

Equity Market Review and Outlook

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KEY TAKEAWAYS

- Stocks rallied handily in the third quarter, led by global markets.
- The Fed has remained on hold this year; upward pressure on the US dollar due to rate hike fears has faded.
- S&P 500 earnings should be bottoming out; while third-quarter earnings will be about flat with last year, fourth-quarter earnings should show some growth.
- Major US indices are at or close to record highs. We expect this slow uptrend to remain into next year.
- Economically sensitive sectors such as technology led the way in the third quarter, a reversal from the interest-sensitive and defensive leadership in the first half.
- Our forecast calls for sluggish real GDP growth of close to 2% for the next couple of years and a constructive, albeit unexciting, outlook.

Global equities provided leadership, for a change, outperforming US equities in the third quarter. While stocks were briefly depressed at the end of the second quarter due to the surprise of the Brexit outcome, they quickly found solid footing. And after a very weak start to the year, emerging market (EM) equities have assumed performance leadership year-to-date.

Several factors contributed to global equity performance. First, stabilized commodity prices, especially oil, provided a boost to the energy sector—although oil has not yet mounted a robust recovery.

Second, central banks around the world remain accommodative and the Federal Reserve (the Fed) has held off on further rate increases after implementing the first hike in over nine years last December.

Third, the US dollar has been relatively stable versus developed market currencies for a year and a half. Emerging market currencies have strengthened moderately from the lows of last winter. While global growth continues to be very slow, there are signs the US may see better growth in the second half than in the first half. This may support positive investor sentiment and has the potential to lead to somewhat more risk-taking by equity investors.

The long-running bull market remains intact, although given its advanced age (starting in March 2009), it is now the second-oldest bull market since the 1930s. Bulls do not die of old age, but typically struggle due to intervening macroeconomic events such as rising inflation, which leads to extended tightening by central banks. While we expect the Fed to raise rates by 0.25% later this year, all signs point to a very slow, deliberate tightening cycle, which has certainly contributed to the longevity of the business cycle, and hence the rally in stock prices.

We began 2016 with the possibility of four rate hikes within 12 months. Many feared the global economy was not strong enough to withstand that many hikes. As investors priced in this possibility, the US dollar continued to strengthen, putting pressure on US companies that do business overseas. Fortunately, the Fed has pulled back from the scenario of multiple rate hikes.



US OUTLOOK

Conditions are looking better for a resumption of growth in the fourth quarter of this year and for all of 2017.

US growth disappointed in the first half, although incoming data suggests the third quarter has been stronger. Employment growth in the US remains healthy, although with unemployment now below 5%, further progress in the unemployment rate will be challenging.

Fundamentals outside the US are not as strong as in the US, but that's not new. Corporate earnings in Europe and Japan disappointed in the second quarter and Brexit will be a source of continuing uncertainty over the next few years. Growth in Japan has disappointed. The recent sharp rise in the yen versus major currencies has weighed on Japan's exporters and lowered earnings forecasts for many companies.

In spite of this sluggish backdrop, we were pleased to see stocks in Europe and Japan recover somewhat in the third quarter following weak performance in the first half. We expect to see steady central bank policies and lower valuations following first half underperformance, as well as a more stable currency backdrop.

S&P 500 Earnings Should Turn Up Later This Year

S&P 500® Index operating earnings per share were roughly flat in 2015 compared to 2014 and are likely to be flat again in 2016. However conditions are looking better for a resumption of growth in the fourth quarter of this year and for all of 2017.

The median S&P 500 company last quarter reported operating earnings growth of about 7%. This compares to the capitalization-weighted calculation of index earnings, which resulted in a decline of 2%, according to Factset. The top-quartile S&P 500 company continues to generate low- to mid-teen operating earnings growth. The strong fundamental performance of many companies is being masked at the index level by the dramatic decline in energy sector earnings. In the past, the energy sector has provided more than 10% of index earnings. In 2016, we believe the contribution will be well below 5% of total index earnings.

The financial sector is also having a challenging stretch, with earnings down about 7% year over year in the second quarter. Fortunately, this was an improvement from the first quarter, when earnings fell by double digits. Right now, we think energy earnings will begin to recover next year, albeit from a very low base. And mid-single-digit or better earnings growth could be broadly achievable for the S&P 500, assuming business conditions remain on their current trajectory.

With earnings growth poised to turn positive again, equity valuations do not appear overly stretched. While the price/earnings ratio on current year estimates is somewhat above average at about 18.5X, stocks will potentially grow into their valuations looking ahead to 2017 and 2018 forecasts. Consensus bottom-up forecasts calling for double-digit earnings per share growth at the index level in each of the next two years is too high. However, growth of even the mid-single digits makes stock prices today look reasonable, especially considering the level of interest rates in the US and around the world.



Dividend Growth Supports the Case for Equities

For investors seeking returns in the mid- to high-single digit range over a full market cycle, equities remain an appealing asset class. The dividend story remains positive, with the S&P 500 sporting a current yield of about 2%, which remains very competitive with alternatives, particularly sovereign debt. Dividend growth will be in the mid-single digits this year, and likely next. Dividend growth has slowed this year following several years of 10%+ dividend growth, in part due to reduced payouts at some energy companies. Dividend growth should track operating earnings growth looking forward assuming the business cycle remains on a positive track.

When including share repurchases, we think the effective yield of the S&P 500 is above 4%—about half from cash dividends and the other half from the positive effect of net share repurchases lowering the outstanding share count. With returns on cash close to zero, buybacks are a good way to put excess cash to work without the risks associated with alternative uses, such as mergers and acquisitions (M&A). Certainly, M&A can create long-term incremental value in many cases. However, M&A can also extend managements beyond core competencies.

We see little evidence that share repurchase activity this cycle has hindered capital expenditures in this slow-growth environment. While the energy sector has pulled in its horns, capital spending, combined with research and development spending, continues to support innovation and growth at many companies.

Strong Quarter for Emerging Markets

Emerging market equities had a strong quarter and are having a good year following mostly weak relative performance since 2011. As an asset class, the emerging market sector and its regional composition has changed a lot in recent years. For example, China (H-shares and ADRs), South Korea and Taiwan together comprise 50% of the index, nearly double the level of 10 years ago. Technology has become a much larger portion of the asset class (currently weighted at 24%) and has doubled since 2011. Some leading internet and social media companies in China with ADRs that trade around the world were added to the benchmark in late 2015, boosting both the China weight and technology weight simultaneously. Semiconductors have led the sector over the long term in Asia, and the fact that the technology sector was the best performer worldwide in the third quarter provided an important boost to emerging market returns.

Investors have long viewed emerging market equity investing as having large exposures to energy, metals and mining—sectors that have been fundamentally challenged over the past couple of years. While exposure remains significant, given a combination of lower stock prices (hence lower weights in the portfolio) and asset class rebalancing in favor of technology, the energy and materials exposure has fallen from over 30% combined in 2009, to less than 15% combined today. Stated simply, this asset class is earning another look from global investors. Why? Partly because of stabilizing fundamentals in a number of key countries and partly due to asset class composition changes, which have made the fundamental prospects potentially more appealing following decidedly weak performance over the past five years.



Third Quarter Review

GLOBAL EQUITY MARKETS

as of September 30, 2016

INDEX TOTAL RETURNS (%)							
INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	
S&P 500®	3.85	7.84	15.43	11.16	16.37	7.24	
MSCI ALL COUNTRY WORLD	5.43	7.09	12.60	5.74	11.23	4.90	
MSCI EMERGING MARKETS	9.15	16.36	17.21	-0.21	3.39	4.28	
MSCI EUROPE	5.45	0.58	3.13	-0.01	8.10	2.10	
MSCI JAPAN	8.76	2.87	12.52	3.65	7.63	1.24	

Global equities outperformed in the third quarter, while emerging markets have pulled well ahead for the year. Europe and Japan were up nicely for the quarter, although year-to-date performance is modest.

We show returns in US dollar in this table. In fact, the MSCI Japan Index in local currency terms has fallen by 13.5% this year. This is an example of how strong the yen has performed versus the dollar. In order to make money in Japanese stocks this year, investors would have needed to get the currency call correct.

Longer-term outperformance of US equities has been substantial. Some are asking if the US should begin to underperform on a “reversion to the mean” theory. We argue that US companies in many cases have fundamental advantages which are difficult to replicate and US earnings trends have been superior.

Emerging market equity returns remain negative over the past three years even with the robust performance over the past year. In the near term, we think that relative stability of the US dollar versus a basket of emerging market currencies will continue to have much to say about shorter-term performance of this arguably depressed asset class.

US EQUITY MARKETS

as of September 30, 2016

INDEX TOTAL RETURNS (%)							
INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	
RUSSELL 1000®	4.03	7.92	14.93	10.78	16.41	7.40	
GROWTH	4.58	6.00	13.76	11.83	16.60	8.85	
VALUE	3.48	10.00	16.20	9.70	16.15	5.85	
RUSSELL MIDCAP®	4.52	10.26	14.25	9.70	16.67	8.32	
GROWTH	4.59	6.84	11.24	8.90	15.85	8.51	
VALUE	4.45	13.72	17.26	10.49	17.38	7.89	
RUSSELL 2000®	9.05	11.46	15.47	6.71	15.82	7.07	
GROWTH	9.22	7.48	12.12	6.58	16.15	8.29	
VALUE	8.87	15.49	18.81	6.77	15.45	5.78	

Value indices have assumed a lead over growth indices this year across the market caps, although growth edged value in the third quarter.

Among the large caps, value’s year-to-date outperformance is attributed to higher weights in income-oriented equities such as utilities. And the resurgent energy sector is also strongly weighted in value. Another less intuitive factor in value leadership this year has been the performance of the healthcare sector. Healthcare stocks in the value index are up nearly 10% year to date, while the performance of healthcare within growth is -4%. Poor performance of biotechnology stocks in the first half of the year weighed on growth index attribution. Value is weighted more heavily in pharmaceuticals, which carry attractive dividend yields.

Growth bounced back somewhat in the third quarter as technology provided global leadership. Income-oriented sectors such as utilities and telecom pulled back as interest rates edged modestly higher from the Brexit-inspired lows of late June.

While the growth versus value analysis is interesting to examine, style performance tends to even out over time. Outcomes are sensitive to relative sector performance in the short run. In the long run, successful management execution is what ultimately matters.

Data Source: FactSet. All returns quoted in US dollars. Performance for one and multi-year periods is annualized. Past performance is no guarantee of future results.



S&P 500 SECTORS
as of September 30, 2016

SECTOR PERFORMANCE ATTRIBUTION (%)						
	INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR
ENERGY		2.24	18.70	18.95	-2.61	4.31
TELECOMMUNICATIONS		-5.60	17.86	26.82	9.64	12.32
UTILITIES		-5.91	16.11	17.38	13.57	12.10
HEALTHCARE		1.01	1.44	10.78	14.37	19.99
CONSUMER STAPLES		-2.63	7.55	15.77	13.05	15.40
MATERIALS		3.71	11.44	22.25	6.50	12.71
FINANCIALS		4.80	1.59	7.69	8.40	17.50
INDUSTRIALS		3.96	10.45	19.38	10.42	17.46
CONSUMER DISCRETIONARY		3.01	3.91	9.86	11.53	20.06
REAL ESTATE		-2.68	5.78	13.83	10.24	12.17
INFORMATION TECHNOLOGY		12.86	12.50	22.81	17.29	17.79
TOTAL RETURN		3.85	7.84	15.43	11.16	16.37

RUSSELL 2000 SECTORS
as of September 30, 2016

SECTOR PERFORMANCE ATTRIBUTION (%)						
	INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR
MATERIALS		12.18	32.82	37.05	2.95	11.80
TELECOMMUNICATIONS		-6.94	9.87	16.93	5.02	12.04
UTILITIES		-5.12	17.71	23.75	14.14	13.94
CONSUMER STAPLES		2.26	14.94	18.74	10.11	17.34
ENERGY		10.43	8.54	-0.04	-23.53	-8.26
HEALTHCARE		13.54	-1.36	8.17	11.17	20.17
FINANCIALS		8.14	12.86	16.47	9.95	17.40
INDUSTRIALS		9.24	17.33	20.52	4.20	15.82
INFORMATION TECHNOLOGY		16.26	17.72	25.73	12.07	18.94
CONSUMER DISCRETIONARY		3.80	4.38	1.07	1.23	14.41
TOTAL RETURN		9.05	11.46	15.47	6.71	15.82

Third-quarter sector performance was a mirror image of first-half performance. In both the large and small caps, technology was the top performer. Other cyclicals also outperformed. Technology sector earnings were fairly healthy in the second quarter. Merger and acquisition activity continues in the technology sector.

Underperformance of interest-sensitive equities in the third quarter is not surprising, given the strong performance over the past year. We do not expect interest rates to move up materially near term, although recent sector performance is implying that business conditions might be getting a little better.

In another sign of growing confidence, small caps outperformed large caps. While investor sentiment seems restrained, the fact is that both the S&P 500 and the Russell 2000® Index are up a very strong 15.5% over the past year, and that includes a very poor start to the year.

Small caps have lagged large caps over the past three years, but on a five-year basis they have performed about in line with large caps. If we are right that earnings are poised to move back to a growth mode later this year, balanced performance across the market cap spectrum and investment styles could follow.

Data Source: FactSet. Performance for one and multi-year periods is annualized. Sorted by respective index quarterly returns. Due to rounding, sector totals may not equal 100%. Past performance is no guarantee of future results.



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Disclosure

All data as of September 30, 2016, unless otherwise noted.

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MSCI All Country World is a market cap weighted index of stocks from developed and emerging markets providing a broad measure of global equity-market performance.

MSCI Europe is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments across European developed markets.

MSCI Japan is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments of the Japanese market.

MSCI Emerging Markets Index is a free float-adjusted market cap index measuring equity market performance of emerging markets.

Russell 1000® Index measures the performance of the large cap segment of the US equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

Russell 1000® Growth Index measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

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Russell Midcap® Growth Index measures the performance of the mid cap growth segment of the US equity universe. It includes those Russell Midcap Index companies with higher price-to-book ratios and higher forecasted growth values.

***Russell Midcap® Value Index** measures the performance of the mid cap value segment of the US equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.*

***Russell 2000® Index** measures the performance of the small cap segment of the US equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

***Russell 2000® Growth Index** measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.*

***Russell 2000® Value Index** measures the performance of small cap value segment of the US equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.*

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