Equity Market Update

As of June 30, 2017 / Volume 6, Issue 2 / FFTAM.COM

The first half of 2017 was very positive for stocks worldwide. Of the 30 major global equity indexes, 26 posted gains—the best showing in four years. Per *The Wall Street Journal,* only four rallies in the past 20 years have been as strong as 2017. Two occurred just before the market crashed (1999 and 2007), while the other two happened after the end of a recession (2003 and 2009).

This year, investors have flocked to equities on increased optimism about growth in the global economy. Corporate earnings were also better than Wall Street expected, with S&P 500 companies reporting 1st quarter earnings growth of 14% on a year-over-year basis. Finally, despite two interest rate hikes from the Fed, central banks around the world continued to be very accommodative.

Stocks have risen eight consecutive months on a total return basis. For most of the first half, market leadership was very narrow as investors rushed into technology stocks. As we approached the mid-point of the year, breadth expanded and technology shares took a breather. Currently, half of the 30 major global stock indexes are at all-time highs, and measures of volatility are near at their lowest points ever.

The S&P 500 gained 9.34% in the first half of the year. The Dow Jones Industrial Average slightly upped the S&P by advancing 9.35%. The NASDAQ Composite Index was the best performer. It zoomed 14.76%, its best first half showing since 2009.

Mid and small-sized companies underperformed their large cap peers. The S&P 400 Mid-Cap Index was up 5.99%, while the S&P 600 Small-Cap Index gained 2.78%. Given that these types of companies do most of their business in the United States, they have been the victim of investors' waning confidence that Mr. Trump and the GOP led Congress can come to an agreement to pass any portion of the President's pro-growth economic agenda.

The largest gains were seen internationally. The MSCI EAFE Index advanced 14.22% on the heels of a strengthening economy in Europe, along with the May election of pro-EU candidate, Emmanuel Macron, as President of France. The MSCI Emerging Markets Index made the biggest jump, leaping 18.55%! International investments have benefitted this year from the US Dollar giving up some its post-election gains and from the boost to global GDP forecasts (+3.7% in 2017 vs. +3.1% in 2016) as the breadth of global growth appears to be widening. Finally, international investments trade at a more attractive PE valuation relative to US stocks.

As mentioned above, for most of the first half, leadership within the market was extremely narrow. Through mid-June, six companies—Facebook, Amazon, Netflix, Alphabet, Apple and Microsoft—accounted for 40% of all the gains in the market! The technology sector, as a whole, was up more than 19%, and its weight of 22.24% of the S&P 500 is its highest representation in the index since 2001. However, in the final two weeks, the technology sector sold off, and we saw funds rotate to other parts of the market. The healthcare sector, primarily biotech, caught a huge bid once it appeared Republicans in the House and Senate were at a stalemate on repealing and replacing Obamacare. Financials also jumped on talk of regulatory relief from the House and President Trump. Banks were the leaders as they also benefitted from better than expected capital return programs from the annual Fed stress tests.

The leadership from technology and biotech has enabled growth to far outpace value in 2017. In just six months, growth has beaten value by over 1,200 basis points. Growth's performance has been so strong that value now trails growth at all performance measurement points since the market bottom in 2009. This is the first time this has happened since 2007.

Next, like 2015, investors are employing a barbell theme in their portfolios. They prefer to own the highest growth technology and healthcare stocks—regardless of their valuation—mixed in with the most defensive stocks in utilities and consumer staples. This is an unusual strategy, in our opinion.

When this last occurred two years ago, there were many question marks about global growth. The US was the only major economy in expansion, commodity prices were plunging, and European banks were hemorrhaging capital due to negative interest rates. It made perfect sense to hide in the only places where growth could be found, while protecting yourself just in case a global recession hit.

Today, the global economy is expanding at an accelerating pace. With the economic picture improving in Europe, global growth is broader than at any time since the financial crisis. This has given the Fed confidence to raise interest rates, and the ECB hinted in late-June they are looking into tapering their quantitative easing program in the Fall.

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These items should be a boon for cyclical sectors trading at attractive valuations. The fact that the opposite is occurring leads us to believe there is a lack of confidence among investors. This has been the problem ever since the financial crisis. Despite the economic data points, investors simply do not believe the growth is sustainable. That is why so many seasoned investors claim this is the most hated bull market in history.

At the current time, cyclical sectors—financials, energy, materials, and industrials—are among the least owned sectors in actively managed portfolios. Energy and financials are also among the worst performing sectors year-to-date. Investor shyness toward financials and energy is so extreme that the two sectors comprise 40% of the Russell 1000 Value Index!

This leads us to the elephant in the room (no pun intended)—politics. The President concluded his first 100 days in office with little to show for legislative victories as Republicans on the Hill are stuck on how to proceed with healthcare reform and tax cuts. The "Trump trade" which encompasses financials, energy, materials, and industrial stocks powered the market forward to conclude 2016 on hopes of swift and bold political action. Like small and mid-cap stocks, this group needs political talk to become reality to reinvigorate investor interest. This leads to a very important point. Without political action on taxes, regulatory relief and infrastructure spending, investors in both stocks and bonds are betting the economy is poised to remain stuck at the same 2% annual GDP clip seen since 2000.

Currently, the S&P 500 trades at 18.76x 2017 EPS estimates. This is above the historical average of 15.47x. The trailing PE is 21.46. These are the highest PEs for non-recessionary conditions in 13 years. Analysts are forecasting earnings growth in the high teens over the next 12 months. Much of the rise is due to improvements in earnings from energy companies, along with further growth from technology and financials.

Besides valuation, rhetoric from the world's central banks is a point of concern for stocks as we move into the second half of the year. The Fed has raised interest rates three times since the election (December, March and June). They also recently discussed shrinking their balance sheet for the first time since the financial crisis. This has occurred as the ECB considers tapering their quantitative easing program in either September or October. Finally, the UK and Canada are also looking at raising interest rates in the second half of the year.

Worry that central banks are becoming less accommodative, along with the lack of pro-growth legislation from Washington, has already made its way into the bond market. The yield curve flattened in the first half of the year. The spread between 2-year and 10-year US Treasuries narrowed to 92 basis points, although this is an improvement from the low spread of 79 basis points seen in early-June.

With interest rates still low compared to historical standards, stocks are able to trade at a premium. Despite the insistence from central bankers that they will move at a slow and measured pace, it is fair to say that further tightening will serve as a headwind for stock PE multiples. This puts additional gains from here solely on the shoulders of continued earnings growth and legislative victories in Washington.

Collectively, we remain positive on the economy and equities; however, we believe volatility will be higher in the second half of the year. Given the strong rally in growth stocks and the above average PE multiples in the market, a rotation into value oriented stocks is also likely to occur. This belief has caused us to accelerate putting new capital to work for clients investing in our Equity Income style.

Our internal economic checklist indicates the economy is still in the latter stages of the mid-cycle, which supports an overweight in cyclical sectors. We maintain a cyclical tilt in our equity portfolios relative to their benchmarks. Among cyclical sectors, we are overweight financials and energy paired with an underweight in materials. In defensive sectors, we are overweight healthcare and telecommunications given their attractive valuation paired with underweights in consumer staples and utilities.

On the global scale, we remain overweight US stocks with an underweight in developed international countries and an inline weight to emerging markets. Inside the US, we have maintained our overweight to mid and small-sized companies since they stand to benefit the most from Trump's pro-growth economic agenda.

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