

Equity Market Review and Outlook

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KEY TAKEAWAYS

- US stocks were far and away the global leaders in Q4.
- The US economy is outperforming the rest of the world; US stocks should take rate increases in stride, but heightened volatility is possible.
- Risks and opportunities related to sharply lower oil will be a critical investment challenge in 2015. Still, S&P 500 earnings should grow this year.
- Domestic equity fundamentals remain supported by healthy dividend growth, prudent share repurchases and a pickup in M&A.

US stocks were far and away the global leaders in the fourth quarter. The S&P 500® Index capped 2014 with its eighth consecutive quarterly gain, returning nearly 5% in the quarter and about 13.5% for the year.

Relative to interest rates and inflation, US equity performance should be regarded as a welcome success, while acknowledging periodic fits of volatility. For US large caps, those fits have been relatively mild in recent years. Ten percent corrections tend to occur every year or two, and the S&P 500 has not posted such a decline for more than three years. On the other hand, many other equity asset classes experienced significant pullbacks in 2014. The Russell 2000® Index, for example, suffered a 13% decline starting in the third quarter and did not recover sharply until mid-October.

Large cap stocks demonstrated some defensive characteristics during volatile periods last year. We attribute this to healthy earnings-per-share growth, continuing buybacks, double-digit dividend growth and strong flows into the US dollar from regions facing slower growth and greater fundamental uncertainty. For investors eager to invest in reasonably priced equities with high single-digit earnings growth denominated in a firm currency, it is not hard to see why US equity assets, particularly liquid S&P 500 companies, continue to gain favor. The S&P 500 reached record highs on more than 50 trading days in 2014, yet even with the seventh year of recovery upon us, the bull market shows relatively few signs of age.

US economic data continue to outperform data from the rest of the world, and the Federal Reserve (the Fed) remains on a path to raise the federal funds target rate in 2015 for the first time since 2004. With other central banks moving toward further stimulus, the US dollar may continue to outperform many global currencies in the near term. This currency advantage, on top of the arguably superior relative fundamental prospects for large US companies, has supported US equity performance in 2014 and is likely to continue as the new year begins.

Volatility may tick up in 2015 as the Fed moves to gradually reduce financial accommodation. A 10% or greater correction would certainly not be a surprise. However, we trust that policy action will reflect economic fundamentals, and with global growth and inflation subdued, the Fed's response is likely to be measured.



**US LARGE CAPS WERE BROADLY HIGHER IN Q4, WHILE GLOBAL EQUITIES STRUGGLED
LONGER-TERM PERFORMANCE ALSO FAVORS US EQUITIES**

As of 12/31/2014

INDEX TOTAL RETURNS (%)					
	Q4 2014	1 YEAR	3 YEAR	5 YEAR	10 YEAR
S&P 500®	4.93	13.69	20.41	15.45	7.67
RUSSELL 1000®	4.88	13.24	20.62	15.64	7.96
GROWTH	4.78	13.05	20.26	15.81	8.49
VALUE	4.98	13.45	20.89	15.42	7.30
RUSSELL MIDCAP®	5.94	13.22	21.40	17.19	9.56
GROWTH	5.84	11.90	20.71	16.94	9.43
VALUE	6.05	14.75	21.98	17.43	9.43
RUSSELL 2000®	9.73	4.89	19.21	15.55	7.77
GROWTH	10.06	5.60	20.14	16.80	8.54
VALUE	9.40	4.22	18.29	14.26	6.89
MSCI ALL COUNTRY WORLD	0.52	4.71	14.72	9.74	6.65
MSCI EMERGING MARKETS	(4.44)	(1.82)	4.41	2.11	8.78
MSCI EUROPE	(4.30)	(5.68)	12.52	5.91	5.20
MSCI PACIFIC	(2.06)	(2.47)	9.80	5.83	4.41

Source: FactSet. All returns quoted in USD. Performance for 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.**

Global Indices Could Not Keep Up With the US

US midcaps also performed fairly well throughout the year, posting a 13.2% return that kept close company with the S&P 500's 2014 gain. Small caps struggled after getting off to a fast start and had a fairly steep correction from the first-quarter peak until the October low. However, as has frequently been the case in recent years, small caps outperformed in the fourth quarter with a gain of nearly 10%, returning almost 5% for the year. We note that three-year returns for US small, mid and large cap indices are bunched tightly around the 20% level. These broad-based gains across the market cap spectrum signal a relatively healthy marketplace not overly dependent on a narrow set of sectors or investment themes.

Though the US economy continued to improve following a dismal first quarter, the same cannot be said for most other global economies—or their equity markets. The challenges are evident in the MSCI All Country World Index (which is nearly 52% weighted in US stocks). Given strong US performance, the overall annual return of 4.7% is a disappointment, reflecting lower-than-expected economic growth outside the US, pressure on certain commodity-sensitive equity markets and, perhaps most importantly, the double-digit appreciation of the US dollar versus most major currencies. While Japan equities were higher in yen terms in 2014 and some European markets eked out small gains in euro terms, the strong dollar was a considerable headwind to unhedged global investment returns.



Most Sectors Posted Strong Annual Gains; Energy- and Commodity-Sensitive Stocks Were Exceptions

Within the US market, healthcare, technology, consumer staples and financials all performed well in 2014, consistent with the broadening economic recovery and rising employment. As interest rates moved lower in 2014, utility stocks took top performance honors with a powerful gain of nearly 30%. At just 3% of the S&P 500, utilities did not drive index performance; however, seeing the sector atop the performance list in both the S&P 500 and the Russell 2000 is a stark reminder of just how surprising sharply lower global interest rates were in 2014.

Of course lower oil prices dominated the second half of the year, particularly the fourth quarter. Cheaper oil is certainly a big win for consumers in developed markets worldwide, although oil producers and exporters will face a transition. With oil prices plunging roughly 50% over the past six months, energy companies have begun to cut capital spending, and stock prices have been hit. Large cap energy stocks in the S&P 500 were down only about 10% in the fourth quarter (and less than that for the full year), but smaller capitalization energy stocks, which tend to be more speculative and carry greater financial leverage, were down over 30% in the quarter and about 36% for the year.

Though energy has been a very poor performer recently, it represents only 8.4% of the S&P 500 Index and barely 3% of the Russell 2000. Within a diversified portfolio, the decline in energy stocks has not materially weighed on performance. However, the full implication of this dramatic shift the energy markets has yet to be seen. Earnings estimates for energy companies have been slashed across the board. The sector is sure to be a drag on overall S&P 500 earnings per share in 2015 and possibly beyond. Some industrial companies will

**S&P 500 & RUSSELL 2000 LEADERSHIP WAS BROAD BASED
CYCLICALS UNDERPERFORMED, LED BY A VERY WEAK ENERGY SECTOR**
As of 12/31/2014

SECTOR PERFORMANCE ATTRIBUTION (%)											
S&P 500® INDEX						RUSSELL 2000® INDEX					
	YR-END WEIGHT	Q4 2014	1 YEAR	3 YEAR	5 YEAR		YR-END WEIGHT	Q4 2014	1 YEAR	3 YEAR	5 YEAR
UTILITIES	3.2	13.19	28.86	13.95	13.35	UTILITIES	4.6	16.60	20.40	14.44	15.27
HEALTHCARE	14.2	7.48	25.35	27.86	19.30	HEALTHCARE	14.8	17.61	19.01	28.28	20.36
INFO TECH	19.7	5.25	20.29	20.77	14.77	CONSUMER STAPLES	3.0	12.85	12.26	22.36	18.76
CONSUMER STAPLES	9.8	8.15	15.98	17.50	16.07	FINANCIALS	25.4	11.43	8.93	20.06	14.86
FINANCIALS	16.7	7.23	15.24	26.42	13.40	INFO TECH	14.9	11.88	8.09	19.74	16.30
INDUSTRIALS	10.4	6.79	9.85	21.31	17.36	CONSUMER DISC	14.4	13.87	2.04	22.36	17.68
CONSUMER DISC	12.1	8.74	9.69	24.81	21.33	INDUSTRIALS	13.4	9.24	(0.40)	19.18	15.80
MATERIALS	3.2	(1.80)	6.91	15.65	11.22	MATERIALS	6.5	2.08	(3.98)	13.75	11.31
TELECOM	2.3	(4.16)	2.57	10.82	11.42	ENERGY	3.2	(31.02)	(36.05)	(7.03)	(0.28)
ENERGY	8.4	(10.68)	(7.75)	6.48	8.76	TOTAL RETURN	–	9.73	4.89	19.21	15.55
TOTAL RETURN	–	4.93	13.69	20.41	15.45						

Source: FactSet. Performance for 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. Sorted by respective index annual returns. Due to rounding, sector totals may not equal 100%.



likely also feel the pinch as global energy producers scale back capital spending. While most companies benefit to some degree from lower energy prices, it is unclear to what extent stronger earnings outside of the energy sector will offset energy-sector weakness. Risks and opportunities resulting from this dramatic shift in the commodity-price landscape will be among the most critical investment challenges in 2015.

What Do We Expect in the Coming Year?

The US expansion has picked up steam in recent months, with GDP growth and employment continuing to surprise on the upside. Lower commodity prices should keep a lid on inflation expectations, and global interest rates remain low. For investors inclined to allocate to equities, there do not appear to be many alternatives with the potential to generate 5% to 10% annual returns over the medium term. Risks include policy errors and a reversal of stronger trends in the US. While Japan and Europe continue with aggressive monetary stimulus, neither economic data nor the relative performance of their equity markets indicates an imminent acceleration in growth.

THE IMPACT OF ENERGY STOCKS

Analyst estimates of S&P 500 energy sector earnings are already suggesting a 20% decline from 2014 levels. But we note that energy sector earnings have not been a major driver of S&P 500 earnings growth in recent years. We expect healthcare, technology and consumer sectors to continue to drive the bulk of 2015 earnings growth.

Capital spending had been improving, and while this is expected to continue, the energy sector generates about one third of all capital expenditures by S&P 500 companies. Utilities and consumer discretionary each provide another 11% or so. Reduced energy capital expenditure will certainly have an impact, but it is unlikely to provide a major headwind for the US economy broadly. Energy stocks will remain under intense scrutiny over the next couple of quarters as we see how managements respond. Analyst estimates of S&P 500 energy sector earnings are already suggesting a 20% decline from 2014 levels. As part of our valuation process, we have been using a mid to high single-digit growth rate in S&P 500 earnings. We are not backing away from this rate for 2015 at this time. Note also that energy sector earnings have not been a major driver of S&P 500 earnings growth in recent years. We expect healthcare, technology and consumer sectors to continue to drive the bulk of 2015 earnings growth.

There are several important fundamental supports to this bull market beyond the current mid-to-high single-digit earnings growth rate 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 perhaps 10% in 2015, even with lower dividend growth from the energy sector. About 85% of S&P 500 companies now pay cash dividends, the highest percentage in many years. Share repurchase activity continues to be very active. Among the 35 largest market cap companies in the S&P 500, about 80% of firms have reduced their fully diluted shares outstanding by at least 4% since 2007. A few companies have reduced shares outstanding by more than 15%.

Growth in shareholder activism and merger and acquisition (M&A) activity continues. According to Bloomberg, globally announced M&A rose more than 60% in 2014 compared to 2013, carrying a notional transaction value of \$4.3 trillion. Activity is balanced across regions and sectors. As the business cycle progresses and CEO confidence continues to grow, we expect heightened activity in the year ahead. The energy sector is likely to be another sector of high activity once CEOs are confident that energy prices have found a footing. We anticipate a greater focus on strategic transactions. Deals such as tax inversions will be far fewer due to regulatory changes enacted in the second half of last year.



Investors have recognized this favorable investment backdrop, and valuations have moved up. The S&P 500 traded in a range of 12x to 14x forward earnings during most of 2010 through 2013. Currently, with the S&P 500 not far from record highs, large cap stocks are valued between 16.0x and 16.5x consensus earnings forecasts for 2015. Earnings showed a welcome acceleration in the second half of 2014, and revenue growth has picked up as well. Margins have held up nicely, and except for the energy sector, we believe this will be the case in 2015 as well.

While valuations are on the high side compared with recent years, they are reasonable versus history and not out of line given our constructive view on inflation and the comparative lack of competition from the bond market. Certainly it is possible for price-to-earnings multiples to expand from here to perhaps the 18x to 20x range as they did in the late 1990s. However, that is not our base case forecast. We prefer a steadier ascent to a rapid, potentially unsustainable advance that comes with heightened valuation risk and potential for disappointment. We recognize that higher volatility may stem from uneven global economic fundamentals and commodity price deflation. Still, moderate stock price corrections should provide selective buying opportunities, much as they have for the better part of the past six years.

Past performance is no guarantee of future results.

Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.

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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.

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.

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

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