US Equities: Five Big Issues to Consider

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With the S&P 500 Index touching new highs, where's the US equity market heading? Our US portfolio managers addressed five big questions that are on investors' minds about valuations, opportunities and risks in the market today.

1.EQUITY VALUATIONS ARE HIGH BUT STILL ATTRACTIVE VERSUS BONDS

Frank Caruso, Chief Investment Officer, US Growth Equities: High valuations are being driven by safe stocks, low-volatility stocks and high-dividend stocks. So if you buy a dollar of the S&P, you're buying into these very expensive parts of the market. However, while US stock valuations are higher than their historical norms, equities are still attractive relative to Treasury bonds. Skillful active managers can still find investment opportunity in this market. You can buy high-quality growth stocks, which usually trade at a premium to the market given their superior financial characteristics, at a market price.

Kurt Feuerman, Chief Investment Officer, Select US Equity: Although a correction is always possible, stocks in this eight-year cycle have continued to represent good value versus fixed- income alternatives. True, valuations have moved up as market gains have outpaced earnings in recent years. But earnings headwinds are abating due to several factors, including more favorable currency translation trends for US companies, rebounding energy profits and the anticipation of pro-growth government policies such as lower regulation.

We don't see the signs of excess that tend to make us wary, such as widening credit spreads or aggressive equity issuance. Quite the contrary. Credit is healthy and public companies are reducing share counts.

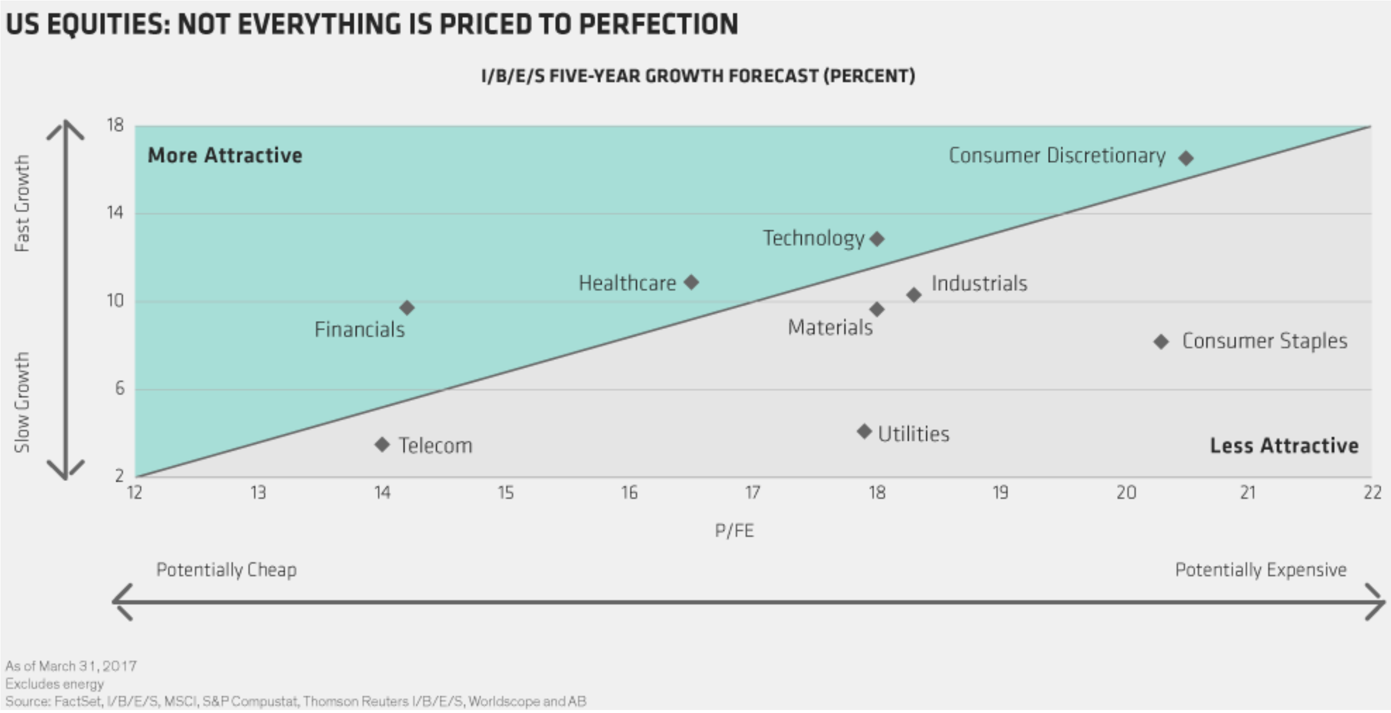
Kent Hargis, Portfolio Manager, Strategic Core Equities: Earnings growth is picking up globally after a slowdown, while earnings expectations are being rapidly revised upward. In our view, broad-based reflation and an acceleration of nominal growth has created a strong environment for equities that validates higher valuations.

2.OPPORTUNITIES CAN STILL BE FOUND IN POCKETS OF THE MARKET

Caruso: Since the US market is so diverse, there are always relative value opportunities to be found. Even today, investors can find great growth businesses that create value over long periods of time and are typically far less dependent on short-term market influences to succeed. When we compare valuations of sectors against their five-year expected growth rates, healthcare and technology stocks look more attractive compared to sectors such as telecom and utilities.

Feuerman: We see opportunities in financials and select stable growth stocks, especially ones with high effective tax rates that can benefit from tax cuts. Technology stocks with solid fundamentals and an opportunity to benefit from repatriation of offshore cash are also attractive. Even after the recent rally in financials, valuations are low because earnings are still depressed; these stocks should benefit as the Fed normalizes interest-rate policy and regulatory pressures ease. In consumer- discretionary stocks, fears of a possible border tax have weighed on the sector, but not all companies will be affected equally, so opportunities can be found.

James T. Tierney, Jr., Chief Investment Officer, Concentrated US Growth: Since the election, cyclical shares have rallied and are relatively expensive. However, companies benefiting from long-term secular growth trends have been underappreciated and are very attractive right now, in our view. Healthcare, for example, is very interesting after the sector lagged in 2016. The collapse of the Republican effort to repeal and replace Obamacare in March has put healthcare reform on the back burner for a while, so there's less short-term uncertainty weighing on the sector.



3.COMPLACENCY IS A MAJOR CONCERN

Feuerman: Elevated investor optimism today is a concern. Low volatility as signalled by the VIX Index isn't a bullish signal, though retail investors seem more committed to stocks than in recent years. In short, this has been a distrusted bull market for a while. But trust has picked up recently.

Tierney: I agree that market complacency—as signaled by the VIX—requires attention. Even big events like Brexit and Trump's victory have hardly prompted market volatility. This is something we're watching closely.

4.TRADE WARS WOULD HURT THE MARKET

Hargis: We're paying close attention to the potential for trade wars to develop. The risk is that potential barriers to free trade, cross-border tax, anti-immigrant policies and a stronger dollar could blunt the pickup in growth and threaten segments of the market that have benefited from globalization in recent decades. Protectionist measures, in combination with rising wages and higher oil prices, could fuel higher inflation. While equity markets generally rise in periods of rising interest rates as economic growth is accelerating, segments of the market would be at risk if the Fed is perceived to be behind the curve.

5.POLITICAL RISK WILL CREATE BOUTS OF VOLATILITY THAT ACTIVE MANAGERS CAN EXPLOIT

Caruso: It would be imprudent to assume that equity markets will rise uniformly during the Trump presidency. At the very least, Trump's unpredictable governing style is likely to prompt volatility. In March, the US stock market fell on the back of a struggle in Congress to repeal Obamacare and there have also been increasing concerns about Trump's ability to fulfil his economic agenda.

Feuerman: Although we think the Republican pro-growth agenda will succeed, passing tax reform will be tricky. Republican conservatives may want any tax reform to be revenue neutral, which will create pressure to include measures such as the border adjustment tax to "pay" for lower taxes. It will be interesting to watch the tax reform debate unfold. For example, will President Trump seek support from center-leaning Democrats?

Tierney: Political risk in the US and around the world is not going away and it will generate market turbulence. But this type of market volatility can create good entry points for active managers to buy stocks with strong fundamentals and businesses that aren't really exposed to political risks.

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