Equity Market Update

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To start the year, we predicted equity markets would have total returns between 0% - 5% with above average volatility. As the year came to a close, our predictions proved true. Throughout 2015, investors battled six major headwinds: 1) a rising US dollar; 2) a slow growing global economy; 3) plunging commodity prices; 4) worries about the Federal Reserve raising interest rates; 5) weak corporate earnings growth; and 6) above average PE values on equities as a whole. These challenges kept stocks within a tight 6% trading range for the year, except for a short period in August and September when stocks fell into correction territory.

The S&P 500 finished the year with a total return of 1.37%. Thank goodness for dividends because the price return for the index was -0.73%. This marked the first yearly decline for the S&P 500 since 2011. The Dow Jones Industrial Average experienced a similar fate. Its total return was 0.21%. Without dividends, the Dow's return was -2.23%.

Stocks outside of domestic, large cap were even worse. The S&P 400 Mid-Cap index lost 3.71% in 2015, while the S&P 600 Small-Cap index dropped 2.01%. The MSCI EAFE index, which is comprised of companies in developed international markets, declined 0.21%. The worst performer in 2015 was the MSCI Emerging Markets index, which lost a staggering 14.83%.

The past year was strange in that investors were punished for having diversified portfolios. The investors who fared the best were those that took large concentrated bets in a few segments of the market. For most of the year, we wrote about investors crowding into higher growth, higher momentum names found in the NASDAQ index. This resulted in large increases in biotech, social media, ecommerce and information security stocks. Many of these companies lack earnings, and in some isolated instances, they do not even have revenue. However, with negative-to-flat tape occurring throughout the remainder of the market, investors used these momentum names as a place to hide.

This odd behavior can be seen in the extreme skewness in returns. According to Morgan Stanley, the top five tech / consumer stocks in the S&P 500 jumped 62.5% in 2015. The top 25 names in the index by market capitalization gained nearly 7%, while the top 100 returned only 2%. Almost 60% of the stocks within the S&P 500 had a negative total return in excess of 4% in 2015.

Wide performance dispersion was also seen in the various economic sectors. Consumer Discretionary was the only sector to gain more than 10%; however, the majority of the return came from Amazon (+117%), Netflix (+134%), Starbucks (+43%) and McDonalds (+29%). Four other sectors--technology, consumer staples, healthcare and telecom--were barely in the black. Energy was the worst performer (-21%), followed by Materials (-8%).

As we enter 2016, the headwinds that plagued the market in 2015 still exist. The leads us to believe it will be another year of single digit returns with above average volatility. We believe returns will be slightly better this year as the effects on corporate earnings from lower energy prices, a strong US dollar and higher interest rates will improve versus 2015 given the easy year-over-year comparisons. Our model indicates a base case S&P 500 total return of 4% - 6%.

The economic tea leaves tell us the US economy is still improving, albeit slowly. Labor markets are growing and wage inflation is running at 2.3% year-over-year. This data, along with low energy prices, is good for consumer spending, which makes up 70% of GDP. Our internal, economic checklist indicates we are in the latter stages of the mid-cycle, although some non-economic market data (i.e. falling commodity prices, underperformance in transport stocks, underperformance in semiconductors and widening credit spreads) suggest the overall global economy remains challenged.

We still believe in our overweight positions in technology, industrials, healthcare and financials. We continue to prefer sectors that are leveraged to the ongoing US economic expansion, have exposure to services favored by global consumers, and have favorable year-over-year earnings comparisons. Given our expectation for further volatility, we intend to equal weight the telecom sector to capture an attractive dividend yield at a below average valuation. Finally, we have been reducing our overweight to the energy space as we believe the recovery in oil and gas will take longer than we initially anticipated. We have also been avoiding industrial names with significant exposure to the oil and gas industry.

Another area we find attractive is domestic, small-cap. In October, we increased our exposure to this space in diversified equity models. We expect small-cap earnings growth to continue to outpace its large cap, mid cap and international peers. Small-caps also tend to outperform in the early stages of a Fed tightening cycle. To fund this trade, we reduced our allocation to emerging markets given the many challenges these countries face.

Finally, stocks in general are still trading above the historical average. The 12-month forward earnings estimate for the S&P 500 is currently 16.1x, which is higher than the 10-year average of 15.7x. Given our view that interest rates will remain low for a prolonged period of time due to structural forces like an aging population and low interest rates around the world, an above average valuation on US stocks is warranted. This does make stocks vulnerable to unexpected short-term events, like the recent summer sell-off, especially since we expect earnings growth to remain subdued. However, we view those pullbacks as temporary given the lack of attractive opportunities in other asset classes. All these forces, when viewed in totality, indicate that stock total returns will be below historical average, while volatility remains above average.

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