road if it stimulates the economy and increases interest rates), reducing floating rate debt or deciding to not roll maturing debt is a consideration of some management teams who have cash to allocate.
- **Contribute to the pension plan:** As the tax rate falls, the deduction a company receives from making pension contributions also declines. To maximize tax savings, certain companies decided to make discretionary contributions to their pension plans. While this is primarily a one-time benefit, proceeds used in this manner will reduce the amount of funds available for other activities.
- **Lower prices:** How much of the tax savings will ultimately flow through to consumers has yet to be determined. Given the way utility prices are set, lower prices are anticipated in this segment of the economy. More consumer-oriented businesses, e.g. retailers like Wal-Mart, also mentioned the possibility of lower prices for consumers.

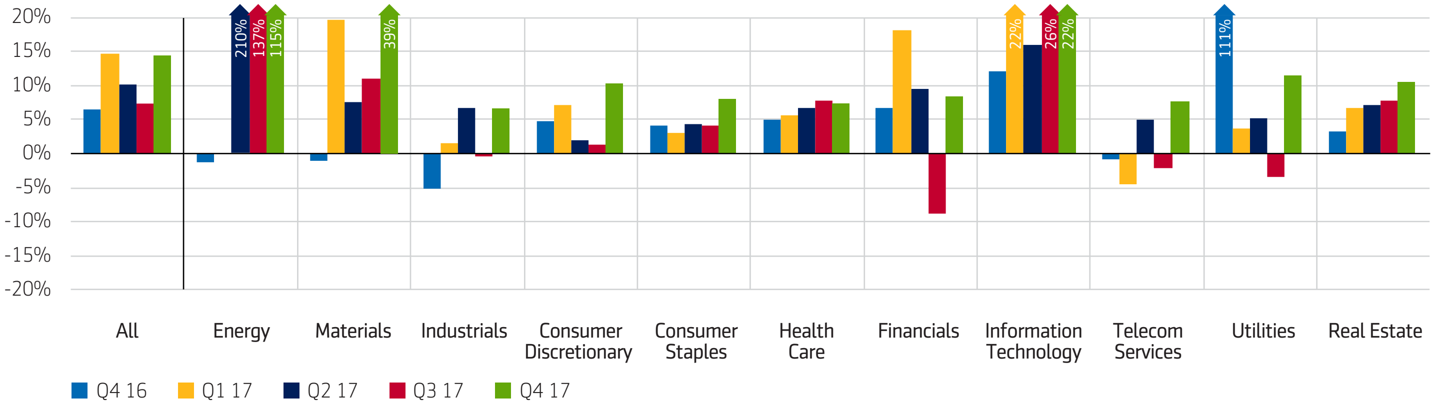
Appendix I

Exhibit 3: S&P 500 Y/Y Revenue growth by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 3/1/2018

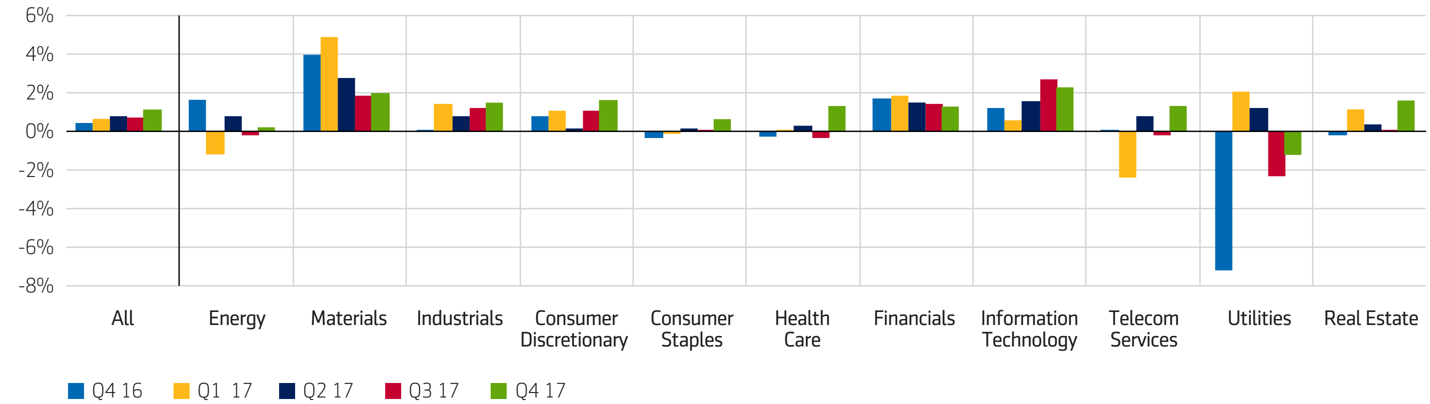
Exhibit 4: S&P 500 Y/Y EPS growth by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 3/1/2018

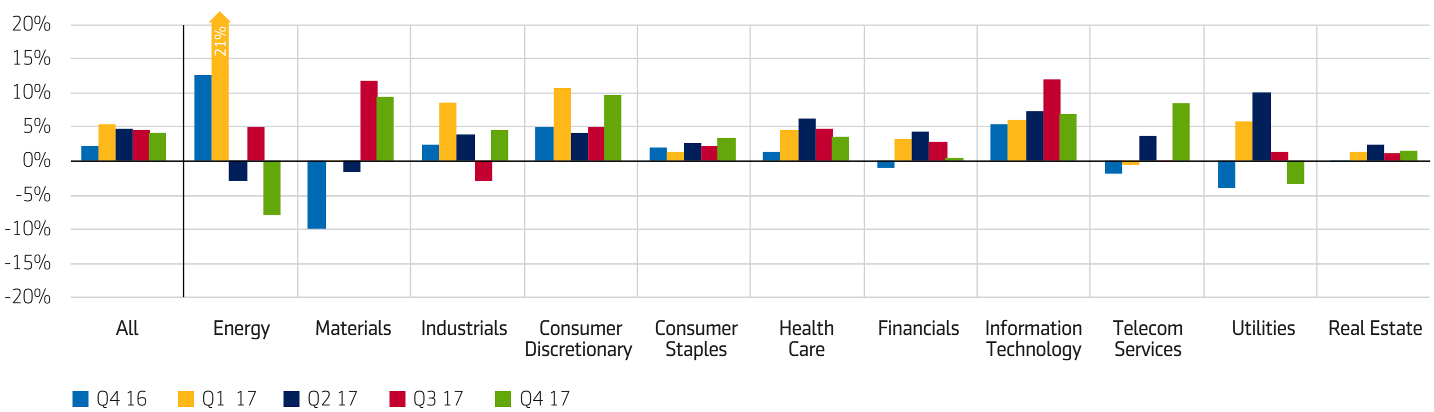
Appendix II

Exhibit 5: S&P 500 Y/Y Revenue surprise by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 3/1/18

Exhibit 6: S&P 500 Y/Y EPS surprise by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 3/1/18

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