Equity Market Review and Outlook

By Richard Skaggs, CFA, VP, Senior Equity Strategist

KEY TAKEAWAYS

- While developed market equity returns have been strong three years running, we see few signs of the bull market losing momentum.
- Macroeconomic factors continued to influence equity markets.
- We believe there are few alternatives to equities worldwide for investors seeking potential returns in the mid to high single-digit range over a full market cycle.

Quantitative easing by global central banks was the story of the quarter. Investors rewarded aggressive accommodation in Japan and Europe, helping those equity markets handily outperform US stocks in dollar and local currency terms. And with markets widely anticipating a US interest rate hike sometime in 2015, currency adjustments were a dramatic feature. The rising dollar exerted pronounced downward pressure on commodity prices, with oil the high-profile casualty of shifting global fundamentals.

Policy Actions a Catalyst for Global Equities

Stocks in Europe and Japan are off to a good start this year, returning 10.34% and 3.58% in US-dollar terms, respectively, but economic growth and improved earnings are keys to longer-term sustainability.

In Europe, the European Central Bank's (ECB's) unprecedented bond-buying program has depressed euro zone sovereign bond yields dramatically. The tonic of low interest rates, lower oil prices and a lower euro has provided a fundamental foundation for heightened growth expectations. While still early, upgraded GDP forecasts, better consumer and business sentiment data, and an acceleration of bank lending to the private sector are all welcome signs. Following several years of earnings disappointments, the strengthening macroeconomic backdrop leads us to believe we could finally see aggregate earnings growth in Europe in 2015. Of course, the sharp rise in stock prices since December discounts some of this potential, but some return-on-equity acceleration from roughly 11% currently would narrow the gap between Europe and the US (which is generating a return on equity closer to 15%).

Japan, which quietly led developed market equities for the quarter, is more than two years into the Abenomics policy initiatives. Though growth remains sluggish, deflation fears have moved to the background. Japanese companies on average are very highly capitalized and carry high, perhaps even excessive, levels of cash. Return on equity among Japanese stocks has been in the 8% to 9% range, lower than Europe and much lower than the S&P 500® Index. Returns have improved since 2012 as corporate earnings have moved higher, but financial performance still is a long way from where it could be in a few years if Abenomics succeeds.

Corporate reforms, including encouraging higher return on equity and greater independence in corporate governance, should remain catalysts. Higher dividend growth, share repurchases and a more shareholder-oriented culture could support healthy equity returns over time.

We See the Global Bull on Firm Footing

Equity returns have been strong across developed market geographies for three years running. Only emerging markets (EM), with three- and five-year returns barely above zero, await their turn.

We see few signs that the global bull market is coming to an end; in fact, it appears to be broadening. In the US, the economic recovery has continued to be strong, and the majority of S&P 500 companies look poised for moderate growth this year. Globally, regional growth prospects are showing signs of improvement, lower commodity prices are capping global inflation expectations, and interest rates are expected to remain at very low levels for an extended period. As such, we believe there are few alternatives to equities worldwide for investors seeking potential returns in the mid to high single-digit range over a full market cycle.

Healthy dividend yields and share repurchase activity should also support global equities. The S&P 500's dividend yield has remained around 2% as dividend increases have generally kept pace with higher equity prices, and in Europe, dividend yields are tracking above 3%. S&P 500 dividends are on pace to grow 8% to 10% in 2015, even with lower dividend growth from the energy sector. February 2015 marked a record high for new share repurchase authorizations by S&P 500 companies, and Japanese companies are focused on capital return strategies as well.

Growing shareholder activism and continued merger-and-acquisition (M&A) activity are two more positives for stocks. According to Bloomberg, global announced M&A over the past twelve months was up more than 50% from levels of the prior year, with activity balanced across regions and sectors. With cash earning nearly nothing, we see more companies pursuing acquisitions as a way to build shareholder value in relatively short order.

Investors have recognized this favorable investment backdrop, and valuations have moved up. With the S&P 500 not far from record highs, large cap stocks are valued between 16x and 18.0x forward-year earnings estimates. Europe and Japan are each valued at about 17x this year's consensus index earnings estimate. Profit margins are poised to edge higher in Europe and Japan, and margins in the US should be able to hold in near current high levels (save weakness in energy). While valuations are on the high side compared with recent years, they are reasonable relative to history and not out of line given our constructive view on inflation and the lack of competition from fixed income yields.

We would prefer a steady ascent in equity prices to a potentially unsustainable advance accompanied by heightened valuation risk and potential disappointment. Changing global economic fundamentals, commodity price swings and, of course, potential US rate increases later this year could lead to higher volatility. And geopolitical risk remains a wild card that cannot be explicitly factored in. In sum, moderate stock price corrections should provide selective buying opportunities, much as they have for the better part of the past six years. Positive equity performance outside the US suggests a broadening of equity investment opportunities, a development that is most certainly welcome.

First Quarter Review

GLOBAL EQUITY MARKETS[1]
as of March 31, 2015

INDEX TOTAL RETURNS (%)					
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR
S&P 500®	0.95	12.73	16.11	14.47	8.01
MSCI ALL COUNTRY WORLD	2.44	5.97	11.35	9.57	7.00
MSCI EUROPE	3.58	-4.42	10.02	7.02	5.52
MSCI JAPAN	10.34	12.39	9.60	6.08	3.70
MSCI EMERGING MARKETS	2.28	0.79	0.67	2.08	8.82

The S&P 500 gained just shy of 1% for the quarter. S&P 500 aggregate earnings will likely be mixed this year, weighed down by the energy sector. But the majority of companies look poised for moderate growth.

Many European countries, including Germany, France, Italy and Belgium, posted local currency returns in the high teens to low 20% range, but the MSCI Europe gained only 3.6% in US-dollar terms. Until the euro began to decline in mid-2014, the risk of owning European equities in dollar terms quite high, and we were skeptical of the market's potential. However, the euro's 23% decline versus the dollar from its peak ten months ago has sharply reduced currency risk for dollar-based investors.

The yen was close to unchanged for the quarter, but it has declined nearly 16% versus the US dollar since last May, and Japan's equity markets have benefited. The MSCI Japan's dollar-based return of more than 10% this quarter reflects slowly improving financial performance in Japan's corporate sector supported by healthy earnings growth.

EM stocks eked out a small gain for the quarter in US-dollar terms, a pleasant surprise given the strong US dollar and broad commodity price weakness. China, India, Korea, Taiwan, South Africa and others posted healthy gains, offsetting a significant decline in Brazil. In general, oil-producing nations were more challenged. While quite small in EM equity indices, Russia posted a double-digit gain in dollar terms but remains 25% lower over the past year.

Given a continuing economic slowdown, it is somewhat surprising that Chinese stocks have fared very well over the past six months. The Chinese government has taken steps to broaden foreign investor access to its equity markets, but this program is going very slowly. Looser margin lending regulations have been one positive catalyst for share performance. And with housing prices showing weakness, perhaps investors figure that equities are now a better bet than real estate. China is a material exporter to Europe, so signs of better growth in Europe could be a positive catalyst for Chinese companies as well.

EM stocks have gotten cheaper on a price-to-book basis, but earnings revisions continue to be negative, and catalysts for better equity performance (namely, better global growth, stronger commodity prices and perhaps a weaker US dollar) do not appear likely in the near term.

US EQUITY MARKETS[1]
as of March 31, 2015

INDEX TOTAL RETURNS (%)					
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR
RUSSELL 1000®	1.59	12.73	16.45	14.73	8.34
GROWTH	3.84	16.09	16.34	15.63	9.36
VALUE	-0.72	9.33	16.44	13.75	7.21
RUSSELL MIDCAP®	3.95	13.68	18.10	16.16	10.02
GROWTH	5.38	15.56	17.41	16.43	10.19
VALUE	2.42	11.70	18.60	15.84	9.61
RUSSELL 2000®	4.32	8.21	16.27	14.57	8.82
GROWTH	6.63	12.06	17.74	16.58	10.02
VALUE	1.98	4.43	14.79	12.54	7.53

Small and mid cap stocks outperformed large caps, regaining ground after lagging large caps in 2014. Additionally, small and mid caps are less exposed to the energy sector and foreign currency than large caps. These lower relative exposures should aid earnings growth prospects for the small and mid cap stocks versus large caps in 2015, and we anticipate further moderate outperformance.

For the first time in several quarters, there was a noticeable difference in performance between growth and value styles, with growth taking the lead. Relative sector weightings are the key. Strong-performing healthcare, consumer and technology stocks are more heavily weighted in the growth space. Large weights in value sectors, such as energy, financials and utilities, weighed on the overall index. We see growth-value divergence as strictly a factor of medium-term sector performance.

[1] *Source: FactSet. All returns quoted in US dollars. Performance for one and multi-year periods is annualized. Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.* ***Past performance is no guarantee of future results.***

S&P 500 SECTORS[2]
as of March 31, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)				
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR
HEALTHCARE	6.47	26.11	26.87	20.00
CONSUMER DISC	4.80	18.26	20.69	20.06
TELECOM	1.54	4.09	10.43	12.77
MATERIALS	0.99	4.97	12.00	10.82
CONSUMER STAPLES	0.99	16.53	15.81	14.99
INFO TECH	0.57	18.08	13.14	14.38
INDUSTRIALS	-0.86	8.76	16.73	14.35
FINANCIALS	-2.05	9.95	17.48	10.57
ENERGY	-2.85	-11.12	4.13	8.00
UTILITIES	-5.17	11.09	12.56	12.96
TOTAL RETURN	0.95	12.73	16.11	14.47

RUSSELL 2000 SECTORS[2]
as of March 31, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)				
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR
HEALTHCARE	12.37	28.90	27.16	21.19
INFO TECH	5.54	13.63	16.72	16.21
CONSUMER DISC	5.11	10.81	17.85	15.00
INDUSTRIALS	2.60	1.33	16.03	14.97
FINANCIALS	1.60	9.15	16.31	12.73
UTILITIES	1.08	15.49	15.68	15.12
MATERIALS	0.50	-4.50	9.49	10.35
CONSUMER STAPLES	0.26	10.38	18.98	16.90
TELECOM	-0.62	-2.40	9.79	9.66
ENERGY	-0.62	-39.32	-9.30	-1.01
TOTAL RETURN	4.32	8.21	16.27	14.57

Healthcare was the top S&P 500 sector for the quarter and was also a leader worldwide over the past year. Biotechnology has been exceptionally strong, benefiting from broad participation across sub-industries and market capitalization. M&A activity (among US companies and between US and European companies) has also been supportive.

Consumer stocks received a tailwind from lower gasoline prices, and auto sales worldwide have supported the discretionary sector. S&P 500 technology sector performance cooled this quarter, after handily outperforming over the past year. Small cap consumer and techs stocks each outperformed their large counterparts.

Energy equities continued to drag on overall index performance; however, with S&P 500 names down 2% for the quarter and 11% for the past year. Energy stocks peaked at the start of the third quarter in 2014, so we have another difficult year-over-year comparison in store for the coming quarter. Small cap energy was only down about 2% in the first quarter, but the sector posted a 44% loss over the past year.

Utilities were off about 5% in the quarter. Expectations for an impending hike in the fed funds rate hurt utilities, but underperformance was primarily due to the sector's exceptional result in the second half of 2014. Utilities returned about 11% on a 12-month basis, including first-quarter underperformance.

Financials were relatively quiet, underperforming benchmarks in the large and small cap spaces. Earnings growth remains sluggish, and regulatory pressure remains intense. Capital ratios among banks are excellent, but revenue growth depends in part on higher interest rates. Bank funding is currently very low, but so are interest rates on earning assets. Financials would welcome a higher rate environment to boost new interest margins, but that remains a longer-term prospect.

[2]Source: FactSet. Performance for one and multi-year periods is annualized. Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index. 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

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Index Definitions

Standard & Poor's (S&P 500®) Index *is a market capitalization-weighted Index of 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance. S&P 500® is a registered service mark of McGraw-Hill Companies, Inc.*

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.*

Russell 1000® Value Index *measures the performance of the large cap value segment of the US equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.*

Russell Midcap® Index *measures the performance of the mid cap segment of the US equity universe. The Russell Midcap is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.*

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.*