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Mast Report ***Making the Important Decisions***

CORPORATE EARNINGS UPDATE

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EARNINGS DATA USED IN THIS REPORT

This report on corporate earnings uses operating earnings for the Standard and Poor's 500 Index. Earnings on both a per share and dollar basis are used in the analysis. The source of data on S&P 500 earnings is S&P Global Inc. and can be found at the S&P Dow Jones web site. Other sources of data on S&P 500 earnings are available and are often used and referred to in the media.

There are several important reasons why S&P Global is used as the source of S&P 500 Index earnings, as opposed to other sources. First, S&P uses a specific definition of earnings that is applied to all companies in an index, notable the S&P 500. This improves consistency. Second, the methodology S&P uses to construct the S&P 500 Index is also used to construct related per share measures, such as earnings, dividends, sales, and book value. This means that these measures can be related to one another on a comparable basis, such as computing dividend yields and price/earnings ratios. This is critically important. Third, S&P provides abundant historical data on these various measures, in the case of the S&P 500 Index (price), reported earnings per share, and dividends per share going back to 1926. This is invaluable for looking at past history over long periods of time that cover a wide array of economic and financial market conditions. This provides a context for assessing prevailing conditions in an historical context.

WHY EARNINGS ARE IMPORTANT

This would seem to be obvious, but is still worth addressing. Stated simply, earnings are the source of value for common stocks and, thus a major determinant of rates of return on stocks, especially over longer periods of time. Ultimately, earnings are the source of dividends that a company pays to shareholders. Earnings that are retained by a company after paying dividends are the core source of future growth in earnings. This is why a ratio of earnings per share to price for the S&P 500 Index is a very insightful predictor of future real rates for the S&P Index over longer time periods. It is a much better and more logical predictor of future rates of return on the S&P 500 Index than past rates of return. Yet, historical rates of return are nearly unanimously used, in financial planning and in "managing" target dated funds and balanced portfolios recommended by most financial/investment advisors, including new- breed robo advisors.

CURRENT EARNINGS ANALYSIS

S&P 500 operating earnings have been rebounding strongly over the past year, since reaching a recent low in the second quarter of 2016. Trailing 4-quarters' operating earnings per share had reached a high of 114.51 in the third quarter of 2014, then fell by 14.3% to 98.17 in the second quarter of 2016. The overwhelming cause of this decline was a massive shift in operating result from a profit to a loss in the energy sector, which was related to a sharp decline in the price of oil. For example, the average price of oil in the second quarter of 2014 was $103.35; in the first quarter of 2016, the average price was $33.31, a decline of 67.8%.

From the third quarter of 2014 through the second quarter of 2016, prior 4-quarters' dollar operating earnings for the S&P 500 declined by $139.736 million, or by 14.0%. Dollar operating earnings over the prior 4-quarters in the energy sector swing from a $125.897 million profit in the third quarter of 2014 to a loss of $45.527 million in the second quarter of 2016, or a swing of -$171.406 million. Collectively, all other sectors experienced a 3.6% increase in 4-quarters' dollar operating earnings from the third quarter of 2014 through the second quarter of 2016. The 14.3% drop in trailing operating earnings per share for the S&P 500 from the third quarter of 2014 through the second quarter of 2016 was entirely the result of a collapse in operating profitability of the energy sector, largely driven by a huge decline in the price of oil.

The S&P 500 Index stood at 2011 on September 18, 2014, just prior to the peak in trailing 4-quarters' operating earnings per share in the third quarter of 2014. Over roughly the next 15 months through June 30, 2016, when earnings hit their recent low, the S&P Index rose by 4.4% to 2099. Not a disaster, but it showed how earnings matter.

Based on data compiled by S&P Dow Jones Indices as of August 11th of this year, trailing 4-quarters operating earnings per share reached 116.16 in the second quarter of 2017. By that date, 91% of companies in the S&P 500 Index had reported second quarter earnings. This was an increase of 18.4% from trailing 4-quarters' earnings in the second quarter of 2016. From June 30, 2016 through June 30, 2017 the S&P 500 Index was up 15.5%. Again, earnings matter, and it has been a major reason why these Reports have assessed stocks to the relatively more attractive than other asset class and have advised holding significant positions in stocks in balanced portfolios of long-term investors.

Just as the collapse in operating profitability in the energy sector was the cause of the decline in S&P 500 operating earnings from the third quarter of 2014 through the second quarter of 2016, an improvement in profitability in the energy sector has accounted for a significant portion of the 18.4% increase in operating earnings per share for the S&P 500 over the past four quarters. Over this period, prior 4-quarters' dollar operating earnings for the S&P 500 increased by $141.283 million from $857.840 million to $999.123, or an increase of 16.5%. The larger 18.4% increase in operating earnings per share is accounted for by a fewer number of shares outstanding for companies in the S&P 500 Index.

Four-quarters' dollar operating earnings for the energy sector swung for a loss of $45.527 million in the second quarter of 2016 to a profit of $20.574 million in the second quarter of this year. The swing of +$66.101 million accounted for 46.8% of the improvement in dollar operating earnings for the S&P 500 Index over this period. Dollar operating earnings for all other sectors combined rose by 8.3%. Again, swings in operating profitability in the energy sector had a huge impact.

After rising by 20.3% in the first quarter of 2017 from a year earlier, operating earnings per share for the S&P 500 are estimated to have increased by 19.8% in the second quarter. Dollar operating earnings in the second quarter were estimated to have risen 18.4% from a year earlier, with the energy sector accounting for 30.0% of the increase. Excluding energy, dollar operating earnings in the second quarter of 2017 for all other sectors are estimated to have increased by 12.6%.

Current earnings' estimates made by analysts and compiled by S&P Global call for operating earnings per share for the S&P 500 to increase by 14.4% in the third quarter of 2017 from a year earlier, and by 24.4% in the fourth quarter. The percentage of the change in dollar operating earnings for the S&P 500 coming from the energy sector is seen moderating to 21.3% in the third quarter and to 15.3% in the fourth quarter. Dollar operating earnings for all other sectors combined are currently forecast to rise by 10.7% in the third quarter and by 20.3% in the fourth quarter.

Current estimates for the fourth quarter do seem to be optimistic. But if those estimates do turn out to be accurate, then S&P 500 operating earnings per share for the full year 2017 will increase by 19.7% from

2016. Even more conservative estimates, especially for the final quarter of this year, would result in 2017 S&P 500 earnings being up by low double digit percentages this year.

Related to that, the current annualized dividend for the S&P 500 was 49.35 on August 10th. This represents a dividend payout ratio of 42% of trailing 4-quarters' operating per share as of the second quarter. Dividends have been growing, with current annualized dividends up 7.4% from a year earlier. If annualized dividends were to increase by 6% over the next year, the dividend payout ratio would decline by to just over 38%, based on current analysts' earnings estimates.

Earnings and dividends are expected to continue to be favorable for stocks. And it may be needed for stock prices to rise, should the Federal Reserve continue to raise its target for the federal funds rate and if the Fed's plans to reduce its asset holdings cause yields on longer maturity Treasuries to rise. If and to the extent that yields on Treasuries do rise, they will increase the attractiveness of Treasuries to investors. It will be difficult for stocks to offset this with even higher valuation levels than currently prevail. The best defense for stocks, which is also their best offense, is rising earnings and dividends. Key metrics to watch will be levels of S&P 500 earnings and dividends compared to yields on long maturity Treasuries, both nominal and real (TIPS). If earnings and dividends rise faster than long Treasury yields, it will be more positive for stocks. The opposite will be negative for stocks. Recent relationships show earnings and dividends rising faster than Treasury yields. Watch to see if this pattern continues or changes. Reading these Reports is one way to do this.

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