"GREAT! #DOW20K"

Donald J. Trump

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Stephen Schwarzman, founder and CEO of Blackstone Group, was recently quoted by *The Wall Street Journal* as remarking that President Trump's policies are "designed to create significantly higher growth" in the U.S. He believes that is bullish for Blackstone's collection of companies. So does Hamilton E. James, president of Blackstone, and a Hillary Clinton supporter. During the company's fourth quarter earnings call, Mr. James commented that Mr. Trump's election created "the prospect of one of the most abrupt and radical changes in our political, regulatory and tax systems in the last 100 years." He believes the proposed changes to the tax code will benefit Blackstone's existing portfolio of businesses and will provide "new and attractive investment opportunities." We have argued the same.

But, what is behind the achievement of Dow 20K and what, if anything, does it signify? Investors have waited 18 years for the Dow to double from 10K to 20K. As a price-weighted index, Dow price performance is influenced by the highest-priced stocks in the index. According to David Rosenberg of Gluskin Sheff, since 2004 if the eight companies removed from the DJIA had been retained, the index would weigh in at 12,885 rather than over 20,000. That speaks to stock selection, to be sure, but also points to the vagaries of the Dow's price performance calculation. If the Dow's appreciation had not been confirmed by strong performance in the S&P 500 and the NASDAQ, we would likely not take note.

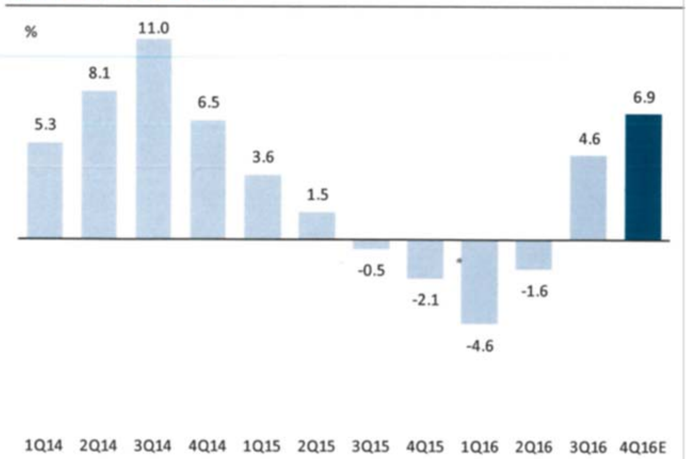
Importantly, the Dow's rise is also confirmed by strong fourth quarter earnings.

According to our friend, Jonathan Golub, at RBC Capital Markets, 160 S&P 500 companies have reported earnings so far this quarter. That represents 44% of the index's market cap (the S&P 500 is market cap, rather than price-weighted, like the Dow) and the average earnings beat is 3%; revenues have surprised by 0.3%. Importantly though, the fourth quarter represents the second quarter of positive earnings and revenue growth after four quarters of negative earnings per share growth and six quarters of negative revenue growth. Earnings are what drive stock returns. The trend is in the right direction.

Exhibit 5: S&P 500 Revenue Growth

Note: Current quarter represents the actual for companies that have reported and consensus estimates for companies that have yet to report
Source: S&P, Compustat, Thomson Financial, FactSet, and RBC Capital Markets

Exhibit 6: S&P 500 EPS Growth



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But, as always, there are near-term and medium-term worries. The proposed border adjustment tax that benefits exporters and punishes importers is on our radar. The strong dollar that has already been blamed for lower forward sales guidance at Johnson & Johnson and Caterpillar carries far-reaching, potentially negative implications for U.S. multi-nationals and emerging markets. A slowing China is another headwind we are watching. One year ago, the U.S. stock market sold off on, among other things, a slowing China. We wrote to you on February 9, 2016 in "Times Like These" to hold tight. Since then, the S&P 500 is up 26.5% through last Friday. We are not forecasting another 26.5% market move over the next 12 months, but we are optimistic that earnings will support a reasonable, high-single digit return for stocks without any benefit from pro-growth economic policies implemented by the current administration. If we see 2017 tax cuts and a repatriation tax holiday for offshore corporate cash, stocks returns could surprise to the upside.

Dow 20K is certainly "Great!" but it is just a number. Stocks trade on earnings and earnings growth. When I began my career, the Dow was trading at 1,200. Today it is trading at 20,000. 30,000 is not far off. But never forget that earnings drive stock returns. Sustainable market returns respond to fundamentals, not magic. Or, for that matter, tweets.