ALGER

Inspired by Change, Driven by Growth.

Capital Markets: Observations and Insights

Business Spending Boost

Autumn 2017

The Earnings Stream

Money often flows like a river, cascading and meandering throughout the economy. In certain areas it picks up speed and intensity while in other places it slows to a trickle. This past spring, we wrote about an earnings resurgence in which corporate profits were set to rise strongly after a two year drought. Earnings growth has indeed been robust, registering the first consecutive quarters of double-digit gains in many years (since 2011). That earnings stream is now set to flow down to business spending.

When corporate cash flows accelerate, so too do investments in areas such as intellectual property, advertising, and equipment. Ultimately, the cash will flow to employees in the form of higher wages but first it is business expenditure that will swell.

Investors looking for growth may want to position for a potential torrent of business spending.

Sincerely,

Daniel C. Chung, CFA
Chief Executive Officer
Chief Investment Officer

Brad Neuman, CFA
Senior Vice President
Client Investment Strategist

Key Observations

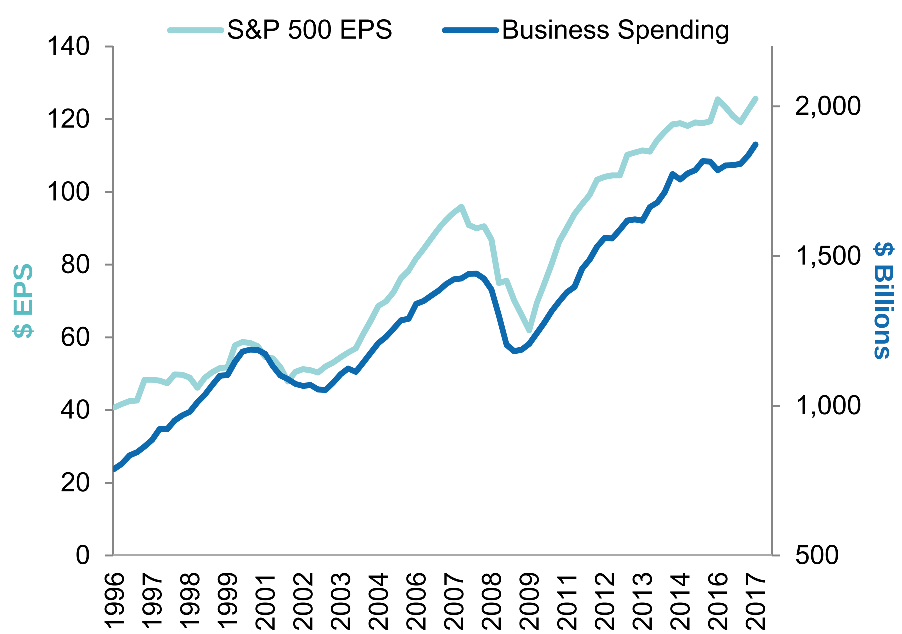
- **Business spending is set to accelerate** and outpace the broader economy, given an earnings resurgence, strengthening business confidence, and potential tax cuts
- **Growth equity fundamentals have outpaced those of Value stocks**, driving performance results
- Leading indicators suggest that **economic growth and corporate profits will continue to expand**

Table of Contents

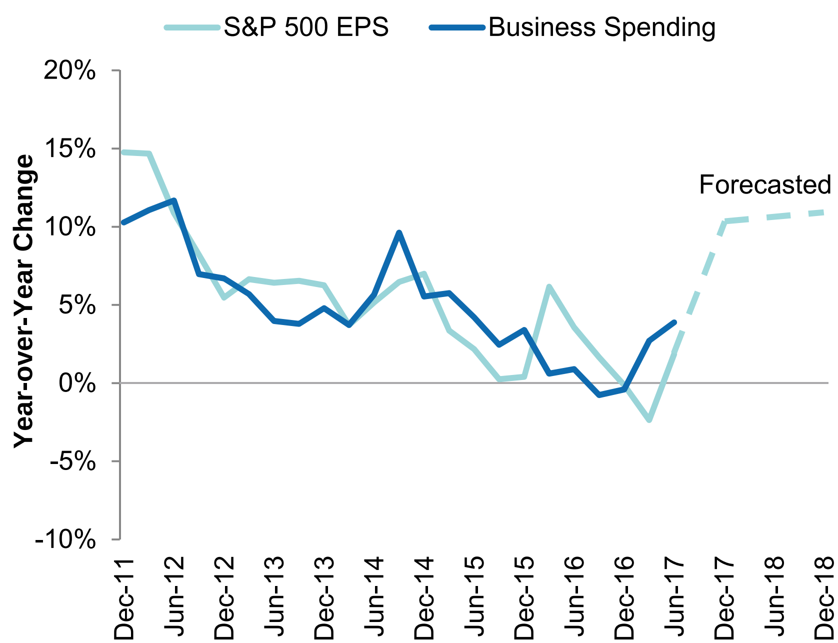
Business Spending Boost
Earnings Resurgence = Business Spending Acceleration

- After a two-year earnings recession, S&P 500 profits are growing strongly
- Robust profit growth typically leads to higher business spending

Strong Relationship…



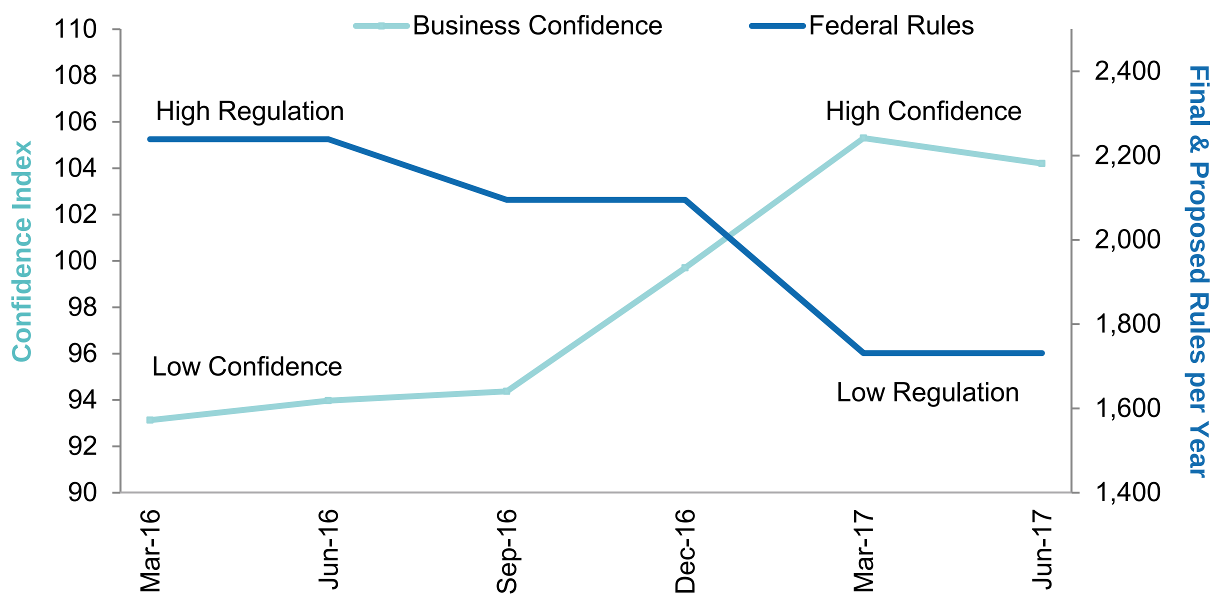
…Implies Acceleration in Business Spending



Source: FactSet and U.S. Bureau of Economic Analysis as of 9/30/17. EPS is last 12 months. EPS forecast is based on bottom-up consensus estimates. Actual earnings per share might be materially different than shown. Business spending is U.S. private fixed nonresidential equipment and intellectual property expenditures.

Business Spending Boost
Less Regulation Is Good for Business

- Lower regulation is improving business confidence
  - Regulation has gone from being the single most important problem in small businesses to being the third (behind taxes and quality of labor)
  - In the past decade, new regulations have required 681 million hours of paperwork at a cost of $1.0 trillion, while year-to-date required paperwork has been *reduced* by more than 23 million hours



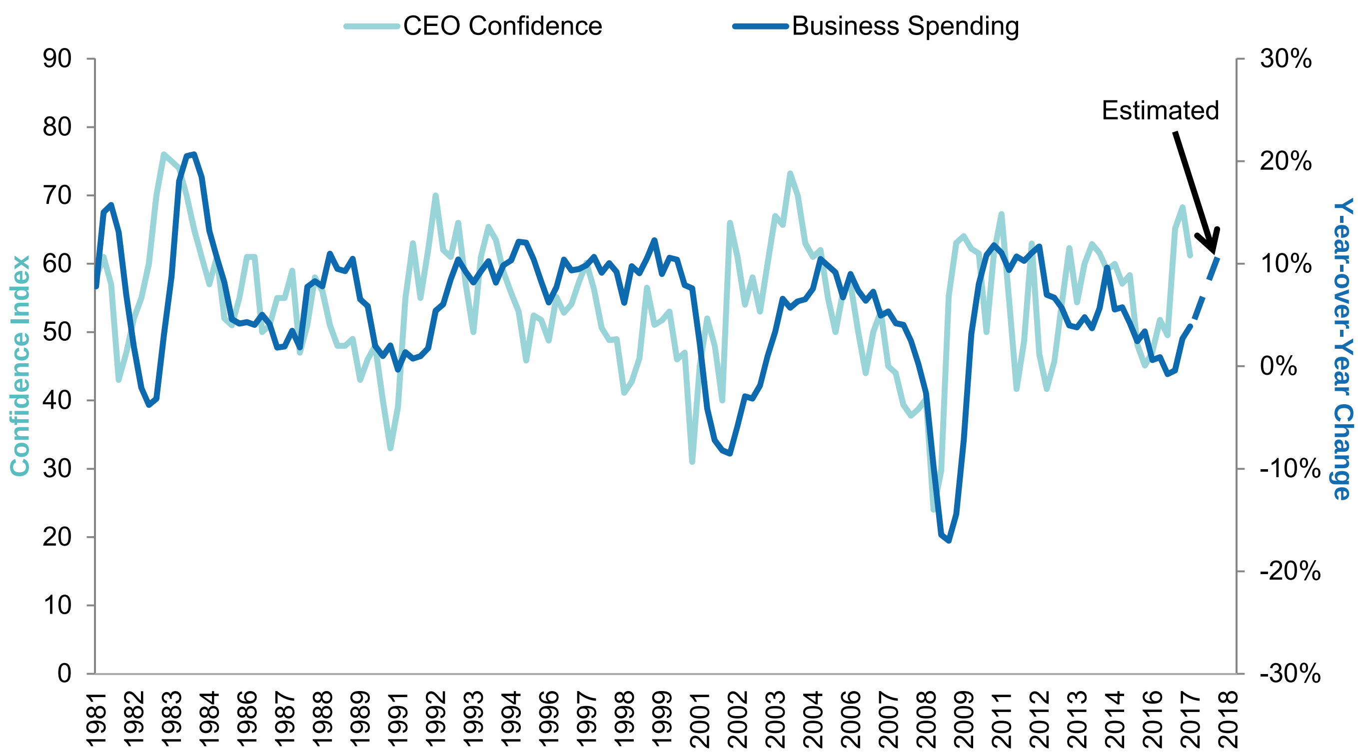
Recent decline in Federal rules strengthened business confidence

Source: FactSet and George Washington University as of 9/30/17. Business confidence is NFIB Optimism Index and Federal Rules data is from Unified Agenda of Regulatory Actions. Small business concerns according to NFIB Economic Trends survey August 2017 vs. July 2016. Cost of regulations from American Action Forum.

Business Spending Boost

Confidence Is Critical for Spending

- CEO confidence tends to lead business spending by 6-12 months
- Strengthening business confidence indicates higher corporate spending



Increase in CEO confidence bodes well for business spending

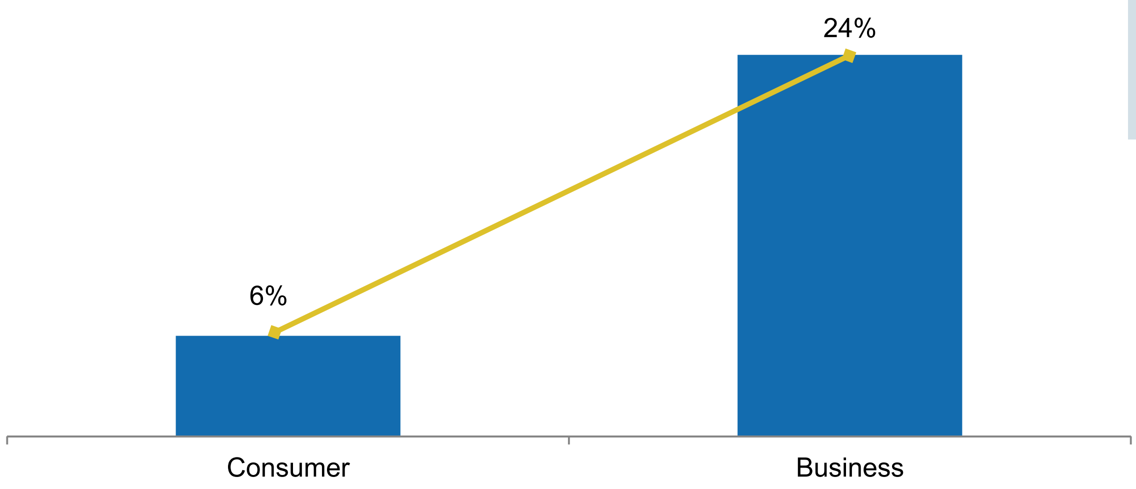
Source: FactSet, U.S. Conference Board and U.S. Bureau of Economic Analysis as of 9/30/17. Business spending is U.S. private fixed nonresidential equipment and intellectual property expenditures. Estimate based on regression of confidence and business spending.

Business Spending Boost

Tax Cut Would Likely Boost Business Spending

- Lower corporate tax rates→ increase in enterprise cash flow→ higher business spending
  - The Tax Foundation's analysis of the Trump campaign plan suggested that wages would rise 6% but capital stock, i.e. business spending, would be 24% higher

Impact of Trump Campaign Plan Relative to Baseline
(Over a Decade)

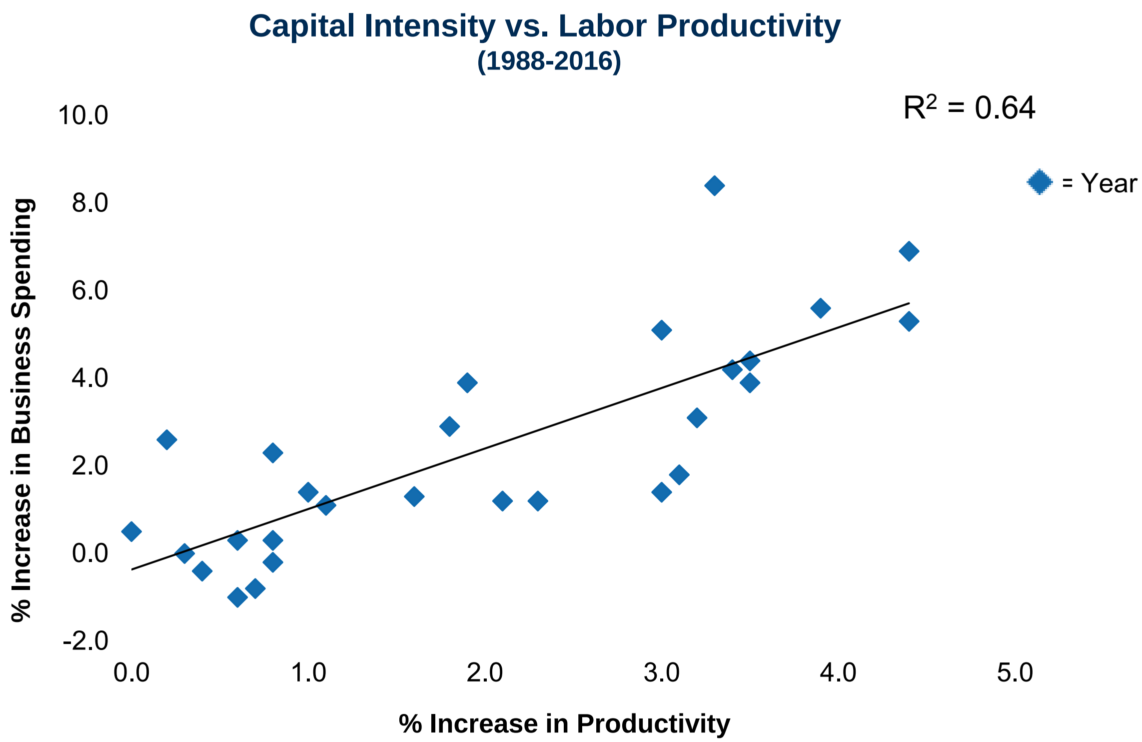


The GOP's September 2017 tax "blueprint" is similar to the Trump campaign's original tax plan

Source: Tax Foundation. "Consumer" is wages and "Business" is capital stock.

Business Spending Boost
Business Spending May Lift Productivity

- Stronger business spending should drive innovation as businesses have more cash to deploy to research and development and capital expenditures
- Historically, increases in business spending lead to higher productivity

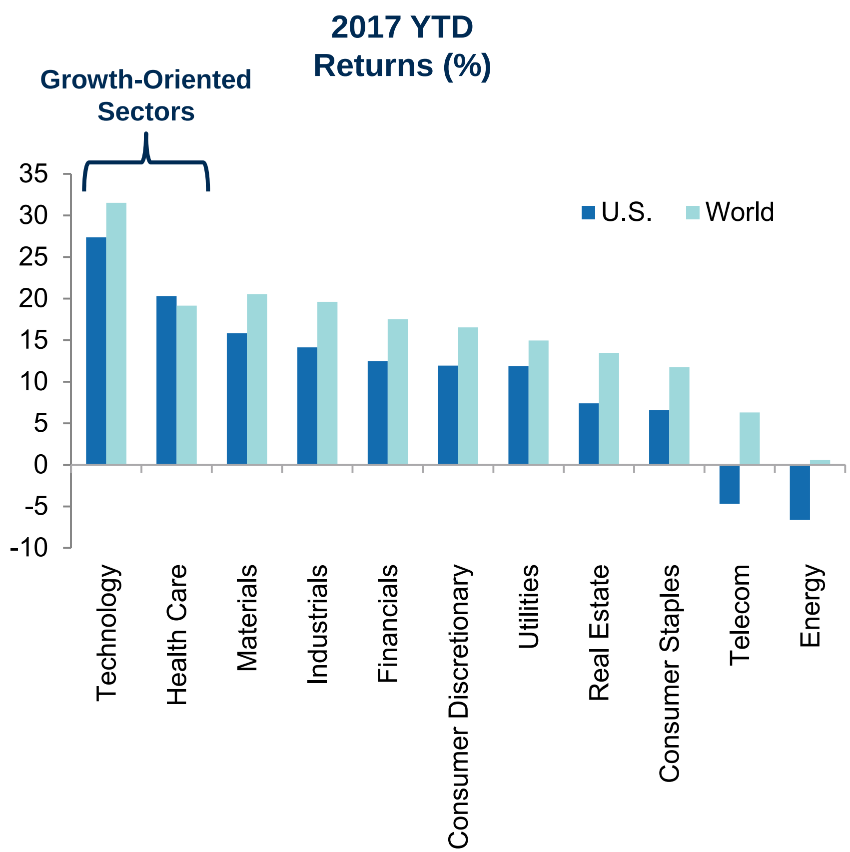


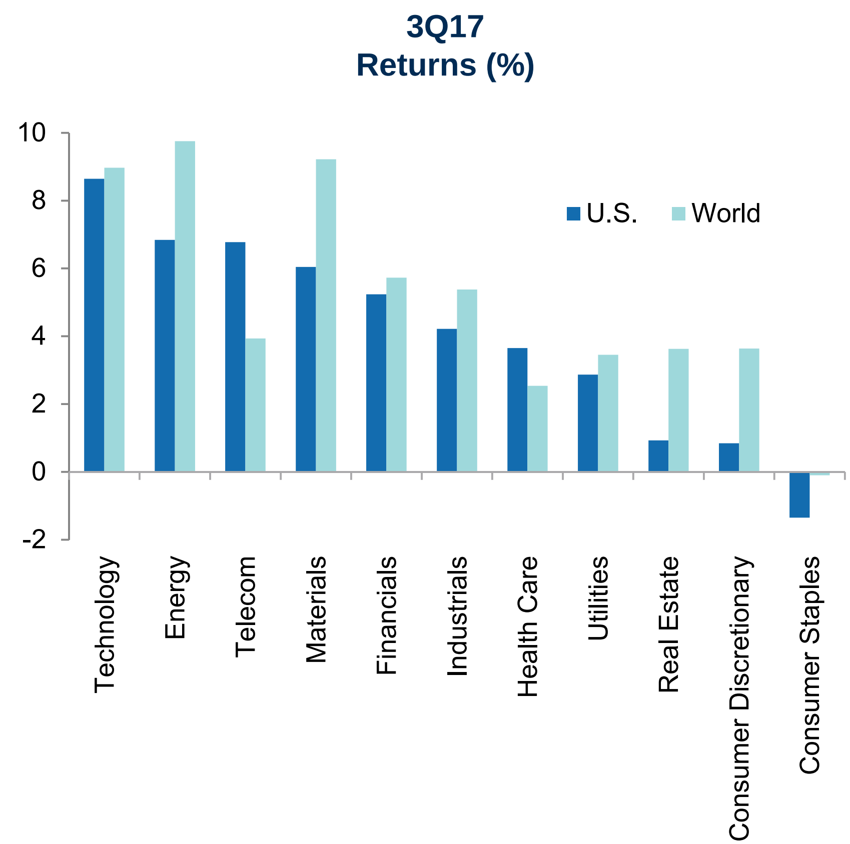
Higher business spending leads to higher productivity

Source: Bureau of Labor Statistics. Note: "Business Spending" is Capital Intensity and "Productivity" is Labor Productivity which is advanced one year

Growth Sectors Are Leading YTD

- As investors refocused on growth and current fundamentals, growth-oriented sectors outperformed year-to-date

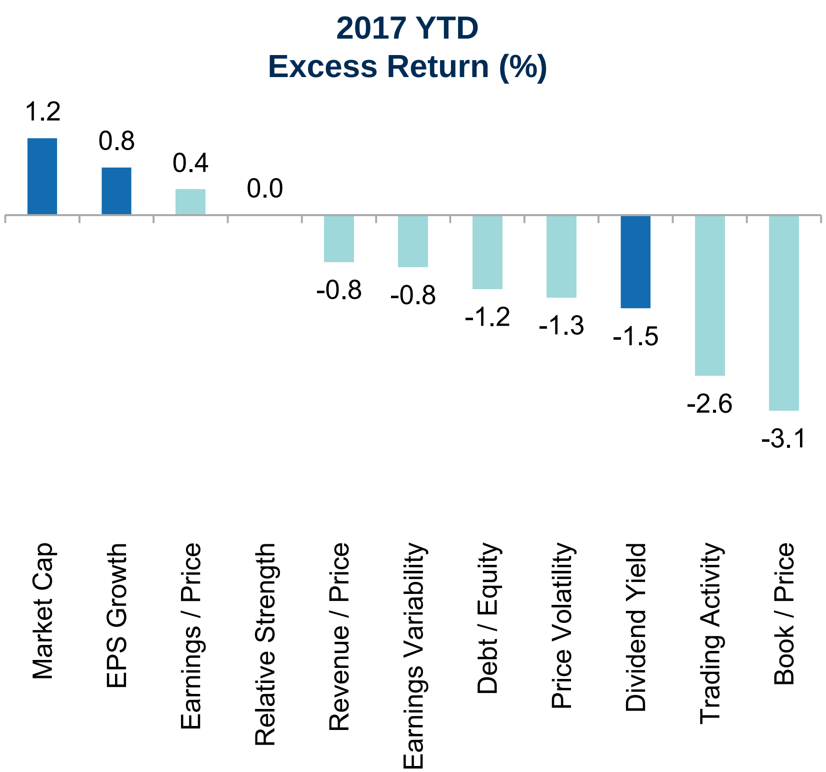


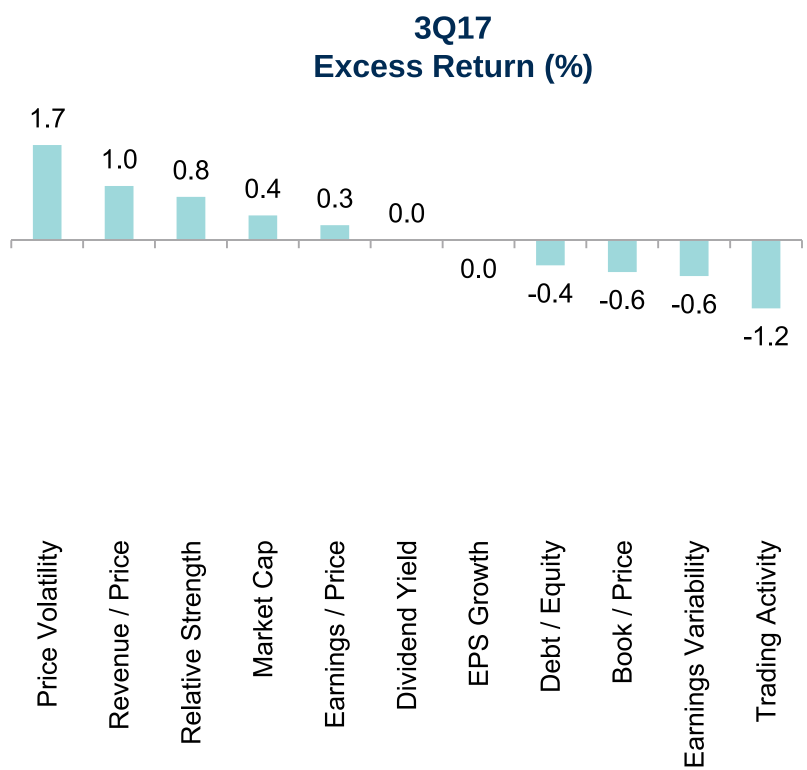


Source: FactSet as of 9/30/17. U.S. represented by S&P 500 and World is represented by MSCI All Country World Index (USD).

Performance
Scale and Growth Rewarded

- Characteristics of large secular growth stocks have done best this year, while last year's leader, dividend yield, underperformed

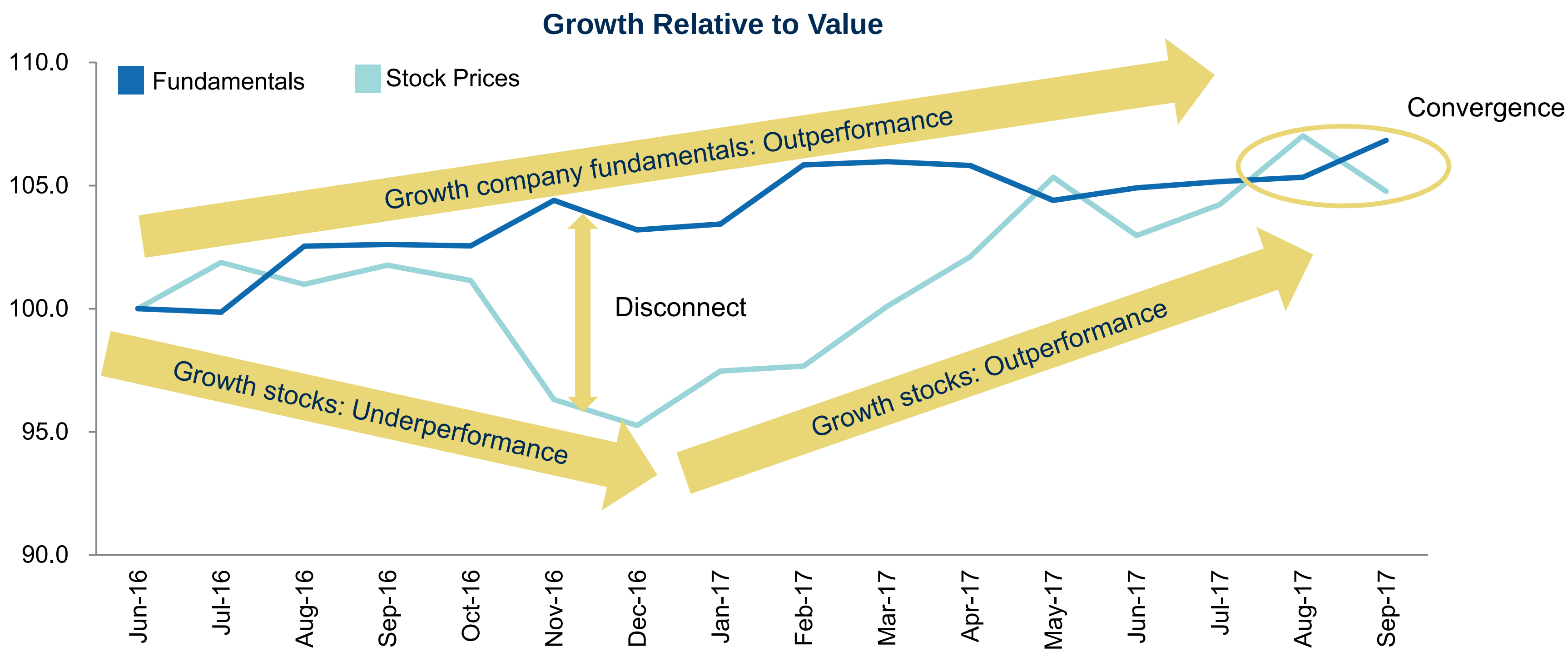




Source: FactSet as of 9/30/17 using Northfield defined quantitative factors for the Northfield broad U.S. market database.

Performance
Prices and Fundamentals Converge

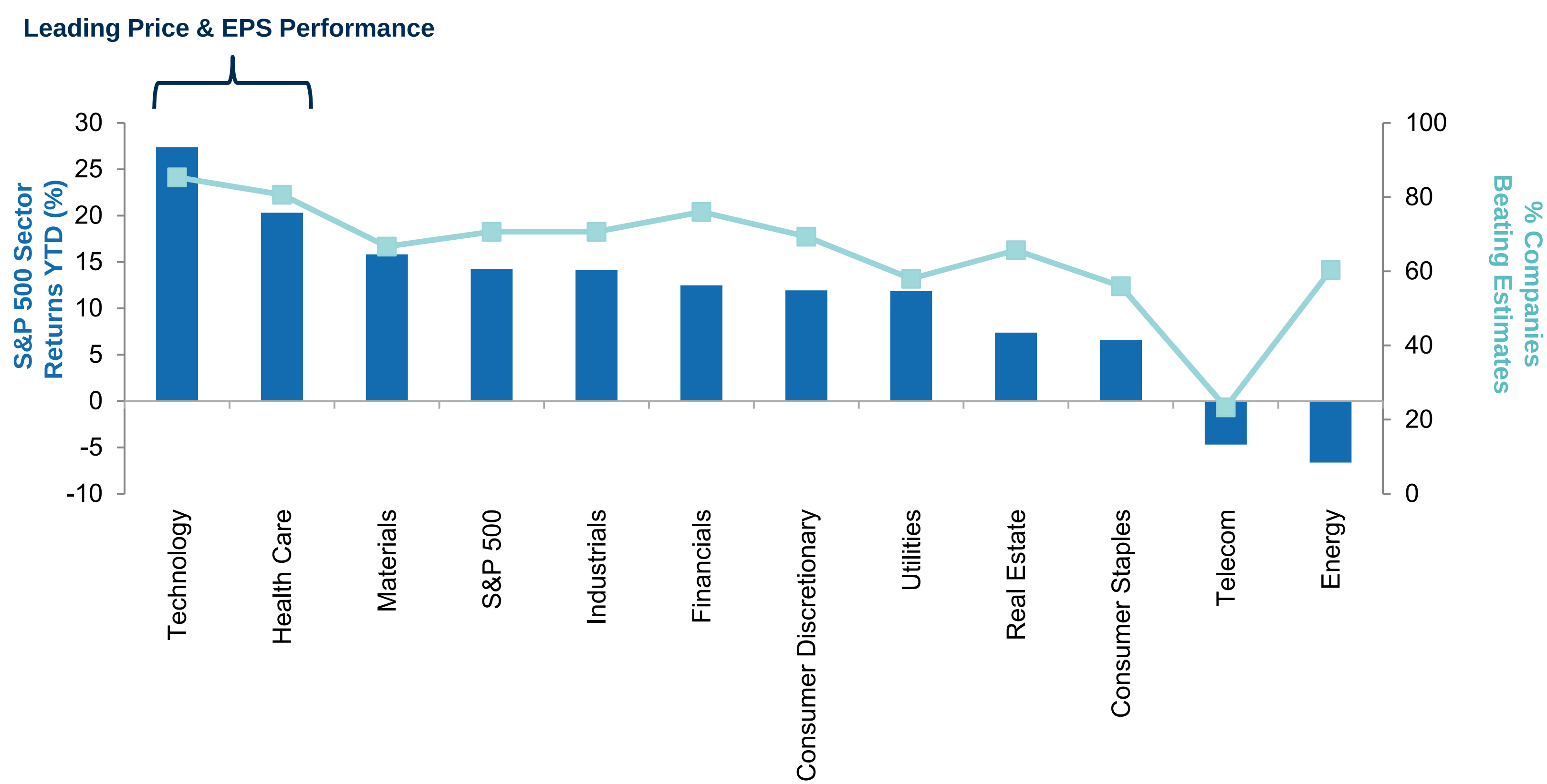
- Last year, stock prices and fundamentals diverged as investors positioned for perceived changes following the U.S. presidential election
- This year fundamentals took center stage again, which has been reflected in stock prices



Source: FactSet as of 9/30/2017. S&P 500 Growth and Value Indices used to represent Growth and Value stocks. Fundamentals are LTM EPS.

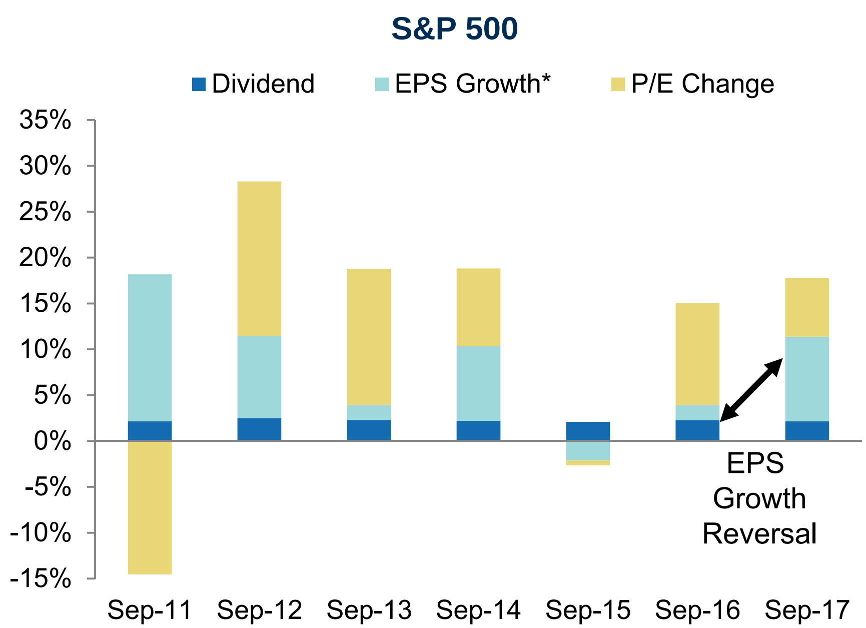
Performance
Earnings Drove Sector Performance YTD

- In contrast to much of last year, this year sectors with the strongest *earnings* performance YTD had the best *stock* performance

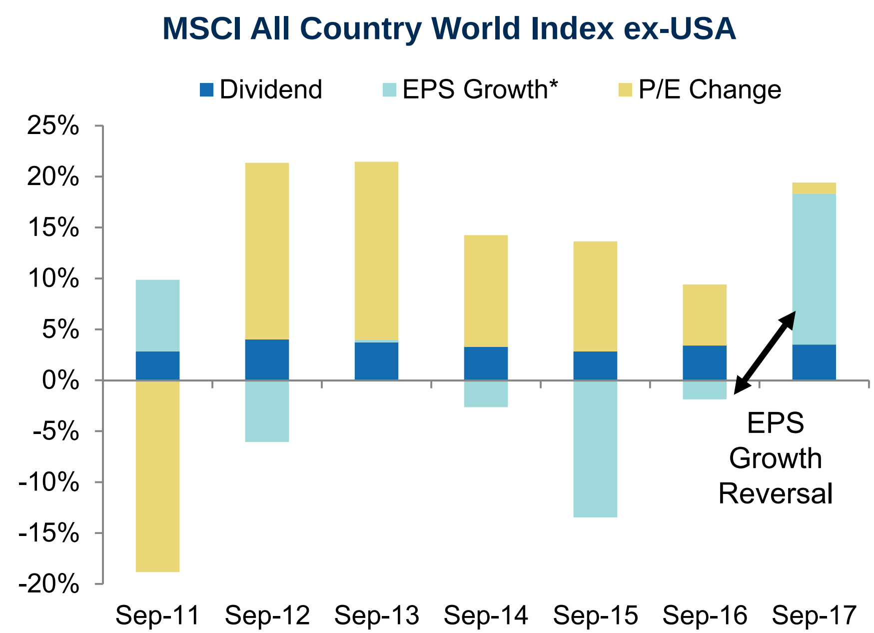


Source: FactSet as of 930/2017. Companies beating estimates based on average of earnings seasons reported in 2017: Q416, 1Q17, and 2Q17.

Total Return = Dividend Yield + EPS Growth +/- P/E Change



12-Month Total Return:	1%	30%	19%	20%	-1%	15%	19%

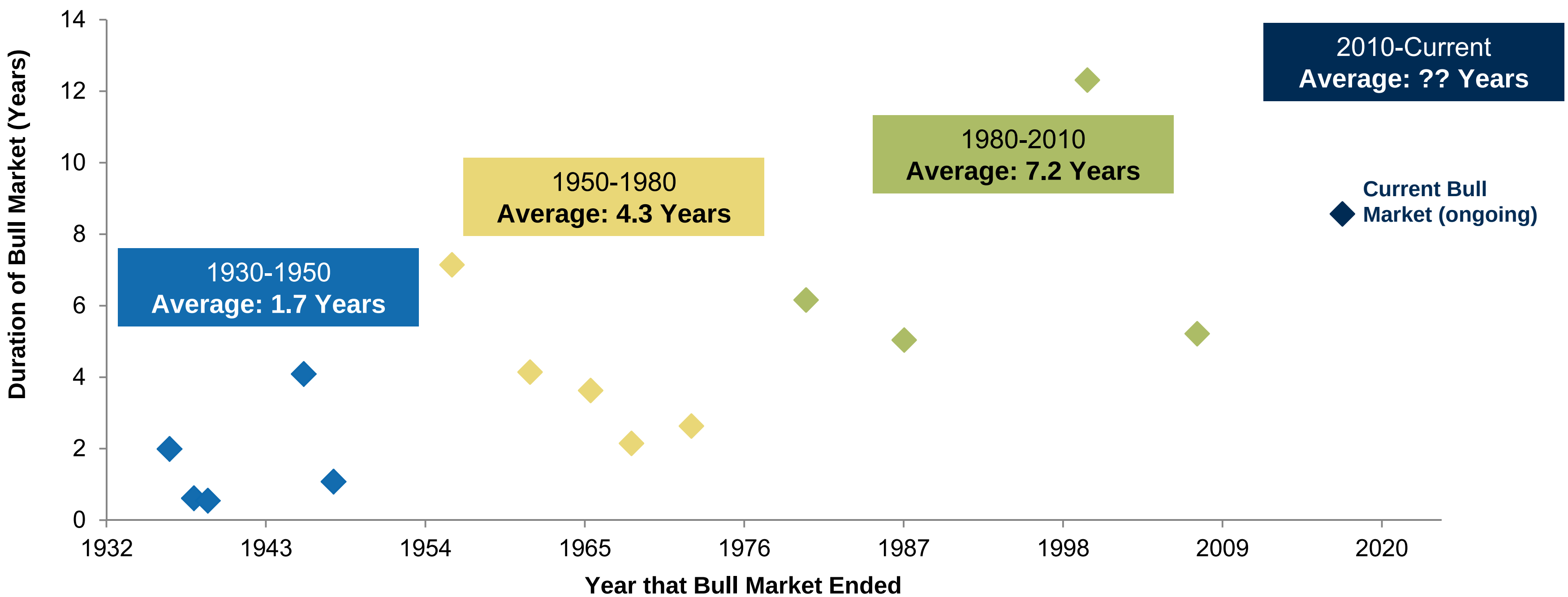


12-Month Total Return:	-10%	14%	21%	11%	-1%	7%	20%

Source: FactSet as of 9/30/17. *Based on consensus estimates of next 12-month EPS. Actual earnings per share might be materially different than shown. MSCI ACWI ex-US performance based on local currency.

Performance
Bull Market Is Aging Well

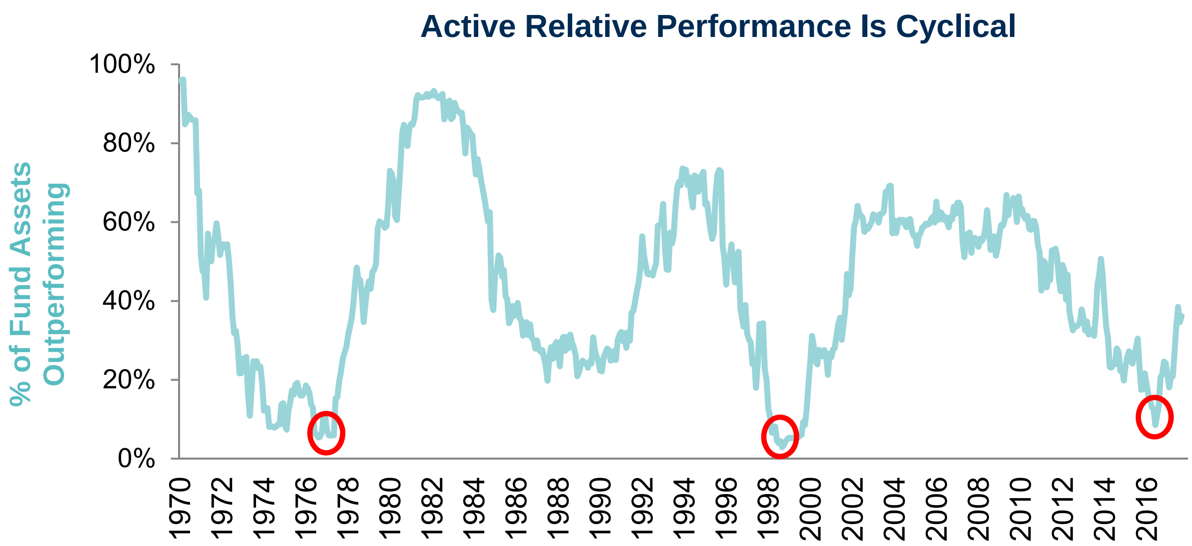
- Bull markets have been getting longer over time
  - Factors prolonging economic expansions include: increased fiscal and monetary intervention, structural changes in the economy, and technological advances such as improved inventory management
  - The current bull market is 3.75 years younger than the 1990s bull market



Source: FactSet and Goldman Sachs as of 9/30/2017. Bull markets over 6-months in duration since 1930.

Performance
Has Active Relative Performance Troughed?

- While there are secular pressures affecting U.S. active management, cyclical factors tend to be much more powerful in the short term, such as
  - interest rates/bond-like equities
  - small cap performance
  - overall market performance
  - non-U.S. stock performance



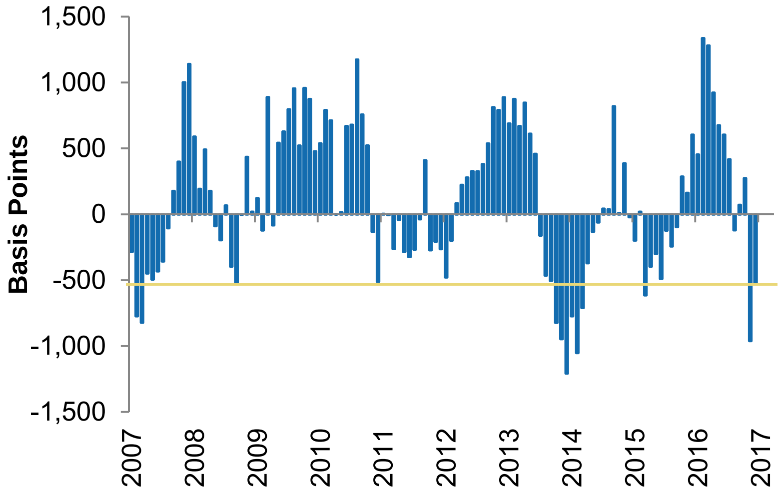
54% of large cap managers have outperformed their style benchmark year-to-date

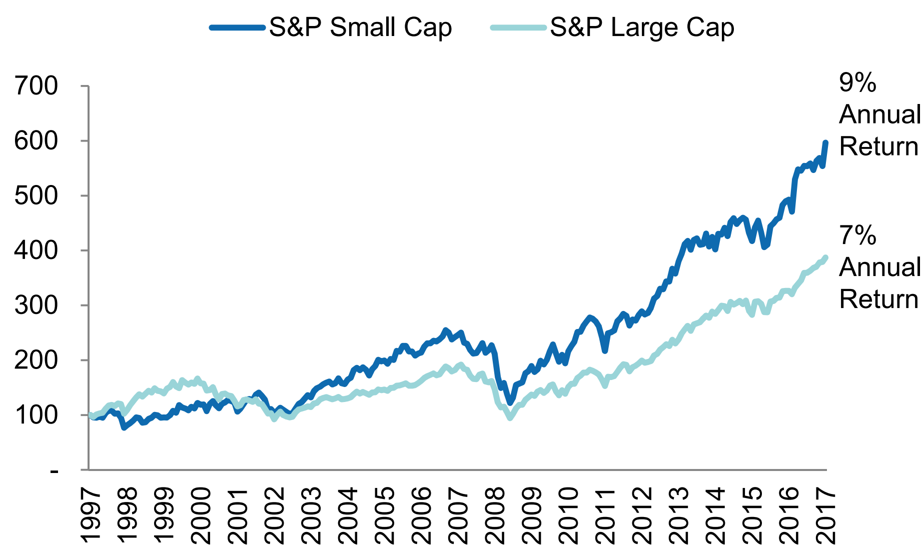
Source: Nomura/Instinet, Joseph Mezrich and FactSet through 9/30/17. Fund performance is trailing 5-year data. Year-to-date active performance from Bank of America Merrill Lynch.

Performance
Small Caps Due for a Comeback

- Small caps have had very weak year-to-date performance—one of the worst 9-month periods in the past decade—in stark contrast to their historic outperformance*
- Taken together, these data points may imply small caps are poised for a comeback
  – After underperforming by this much, small caps have outperformed by over 300bps in the following 12-month period, on average, over the past decade

S&P Small Cap Performance Relative to S&P Large Cap
(rolling 9-months)

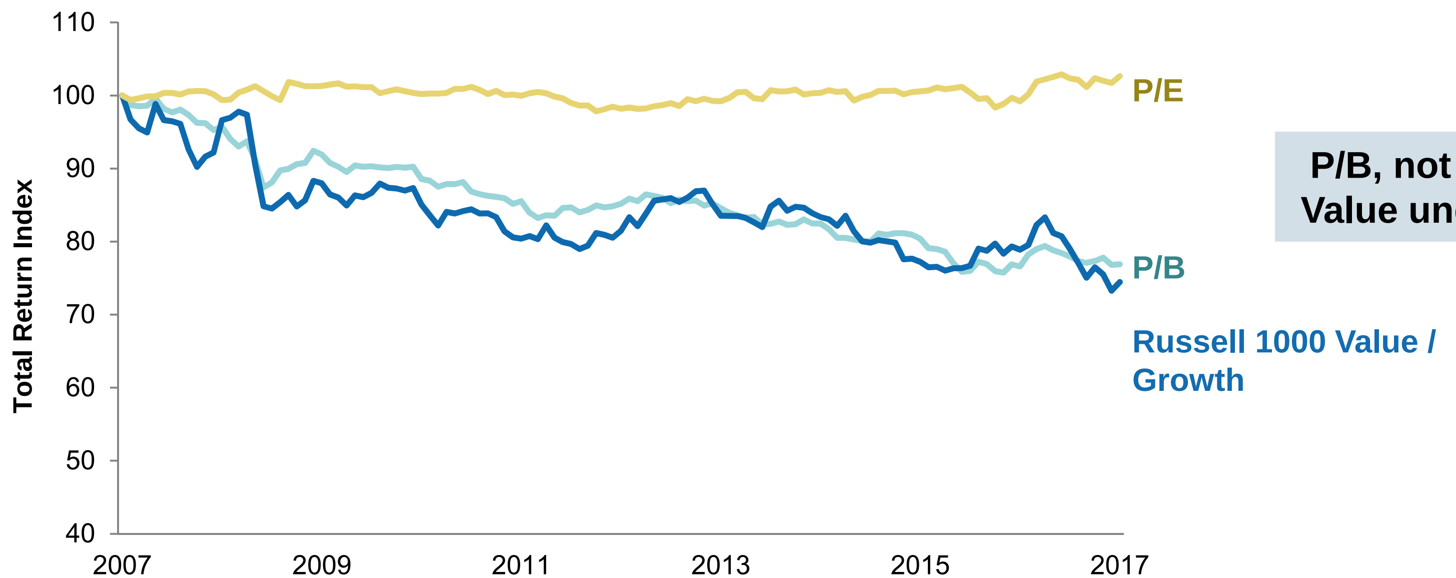




Source: FactSet as of 9/30/17. *Data from Ibbotson/Morningstar shows small caps have outperformed large caps by 189bps annually 1925-2016.

Performance
Structural Issues Driving Growth vs. Value

- Growth stocks have dramatically outperformed Value stocks—35%—over the past decade
- The culprit for value investors has been very weak performance in buying low P/B stocks, while P/E strategies have fared much better
- Book value may no longer be as relevant given changing business models, e.g., R&D is not capitalized in book value

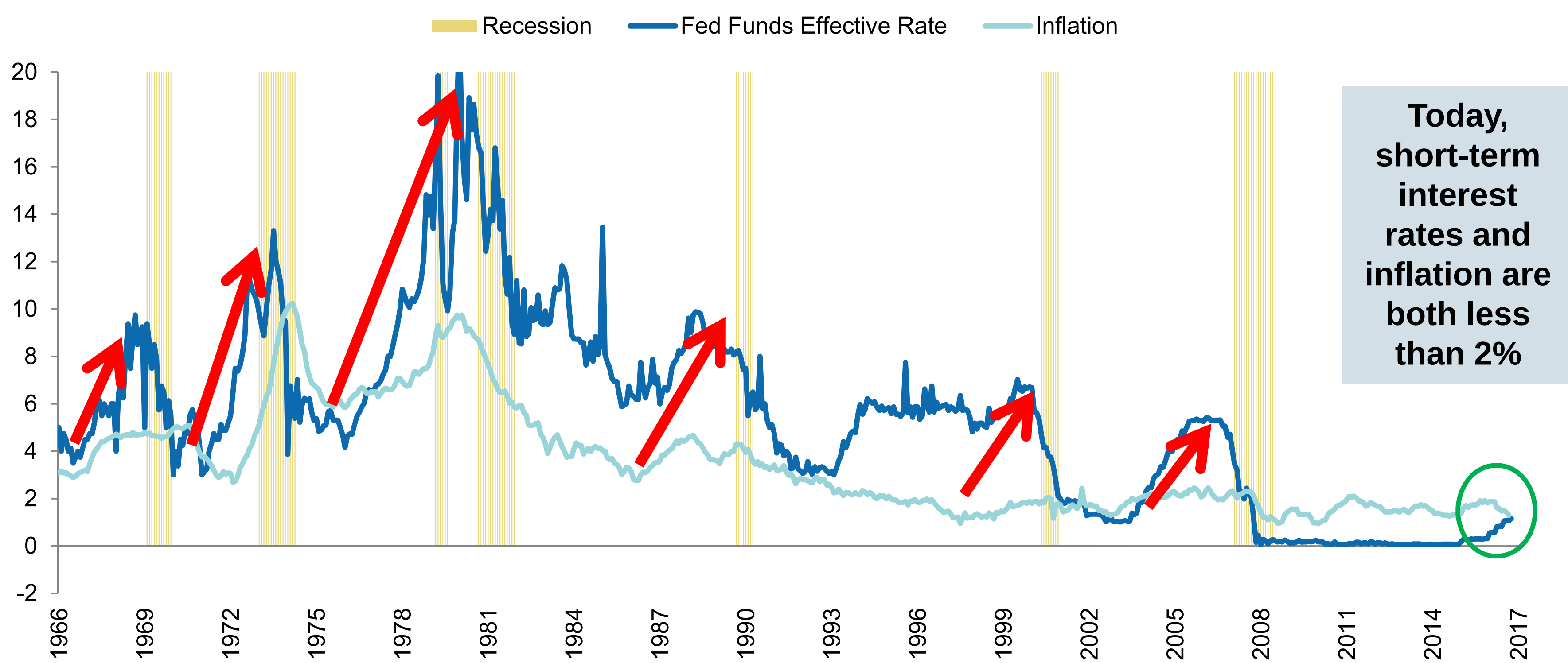


P/B, not P/E, has driven Value underperformance

Source: FactSet as of 9/30/17. Price-to-earnings and price-to-book returns are based on the E/P and B/P Northfield factors for the Northfield broad U.S. market database.

Fundamentals
Leading Cycle Indicators Are Benign

- Every major recession in the past 75 years has been preceded by substantial Fed Funds rate tightening or inflation acceleration, or both
- We believe the Fed can be patient given forces weighing on inflation including innovation (price transparency), labor dynamics (retirees), and globalization

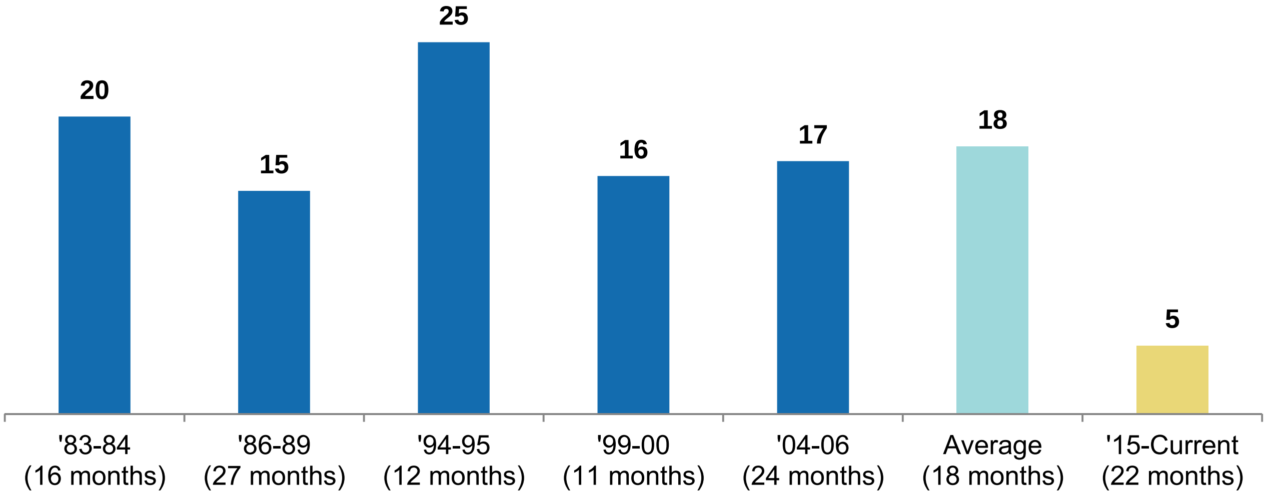


Source: FactSet as of September 2017. Inflation represented by PCE Price Index ex-food and energy (year over year).

A Slow Fed Keeps Away the Red?

- On average, the U.S. has not entered a recession until about three years after *material* Fed tightening
- But the Fed is tightening much more slowly than it has historically

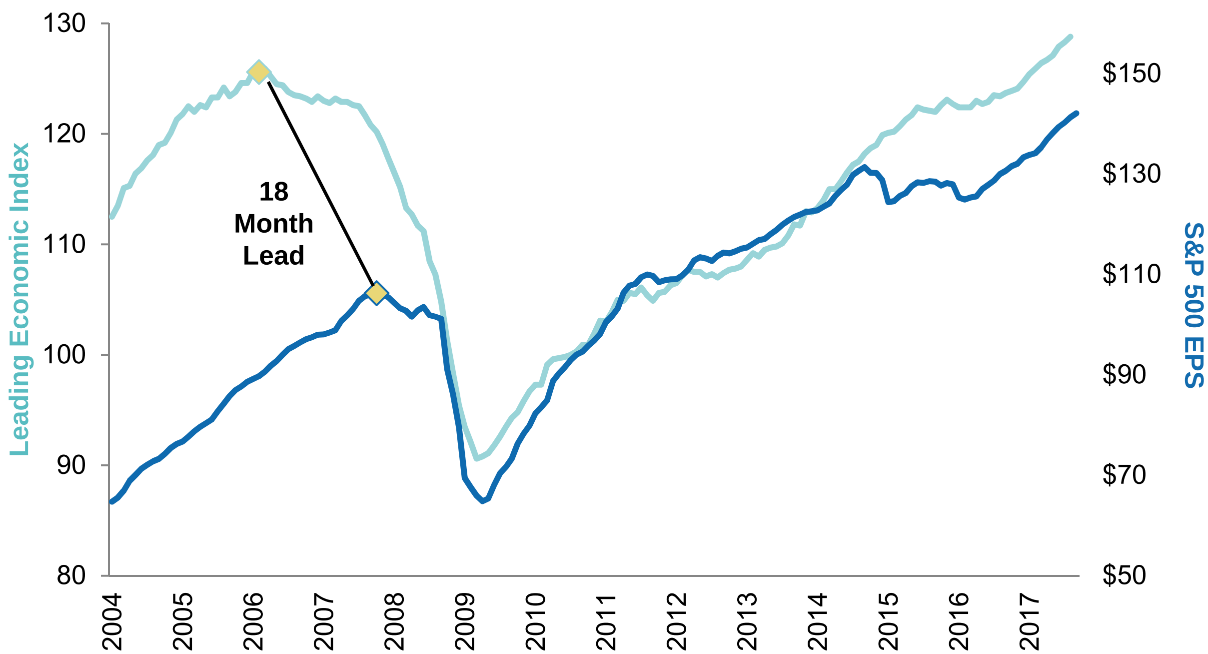
Fed Has Been Tightening Very Slowly
(Basis Points per Month)



Source: FactSet and J.P. Morgan as of 9/30/2017.

Leading Indicators Suggest Earnings Will Continue to Rise

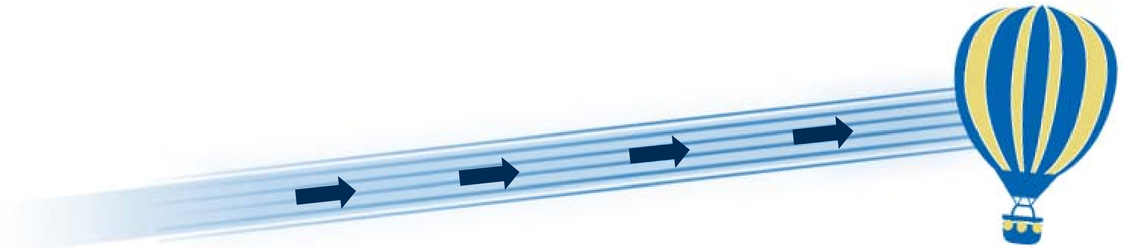
- The Conference Board Leading Economic Index (LEI) typically leads earnings by 6-18 months and usually peaks one to two years prior to a recession
- Given that the LEI is increasing solidly year-over-year and hit a record high in 3Q17, we believe the economy and earnings have room to run



Leading Economic Index indicates further EPS growth

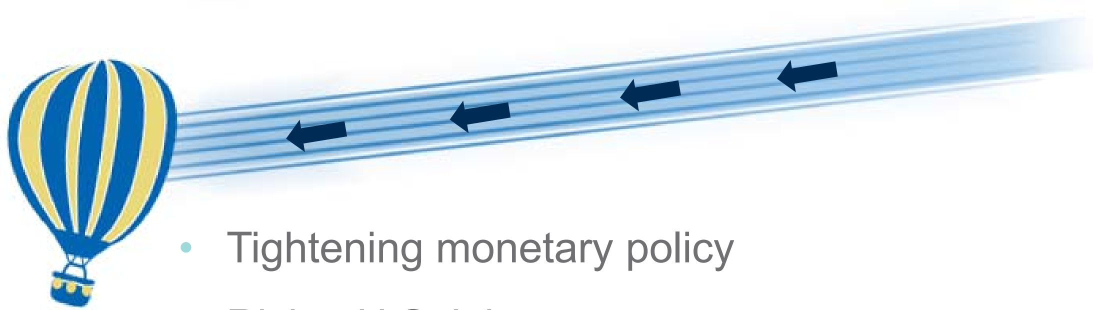
Source: FactSet, Conference Board as of September 2017. Based on NTM EPS estimates.

Fundamentals
Economic Outlook



Tailwinds

- Strong business and consumer confidence
- Solid U.S. consumer balance sheet
- Robust corporate profits
- Potential fiscal stimulus

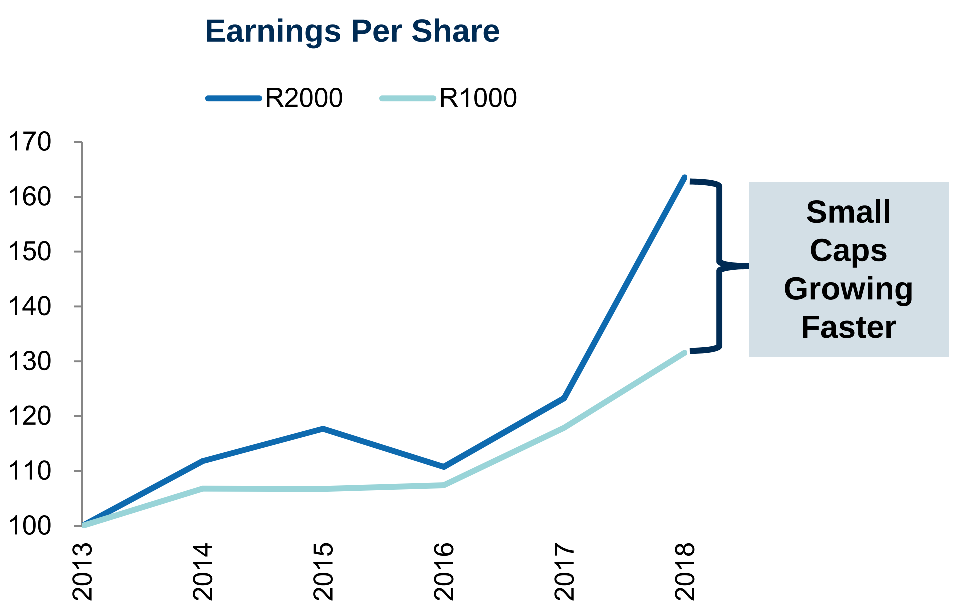


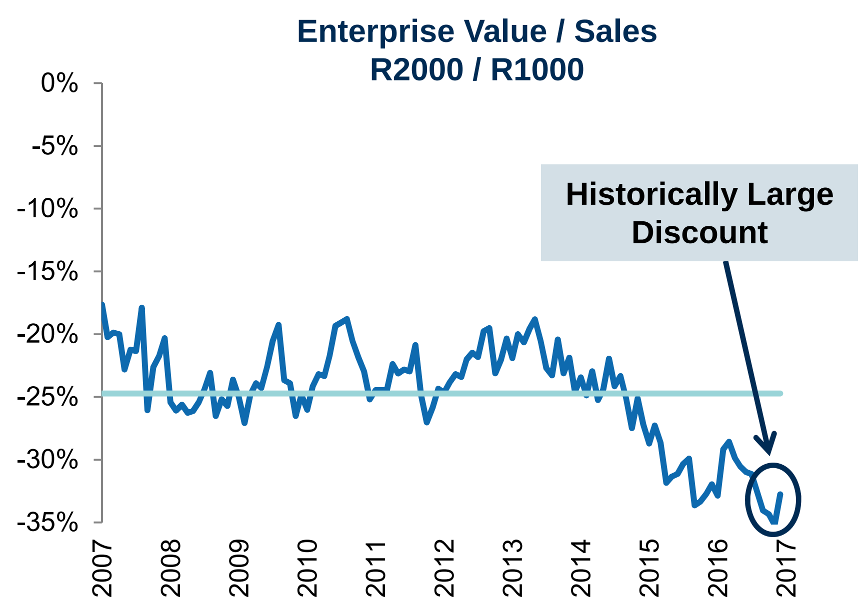
Headwinds

- Tightening monetary policy
- Rising U.S. labor costs
- China debt levels
- Political risk

Smaller Capitalization Stocks Poised to Outperform

- **Stronger fundamentals**: Estimated EPS growth for 2018 more than double that of large cap
- **More levered to fiscal stimulus**: Small caps are more U.S.-oriented and have higher operating leverage
- **Rising interest rates**: Small caps have historically outperformed large caps in rising rate environments and vice versa in falling rate environments
- **Attractive valuation**: Small cap sales multiple discount implies opportunity





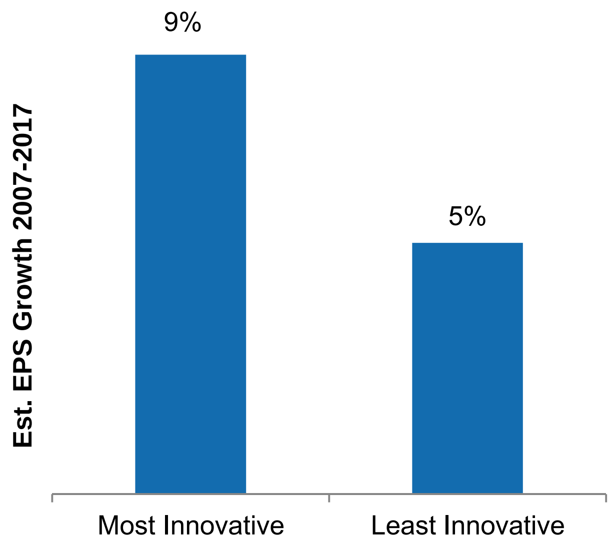
Source: FactSet as of September 2017. EPS for 2017-2018 are consensus estimates and actual earnings per share might be materially different than shown.

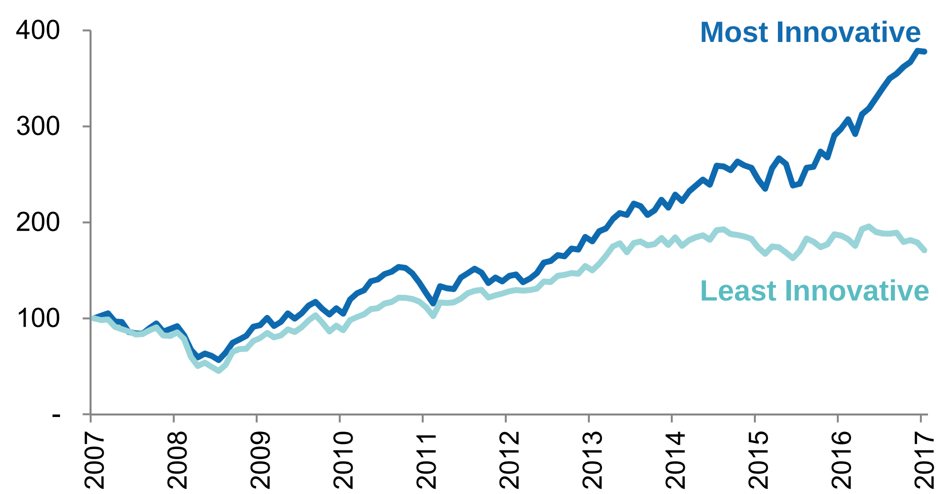
Innovative Companies Grow Earnings and Stock Prices Faster

- Innovation propels economic growth over time
  – Studies have shown, and our research demonstrates, that the most innovative companies grow their sales, earnings, and stock prices faster*

Innovation Drives:

EPS Growth… **and** **…Stock Prices**





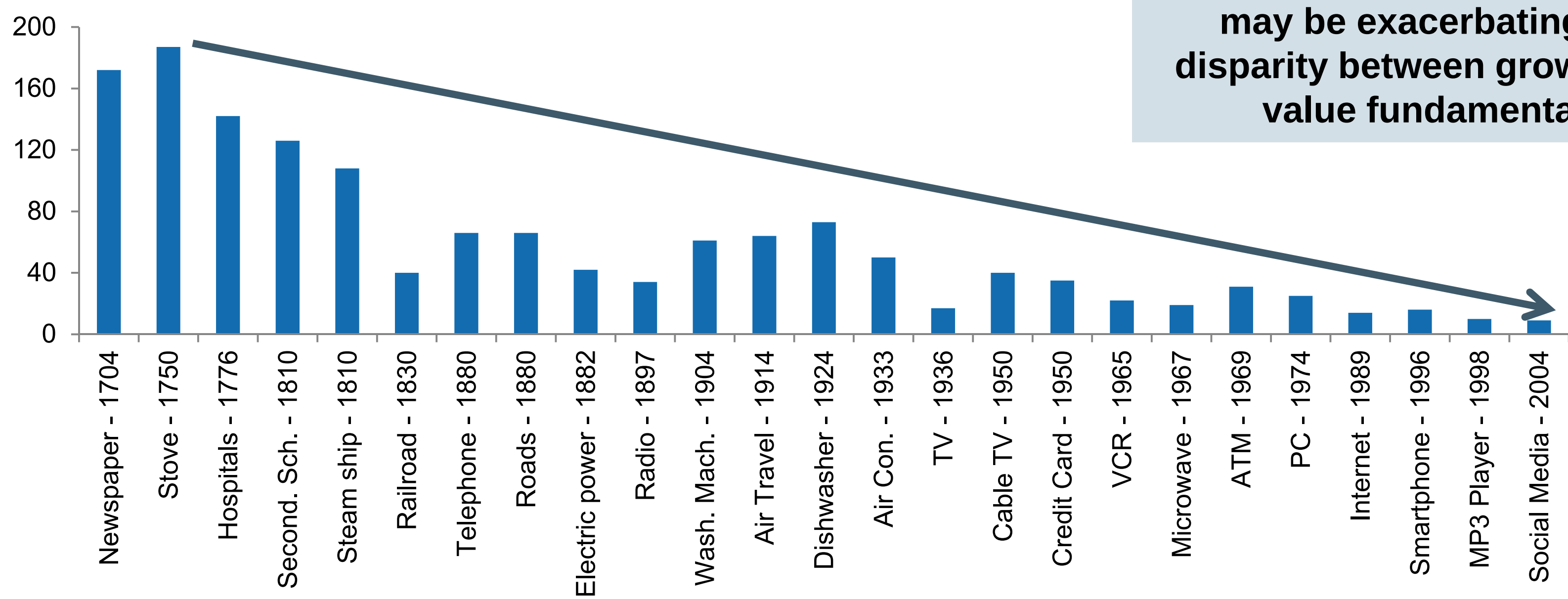
Source: FactSet. Most/least innovative based on R&D % of sales. Est EPS growth July 2007- July 2017 measured after classification of S&P 1500 companies into innovation quintiles in Dec. 06. Most/least innovative stock performance based on S&P 1500 quintiles one month returns for same time period, normalized for market value.

*Baruch Lev and Suresh Radhakrishnan, "The Stock Market Valuation of R&D Leaders."

Fundamentals
Speed of Innovation Is Accelerating

- Innovations are penetrating U.S. markets at an even faster pace
  – “Growth” stocks should benefit from innovation while “value” stocks that appear cheap may simply be victims of change

Years from Market Entry to 50% Penetration in the U.S.

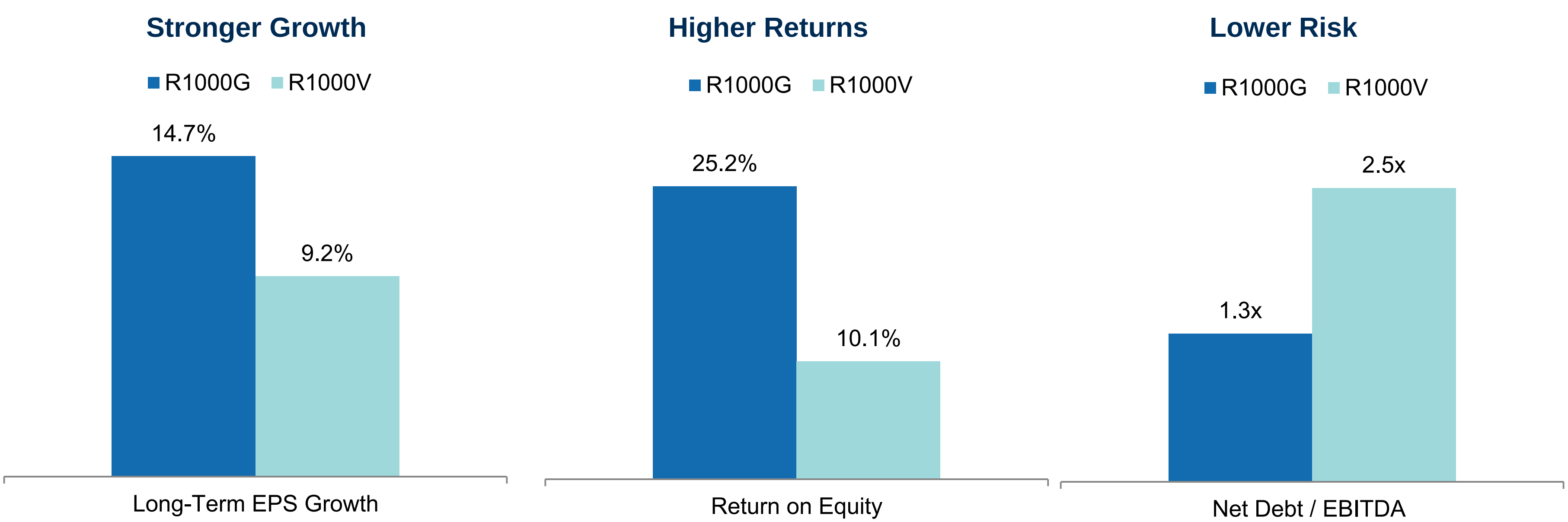


The faster speed of innovation may be exacerbating the disparity between growth and value fundamentals

Source: Asymco.

Fundamentals
The Growth Advantage

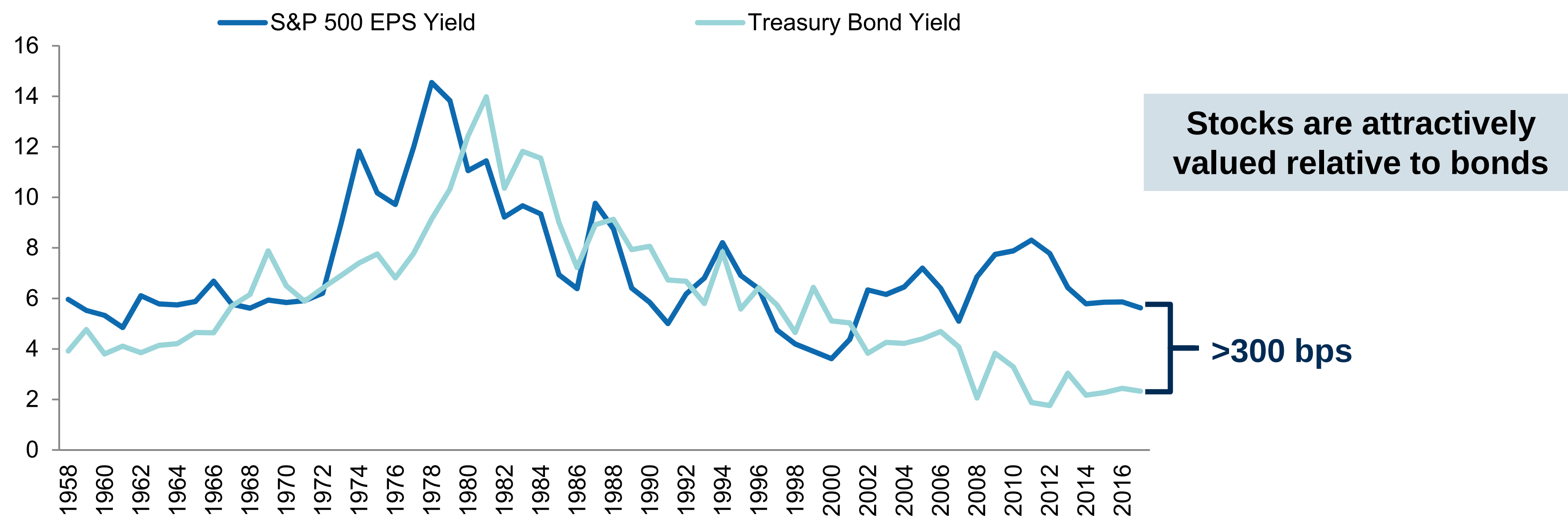
- Three variables drive P/E multiples: growth, returns, and risk
- As compared to the Russell 1000 Value, the Russell 1000 Growth has higher expected EPS growth, higher returns on equity, and lower risk in the form of better balance sheets



Source: FactSet as of September 2017. Growth represents consensus long-term analyst estimates, and actual future EPS growth rates might be materially different than the forecasts shown.

- Moving from monetary stimulus and quantitative easing to fiscal stimulus and increased deficits should drive a Great Rotation from bonds to stocks
- The magnitude of the rotation will be fueled by the valuation disparity between equities and bonds, which are expensive by comparison
  - The earnings yield for equities is more than 300 bps greater than 10-year Treasury notes vs. a 60 bps median over the past half-century

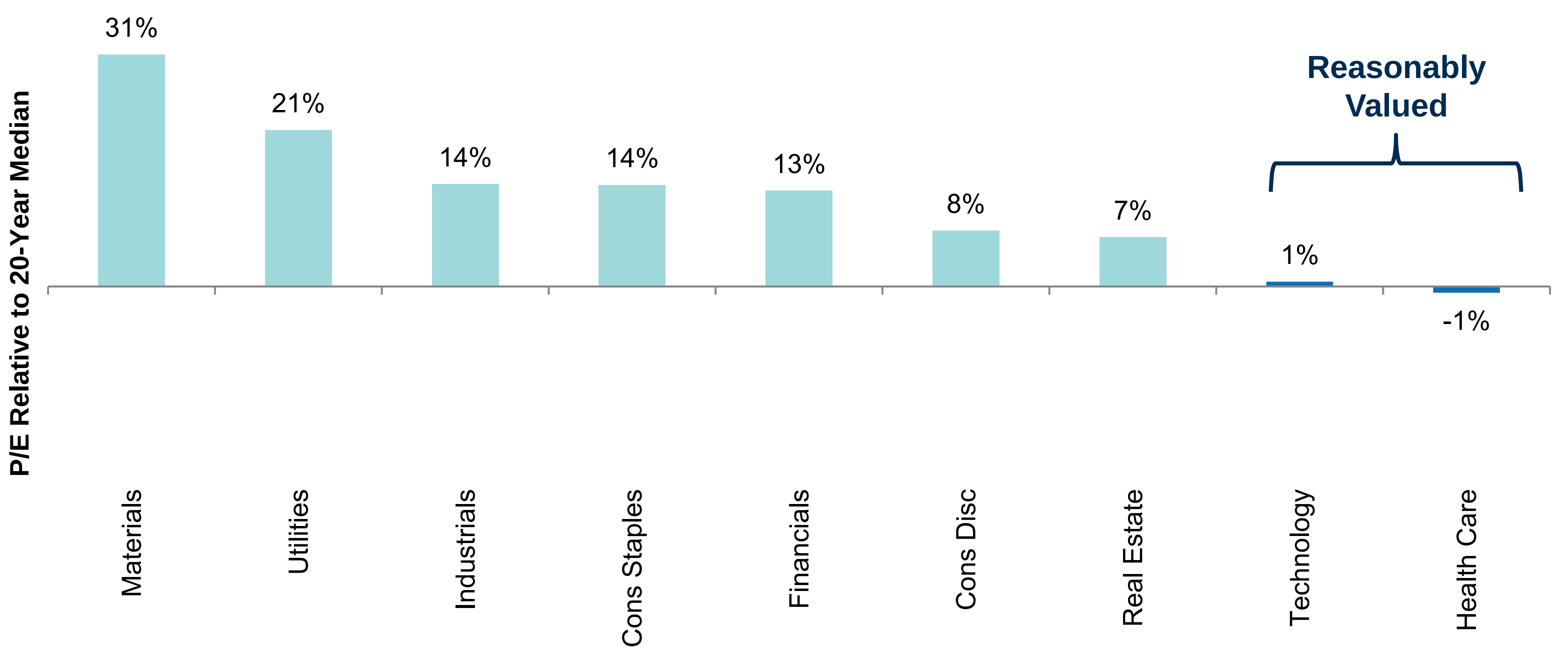
Equity vs. Bond “Yields”



Source: FactSet, Federal Reserve, and S&P, as of 09/30/17.

Valuation
Not All Sectors Are Expensive

- Growth-oriented sectors are reasonably valued compared to history, particularly given low levels of interest rates—in contrast to many other sectors

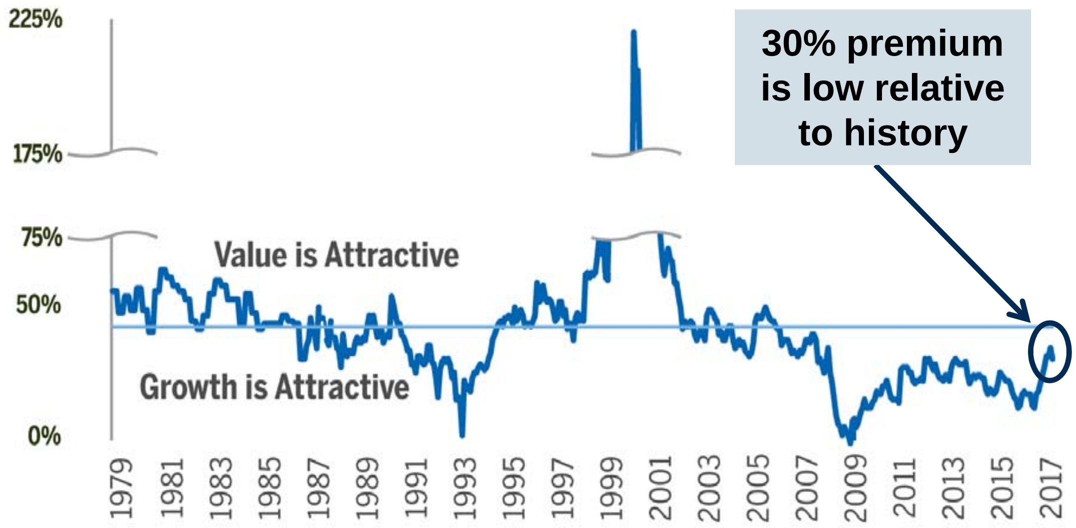


Source: FactSet, based on S&P 500 Index, 9/30/17. Note: energy and telecom are excluded; the former because of an extremely high P/E due to depressed earnings and the latter owing to a small number of constituents. Real estate is a new sector classification, so for the historical data shown above, an industry group category that has approximately 16 years of data was utilized.

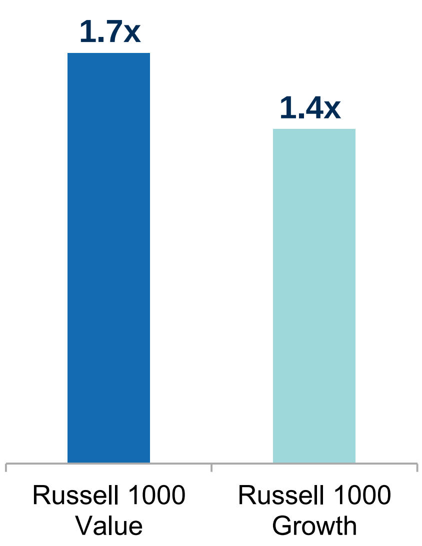
Growth Valuations Are Reasonable

- Despite their recent outperformance, Growth stocks remain attractively valued compared to Value stocks, relative to history and their respective growth rates

Russell 1000 Growth vs. Russell 1000 Value P/E



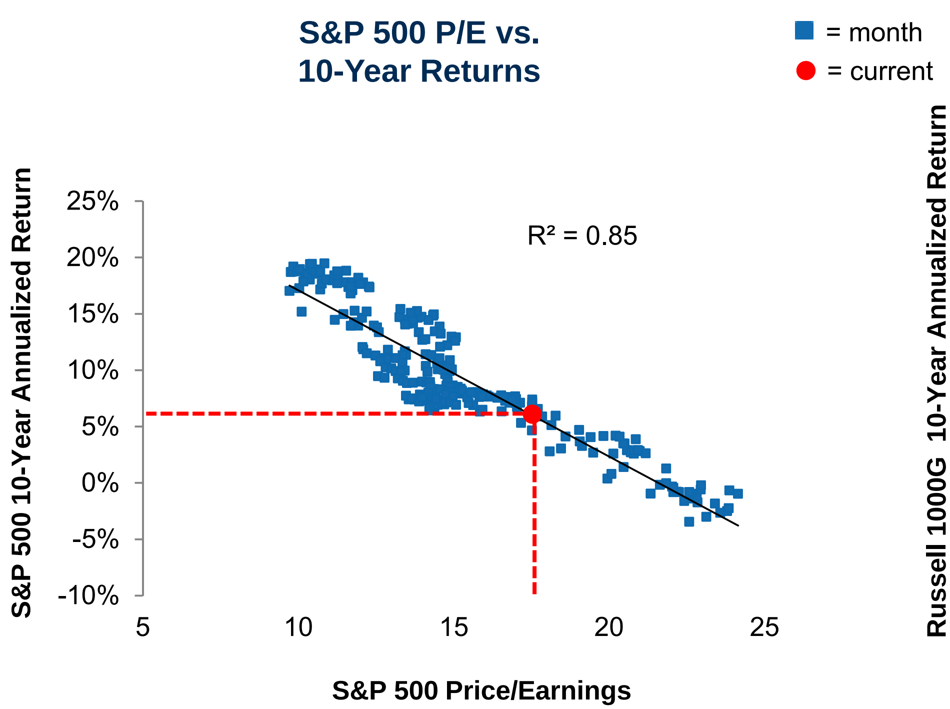
Russell 1000 Growth vs. Russell 1000 Value PEG Ratio
(P/E Divided by Long-Term Growth Rate)

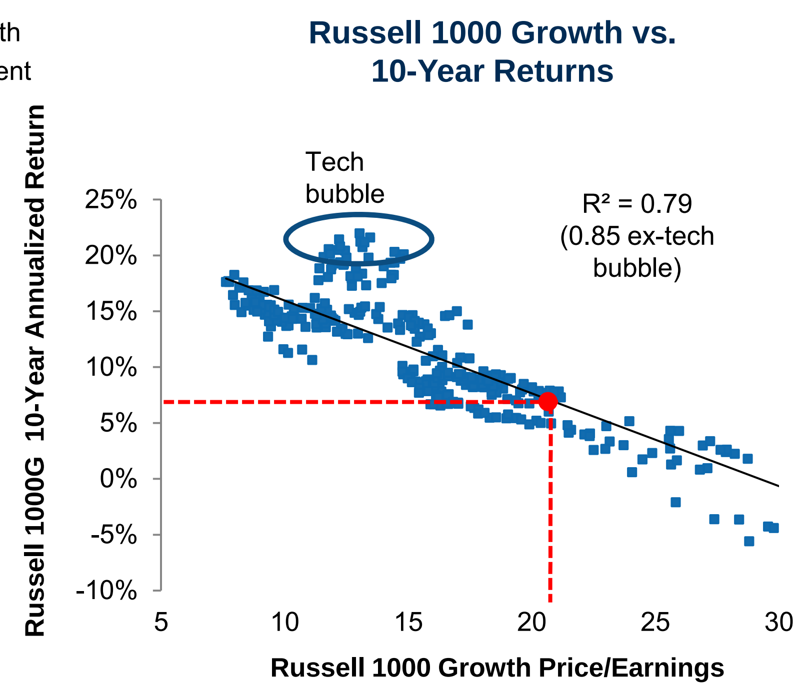


Source: FactSet, Bank of America as of 09/30/2017.

Valuation
The Single Greatest Predictor of Future Stock Market Returns

- There is a strong relationship between starting valuation and ensuing 10-year returns
- Current valuations suggest equities should materially outperform bonds over the coming decade (mid-single digit vs. low-single digit annualized returns) owing to the low interest rate environment

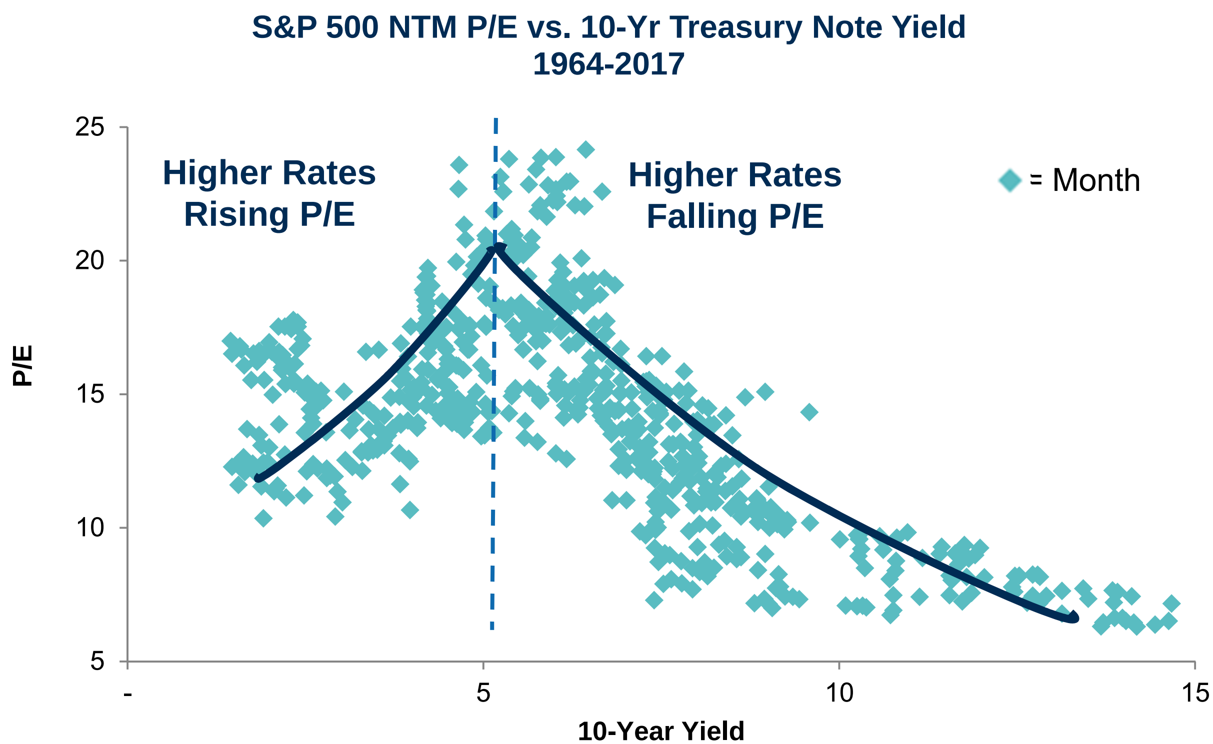




Source: FactSet. Monthly data through September 2017 and beginning in January 1986 (S&P 500) and December 1978 (Russell 1000 Growth). The tech bubble, represented by the 10-year returns beginning in April 1987-March 1990 and ending in April 1997- March 2000, skewed the regression by resulting in higher returns for given valuations than the historical relationship would imply.

Addressing Interest Rate Risks—It's Too Soon to Worry

- **Potential Risk**: higher bond yields → lower equity valuations?
- **Potential Solution**: favor equities over bonds given that increasing interest rates have supported higher P/E multiples at low absolute levels



Source: RBC Capital Markets and FactSet. Data is through September, 2017.

Disclosure

The views expressed are the views of Fred Alger Management, Inc. as of September 2017. Alger has used sources of information which it believes to be reliable; however, this publication is not intended to be and does not constitute investment advice. These views are subject to change at any time and they do not guarantee the future performance of the markets, any security, or any funds managed by Fred Alger Management, Inc. These views should not be considered a recommendation to purchase or sell securities. Individual securities or industries/sectors mentioned, if any, should be considered in the context of an overall portfolio and therefore reference to them should not be construed as a recommendation or offer to purchase or sell securities. References to or implications regarding the performance of an individual security or group of securities are not intended as an indication of the characteristics or performance of any specific sector, industry, security, group of securities, or a portfolio and are for illustrative purposes only.

Risk Disclosures: Investing in the stock market involves gains and losses and may not be suitable for all investors. Growth stocks tend to be more volatile than other stocks as the prices of growth stocks tend to be higher in relation to their companies' earnings and may be more sensitive to market, political and economic developments.

The S&P 500 Index is an unmanaged index generally representative of the U.S. stock market without regard to company size. The Russell 1000® Growth Index is an unmanaged index designed to measure the performance of the largest 1000 companies in the Russell 3000 Index with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index is an unmanaged index generally representative of common stocks designed to track performance of small-capitalization companies with greater than average growth orientation. The Russell 2000 Value Index is an unmanaged index generally representative of the small-cap value segment of the U.S. equity universe and measures the performance of Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 3000® Growth Index is an unmanaged index designed to measure the performance of those Russell 3000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 3000 Value Index is an unmanaged index generally representative of stocks from the Russell 3000 Index with lower price-to-book ratios and lower expected growth rates. The MSCI ACWI Index (gross) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. The indices presented are provided for illustrative purposes, reflect the reinvestment of dividends and do not assess fees and expenses that would have the effect of reducing returns. Investors cannot invest directly in any index. The index performance does not represent the returns of any portfolio advised by Fred Alger Management, Inc. and actual client results might differ materially than the indices shown. Note that past performance is no guarantee of future results. Comparison to a different index might have materially different results than those shown.

ALCAPPRESSPR-0917