Equity Market Review and Outlook

By Richard Skaggs, CFA, VP, Senior Equity Strategist

KEY TAKEAWAYS

- We firmly believe the long-term bull market still has life in it.
- A broad global equity rally ignited mid-quarter after the strong US dollar and plunging commodity prices reversed course.
- We believe the US dollar's pause versus trading partners—especially the emerging markets—is a welcome development.
- We continue to expect new highs in the S&P 500 later this year. Upcoming earnings reports will be key to the duration of the current rally.
- Earnings estimates have been marked down considerably, to levels we think are broadly achievable.
- Income-oriented equities have been strong performers for quite some time, and cyclical shares are showing signs of life recently.

In early January, our investment position seemed questionable to many. Back then, we reiterated our long-held view that "the long-term bull market remains intact" even though it was showing signs of age. We also said new highs were possible in 2016.

And as the first quarter progressed, our firm belief began to look downright wrong, with January proving to be one of the worst January outcomes in history performance-wise since the S&P 500® Index's initiation in 1957. Weakness in December continued into January, as fears about a recession, the prospect of the Federal Reserve (the Fed) hiking rates up to four times in 2016, the dollar becoming ever stronger and wreaking havoc with emerging markets, a Chinese currency devaluation and, finally, the impact of falling oil and commodity prices took hold in the market leading to a double-digit early-quarter decline in the S&P 500.

Fortunately, stocks took a dramatic turn for the better in mid-February with such fears receding and the S&P 500 posting one of its biggest same-quarter recoveries on record by the end of March. Now, we believe we are in a profits recession, not an economic recession as feared by some. Also, the Fed figures to hike rates only twice this year, the dollar has weakened some, the renminbi stabilized a bit and oil and commodity prices are off recent lows.

Why the Long-Term Bull Market Still Has Life

We remain firm believers that the long-term bull market lives on. Certainly market returns over the past year have been meager at best, with many major global equity indices showing declines. Yet, it is hard for us to call an end to the bull market now that the Fed has backed off its mechanical rate hike plans, unemployment in the US remains around 5.0%, job growth continues month after month, and the auto and housing sectors, for example, are still performing quite well.

To the extent some investors were concerned that valuations were "too high," many stocks have fallen much more than index averages, providing better entry points than were available a few quarters ago. Bull markets typically end with unsustainably high valuations and rising commodity prices, especially rising oil prices, which certainly is not the case now. Moreover, Fed tightening is normally a precursor to a major downturn. We do not see the Fed engaging in abrupt tightening any time soon, especially given developments after the first small rate hike last December and the decision to take a pass on a rate hike at the March meeting.

We are not in the camp that believes the Fed's 25 basis point rate hike last December caused global equities to start 2016 off so badly. We believe the prospect of a stronger and stronger dollar was a primary culprit in the market's precipitous fall. When investors factored multiple Fed rate hikes in 2016 and in 2017 into their outlooks, it appeared the strong US dollar had only one way to go from already high levels—higher! US multinationals, for example, have struggled with poor revenue growth for several quarters, in part because the strong dollar was putting material pressure on top-line growth.

The dollar has strengthened by almost 35% versus our trading partners since mid-2011. Fortunately, the dollar has eased a bit from the mid-January peak. We believe that after an increase in value of such extreme proportions, a flattening out of the dollar versus our trading partners—especially those in the emerging markets—should be a welcome development for companies, customers and investors.

Many Companies Are Doing Just Fine: Will Earnings Turn up in 2016?

The S&P 500 today is quoted at the same levels it traded at in the fourth quarter of 2014. Why so little progress? As we've noted, the list of general investor concerns is long. GDP growth in the US and around the world has disappointed. China's growth is slowing. Emerging markets have been hurt by falling commodity prices. Monetary stimulus in Europe and Japan has not generated the hoped-for traction. Did I forget Brexit? US elections? I'm sure I missed a few more. Geopolitical risks abound.

In terms specific to the S&P 500, the lack of progress can be attributed to disappointing earnings growth. S&P 500 operating earnings per share (EPS) were roughly flat in 2015 compared to 2014, and we do not expect much growth in earnings this year either. The median S&P 500 company continues to report low- to mid-single-digit earnings growth in these challenging times. By contrast, the top quartile S&P 500 company is reporting double-digit earnings growth.

The problem with the index overall can be traced to the energy sector and its suppliers. Energy sector operating earnings have almost entirely vanished due to the sharply lower commodity price. And many energy companies have been taking material write-downs of reserve estimates, a charge that operating earnings estimates generally exclude but are evident in net earnings reported under GAAP.

Moreover, in recent years, the energy sector has contributed roughly 11% to 14% of overall index earnings. With an S&P 500 operating EPS base currently in the $120 range, this means (based on history from 2005 to 2014) that we would be looking for the energy sector to contribute well over $12 of the $120 in normal times. With a decline of over 60% in earnings in 2015, and with another decline expected in 2016, it is possible that the S&P 500 energy sector will contribute little to index EPS this year.

So is earnings progress for the index overall as bad as it appears? Well, we expect a recovery in energy sector earnings, although it is likely to just begin in 2017 before improving further in 2018. The energy and mining sectors, and the industrial suppliers to those companies, have been in an earnings recession for several quarters now.

Does this mean we have a case for EPS acceleration late in 2016 and in 2017? We think the answer is yes. Our forecast remains one of slow growth in the US, but no recession. Policy traction in Europe and Japan would also be a welcome development. Emerging markets have shown a few signs of life recently and a less-strong dollar and partial recovery in commodity prices would boost many hard-hit markets such as Brazil.

And if the dollar moves into more of a trading range versus global currencies, rather than the one-way rally pattern we have witnessed for a long time, US multinationals, particularly consumer staples companies, would be poised to show earnings improvement as well. Taken together, we are becoming more confident in our forecast of mid- to high-single-digit operating earnings growth in 2017, after what will likely be another year of sluggish aggregate performance in 2016. Investors will anticipate this acceleration, and if we are correct, this could provide the valuation-based foundation for stocks to reach new highs later in 2016.

The Case for Global Equities Remains Constructive

In spite of disappointing recent performance, we still see few alternatives to equities for investors seeking potential returns in the mid- to high-single-digit range over a full market cycle. The dividend story remains positive, although 2016 will mark the end of the S&P 500's multiple years of 10%+ dividend growth. The energy sector has been in a holding pattern at best when it comes to dividends, with a number of companies cutting payments to retain financial flexibility.

Consider that the S&P 500 is yielding more than 2.0% today. That is much higher than the yield available on most sovereign debt. While corporate debt yields have risen in some segments, we see potential dividend growth in 2016 as further support for stocks, even as a few companies are forced to trim payouts around the world. We still expect the S&P 500's dividend growth rate to grow at least in the mid-single digits this year.

First Quarter Review

GLOBAL EQUITY MARKETS
as of March 31, 2016

INDEX TOTAL RETURNS (%)

INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR
S&P 500®	1.35	1.78	11.82	11.58	7.01
MSCI ALL COUNTRY WORLD	0.38	-3.81	6.10	5.80	4.63
MSCI EUROPE	-2.37	-7.96	3.27	2.67	2.65
MSCI JAPAN	-6.38	-6.75	4.14	4.28	-0.24
MSCI EMERGING MARKETS	5.75	-11.70	-4.15	-3.80	3.34

The S&P 500 managed a small gain for the quarter, a far better outcome than seemed likely a few weeks ago. In mid-February, the price of oil began to firm up, sparking a rally across the commodity and industrial sectors, which spread to the broader market as well. While the one-year return of the S&P 500 is hardly inspiring, the longer-term returns remain quite positive. The standout for the quarter was the recovery in emerging market equities, posting a gain of nearly 6.0% following a multi-year period of underperformance. The bounce in oil and other commodities, coupled with a modest strengthening of major emerging market currencies, was a catalyst for outperformance. Brazil stocks, in particular, were strong based on potential political changes in addition to the commodity bounce.

Stocks in Europe and Japan recovered from mid-quarter lows but were unable to move into the plus column. The one-year returns are also negative. Both regions are struggling with sluggish growth. And both are engaging in aggressive monetary stimulus, with negative interest rates commonplace in these regions. Both the euro and yen have strengthened versus the dollar in recent weeks, an outcome that was surprising to many.

US EQUITY MARKETS
as of March 31, 2016

INDEX TOTAL RETURNS (%)

INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR
RUSSELL 1000®	1.17	0.50	11.52	11.35	7.06
GROWTH	0.74	2.52	13.61	12.38	8.28
VALUE	1.64	-1.54	9.38	10.25	5.72
RUSSELL MIDCAP®	2.24	-4.04	10.45	10.30	7.45
GROWTH	0.58	-4.75	10.99	9.99	7.43
VALUE	3.92	-3.39	9.88	10.52	7.23
RUSSELL 2000®	-1.52	-9.76	6.84	7.20	5.26
GROWTH	-4.68	-11.84	7.91	7.70	6.00
VALUE	1.70	-7.72	5.73	6.67	4.42

Small caps did not quite catch up to large caps this quarter, with the Russell 2000® Index posting a small decline. The midcap sector was the best performer in the US. Still, small and midcap stocks have lagged large caps considerably over the past year as investors have taken a conservative approach to stock selection. Large caps have a better record of dividend growth and earnings stability, and many large caps have used market weakness to add to share repurchase programs.

Still, the comeback in small caps this quarter from the mid-quarter low was extraordinary. The Russell 2000 ended the quarter about 18% above its quarter low. Given the tendency for small caps to be more volatile than large caps, it is not surprising that they were hit hard by recession fears before rebounding aggressively when fears proved to be overdone.

In terms of growth versus value, large caps performed pretty much in line, but the small and midcap sectors favored value stocks. Cyclical shares, which are heavily weighted in value indices, recovered sharply. By contrast, healthcare (including biotechnology), which carries larger weights in growth indices, underperformed. This helped to tilt the style performance outcome in favor of value.

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 March 31, 2016

SECTOR PERFORMANCE ATTRIBUTION (%)				
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR
TELECOMMUNICATIONS	16.61	18.74	7.98	10.57
UTILITIES	15.56	15.95	12.39	13.68
CONSUMER STAPLES	5.57	11.43	12.82	15.17
INDUSTRIALS	4.99	3.21	12.61	10.66
ENERGY	4.02	-15.54	-5.68	-4.96
MATERIALS	3.61	-6.00	6.74	4.82
INFORMATION TECHNOLOGY	2.60	8.07	16.80	13.51
CONSUMER DISCRETIONARY	1.60	6.76	16.10	17.08
FINANCIALS	-5.07	-4.58	9.44	8.70
HEALTHCARE	-5.50	-5.19	15.62	17.60
TOTAL RETURN	1.35	1.78	11.82	11.58

RUSSELL 2000 SECTORS
as of March 31, 2016

SECTOR PERFORMANCE ATTRIBUTION (%)				
INDEX	3 MONTH	1 YEAR	3 YEAR	5 YEAR
UTILITIES	12.02	9.19	12.52	12.75
TELECOMMUNICATIONS	5.91	5.44	10.33	7.35
MATERIALS	5.09	-19.57	-4.07	-1.04
INDUSTRIALS	4.49	-11.22	4.43	6.08
CONSUMER STAPLES	3.13	0.09	13.82	13.37
CONSUMER DISCRETIONARY	2.33	-13.01	6.44	8.62
FINANCIALS	0.32	-1.62	7.83	9.88
INFORMATION TECHNOLOGY	-1.36	-3.79	12.59	7.62
ENERGY	-8.14	-43.85	-25.39	-19.18
HEALTHCARE	-16.99	-20.29	11.99	12.03
TOTAL RETURN	-1.52	-9.76	6.84	7.20

The risk-averse nature of equity performance in recent periods is seen very clearly in S&P 500 sector attribution, which for the first quarter and past year has greatly favored high dividend yielders such as telecom and utilities. Consumer staples is another sector with strong earnings stability and dividends, although the underlying growth rate is not high.

Energy stocks recovered nicely among the large caps, although we attribute that as much to dividend safety as an anticipation of a major recovery in oil prices. The longer-term performance of energy has been very poor across the board.

Financial stocks have had trouble this year as well, which we attribute to the expectation that interest rates will stay lower for longer than investors have hoped. The low rates continue to weigh negatively on lender net interest margins.

Among the most disappointing sectors has been healthcare, a sector that has been a performance leader over the past five years. We attribute underperformance primarily to heightened political risk, as the current political season is witnessing threats of pricing regulations from both parties. While the fundamental performance of the sector remains good, we have witnessed some price/earnings multiple compression.

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 March 31, 2016, unless otherwise noted.

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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.*

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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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