# equity market review & outlook

By Richard Skaggs, CFA, Senior Equity Strategist

third quarter 2013

## EQUITIES WORLDWIDE PERFORMED WELL IN THE THIRD QUARTER

Equities generally performed well across the board in the third quarter. The *S&P 500® Index*'s solid 5.24% return built on strong gains from earlier in the year. The *Index* has returned more than 19% through September, surpassing expectations at the start of the year. Slow but steady economic growth in the US, support from the Federal Reserve (the Fed), and more recently, signs of potentially better growth in Europe and Asia have been important positive catalysts. Equity performance during the summer was not especially volatile, a pleasant surprise to many investors. While the *S&P 500* posted a small decline in August, roughly offsetting the gains of July, September returns were strong despite speculation and controversy surrounding the Fed's "taper" talk. In the end, the decision to postpone tapering led to a brief bounce in equity markets, but those gains were quickly given back. Our view is that when the Fed eventually begins to taper its quantitative easing (QE) program, the near-term impact on equity markets will likely be limited.

Large cap stocks have generally performed well, but the bigger story for the quarter and year is renewed leadership from small and midcap equities. The small cap *Russell 2000® Index* earned nearly double the return of the *S&P 500*, posting a three-month gain of 10.21%. Looking at year-to-date and 12-month performance, small caps have handily outperformed large caps. While the *Russell 2000*'s close to 30% return year-to-date is not likely to be repeated in 2014, we like the small and midcap asset class for the long haul because many of the faster growing innovators reside in this part of the equity market.

Considering longer-term performance, each of the major US equity indices now sport a five-year annual return in the double digits. And soon, five-year returns will no longer reflect the severe stock market decline experienced during the fall of 2008.

Outside the US, quarterly equity performance was strong. The *MSCI All Country World Index* posted a return of more than 8.02% in dollar terms, and *MSCI Europe* earned a remarkable gain of 13.66%. While global equities have lagged the *S&P 500* year to date, they regained a lot of ground in the third quarter and now trail the *Index* only modestly for the year. Europe and Asia performed particularly well. Some may find it surprising that European equities have outperformed the *S&P 500* over the past year in dollar terms, with a gain of nearly 25%, but there are several reasons for the recovery. The euro has been firm versus the dollar.

**INDEX TOTAL RETURNS**

| | Third Quarter 2013 | YTD 2013 | 1 Year | Annualized 3 Years | Annualized 5 Years | Annualized 10 Years |
|---|---|---|---|---|---|---|
| **S&P 500®** | 5.24% | 19.79% | 19.34% | 16.27% | 10.02% | 7.57% |
| **Russell 1000®** | 6.02 | 20.76 | 20.91 | 16.64 | 10.53 | 7.98 |
| Growth | 8.11 | 20.87 | 19.27 | 16.94 | 12.07 | 7.82 |
| Value | 3.94 | 20.47 | 22.30 | 16.25 | 8.86 | 7.99 |
| **Russell Midcap®** | 7.70 | 24.34 | 27.91 | 17.53 | 12.97 | 10.78 |
| Growth | 9.34 | 25.42 | 27.54 | 17.65 | 13.92 | 10.16 |
| Value | 5.89 | 22.94 | 27.77 | 17.27 | 11.86 | 10.91 |
| **Russell 2000®** | 10.21 | 27.69 | 30.06 | 18.29 | 11.15 | 9.64 |
| Growth | 12.80 | 32.47 | 33.07 | 19.96 | 13.17 | 9.85 |
| Value | 7.59 | 23.07 | 27.04 | 16.57 | 9.13 | 9.29 |
| **MSCI All Country World** | 8.02 | 14.92 | 18.37 | 10.81 | 8.30 | 8.41 |
| **MSCI Europe** | 13.66 | 16.71 | 24.95 | 9.41 | 6.71 | 9.08 |
| **MSCI Pacific** | 8.04 | 16.58 | 23.47 | 8.50 | 7.50 | 7.37 |
| **MSCI Emerging Markets** | 5.90 | (4.05) | 1.33 | (0.003) | 7.56 | 13.16 |

*Source: FactSet, data as of September 30, 2013. All returns quoted in USD.*

Economic data across the continent has shown clear improvement in recent months, as many European countries may have pulled out of recession. And, absolute valuations of stocks throughout Europe were lower than in other parts of the world (particularly the US).

Taking a longer-term view, the relative underperformance of global equities versus US equities is immediately evident in the three- and five-year results. However, as global financial conditions stabilize and growth shows signs of improvement, there is increased potential for global developed equity markets to perform more consistently in the coming quarters. This may contrast with performance over the past few years, which favored the US as it emerged more quickly from the global financial crisis than other parts of the world.

Lastly, we observe that the *MSCI Emerging Markets Index* posted a single-digit gain in the third quarter, an improving result despite the fact that fundamental conditions within emerging market equities remain more challenging than within developed markets. Emerging market equities are still down for the year, and the three-year return is essentially zero. The emerging market asset class is more heavily weighted in commodity, energy and industrial companies, which have struggled in recent quarters for reasons including questions as to the growth rate of critical commodity end-users like China.

## ECONOMICALLY SENSITIVE SECTORS LED IN THE THIRD QUARTER

Sector returns within the *S&P 500* clearly favored economically sensitive sectors. Materials, industrials and consumer discretionary were the performance leaders (incidentally, the same sectors topped the *MSCI All Country World*). The quarter was characterized by better global economic news and somewhat higher interest rates, prompting investors to position for a potential pickup in the global economy during the second half of 2013 and into 2014. During the first half of the year, consumer staples and financials were among the *S&P 500*'s top sectors, suggesting some leading global industrial stocks may have become cheap on a relative basis. In our view, staples, utilities and telecommunications were held back in part by rising interest rates, as dividend yield is an important component of the total return case in these sectors, while financials consolidated early-year gains.

Small caps materially outperformed the large caps, with many sectors boasting double-digit quarterly returns. Reflecting excellent balance across the asset class, healthcare, technology, energy and industrials all showed strength. This outperformance of small caps versus large caps comes after years in which total returns have been nearly equal (five-year returns of the *S&P 500* and *Russell 2000* are 10.02% and 11.15%, respectively). If the current expansion remains on track, even with sluggish growth, we believe small caps may be positioned to outperform large caps more consistently.

**INDEX PERFORMANCE ATTRIBUTION**

| | S&P 500 Q3 2013* | S&P 500 YTD 2013 | Russell 2000 Q3 2013 | Russell 2000 YTD 2013 | MSCI All Country World Q3 2013 | MSCI All Country World YTD 2013 |
|---|---|---|---|---|---|---|
| **Materials** | 10.34% | 13.54% | 9.96% | 11.78% | 11.83% | (4.25)% |
| **Industrials** | 8.90 | 23.91 | 12.08 | 28.93 | 11.03 | 19.61 |
| **Consumer Discretionary** | 7.81 | 28.88 | 7.74 | 33.12 | 10.30 | 26.56 |
| **Health Care** | 6.82 | 28.42 | 15.02 | 38.98 | 6.65 | 25.30 |
| **Information Technology** | 6.58 | 13.48 | 14.16 | 34.22 | 8.71 | 14.00 |
| **Energy** | 5.15 | 15.42 | 13.25 | 22.71 | 7.93 | 8.06 |
| **Financials** | 2.87 | 23.10 | 5.25 | 19.36 | 7.59 | 14.70 |
| **Consumer Staples** | 0.81 | 16.09 | 12.83 | 37.32 | 3.26 | 13.02 |
| **Utilities** | 0.19 | 10.14 | 0.84 | 11.14 | 4.04 | 8.89 |
| **Telecommunications** | (4.39) | 5.70 | 10.69 | 21.79 | 7.82 | 15.45 |
| **Total Return** | 5.24 | 19.79 | 10.21 | 27.69 | 8.02 | 14.92 |

*Source: FactSet, data as of September 30, 2013.*

**Sorted by S&P 500 returns for the quarter.*

## EARNINGS GROWTH SHOULD BE MID SINGLE-DIGITS OR BETTER IN 2014

*S&P 500* operating earnings reached a record high in 2012, and the first half of 2013 has kept pace. We continue to estimate earnings growth in the mid single-digit range for this year and next. Earnings have more than doubled since the cyclical trough reached in 2008–2009. While margin expansion from recessionary lows has largely played out, the evidence tends to support our view that margins should remain healthy in an environment of moderate but steady GDP growth. Revenue growth, mired in the low single digits for the *S&P 500*, continues to be a challenge. It is important to recognize that while some commodity-sensitive sectors, such as energy, have recently experienced negative year-over-year revenue growth, other key sectors, such as healthcare, consumer discretionary and consumer staples, have posted a stronger top line. In aggregate, this low inflation/low revenue growth environment places a premium on management execution and organic revenue growth. Companies with mid single-digit revenue growth or higher will likely be among the fundamental outperformers. As the expansion matures, company-by-company stock valuations continue to diverge based on stock-specific growth prospects, underscoring the need for research-intensive stock selection to help ferret out potential winners and losers.

## THE TOTAL-RETURN CASE FOR EQUITIES

The US equity market has returned to price-to-earnings valuation levels comparable to the 50-year average in the 15x–17x range. The bottom-up analyst estimate for 2013 *S&P 500* earnings is currently around $108, as compiled by *S&P Dow Jones Indices*. This may edge slightly lower as managements report third-quarter earnings and provide updated outlooks in the weeks immediately ahead. While estimates may decline slightly, we do not foresee conditions that would lead to a material contraction in corporate earnings power, and we expect growth in the mid single-digits or better in 2014 and possibly 2015. We are currently facing macro-level concerns including Fed policy and tapering, ongoing US federal budget and debt ceiling political infighting, and more importantly, the strength and sustainability of improving business conditions in Europe and Asia. Japan is engaged in a major set of policy initiatives that have helped accelerate GDP growth in the near term; however, the staying power of this improvement remains debatable. Still, equity investors are used to considerable uncertainties. This environment is no different. Fortunately, US economic data has maintained a positive tone, supporting our constructive outlook for the year ahead. For example, assuming conditions remain on track, achieving a mid-teens multiple on estimated operating earnings of $112–$116 next year suggests stock prices could advance further in the quarters ahead. However, we acknowledge that very strong performance this year and during the past three years may contribute to a pause or a period of range-bound trading.

The *S&P 500* dividend yield is currently a little above 2.0%, and dividend growth may remain one of the strong fundamental factors supporting our constructive case for equities. Dividends rose by a mid-teens percentage in both 2011 and 2012 and are expected to grow at a double-digit rate again in 2013 and probably 2014. Corporate cash dividend payout ratios were well below 40% of operating earnings, meaning many companies continued to have the financial ability to boost payouts. The potential for dividend growth and moderately higher equity prices could provide equity investors with two different potential opportunities over time. Although equities are no longer trading at the highly discounted earnings multiples of recent years, we believe our case for equities remains sound in view of the fairly low interest rates offered by many fixed income securities. With inflation contained around 2.0% or less, equities can offer reasonable prospects for real return.

While the Fed has refrained from tapering QE for now, investors should prepare for an eventual return to a more normal interest rate environment with a federal funds rate above the zero lower bound. While it appeared economic data was accelerating in the first half of the year, figures cooled enough during the summer months to cause the Fed to maintain its current level of stimulus. However, Fed Chairman Ben Bernanke continues to stress that future decisions will be dependent on incoming economic reports.

Our working assessment is that interest rates will likely remain low and at levels that permit businesses to function smoothly. Therefore, if yields gradually normalize on the basis of improved economic growth with contained inflation, equity investors should be able to adjust to the changing environment and use periodic average corrections as opportunities to add to favored positions. With valuations at reasonable levels today, and the prospect of higher earnings and dividends ahead, the total-return case for equities remains appealing in our view.



## 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.*

***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 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.*



***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.*



***MSCI All Country World Index*** *is a market cap weighted index of stocks from developed and emerging markets providing a broad measure of global equity-market performance.*

***MSCI Europe Index*** *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe.*

***MSCI Pacific Index*** *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in the Pacific region.*

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

MALR011128

LOOMIS | SAYLES®

One Financial Center Boston, MA 02111 **www.loomissayles.com**