Equity Market Update

As of September 30, 2016 / Volume 5, Issue 3 / FFTAM.COM

Large Cap stocks were basically unchanged again in September. The market has been in a holding pattern since mid-July as investors fret over the lack of earnings growth and debate when the Federal Reserve will next raise interest rates. For the quarter, stocks had their best showing of the year; however, almost all the gains occurred in the first 7 trading sessions.

Year-to-date, stocks continue to post attractive total returns. The S&P 500 is up 7.84%, while the Dow Jones Industrial Average is close behind at 7.21%. The NASDAQ Composite, which has been the laggard all year, experienced large gains in the quarter. It is now up 7.15% year-to-date.

Domestically, the best results remain in mid- and small-sized companies. The S&P 400 Mid-Cap Index has advanced 12.40% this year, while the S&P 600 Small-Cap Index is up an impressive 13.86%. Improving US economic conditions, along with stabilization in oil prices and anticipation of further Fed rate hikes, has steered investors to these corners of the market.

Emerging markets has been another bright spot. The MSCI Emerging Markets Index has gained 16.29%. Stabilization in commodity prices has been key for many of the emerging economies, yet the biggest driver for performance continues to be investors' stretch for yield. Large inflows into emerging market bonds has led to a near identical rush into these regions' stocks.

The worst performing stocks are in developed international. In 2016, the MSCI EAFE Index is only up 2.20%, on a total return basis. European and Japanese stocks have experienced investor outflows for much of the year. Negative interest rates are putting European and Japanese banks in a precarious position. The negative rates act like a tax on the banking system, thereby hurting capital ratios. This is especially worrisome in Europe as many of their banks still have questionable loans and other assets on their books. The recent headlines concerning the health of Deutsche Bank is sparking fears within European banks not seen since the days of the financial crisis in 2008. In totality, weak earnings, major elections throughout the Eurozone, and uncertainties surrounding the implementation of Brexit, lead us to believe the MSCI EAFE Index will remain the worst performer among major stock indexes for the foreseeable future.

As we move into the latter stages of the year, investors have begun to allocate to more economically sensitive names. To start 2016, stable business models and above average dividend yields were all the rage as global interest rates collapsed. Bond surrogates, such as utilities, telecommunications, and consumer staples far outpaced other sectors. Their success created PE ratios that exceeded their fundamental reality. Recently, investors have begun to rotate out of these sectors. In the third quarter, utilities declined 5.91%, followed by telecom and staples dropping 5.60% and 2.63%, respectively. The biggest benefactor from this rotation has been technology, which jumped 12.86%. The other leading sectors were financials and energy, which were up 4.59% and 2.26%, respectively.

With three months remaining in the year, investors will be keeping a close eye on a series of major events. The first is the outcome of the US Presidential election. The market is currently positioned for a Clinton victory with Republicans controlling both chambers of Congress. Any unforeseen outcome which would disrupt the "divided government" consensus could lead to short-term volatility in stocks. Next, the market will await the results from several key European elections. The market is currently allocated for no further radical government actions, like Brexit. Finally, the most important items of interest to investors are central banks and earnings.

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Last month, markets were choppy after comments from three central banks. The Bank of England chastised negative interest rates and declared them the "wrong route" for growth. Echoing these remarks was the Bank of Japan. They chose at their September meeting to not push rates deeper into negative territory. Finally, the Fed decided not to raise interest rates until December at the earliest. These actions have investors questioning whether we have reached the limits of easy money policies. The volatility caused by the central banks increased the correlation between stocks and bonds to their highest levels in 5 years. We continue to believe the actions taken by the world's major central banks will be the leading factor for total returns in stocks.

With third quarter earnings reports due in the next few weeks, it appears we are on track for a sixth consecutive quarter of year-over-year declines in corporate profits. Currently, the S&P 500 trades at 17.4x forward 12-month earnings estimates, which is above the 5-year and 10-year averages (Exhibit 1). It even exceeds the long-term historical average of 14.7x. The multiple is being skewed to the upside by the decline in energy earnings—which we see improving in future quarters—and the high PEs associated with defensive stocks. Even though the PE is above historic measures, it is not excessive compared to other occasions in which the market was making all-time highs. Finally, given the extremely low interest rate environment, a premium valuation for stocks is warranted, in our opinion. However, if stocks are to rise much further from here, it would require earnings growth instead of further PE multiple expansion. Analysts are currently forecasting 2017 earnings growth of 14% (Exhibit 2). That exceeds of our internal estimates and many of the individual analysts we follow, so it is likely the consensus number will have to be revised downward.

Autumn tends to be a turbulent time for stocks. With volatility at historic lows, the market could be ripe for a pullback. If a sell-off should materialize, we recommend investors buy the dip. Earnings appear to be improving, and the Fed remains very accommodative, even though we believe they will raise interest rates by a quarter of a percentage point at the December meeting. This should keep stocks on their upward trajectory heading into year-end.

We remain more cyclically positioned versus the benchmarks in the Equity Income and Core portfolios. For valuation reasons stated above, we are underweight defensive sectors, like utilities and staples. We are focusing on sectors with attractive valuation and upside catalysts due to secular and demographic trends (i.e. healthcare, consumer discretionary and financials). In Strategic Growth, we remain more value oriented than the benchmark. Recently, we have used the performance disparity between growth and value to increase our exposure to growth oriented sectors like healthcare, technology, and consumer discretionary.

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Exhibit 1

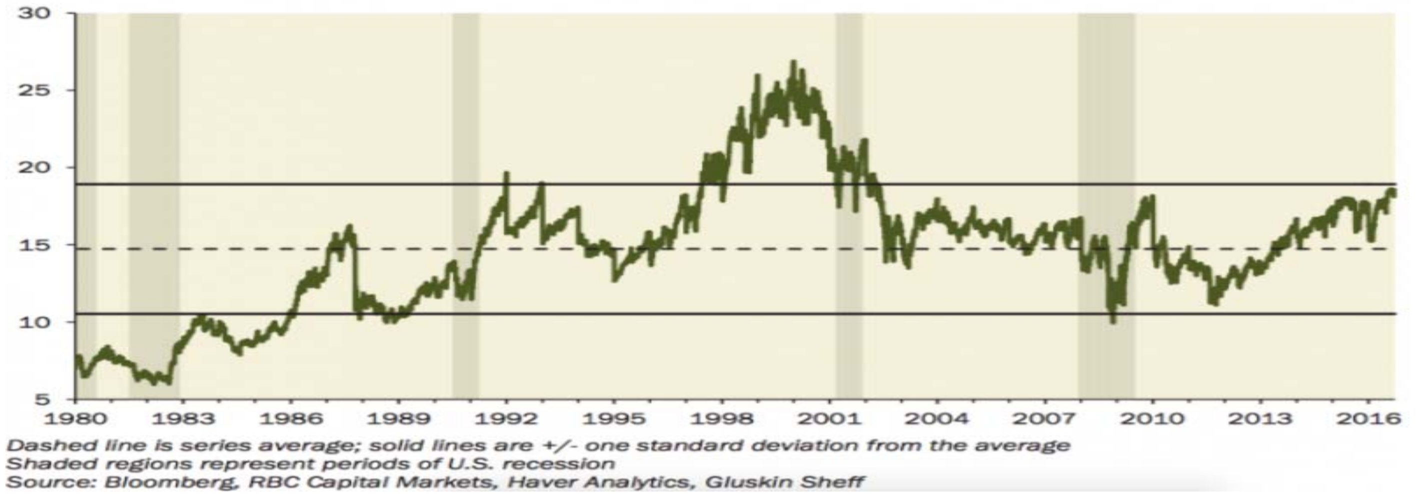
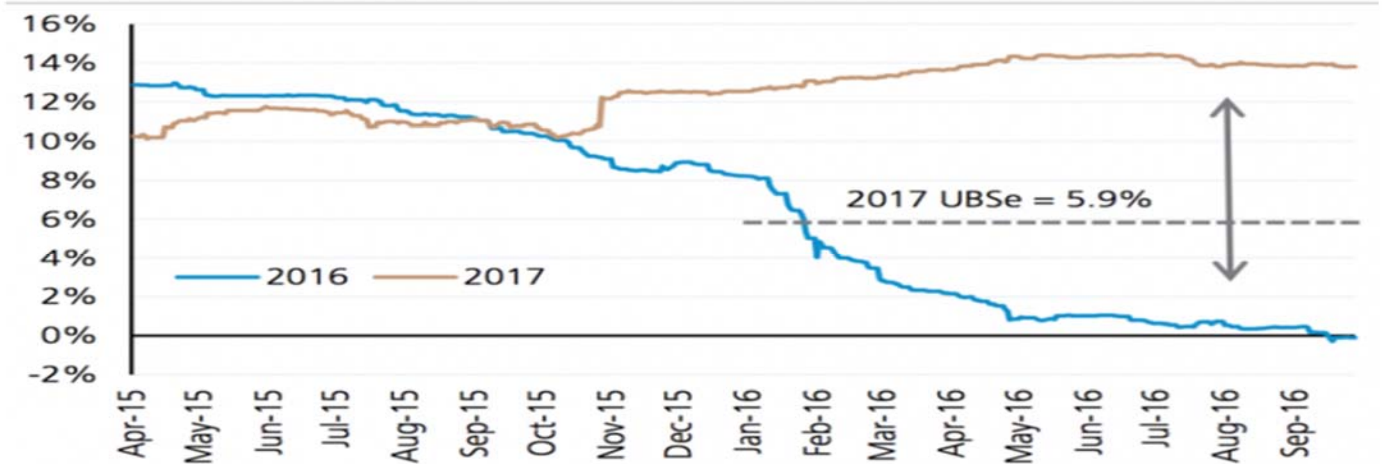


Exhibit 2



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