



equity market review & outlook

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first quarter
2014

EQUITIES BUILT ON GAINS IN THE FIRST QUARTER

It took a rally in late March, but the S&P 500® Index managed nearly a 2% first-quarter return, a respectable result considering the index gained more than 30% in 2013 and over 10% in the fourth quarter alone. First-quarter trading was choppy, but the moderate 5.8% decline in early 2014 paved the way for stronger performance in February and March, and the S&P 500 reached record highs on several occasions in the second half of the quarter. The early year pullback was not surprising—and perhaps even welcome—given 2013’s strong finish. Investors wrestled with a number of macroeconomic factors that accentuated day-to-day volatility, including Federal Reserve Chair Janet Yellen’s statement that the Fed may raise rates as soon as six months after quantitative easing ends. Ultimately, these factors did not derail the uptrend or produce a decline close to the traditional “correction” level of -10% or more. Small cap and mid cap stocks also posted low single-digit gains, with the Russell Midcap® Value Index taking performance honors for the quarter.

Japanese stocks continued to consolidate strong gains earned last year, contributing to the decline in the MSCI Pacific Index, while European equities performed roughly in line with the S&P 500 this quarter. The MSCI Europe’s one-year return of more than 25% suggests European equity performance is getting back on track. Signals that Europe is emerging from its lingering recession and a substantial decline in borrowing rates for several periphery nations have supported performance.

Emerging market (EM) equities posted a fractional loss for the quarter after slumping almost 9% in US dollar terms mid-quarter. Weakness in emerging market equities (and currencies) was one important

KEY TAKEAWAYS

- First quarter equity returns were modest overall, in line with our view that stocks can build on hearty gains realized since the market’s 2009 bottom.
- Moderate returns reinforce our view that the strong equity gains of 2013 may have “pulled forward” performance.
- P/E multiples could expand from here, but expansion without underlying acceleration in operating earnings could raise the risk of a more significant correction.

THE US & EUROPE POSTED SMALL GAINS THIS QUARTER; 5- AND 10-YEAR RETURNS ARE RESPECTABLE ACROSS THE BOARD

INDEX TOTAL RETURNS

	First Quarter 2014	1 Year	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
S&P 500®	1.81%	21.86%	14.66%	21.16%	7.42%
Russell 1000®	2.05	22.41	14.75	21.73	7.80
Growth	1.12	23.22	14.62	21.68	7.86
Value	3.02	21.57	14.80	21.75	7.58
Russell Midcap®	3.53	23.51	14.39	25.55	10.05
Growth	2.04	24.22	13.52	24.73	9.47
Value	5.22	22.95	15.17	26.35	10.24
Russell 2000®	1.12	24.90	13.18	24.31	8.53
Growth	0.48	27.19	13.61	25.24	8.87
Value	1.78	22.65	12.74	23.33	8.07
MSCI All Country World	1.21	17.17	9.14	18.43	7.53
MSCI Emerging Markets	(0.37)	(1.07)	(2.54)	14.83	10.45
MSCI Europe	2.21	25.20	9.05	18.22	8.03
MSCI Pacific	(2.42)	5.26	5.29	13.60	5.00

Source: FactSet, data as of March 31, 2014. All returns quoted in USD.



catalyst for the profit taking in developed market equities at the beginning of the year. EM currencies also stabilized and began to recover coincident with the bottom in EM equities. Chinese stocks and copper prices—frequently cited indicators of EM health—both stabilized late in the quarter, lending further support to the recovery in EM equities. Though EM equities have been difficult over the past three years, the long-term returns from this asset class can be quite attractive, albeit volatile. Given the duration of underperformance and comparatively low absolute valuations, we are watching for signs of potentially better returns ahead.

QUARTERLY SECTOR PERFORMANCE A MIXED BAG, WHILE 1- AND 3-YEAR RESULTS REFLECT A BALANCED EQUITY RECOVERY

S&P 500 sector returns were mixed this quarter. Utilities, which lagged in 2013, surprisingly posted the strongest return. The almost 10% quarterly gain in this interest-rate-sensitive sector coincides with the interest rate decline in the first quarter. Healthcare stocks also performed well, and healthcare remains the leading S&P sector over the past three years, returning 23.4% annually during that time. Technology and financials were both solid quarterly performers and produced strong returns over the past year. The potential for a cyclical recovery in capital spending is boosting the technology sector, as is the ongoing trend of dividend increases and share repurchases among leading technology companies. In fact, the technology sector continues to be the S&P 500's largest dividend payer in US dollar terms. Financial stocks continued to recover from the depths of 2009. While credit quality is now clean for financials, investors await stronger loan growth and higher net interest margins, both of which could become evident with a stronger economy and a somewhat higher interest rate regime.

Consumer discretionary was a notable laggard this quarter, following a long stretch of leading performance. The unusually harsh winter kept consumers at home, contributing to sector underperformance. Some media- and entertainment-related companies also lagged following strong performance last year. The discretionary sector remains the top performer on a five-year basis, as this has been a consumer-driven economic recovery, and the sector's three-year return of over 20% is second only to healthcare. While employment growth has been sluggish during this expansion, consumers have benefited from sustained low interest rates, rising home prices and improving personal balance sheets.

Small cap quarterly performance was led by utilities, energy and healthcare. Over the past year, six of the nine major sectors posted returns of 20% or higher. Small caps pulled back late in the quarter as some of

BROAD SECTOR PARTICIPATION OVER THE PAST 1, 3, AND 5 YEARS

SECTOR PERFORMANCE ATTRIBUTION

	S&P 500® Index				Russell 2000® Index				
	Q1 2014	1 Year*	3 Year	5 Year	Q1 2014	1 Year*	3 Year	5 Year	
Healthcare	5.82%	29.13%	23.41%	21.56%	Healthcare	0.80%	36.60%	19.89%	24.93%
Industrials	0.14	27.17	13.92	25.27	Consumer Staples	1.94	33.12	19.26	24.16
Info Tech	2.29	25.49	14.27	21.42	Info Tech	5.02	30.59	9.78	26.31
Financials	2.66	24.86	13.08	22.44	Telecom	0.77	30.42	11.73	16.35
Consumer Disc	(2.80)	23.91	20.34	29.10	Industrials	(3.15)	26.50	14.23	25.84
Materials	2.86	23.23	8.67	19.94	Consumer Disc	3.75	25.04	16.11	29.19
Energy	0.83	14.40	5.74	16.45	Energy	0.40	22.12	0.49	23.49
Consumer Staples	0.51	10.60	15.99	18.58	Financials	3.00	16.68	14.28	19.79
Utilities	9.99	10.13	13.76	14.91	Materials	1.37	14.32	6.87	28.22
Telecom	0.06	1.89	10.37	14.49	Utilities	5.38	12.95	13.05	16.52
Total Return	1.81	21.86	14.66	21.16	Total Return	1.12	24.90	13.18	24.31

Source: FactSet, data as of March 31, 2014. Performance for three year and five year time periods are annualized.

*Sorted by S&P 500 or Russell 2000 one year returns.



the top-performing technology and biotechnology stocks and recent new issues came in for a bout of profit taking. While certain pockets within the small and large cap realms are sporting relatively high valuations, the long-term sustainability of equity returns, of course, depends on successful management execution over time.

WHAT SHOULD WE ANTICIPATE AS THE YEAR PROGRESSES?

There are several important fundamental supports to this bull market beyond earnings growth, notably the interest rate environment, healthy dividends and a constructive macroeconomic backdrop. Interest rates on sovereign debt and corporate debt remain very low. We expect low rates to persist for some time, especially with inflation appearing well under wraps, and think the Fed may be in a position to raise rates in the second half of 2015. From an equity perspective, if the economy is strong enough to tolerate a boost in short-term rates, that should mean business conditions are looking up and companies can continue to perform well.

The dividend yield on the S&P 500 has remained around the 2.0% level more often than not in recent quarters, even as stocks have gone up in price. Companies continue to raise payouts at a healthy rate. Well over 400 of the S&P 500 companies now pay cash dividends, the highest number in years. In terms of macroeconomic factors, low inflation means equity ownership has generated attractive inflation-adjusted real returns, and we expect this to remain. Oil prices, while fluctuating, are around 2011 levels. US employment growth has been moderate but steady month after month, and we anticipate more of the same. Consumer confidence has trended higher, not just in the US but worldwide. While day-to-day stock price fluctuations can be jarring, volatility has been trending irregularly lower since the fall of 2011. Equity fund flows have become more consistently positive since the beginning of 2013, following a long stretch of net outflows as investors flocked to bonds for perceived relative safety.

Investors have recognized this better investment backdrop, and valuation expansion has been significant. The S&P 500 traded around 12x-14x forward earnings during much of 2011 and 2012. Today, with the S&P 500 near a record high, large caps are valued between 16x and 16.5x consensus estimates for 2014. Most of this multiple expansion occurred in 2013. Earnings estimates were revised slightly lower as we began the year, a common occurrence, although temporary weather-related shortfalls were more plentiful this winter than is typical. We continue to expect mid-to-high single-digit operating earnings growth in 2014 compared to 2013. A similar gain is possible in 2015 if the economy continues to track in line with the slow but steady recovery path witnessed in recent years. Accelerating growth would certainly be welcome, although it is not necessary for earnings to continue to grow at a moderate pace in our opinion.

Moderate first-quarter returns tend to reinforce our view that the strong equity returns of 2013 may have “pulled forward” performance. Stocks need time (and earnings growth) to grow into higher valuations. The 2% return for US stocks on average this quarter is more or less in line with our expected pace of core earnings growth. Certainly it is possible for price-to-earnings multiples to expand from here. However, should multiples continue to expand without underlying acceleration in operating earnings, a correction of 10% or more could come to pass later this year or in 2015. Therefore, we believe this quarter of relatively modest positive returns improves the foundation of this bull market by keeping valuation at reasonable levels while we await further fundamental developments.

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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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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.

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