equity market review & outlook

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CAPPING ANOTHER STRONG YEAR FOR STOCKS–HOW ABOUT 2014?

Equities performed extremely well across the developed world in the fourth quarter, topping off an impressive year. The *S&P 500® Index* returned 10.51% for the quarter, building on gains from earlier in 2013. The Index's 32.39% 12-month return marked its best annual performance since 1997. A variety of factors in the final quarter of the year contributed to these strong results. The bipartisan federal budget deal struck in December was a welcome break from what seemed like interminable political gridlock in Congress. And better economic data gave the Federal Reserve (the Fed) a window to begin tapering its third round of quantitative easing (QE3). Rather than precipitating broad equity selloff, the tapering announcement helped fuel the year-end rally. Equity investors took the Fed action as a sign of confidence in the economic outlook rather than the beginning of a material tightening of monetary policy. Confidence ended the year on a high note. And with five-year annual returns sharply higher now that losses from the fall of 2008 have rolled off, these performance numbers may further inspire confidence.

KEY TAKEAWAYS

- Improving economic growth should support stock prices in 2014.
- Economically sensitive sectors have outperformed since last May, and we think this can continue.
- Stocks could perform well even in a rising rate environment as long as rates rise in line with improved global growth.

US equities posted notable gains across the market cap spectrum. European equities turned in a surprisingly strong year. Pacific equities performed well too, led by strong gains in Japan. Global equities, as measured by the *MSCI All Country World Index*, performed well overall, with top-tier returns from major developed markets pulled down somewhat by emerging markets. In fact, emerging market equities were the one major equity asset class that struggled in 2013, and small losses over the past three years have reversed some of the prior long-term outperformance. While developed market equities experienced price earnings multiple expansion as global financial tensions eased, the more commodity-, energy- and banking-sensitive emerging

VERY STRONG Q4 PERFORMANCE IN THE US & EUROPE CAPPED AN EXCEPTIONAL YEAR IN DEVELOPED MARKETS

INDEX TOTAL RETURNS

	Fourth Quarter 2013	2013	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
S&P 500®	10.51%	32.39%	16.18%	17.94%	7.41%
Russell 1000®	10.23	33.11	16.30	18.59	7.78
Growth	10.44	33.48	16.45	20.39	7.83
Value	10.01	32.53	16.06	16.67	7.58
Russell Midcap®	8.39	34.76	15.88	22.36	10.22
Growth	8.23	35.74	15.63	23.37	9.77
Value	8.56	33.46	15.97	21.16	10.25
Russell 2000®	8.72	38.82	15.67	20.08	9.07
Growth	8.17	43.30	16.82	22.58	9.41
Value	9.30	34.52	14.49	17.64	8.61
MSCI All Country World (USD)	7.42	23.44	10.33	15.53	7.72
MSCI Emerging Markets	1.86	(2.27)	(1.74)	15.15	11.52
MSCI Europe	7.92	25.96	10.57	14.09	7.89
MSCI Pacific	1.59	18.43	5.45	11.10	6.54

Source: FactSet, data as of December 31, 2013. All returns quoted in USD.

markets struggled with lower commodity prices and overcapacity. Some key emerging markets have been grappling with higher-than-desired inflation, contributing to upward interest rate pressure and the rather meager equity performance of recent years.

US stocks have outpaced global equities over the past three years, as the US emerged sooner from the global financial crisis than other parts of the world. With global financial conditions beginning to stabilize and growth showing signs of improvement from low levels, we continue to believe developed equity markets may perform more consistently in the quarters ahead.

ECONOMICALLY SENSITIVE SECTORS HAVE ASSUMED LEADERSHIP

Within the *S&P 500*, sector returns were strong pretty much across the board. More than 90% of Index constituents posted gains for 2013 and most sectors achieved double-digit returns for the fourth quarter. The year began with strong relative performance in many interest-rate-sensitive and defensive equities. In May, performance shifted in favor of more economically sensitive sectors, including consumer discretionary, industrials and financials, when Fed Chairman Bernanke raised the possibility of tapering QE3 sooner than many anticipated. These sectors, together with healthcare, represent over half of the *S&P 500* by weight and propelled total return for the year. In contrast, sectors that lagged, such as materials, energy, utilities and telecommunications, constitute less than a quarter of the Index weight.

Small cap sectors performed even better than large caps, reflecting across-the-board participation in the rally. Five of the *Russell 2000*'s major sectors ended 2013 with yearly gains of more than 40%. Healthcare was very strong as the biotechnology industry hosted many large winners.

Consumer discretionary stocks have essentially led the bull market since the 2009 low. The sector can claim top performance honors in both the large and small cap realms over the past five years. While employment growth has been sluggish during this expansion, consumers have benefited greatly from sustained low interest rates, rising home prices and improving personal balance sheets. This slow but steady consumer recovery evident in equity-sector performance and broad economic data is, in our view, one of the most critical sustaining factors of this bull market.

WHAT SHOULD WE EXPECT IN 2014?

Valuation expansion has been significant this cycle. The *S&P 500* opened each of the past three years with a forward multiple of only about 13x. Today, with the *S&P 500* around 1840, there is roughly a 16x multiple

SECTOR PARTICIPATION HAS BEEN BROAD

SECTOR PERFORMANCE ATTRIBUTION

	S&P 500® Index					Russell 2000® Index			
	Q4 2013	1 Year*	3 Year	5 Year		Q4 2013	1 Year*	3 Year	5 Year
Consumer Disc	10.81%	42.82%	23.37%	27.67%	Healthcare	8.46%	50.74%	21.73%	20.93%
Healthcare	10.10	41.39	23.33	18.21	Consumer Staples	6.24	45.86	20.55	21.13
Industrials	13.53	40.67	17.17	19.56	Consumer Disc	8.94	45.05	18.71	28.78
Financials	10.33	35.82	13.23	13.80	Info Tech	7.52	44.31	13.90	25.58
Info Tech	13.26	28.53	14.73	21.89	Industrials	11.14	43.27	16.97	19.03
Consumer Staples	8.66	26.14	16.76	15.85	Financials	9.13	30.26	14.94	12.66
Materials	10.66	25.64	9.26	18.80	Energy	6.09	30.19	4.89	16.73
Energy	8.35	25.06	11.05	13.43	Telecom	5.32	28.27	11.06	14.72
Utilities	2.79	13.21	11.21	10.20	Materials	11.07	24.16	10.33	23.78
Telecom	5.46	11.47	12.21	12.81	Utilities	6.47	18.33	13.19	12.68
Total Return	10.51	32.39	16.18	17.94	Total Return	8.72	38.82	15.67	20.08

Source: FactSet, data as of December 31, 2013. Performance for three year and five year time periods are annualized.
**Sorted by S&P 500 or Russell 2000 one year returns.*

on 2014 consensus earnings estimates. After a big year in 2013, and with the *S&P* having compounded almost 18% annually for the past five years, investors are wrestling with the obvious: Did the *S&P 500*'s 32% return with only single-digit 2013 earnings-per-share (EPS) growth pull forward returns from 2014? Or could further multiple expansion bring the Index closer to a high-teens multiple, driving another year of very strong equity returns?

If earnings growth were accelerating, it could be easier to simply raise earnings estimates and the *S&P 500* price target together. But we don't anticipate earnings growth to surge to 10% or more at this point in the cycle, even if US GDP growth were to accelerate in 2014. Margins are high following five years of recovery since the last recession, competition is fierce, and revenue growth is a challenge. In our view, earnings growth of roughly 6% to 8% is realistic in 2014 (and possibly 2015, if economic fundamentals continue on their present course). We think the *S&P 500* should be able to maintain its current valuation level and potentially achieve a multiple between 16x and 17x. We are not calling for significant multiple expansion from here. Below, we outline the positive and negative factors shaping our outlook.

- **Macroeconomic Tailwinds:** Many persistent global macroeconomic risks have moved to the back burner, which should continue to lend support to equities. The Fed is expected to keep rates low for an extended period, Congressional budget fights have been pushed off the front pages, and the US employment backdrop has been improving month by month. We expect the US to lead a modest improvement in global growth in the coming year, Europe may be emerging from recession and Japan continues to pursue pro-growth policies. Corporate activism is on the rise and has contributed to positive developments at a number of companies. Financial flash points that dogged the markets off and on for the past five years—principally bouts of instability in the euro zone—have subsided. The double-digit fourth-quarter return of *S&P 500* confirms that investors have noticed these positives.
- **Low Rates and Low Inflation Remain Bullish Supports:** Two fundamental factors could support considerably higher stock prices simply due to mean reversion: stocks remain historically cheap relative to bonds and inflation. As for Treasurys, the *Barclays Long-Term Treasury Index* has yielded an average 1.1x *S&P 500* operating earnings yield (the inverse of price-to-earnings ratio, or P/E) since 1985. As of year-end, the *Barclays Index* yielded about 3.55%, while the *S&P 500* operating earnings yield on 2013 estimated earnings was 5.8%.[1] For this relationship to normalize, either the *Barclays Index* would have to yield 6.4%, or the *S&P 500* earnings yield would have to be 3.2%—implying a P/E ratio of over 30x. This would be more than 80% above the current 16x P/E on 2014 consensus estimates. This valuation would be higher than the *S&P 500* has ever traded—not a realistic possibility in our view. Still, given this math, stock valuations should have a fair amount of cushion if Treasury rates continue to rise in response to a strengthening economy, as is widely anticipated.

  Relative to inflation, the case for equities remains compelling. Historically, equities have risen at a 15.2% annual rate when the earnings yield of the *S&P 500* is more than 200 basis points above the rate of inflation.[2] With the current earnings yield at 5.8% and inflation just under 2.0%, we get a real earnings yield of about 3.9%[3], indicating stock prices may continue to be supported by low inflation.
- **Other Common Valuation Factors are Mixed:** Though stocks look attractive in the context of an improved macroeconomic backdrop, interest rates and inflation, some other valuation factors are mixed. We do not expect margins to decline from high levels as long as growth continues—but they are not likely to move materially higher. On a price-to-sales basis, stock valuations appear fairly full versus history. The median stock's P/E is higher than that of the Index as a whole, and while the median company deserves some premium (for growing faster than the overall Index), stocks also look fairly valued on this basis. And, at 2.0%, the *S&P 500* cash dividend yield is about 100 basis points below the long-term average, although dividends continue to rise at a double-digit rate.

[1] *Source: Ned Davis Research, as of December 31, 2013.*
[2] *Source: Ned Davis Research, study period January 1, 1966 to December 31, 2013.*
[3] *Source: Ned Davis Research, as of December 31, 2013.*

PUTTING IT ALL TOGETHER: WHY WE THINK A FORWARD P/E MULTIPLE OF 16x TO 17x LOOKS FAIR

So where does this leave us? At the beginning of 2013, the yield on long-term investment grade corporates was quoted around 4.25%[4], and our discounted cash flow work estimated an implied equity risk premium of 6.00%, for an estimated cost of equity of 10.25%. This combination suggested a fair P/E of around 14x on one-year forward estimated earnings. Today, credit conditions have begun to normalize, we are another year removed from the 2008 recession, and interest rates have moved up as investor confidence and corporate earnings have improved. Investment grade corporates are now quoted around 5.00%[5], and we estimate the equity risk premium has declined to 4.50%, for an estimated cost of equity 9.50%. While a move from 10.25% to 9.50% in the estimated cost of equity may not seem significant, this 75-basis-point downward shift supports, by our estimates, an increase of about 2.5 multiple points in the P/E ratio compared to a year ago. Of course, we are always wary of "false precision" in these computations. And we must be prepared for a wide variety of outcomes. Equity markets almost never follow the script over the short run. Still, this approach is one key factor supporting our constructive outlook for developed market equities in 2014.

A CONSTRUCTIVE CASE, BUT NOT IMMUNE TO A PULLBACK

Following the large gains of 2013, a pause or pullback would hardly be surprising. Dips have been few in recent quarters, and we are overdue for some sort of correction. We believe pullbacks will be viewed by many as a longer-term buying opportunity. Corrections of a large magnitude, greater than 10% to 15%, will likely require a new or largely unanticipated negative catalyst. Our biggest worry is a sudden, unexpected upward surge in long-term interest rates, one of several low-probability risks for 2014. But a slow, controlled normalization of rates has been fairly well anticipated by equity investors. If any fundamental events led the Fed to change course, we would reassess return potential. Absent that, the bull market, now almost five years old, appears poised to carry on for some time to come.

[4] *Source: Thompson Reuters.*
[5] *Source: Thompson Reuters.*

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