



# equity market review & outlook

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fourth quarter  
2011

## A STRONG FOURTH QUARTER CAPPED OFF A VOLATILE YEAR

The *S&P 500* gained almost 12% in the fourth quarter, marking a strong recovery from its near 14% decline in the treacherous third quarter. Thanks to good performance in the first half of 2011 and a strong closing quarter, the *S&P 500* generated a positive 2.11% return for the year. US large cap stocks, as represented by the *S&P 500*, disappointed relative to expectations at the beginning of the year; however, given the powerful undertow of global macroeconomic events emanating from the euro zone, we think performance was respectable.

	INDEX TOTAL RETURNS				
	Fourth Quarter 2011	2011	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
<b>S&amp;P 500</b>	11.82%	2.11%	14.11%	(0.25)%	2.92%
<b>Russell 1000</b>	11.84	1.50	14.81	(0.02)	3.34
Growth	10.61	2.64	18.02	2.50	2.60
Value	13.11	0.39	11.55	(2.64)	3.89
<b>Russell MidCap</b>	12.31	(1.55)	20.17	1.41	6.99
Growth	11.24	(1.65)	22.06	2.44	5.29
Value	13.37	(1.38)	18.19	0.04	7.67
<b>Russell 2000</b>	15.47	(4.18)	15.63	0.15	5.62
Growth	14.99	(2.91)	19.00	2.09	4.48
Value	15.97	(5.50)	12.36	(1.87)	6.40
<b>MSCI All Country World</b>	7.30	(6.86)	12.60	(1.41)	4.76
<b>MSCI World</b>	7.72	(5.02)	11.75	(1.82)	4.15
<b>MSCI Emerging Markets</b>	4.45	(18.17)	20.42	2.70	14.20

*Source: FactSet as of 12/31/11.*

The United States was the best-performing major market in the world in 2011. Corporate earnings growth continued, and the US remained a step removed from the sovereign credit issues that tended to dominate trading in other parts of the world. Also, domestic economic data showed improving trends throughout the late summer and autumn, with GDP growth posting consecutive improvements in the second and third quarters. US employment data have reflected slow but steady progress in recent months, while many other nations have seen some slowing in economic fundamentals.

Though US large caps were up modestly for the year, gains did not extend to small and mid cap stocks. The large cap *Russell 1000 Indices* (which are capitalization weighted in a fashion similar to the *S&P 500*, where performance is driven by the largest companies in the index) showed modest gains; however, the *Russell MidCap Index* was down 1.55% for the year, and the small cap *Russell 2000 Index* was down 4.18%. Still, considering that a harrowing third-quarter decline left the *Russell 2000 Index* off 17.02% year to date through September 30, a final loss of only 4.18% reflects the substantial rebound in stock prices during the fourth quarter. By comparison, these declines were fairly small in the context of overall global equity market performance, as the capitalization-weighted *MSCI All Country World Index*, which includes returns from developed and emerging markets, ended the year down 6.86%.

Taking a longer-term view of US equities, the three-year annualized returns of 14.11% per year for the *S&P 500* and 15.63% per year for the *Russell 2000* highlight the rally in stocks since the trough of late 2008 through early 2009. In fact, on a total-return basis, the *Russell 2000 Index* reached a record high as recently as April 2011, and the *Russell MidCap Index* reached a record high this past July. While the *S&P 500* has yet to match its 2007 total-return record high, assuming the US recovery continues, the prospect of attaining such a level within the next year or two seems possible.

A still longer-term analysis of the *S&P 500* reveals unimpressive five-year returns, but the ten-year returns are somewhat better than often heard “lost decade” comments imply. Specifically, large cap stocks, as represented by the *S&P 500*, have returned 2.92% per year annually over the past ten years, a period that included two recessions. The returns for small and mid cap stocks are roughly double those of large caps.



Globally, the *MSCI World Index* posts ten-year returns of 4.15%. While emerging markets certainly fared poorly in 2011 with a loss of 18.17%, the ten-year compound return of 14.20% is a reminder of the potential returns faster-growing developing markets can offer equity investors over long periods of time.

## SECTOR ATTRIBUTION REVIEW

Though 2011 was difficult overall, it may be surprising to note that only two *S&P 500* sectors, financials and materials, had significant negative returns for the year. The financial sector finished 2011 down 17.06% despite a double-digit gain in the fourth quarter, underscoring just how difficult the year was for financials. Financial stock underperformance was a global phenomenon to be sure. Because the global financial sector is so critical to the functioning of worldwide commerce, a weak financial sector tends to weigh heavily on global investor sentiment. This was certainly the case in 2011. The materials sector was hurt by weaker commodity prices in the second half of the year, accentuated by concerns over slowing emerging market fundamentals, including signs of moderating growth in China.

The results for most other US equity sectors were fairly bright, with utilities, consumer staples and healthcare generating healthy double-digit returns during the year. Utilities benefited from strong outperformance among stocks that offered healthy dividend yields. Falling US interest rates continued to fuel the hunt for current yield (annual income divided by the current price of the security). Staples and healthcare companies benefited from their generally above-average dividend yields, exceptionally strong balance sheets and less cyclical business models. While economically sensitive sectors were performance leaders from the beginning of the year until roughly April, they were unseated during the height of global financial tensions in the summer and early fall when defensive sectors gained favor. This period of risk aversion gave defensive sectors a big lead in terms of relative performance for the full year.

Sector returns had a similar flavor among the small caps, although underperformance from financials was less of an issue. Within the *Russell 2000 Index*, utilities posted strong performance, with staples and healthcare also generating positive returns. Small cap energy and materials companies were notable underperformers, as these companies tend to have weaker balance sheets relative to their *S&P 500* counterparts.

Globally, materials and financials were each down about 20%, and industrials were down nearly 10%. The Index's negative 7% return for the full year partially masks the fact that many individual country constituents were down 15% or more for the year.

### INDEX PERFORMANCE ATTRIBUTION

	S&P 500 4Q	S&P 500 2011	Russell 2000 4Q	Russell 2000 2011	MSCI All Country World 4Q	MSCI All Country World 2011
Utilities	8.28%	19.93%	10.60%	16.64%	2.38%	(3.74)%
Consumer Staples	10.19	13.92	9.25	7.81	8.02	8.42
Healthcare	9.97	12.73	11.90	2.09	7.89	9.56
Financials	10.82	(17.06)	15.56	(4.16)	4.27	(18.99)
Industrials	16.37	(0.84)	20.53	(5.53)	9.85	(9.83)
Consumer Discretionary	12.58	6.11	14.72	(6.79)	6.63	(4.91)
Information Technology	8.71	2.41	14.49	(7.07)	6.96	(4.12)
Telecommunications	7.91	6.27	8.49	(7.60)	3.88	0.62
Energy	18.18	4.71	22.69	(8.11)	14.98	(2.52)
Materials	15.38	(9.75)	15.44	(12.86)	4.83	(21.18)
Total Return	11.82	2.11	15.47	(4.18)	7.30	(6.86)

Source: FactSet as of 12/31/11.



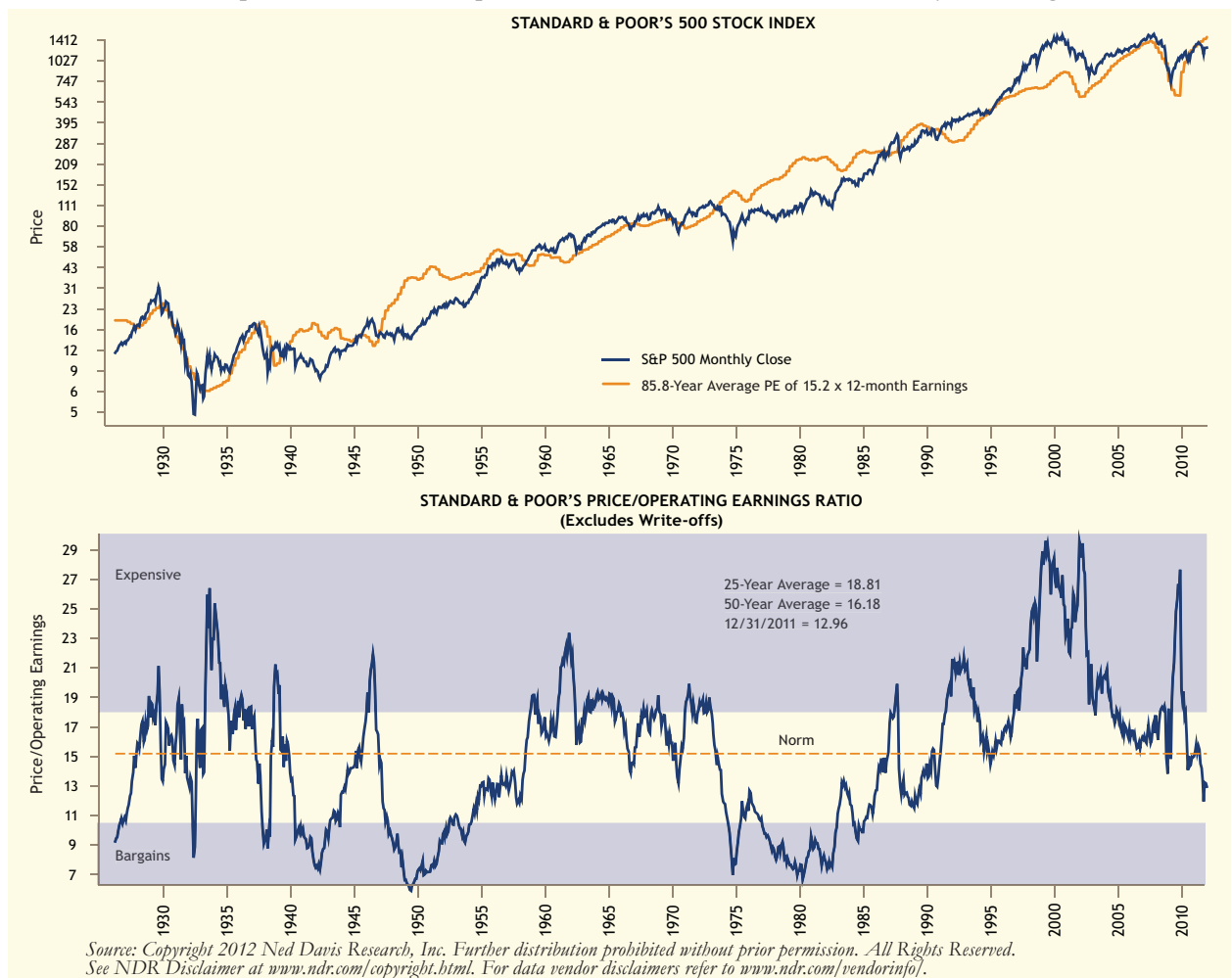
## EARNINGS GROWTH HAS REMAINED STRONG

S&P 500 corporations reported strong profits through the end of the third quarter. While fourth-quarter earnings reports have not begun to flow, there have been slightly more negative preannouncements than in prior quarters. Still, earnings are likely to grow close to 10% year over year in the fourth quarter, and earnings for the full year are likely to be up more than 15% compared to 2010 levels. Profit growth is expected to slow as the economic cycle matures. While 2012 full year earnings estimates for the S&P 500 are a few dollars lower today than they were some months ago, earnings of \$106-\$108, (a gain of around 10%), are firmly within our base case thinking.

We do not expect a US recession in 2012, although the euro zone seems likely to experience a pause. *Standard & Poor's Corporation* estimates that S&P 500 companies source about 12%-15% of revenues from Europe, so a recession would contribute to revenue and profit deceleration. However, half of S&P 500 companies do not report any revenues sourced from Europe, meaning a euro zone recession could have little to no impact for many US-based companies. But, of all the factors that could render our 2012 outlook too optimistic, negative developments in Europe seem most likely to potentially alter the outcome for the worse.

## US STOCKS ARE EXPECTED TO RISE IN 2012

Stock market valuation indicators suggest equities are attractively valued relative to history and stocks appear especially attractively valued relative to interest rates. However, the equity risk premium has continued to edge higher. That is, even as Treasury rates have moved lower, investors are expecting continued uncertainty causing equity prices to lag earnings, depressing price/earnings (P/E) multiples. This year, for example, the 15% earnings per share (EPS) growth for the S&P 500 Index was met with only a 2% return and, as a result, further compressed its P/E multiple. As shown in the chart below, the 85-year average P/E ratio





on trailing operating earnings has been 15.2X. Based on operating earnings of \$97 expected for all of 2011 and the closing price of 1257 for the *S&P 500*, the P/E at the year-end was a mere 13.0X. This is the lowest valuation seen in many years. Back in the 1970s and early 1980s when the P/E of the market was comparable or lower, US interest rates were much higher, in the double digits in fact, providing much greater competition for investor dollars than interest rates provide today. We believe that stocks continue to present an attractive long-term investment opportunity at current levels. Even without multiple expansion, if a P/E of 13.0X can be achieved on our expected earnings range of \$106-\$108 for 2012, a price target range of 1375-1425, plus dividends, may be attainable.

In conclusion, we recognize that fundamental conditions in the euro zone and the aging US economic recovery make the 2012 earnings outlook somewhat less clear and less robust than it was in 2011. While equity valuation appears supportive and US economic data is moderately improving, unexpected events can upset the balance making for greater than desired volatility, as seen in 2011. We believe equity performance for 2012 will hinge as much on macroeconomic developments as on company-specific business execution. A trading range both above and below current levels should be expected for 2012. We should have seen better equity performance than was achieved in 2011 given the performance of individual companies, but macroeconomic events got in the way. As shown in the chart on the previous page, P/E multiples have mostly trended lower for over ten years now, and we firmly believe we are closer to the end of the multiple-contraction trend than we are to the beginning.

*Russell 1000 Index: measures the performance of the large cap segment of the US equity universe and includes approximately 1,000 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 and includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. Russell 1000 & 2000 Value Indexes are unmanaged market cap-weighted indexes of those stocks of the 1,000 & 2,000, respectively, largest US domiciled companies that exhibit value-oriented characteristics. Russell 1000 & 2000 Growth Indexes: unmanaged market cap-weighted indexes of those stocks of the 1,000 & 2,000, respectively, largest US domiciled companies that exhibit growth-oriented characteristics. Russell Midcap Index: measures the performance of the mid-cap segment of the US equity universe and is a subset of the Russell 1000 Index that includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. Russell Midcap Growth & Midcap Value Indexes: measures the performance of the mid-cap growth and value segments of the US equity universe, respectively. Standard & Poor's 500 Index (S&P 500): an unmanaged market cap-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent US equity performance. MSCI World Index: unmanaged index measuring global developed market equity performance. MSCI Emerging Markets Index: free float-adjusted market cap index measuring equity market performance of emerging markets. MSCI All Country World: market cap weighted index of stocks from developed and emerging markets providing a broad measure of global equity-market performance.*

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

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**Past performance is no guarantee of future results.**

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