



equity market review & outlook

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third quarter
2014

WHILE THE S&P 500 BUILT ON 2014 GAINS, SMALL & MID CAP STOCKS WERE DOWN

Equities were mixed in the third quarter. While the S&P 500 posted its seventh consecutive quarterly gain, the 1.13% return was modest compared with the returns of recent quarters. The Russell 1000® Index, an alternative measure of US large cap performance, had a fractional gain of less than 1%. Mid cap stocks, small cap stocks and global indices all posted declines. Within the Russell 1000 Index, the growth subset was up 1.49%, while the value subset posted a fractional decline of 0.19%.

Moving down the market-cap spectrum, midcap stocks, as measured by the Russell Midcap® Index, declined 1.66%, while small cap stocks, as captured by the Russell 2000® Index, had a 7.36% correction. Among the small cap stocks, growth edged out value modestly, but not by much. Small cap stocks briefly touched a record high at the beginning of the third quarter, but further rally attempts fizzled, and small caps closed the quarter around the lowest levels of 2014.

Demonstrating the relative consistency of large cap equity performance, the S&P 500 has reached record closing highs on more than 30 occasions so far in 2014, the most recent being in mid-September. For large cap stocks, this is a continuation of the constructive, lower-volatility uptrend that has been evident for the better part of the past three years. The case for US large cap stocks has been strong for some time, and positive factors remain broadly intact. This bull market shows few signs of its age, even as we are more than five years removed from the generational low of March 2009.

KEY TAKEAWAYS

- While small and mid cap stocks struggled in the third quarter, the case for US large cap stocks continues to be healthy.
- US economic data continue to outperform data in the rest of the world, so much so that the Federal Reserve remains on a path to raise its federal funds rate target sometime in 2015 for the first time since 2006.
- It is understandable that equity returns have been less robust recently, and global equities face additional challenges compared to the US. Domestic large cap equity fundamentals continue to be firmly supported by double-digit dividend growth, prudent share repurchase activity and a recent pickup in M&A.

US LARGE CAP STOCKS POSTED SMALL GAINS IN Q3 WHILE OTHER GLOBAL EQUITY INDICES WERE DOWN

INDEX TOTAL RETURNS

	Third Quarter 2014	YTD 2014	1 Year	3 Year	5 Year	10 Year
S&P 500®	1.13%	8.34%	19.73%	22.99%	15.70%	8.11%
Russell 1000®	0.65	7.97	19.01	23.23	15.90	8.46
Growth	1.49	7.89	19.15	22.45	16.50	8.94
Value	(0.19)	8.07	18.89	23.93	15.26	7.84
Russell Midcap®	(1.66)	6.87	15.83	23.79	17.19	10.34
Growth	(0.73)	5.73	14.43	22.74	17.12	10.24
Value	(2.65)	8.20	17.46	24.72	17.24	10.17
Russell 2000®	(7.36)	(4.41)	3.93	21.26	14.29	8.19
Growth	(6.13)	(4.05)	3.79	21.91	15.51	9.03
Value	(8.58)	(4.74)	4.13	20.61	13.02	7.25
MSCI All Country World	(2.20)	4.16	11.89	17.24	10.65	7.84
MSCI Emerging Markets	(3.36)	2.75	4.66	7.56	4.76	11.03
MSCI Europe	(6.98)	(1.44)	6.36	16.22	7.54	7.24
MSCI Pacific	(3.56)	(0.42)	1.16	10.46	6.29	6.01

Source: FactSet, data as of September 30, 2014. All returns quoted in USD. Performance for three year, five year and ten year time periods are annualized.



THE STRONG US DOLLAR WEIGHED ON GLOBAL EQUITY RETURNS

Global equities struggled in the third quarter as economic data from Europe disappointed and geopolitical developments increased the overall level of risk aversion. While more monetary stimulus from the European Central Bank (ECB) and the Bank of Japan (BoJ) may support stronger economic growth later this year and in 2015, the euro and the yen were both particularly weak versus the US dollar in the second half of the quarter. Emerging market currencies, which had strengthened in the first part of 2014, also weakened versus the US dollar in the latter part of the third quarter. As such, global equity terms, when measured in US dollars, also had negative returns. Specifically, returns for the MSCI All Country World Index, the MSCI Emerging Markets Index, the MSCI Europe Index and the MSCI Pacific Index all were down in the low-to-mid single digits.

US economic data continue to outperform data in the rest of the world, so much so that the Federal Reserve (the Fed) remains on a path to raise its federal funds rate target sometime in 2015, for the first time since before the financial crisis began. At the same time, with other central banks moving toward further stimulus, the relative outperformance of the US dollar versus many global currencies may continue for the near term. This currency advantage, on top of the arguably superior relative fundamental prospects for large US companies, has supported US equities in recent months. While third-quarter results may have disappointed, we should keep in mind that US equities have posted strong longer-term, multi-year returns across all market capitalizations.

HEALTHCARE & TECHNOLOGY PERFORMED WELL, WHILE ENERGY & UTILITIES REVERSED THE GAINS OF LAST QUARTER

Sector performance reflected a wide dispersion this quarter. Within the S&P 500, healthcare and technology were solid performers. These two sectors have larger weights in the Russell 1000® Growth Index than the Value Index, and Growth outperformed modestly in the third quarter. These sectors are dominated by many of the largest companies in the S&P 500® Index, and year-to-date performance has been robust. Innovation, somewhat improving revenue growth, dividend growth and share repurchases are all supporting factors in performance of these sectors.

Despite being top performers in the second quarter, energy and utility stocks were weak in the third quarter. Energy, a sector with a larger representation in the Russell 1000® Value Index, was quite weak, down 8.6% within the S&P 500. Energy was down considerably more within the small cap Russell 2000 Index. Within

S&P 500 HEALTHCARE & TECHNOLOGY SECTORS LED IN Q3 WHILE ENERGY WAS A PRONOUNCED UNDERPERFORMER

SECTOR PERFORMANCE ATTRIBUTION

	S&P 500® Index					Russell 2000® Index					
	Q3 2014*	YTD 2014	1 Year	3 Year	5 Year	Q3 2014*	YTD 2014	1 Year	3 Year	5 Year	
Healthcare	5.45%	16.63%	28.41%	28.75%	19.66%	Consumer Staples	(3.26)%	(0.52)%	5.69%	20.93%	17.64%
Info Tech	4.77	14.29	28.64	21.82	15.83	Healthcare	(3.41)	1.20	9.76	26.09	17.14
Telecom	3.07	7.02	12.86	15.24	13.95	Financials	(5.20)	(2.27)	6.66	21.49	12.80
Financials	2.33	7.47	18.58	27.73	11.07	Info Tech	(5.60)	(3.36)	3.90	20.58	14.41
Consumer Staples	1.95	7.23	16.52	18.19	15.39	Telecom	(6.95)	(7.10)	(2.16)	14.29	8.71
Consumer Disc	0.27	0.87	11.78	26.19	21.42	Materials	(8.47)	(5.97)	4.32	18.56	13.07
Materials	0.22	8.87	20.47	21.98	13.19	Consumer Disc	(8.55)	(10.39)	(2.38)	22.66	15.58
Industrials	(1.09)	2.87	16.78	24.77	16.97	Industrials	(9.59)	(8.82)	1.34	23.05	14.71
Utilities	(3.96)	13.84	17.02	12.24	10.01	Utilities	(10.02)	3.26	9.94	12.40	13.27
Energy	(8.62)	3.28	11.91	16.88	12.46	Energy	(20.56)	(7.25)	(1.48)	12.63	8.87
Total Return	1.13	8.34	19.73	22.99	15.70	Total Return	(7.36)	(4.41)	3.93	21.26	14.29

Source: FactSet, data as of September 30, 2014. Performance for three year and five year time periods are annualized.

*Sorted by respective index: quarter returns.



the small cap stock realm, every sector posted negative returns in the third quarter. Small cap stocks are down mid-single digits year-to-date as seen in the table on the previous page. Many commodity prices have fallen fairly sharply in recent months thanks in part to the relative strength of the US dollar. For example, crude oil was down more than 10% in the quarter, and agricultural commodities were down by even greater percentages. Crude prices topped out and began to move lower at the beginning of the quarter. While the decline hurt the performance of energy stocks, lower gasoline prices, coupled with declining raw input costs, should bolster the outlook for consumer spending. So far this year, consumer discretionary stocks have been underperforming. However, they have been strong performers over both the three-year and five-year periods, and we expect a boost in consumer spending should support improved performance in future quarters.

WHAT DO WE EXPECT IN THE COMING YEAR?

The Fed's program of quantitative easing (QE) will likely come to an end this quarter. While some have recently suggested that this is a reason for less robust equity performance, we do not think this is a material factor. Although the timing remains uncertain, signals continue to point to the Fed moving to raise the funds rate next year.

Although the US expansion is poised to continue for the medium term, a serious shortfall in global growth, or a policy error by the Fed (which we do not anticipate) remain risks to the global and domestic equity outlook. We believe equity markets will not be negatively affected if the Fed can engineer a measured increase in US interest rates over the coming quarters. US inflation is well under control thanks in part to the recent weakness in commodity prices. Therefore price increases should not interfere with the Fed's rate plans. Indicators that would signal a need for more aggressive monetary policy—for example very high stock market valuation, excessive consumer or corporate leverage, and real estate speculation—are not present in the current landscape. We believe it is highly probable that interest rates will remain well within a band that allows businesses to function smoothly in the quarters ahead and what we expect to be a measured rate increase will not derail an economic recovery or hurt the equity market.

There are several important fundamental supports to this bull market beyond the current pace of mid-to-high single-digit earnings growth and low interest rates. The dividend yield on the S&P 500 has remained around the 2% level as dividend increases in aggregate have kept pace with higher equity prices. Dividends are on track to grow more than 10% this year compared to the level of 2013, and we expect double-digit dividend growth next year as well. More than 80% of the S&P 500 companies now pay cash dividends, the highest number in years. The dividend growth story should continue to build as the expansion continues.

Share repurchase activity has slowed somewhat compared with the torrid activity of the first quarter. However, when combining the cash yield on the S&P 500 with the impact of net share repurchases, the effective dividend yield of the S&P 500 continues to track around the 4.0% level. While some have suggested that share repurchases have been excessive, the return on equity of the S&P 500 is above 15% over the past several quarters. Such returns should provide companies ample flexibility to fund future growth, pay dividends and prudently repurchase shares.

Finally, there has been a surge in merger and acquisition (M&A) activity. According to Bloomberg, global announced M&A is up more than 60% so far this year compared with M&A activity in 2013, carrying a notional transaction value of \$3.3 trillion. Of course, not every proposed transaction will be completed, but the fact that so many CEOs are talking to other CEOs is a relatively new feature of this cycle and is indicative of greater confidence in the global business outlook.

Investors have recognized this favorable investment backdrop and valuations have moved up. The S&P 500 traded around 12x–14x forward earnings during much of 2010–2013. Currently, with the S&P 500 not far from record highs, large cap stocks are valued between 15.5x and 16.0x consensus estimates for 2015. Second-quarter earnings showed welcome acceleration compared with rather meek first-quarter trends. Earnings revision trends for the third quarter and full year have been constructive. Compared with the



first quarter, US macroeconomic data have clearly improved. And, perhaps most importantly, employment growth remains solid. We continue to expect mid-to-high single-digit operating earnings growth in the second half of 2014 and anticipate a similar earnings growth rate for next year in an environment of US GDP growth in the 2.5% to 3.0% range.

It is understandable that equity returns have been less robust recently, and global equities face additional challenges compared to the US. In line with our forecast, S&P 500 earnings have picked up recently, and if this trend continues, further equity price gains may very well be in store. While valuations are on the high side compared with the gains of recent years, they are reasonable and not out of line in our view, given low inflation and very low interest rates. Equity fundamentals remain firmly supported by double-digit dividend growth, prudent share repurchase activity and a recent pickup in M&A. Certainly it is possible for price-to-earnings multiples to expand from here as they did in the late 1990s, however we prefer a slower and steadier advance as opposed to a rapid and potentially unsustainable advance that comes with greater risk and a possible correction. As we weigh the pluses and the minuses, we come down firmly on the positive side of the ledger and hold the opinion that moderate stock price corrections should provide selective buying opportunities, just as they have during the better part of the past five years.

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INDEX DEFINITIONS

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 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 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 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.

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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.

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.

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MSCI World Index is an unmanaged index measuring global developed market equity performance.

MSCI Emerging Markets Index is a free float-adjusted market cap index measuring equity market performance of emerging markets.

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.

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