Equity Market Review and Outlook

By Richard Skaggs, CFA, VP, Senior Equity Strategist

KEY TAKEAWAYS

- The global bull market is showing signs of age.
- Still, the long-term bull market remains intact, but double-digit returns may be hard to achieve.
- We expect new highs for the S&P 500 Index and the Nasdaq Composite Index in 2016.
- Remember there are some major fundamental positives on the horizon.
- The energy and commodity sectors are weighing on index earnings.
- We expect gradual Fed rate hikes in 2016 if economic data cooperate.
- With top-line revenue growth a challenge, M&A activity is likely to remain aggressive.

There's no doubt about it—the global bull market is showing signs of age nearly seven years into its run. Its faltering, cautious pace, marked by less resiliency and precipitous tumbles, is becoming more evident as we enter 2016.

Last year's market performance tells the story. Following three years of double-digit gains, a number of factors—plunging oil and commodity prices, China's economic quagmire, an ever stronger dollar, uncertainty about future Federal Reserve (Fed) policy, to name a few—conspired to create subpar results for 2015. Stocks reached their highs for the year late last spring and never managed to broadly exceed those levels for the rest of 2015. The disappointing start to 2016 is yet another telltale sign of the bull market's age, but we're certainly not throwing in the towel after the first week!

We are still firm believers that the long-term bull market remains intact, but that as the cycle ages, double-digit returns may be hard to achieve. While bull markets typically end with unsustainably high valuations and recession, we do not see either as likely in the near term. Rather, a lumbering, selective advance is our base case expectation for 2016.

Potential Buying Opportunities for 2016

We see potential buying opportunities for the long-term investor, but after years of unusually low volatility, a smooth ride is hardly assured. Mid to high single-digit returns are probably the best investors can hope for over the next year or two given the less-than-exciting pace of global growth, the upcoming US presidential election and uncertainties in the geopolitical sphere.

We expect new highs for the S&P 500® Index and the Nasdaq Composite Index in 2016, although gains will likely be limited to the single digits. Our top picks for 2016 are US large caps, and we are positive on both Germany and Japan within the developed market realm. We give the edge to US large cap growth, based largely on relative sector exposure, and continue to have a favorable view of US mid caps.

Remember there are some major fundamental positives on the horizon, namely stable-to-improving developed market growth prospects, lower commodity prices, capped global inflation expectations and continuing low long-term interest rates.

Also, we believe the Fed will continue a path toward normalization unless macroeconomic or geopolitical conditions take a turn for the worse. Policy normalization should not be a major problem for global equities, but we remain alert to changing fundamental conditions that could lead to less favorable performance in the year ahead.

Why the Case for Global Equities Remains Constructive

We see relatively few alternatives to equities for investors seeking potential returns in the mid to high single-digit range over a full market cycle. Moreover, we believe the opportunity for fundamental stock pickers is on the rise as company-by-company fundamental performance becomes more diverse.

Healthy dividend payments around the world are another plus, and dividend-paying stocks can out-earn interest rates on sovereign debt (though equity volatility is a consideration). The S&P 500's dividend yield has kept pace with higher equity prices, holding at around 2% for many years. 2015 was another year of 10% dividend growth for the S&P 500; however, we expect dividend growth in the 7% to 9% range for 2016. Energy- and commodity-sensitive sectors will be hard pressed to maintain dividends; increases will be few and far between. In Europe, dividend yields are tracking around 3.5%, a healthy level relative to inflation and interest rates. Japan indices carry current dividend yields of nearly 2%.

Growing shareholder activism and continued mergers and acquisitions (M&A) activity are two more positives for stocks. According to Bloomberg, global announced M&A for all of 2015 exceeded the prior record high in 2007 in both the number of deals announced and in terms of dollar value. Activity remains balanced over regions and sectors as managements work to supplement relatively sluggish top-line growth with a wide variety of strategic decisions.

For Emerging Markets, Still an Uphill Battle

With emerging economies under strain relative to the developed markets, we are not as favorable on emerging market (EM) equities. The commodity cycle remains challenged, and energy, commodity and banking represent more than 40% of major EM equity indices. Fundamentals in China (20% of the EM equity index) are closely tied to commodity markets and will be a key determinant of emerging market equity performance in the year ahead. We believe China's currency will continue to move lower versus the dollar in 2016 as policymakers try to sustain the nation's growth objectives.

Currency translation has been a negative factor that will likely persist unless EM economies broadly accelerate (which is not our base case expectation). Some currencies and EM equities have been punished excessively in recent months, and selective opportunities may be available, but currency risk to a dollar- or euro-based investor remains real. EM equities in general will face challenges until economic growth in key countries begins to improve.

Back in the US, Valuations Appear Attractive, Although Risks Remain

The S&P 500 is valued at about 16x estimated 2016 operating earnings, a reasonable level, but not especially cheap either. We expect healthy earnings growth in healthcare, technology, financial and consumer companies to offset continued weakness and write-downs in energy and commodity sector earnings. Global industrials also face a challenging 2016 with capital spending plans, especially in the energy patch, being ratcheted down.

Profit margins are edging a bit higher in Europe and Japan, outperforming margin trends in the US. We do not expect significant margin expansion from here, although margins in the US should hold around current high levels (save energy). While growth has been frustratingly slow, recession risk appears limited. We are continuing to monitor China and other emerging markets closely.

Fourth Quarter Review

GLOBAL EQUITY MARKETS
as of December 31, 2015

INDEX TOTAL RETURNS (%)

INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR
S&P 500®	7.04	1.38	15.13	12.57	7.31
MSCI ALL COUNTRY WORLD	5.15	-1.84	8.26	6.66	5.31
MSCI EUROPE	2.53	-2.34	5.08	4.48	3.96
MSCI JAPAN	9.38	9.90	10.45	4.61	1.08
MSCI EMERGING MARKETS	0.73	-14.60	-6.42	-4.47	3.95

Major global indices were higher in the fourth quarter, although only Japan posted meaningful gains in dollar terms for the full year. While stocks recovered sharply in October following the summer global swoon, the momentum was not sustained in November. And December was a month of losses across the board. While the Fed moved to hike the funds rate for the first time in over nine years, in our view the late-year weakness was tied to ongoing turbulence in the energy and commodity sectors and not a result of the Fed's policy move.

Japan outperformed this year due to improving earnings growth and the fact that it is a massive importer of its energy needs. Valuations remain reasonable compared to global averages as well. While weakness in China will likely continue to weigh on Japanese exporters in the year ahead, these risks are at least partially built into valuations today.

European equities performed well in local currency terms in 2015, although UK indices struggled because of relatively higher commodity exposure than other equity markets in Europe. Complicating matters, the weakness in the euro made for relatively meager results when translated into dollars. However, we think that the bulk of depreciation of both the euro and the yen versus the US dollar is behind us.

We note that the three- and five-year returns continue to favor the US over global equities, particularly relative to emerging market equities. While EM equities have underperformed developed market equities since mid-2011, we still do not see catalysts in place for EM equity outperformance.

US EQUITY MARKETS
as of December 31, 2015

INDEX TOTAL RETURNS (%)

INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR
RUSSELL 1000®	6.50	0.92	15.01	12.44	7.40
GROWTH	7.32	5.67	16.83	13.53	8.53
VALUE	5.64	-3.83	13.08	11.27	6.16
RUSSELL MIDCAP®	3.62	-2.44	14.18	11.44	8.00
GROWTH	4.12	-0.20	14.88	11.54	8.16
VALUE	3.12	-4.78	13.40	11.25	7.61
RUSSELL 2000®	3.59	-4.41	11.65	9.19	6.80
GROWTH	4.32	-1.38	14.28	10.67	7.95
VALUE	2.88	-7.47	9.06	7.67	5.57

Large caps showed the strongest recovery from the summer correction with a gain of about 7% in the fourth quarter. Sluggish global growth coupled with continuing investor caution led to underperformance of small and mid caps for the quarter and for the full year. Large caps have outperformed in the past three to five years, as investors have favored durable business models that combine visible growth with capital return in the form of dividends and buybacks. Over the past decade, we have seen relatively small differences in performance based on size, however small caps relative to large caps have underperformed somewhat since 2013. Accelerating economic growth would be a signal that small cap outperformance versus large caps may resume.

Among large caps, growth outperformed value moderately in the fourth quarter and by a relatively large amount over the past year. Growth indices have benefited from relatively strong performance in several consumer, healthcare and technology shares, which have continued to grow nicely in spite of sluggish global macroeconomic conditions. The performance edge of growth over value in the large cap and small cap spaces last year was unusually large, and over a full cycle, we would expect comparative performance of these styles to narrow.

Many cyclical stocks have been under fundamental pressure due to the sharp decline in commodity prices and associated impact on capital spending. These industries are more heavily weighted in the value indices. The financial sector also is heavily weighted in value indices relative to growth indices, so this will be an important sector to monitor as the Fed pursues its rate normalization strategy in the quarters ahead.

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 December 31, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)				
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR
MATERIALS	9.70	-8.38	7.15	5.01
HEALTHCARE	9.22	6.89	23.74	20.24
INFORMATION TECHNOLOGY	9.16	5.94	17.49	13.75
INDUSTRIALS	8.00	-2.53	14.63	11.49
CONSUMER STAPLES	7.64	6.60	15.96	14.50
TELECOMMUNICATIONS	7.61	3.40	5.74	8.29
FINANCIALS	5.96	-1.55	15.51	10.50
CONSUMER DISCRETIONARY	5.79	10.12	19.93	17.79
UTILITIES	1.07	-4.86	11.58	11.04
ENERGY	0.20	-21.12	-4.46	-2.83
TOTAL RETURN	7.04	1.38	15.13	12.57

RUSSELL 2000 SECTORS
as of December 31, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)				
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR
HEALTHCARE	9.66	7.90	24.63	18.31
INFORMATION TECHNOLOGY	6.81	2.91	17.04	10.42
TELECOMMUNICATIONS	6.35	-1.06	8.68	6.59
UTILITIES	5.13	-1.48	11.98	11.47
CONSUMER STAPLES	3.30	-2.56	16.88	13.82
MATERIALS	3.19	-23.09	-2.79	-0.12
FINANCIALS	3.13	-0.36	12.24	10.50
INDUSTRIALS	2.71	-12.84	7.54	6.85
CONSUMER DISCRETIONARY	-3.19	-10.62	9.79	8.82
ENERGY	-7.89	-39.13	-20.00	-14.71
TOTAL RETURN	3.59	-4.41	11.65	9.19

Looking at sector performance for the fourth quarter, all S&P 500 sectors posted gains although the energy sector was barely higher and smaller capitalization energy companies were quite weak. The S&P 500 materials sector was the top performer, although performance was driven principally by M&A activity with some of the heavily weighted companies in the sector rather than due to accelerating fundamental performance. The materials sector declined for all of 2015.

Healthcare and technology, which combined by weight are more than one third of the S&P 500, were important leaders in the fourth quarter recovery and also posted gains for the year. Biotechnology and software services were among the leading performers in these two key sectors. While consumer discretionary slightly underperformed in the fourth quarter, it was the top-performing S&P 500 sector for the year and is second only to healthcare on a three-and five-year basis.

Healthcare's innovation and growth are well understood (although political risk may be a greater factor in the upcoming election year). The discretionary sector is an eclectic mix of companies ranging from retail (brick and mortar and on-line), home improvement, media, automotive, travel, dining and entertainment. This diverse set of companies continues to provide potentially bountiful long-term opportunities for stock pickers, even as some companies struggle to execute well in this fast moving consumer environment.

Energy stocks have suffered large losses over the past 18 months, with little immediate relief in sight. However, we know consumers worldwide are benefiting from higher discretionary cash flow even though we cannot trace the impact of reduced gasoline prices directly to specific companies or services. We think robust auto sales and growing home improvement spending are by-products of lower energy prices, coupled with rising employment and incomes.

While the S&P 500 managed a small gain for the year including dividends, the same cannot be said for the small cap Russell 2000. As with the large caps, healthcare was a top performer for the quarter and year. However,

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.***

beyond healthcare, full-year gains were few and far between at the sector level.

For all of 2015, while materials and energy make up a relatively small weight of the Russell 2000 Index (less than 10% combined), the declines in many individual issues were quite large. And the discretionary sector did not perform nearly as well as in the large cap arena. Within small caps, financials make up over 25% of the index and were market performers in the fourth quarter and fractionally higher for the year. While higher interest rates may be a benefit for financials in 2016, rate increases are likely to be slow and thus limit the magnitude of any positive impact on financial companies' earnings power, and hence equity valuation.

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Disclosure

All data as of December 31, 2015, unless otherwise noted.

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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.*

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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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