Equity Market Review and Outlook

By Richard Skaggs, CFA, VP, Senior Equity Strategist

KEY TAKEAWAYS

- Equities are under pressure, with the US moving into correction territory for the first time since 2011.
- Global equities underperformed the S&P 500, with emerging markets the biggest underperformers.
- Economic data in the US remain healthy; this has favored domestically-oriented companies over global and commodity-based companies.
- We believe there are opportunities for the long-term investor.

We knew it was bound to happen sometime soon—a global sell-off in equities like the one that began this past August would eventually take hold of the market. It was just a matter of when.

After all, the US stock market had been on a bull-market run since lifting itself from its 2009 nadir to a six-year high in March 2015. Other developed markets–Europe and Japan–had also racked up healthy gains, though to a lesser degree than the US.

As early as this past February, we had our doubts about the market continuing to surge upward this year without a hitch. While we firmly believed the long-term bull market remained intact, we felt it would not be surprising to see higher volatility and potentially a 10% or greater pullback sometime in 2015. In our view, geopolitical concerns, unstable energy and commodity prices, rapidly fluctuating currencies and evolving global economic fundamentals promised potentially more volatile, although likely still rewarding, equity markets as the year unfolded.

What we didn't know back in February was that a modest 3% fall in the value of the Chinese renminbi would be the catalyst causing a host of investors to question the basic premises of China's spectacular GDP growth and triggering a dramatic drop in stock prices around the globe. By quarter end, however, markets had recovered some, with the S&P 500® posting a fairly moderate decline of about 6.5%, and outperforming most global equity markets. Asian stock markets, including Japan, were down in the low double digits to 20% range, while emerging markets, led on the downside by China and Brazil, were also off materially. The sell-off resulted in most major markets turning negative for the year, with Japan close to the flat line, the S&P 500 down mid single digits and emerging markets down in the mid teens.

Despite the stock market correction this past quarter, we remain positive about the months ahead. Improving regional growth prospects, lower commodity prices capping global inflation expectations and continuing low long-term interest rates are some of the positive factors we see on the horizon. And challenging as bouts of volatility may be for investors, they can also provide opportune times to buy stocks that were previously seen as overpriced. We also expect many companies' quarterly earnings will surprise on the upside.

Developed Market Recoveries Continue, As Earnings Outside the Energy Sector Remain Healthy

Prior to the market's disappointing third quarter performance, the US economy appeared to be continuing on its path of steady but slow recovery. It still is. US economic data improved in the second quarter, lending fundamental support to equities. GDP grew solidly after a sluggish first quarter, employment trends remained strong and there were early signs of improvement in wages. Europe's recovery has shown improvement as well, as concerns tied to Greece earlier this year did not lead to a slowdown in economic activity.

On the other hand, the decline in oil prices to around the $40 level this summer was much greater than expected as recently as six months ago. Many companies are being forced to manage in this new, lower commodity price regime, creating stress and challenging stock prices. However, for consumers worldwide, as well as most businesses, lower energy and commodity prices are a positive.

Not surprisingly, energy sector earnings are down about 60% versus a year ago among the large caps, while small- and mid-cap energy companies are reporting even greater declines. The dramatic decline in energy sector earnings, together with unfavorable currency translation for multinationals, has flattened S&P 500 aggregate earnings. However, excluding energy, S&P 500 earnings growth continued to be healthy, with the median company posting mid single digit, year-over-year operating earnings growth in the second quarter. We expect a similar growth rate for the median company in the second half of 2015.

Energy and commodity earnings will likely remain a drag in 2016, not just in the US but worldwide. That said, if commodity prices can mount a partial rebound, the worst of the energy- and commodity-related markdown should be realized this year, providing a lower base on which to build in the next couple of years.

On the positive side of the ledger, US healthcare and consumer sector earnings growth has continued to be healthy. We see consumer-oriented sectors, including healthcare, as attractive for the medium term as many companies have relatively limited exposure to the challenged emerging markets and profit margins are expected to remain strong. Technology and financial companies have constructive outlooks, and financials, in particular, may benefit should the Fed raise rates in the next few months. While the quarter ended on a sour note for stocks across sectors, we highlight that the healthcare sector, in particular, witnessed significant profit taking. We believe that healthcare sector weakness will prove to be transitory although a pause in healthcare leadership is not surprising.

While The Global Bull Has Faltered, We Remain Constructive

We see relatively few alternatives to equities for investors seeking potential returns in the mid to high single-digit range over a full market cycle. Moreover, we believe the opportunity for fundamental stock pickers is on the rise as we are seeing a much wider differentiation in company by company fundamental performance than was the case at times earlier in this cycle.

Healthy dividend payments remain another plus for investors. The S&P 500's dividend yield has held around 2% for many years, as dividend increases have generally kept pace with higher equity prices. The recent decline has caused the S&P 500 yield to rise to 2.3%, an increase that might not seem like a lot, but it's higher than seen during most recent periods.

S&P 500 dividends are on pace to grow 8% to 10% in 2015, even when building in lower dividend growth from the energy sector. In Europe, dividend yields are tracking above 3.5%, a very healthy level relative to inflation and interest rates.

Two more positives for stocks are growing shareholder activism and continued M&A activity. According to Bloomberg, global announced M&A in the first half of 2015 is running at a rate of nearly 20% above levels of 2014. Activity remains balanced over regions and sectors.

For Emerging Markets, Still an Uphill Battle

We are not as positive on the case for emerging market equities compared to developed markets. The commodity cycle remains challenged. And emerging market equity indices are, for the most part, dominated by energy, materials and industrial companies and bank stocks. While we recognize that many EM equities have fallen sharply in price, currency risk to a dollar- or euro-based investor remains real.

With many EM currencies continuing under strain relative to DM, currency translation has been a negative factor that will likely persist unless we see a broader acceleration in EM economies (which is not our base case expectation). While some currencies and EM equities may have been punished excessively in recent months, and opportunities may be selectively available, we see EM equities, in general, as a challenging asset class until economic growth in key countries begins to improve.

Valuations Appear More Attractive, Although Risks Remain

As we've mentioned, equity valuations have pulled back in this correction, providing opportunity in our view, especially relative to interest rates and inflation. For example, the S&P 500 is now valued at about 15.0x estimated 2016 operating earnings. Of course, earnings have to materialize in the quarters ahead to justify this valuation, but we believe earnings in the mid single digits are a reasonable expectation for next year. Recession risk appears limited, although we will continue to monitor China and other emerging markets closely. Profit margins are edging higher in both Europe and Japan, actually outperforming margin trends in the US. We do not expect significant margin expansion from here, although margins in the US should hold around current high levels (save weakness in energy).

We believe there are currently potential opportunities for the long-term investor. We have not experienced a decline in the S&P 500 of over 10% since the fourth quarter of 2011, so investors are understandably unnerved by the recent bout of volatility, especially following a long period of fairly low volatility. We recognize there are factors which could cause this recent correction to become a more significant decline. However, we do not see a US recession in the medium term, and there are very few cases of equity market declines of, say, 20% or greater developing without an accompanying recession.

Third Quarter Review

GLOBAL EQUITY MARKETS
as of September 30, 2015

INDEX TOTAL RETURNS (%)

INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
S&P 500®	-6.44	-5.29	-0.61	12.40	13.34	6.80
MSCI ALL COUNTRY WORLD	-9.34	-6.65	-6.16	7.52	7.39	5.14
MSCI EUROPE	-8.66	-4.75	-8.85	6.60	4.89	3.91
MSCI JAPAN	-11.70	0.48	-1.93	9.23	5.14	1.31
MSCI EMERGING MARKETS	-17.78	-15.22	-18.98	-4.93	-3.25	4.60

While the S&P 500 posted a moderate pullback, intra-quarter volatility was above the average of recent periods. The S&P is now about flat for the past year as third quarter performance reversed earlier gains. Global equities were under greater pressure with emerging market indices pulling back more significantly. Significant weakness in key commodity markets, coupled with declining currency values versus the dollar were drivers of negative performance. On a twelve-month basis, global equities have underperformed the US, although Japan's loss is quite modest. The three- and five-year returns remain solid for all except emerging markets. The US firmly retains performance leadership over longer-term time frames. We do not see the fundamental factors driving the negative commodity cycle ending soon. And the question of business conditions in China, the largest component of emerging markets, remains front and center.

US EQUITY MARKETS
as of September 30, 2015

INDEX TOTAL RETURNS (%)

INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
RUSSELL 1000®	-6.83	-5.24	-0.61	12.66	13.42	6.95
GROWTH	-5.29	-1.54	3.17	13.61	14.47	8.09
VALUE	-8.39	-8.96	-4.42	11.59	12.29	5.71
RUSSELL MIDCAP®	-8.01	-5.84	-0.25	13.91	13.40	7.87
GROWTH	-7.99	-4.15	1.45	13.98	13.58	8.09
VALUE	-8.04	-7.66	-2.07	13.69	13.15	7.42
RUSSELL 2000®	-11.92	-7.73	1.25	11.02	11.73	6.55
GROWTH	-13.06	-5.47	4.04	12.85	13.26	7.67
VALUE	-10.73	-10.06	-1.60	9.18	10.17	5.35

Concerns over slower global growth, coupled with a general environment of de-risking led to notable underperformance of small caps versus their mid and large counterparts. However, for the year-to-date period, underperformance was modest; over the past year, small caps are up a bit. Longer-term performance measures of small versus large caps are fairly close. In our view, the underperformance of small caps in the recent quarter may provide an opportunity, as we move into what has in the past been a seasonally stronger time of year for small cap performance.

Among large caps, growth outperformed value somewhat, and the performance advantage of growth for the year-to-date and twelve-month periods remains sizeable. This is attributed to relative sector performance based on index composition. In the mid-cap space, growth and value performed about evenly, while in the small-cap sector growth underperformed value for the quarter but is ahead for the year.

Growth's leadership within the large-cap space is directly attributable to relative sector weights, as typical growth sectors continue to do well. Healthcare, especially biotechnology, and the information technology sector have been outperforming. Commodity-sensitive sectors, such as energy and materials, continue to languish under the cloud of lower oil prices and concerns over worldwide commodity demand. Among small caps, however, late quarter declines in healthcare shares, particularly biotechnology, weighed on the growth index within the small-cap space.

Data Source: FactSet. All returns quoted in US dollars. Performance for one and multi-year periods is annualized. ***Past performance is no guarantee of future results.***

S&P 500 SECTORS
as of September 30, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)					
INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR
UTILITIES	5.37	-5.87	6.55	10.15	11.04
CONSUMER STAPLES	-0.20	-0.97	7.10	12.52	14.17
CONSUMER DISCRETIONARY	-2.54	4.10	13.20	18.57	19.28
INFORMATION TECHNOLOGY	-3.68	-2.95	2.14	11.91	13.95
FINANCIALS	-6.75	-7.09	-0.37	15.54	11.64
TELECOMMUNICATIONS	-6.85	-3.91	-7.91	1.05	8.26
INDUSTRIALS	-6.90	-9.75	-3.63	13.12	12.26
HEALTHCARE	-10.67	-2.13	5.19	20.23	18.99
MATERIALS	-16.90	-16.48	-17.98	4.84	6.72
ENERGY	-17.41	-21.28	-29.68	-5.02	1.20
TOTAL RETURN	-6.44	-5.29	-0.61	12.40	13.34

RUSSELL 2000 SECTORS
as of September 30, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)					
INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR
UTILITIES	-0.30	-6.29	9.27	9.37	11.69
CONSUMER STAPLES	-4.68	-5.75	6.37	15.25	15.35
FINANCIALS	-5.28	-3.39	7.67	12.03	12.50
TELECOMMUNICATIONS	-6.02	-6.96	1.31	4.62	8.16
INFORMATION TECHNOLOGY	-10.34	-3.67	7.75	15.37	12.50
CONSUMER DISCRETIONARY	-11.90	-7.66	5.15	12.11	12.83
INDUSTRIALS	-15.44	-15.14	-7.30	9.92	10.15
HEALTHCARE	-17.20	-1.60	15.73	17.88	18.86
MATERIALS	-21.91	-25.47	-23.60	-2.04	3.20
ENERGY	-32.77	-34.05	-54.67	-18.41	-8.77
TOTAL RETURN	-11.92	-7.73	1.25	11.02	11.73

Looking at sector performance for the quarter, the only positive number on the board was posted by S&P 500 utility stocks, seen as a safe haven in times of uncertainty and benefiting when long-term interest rates are stable to lower. Consumer and technology stocks outperformed the S&P 500 modestly, while financials were about in line. While the fact that energy, materials and industrials lagged is not a surprise, healthcare was a dramatic underperformer in September on profit taking linked in part to re-emerging concerns over drug pricing. The healthcare sector has posted sharp corrections from time to time but has had a tendency to recover rather decisively. Whether this time will be different will be seen in the months ahead. The longer term, three- and five-year returns of consumer and healthcare stocks remain excellent, and we are optimistic that they can continue to lead over the longer run.

Small caps demonstrated significant weakness in the materials and energy sectors, a trend that has been in place for more than a year now. While the sector losses are dramatic, the combined weight of these two sectors within the Russell 2000 is modest, at less than 10% of the index weight. Still, looking at one year performance, it is obvious that small-cap energy and materials stocks have been pressured severely in this commodity downturn. As with the large caps, consumer and healthcare stocks show leading performance over longer time frames, and we expect this to continue over time. Small caps also carry a relatively high financial sector weight of about 27%, so a rise in interest rates coupled with a continued benign credit environment could be a meaningful positive for this important sector looking ahead.

Data Source: FactSet. All returns quoted in US dollars. Performance for one and multi-year periods is annualized. Sorted by respective index quarterly returns. Due to rounding, sector totals may not equal 100%. ***Past performance is no guarantee of future results.***

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Disclosure

All data as of September 30, 2015, unless otherwise noted.

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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.

Index Definitions

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. S&P 500® is a registered service mark of McGraw-Hill Companies, Inc.*

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.*

MSCI Europe *is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments across European developed markets.*

MSCI Japan *is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments of the Japanese market.*

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

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 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 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 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.*

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 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 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.*