U.S. Equities Quarterly Update: Expecting a More Challenging “Next Leg Up”

Executive summary
Market and investor stress appears to be on the rise. Equities have begun the fourth quarter in a tumultuous fashion over concerns that the divergence between the U.S. economy and the rest of the world, particularly Europe and China, is widening. The U.S. economy continues to show varying degrees of improvement, with revenue and profit outlooks for domestically focused companies remaining relatively strong. Conversely, the global economy is softening, presenting a headwind for U.S. multinational companies and implying that fourth quarter and 2015 estimates need to be revised downward, a process that is likely to continue throughout the fourth quarter.

Looking toward year-end, we continue to expect equities to grind higher based on the favorable U.S. macro environment. Earnings are increasing, interest rates remain low, inflation is restrained, valuations have improved, the list of compelling alternatives to equities seems limited, and seasonal and midterm election year tendencies support favorable fourth quarter performance. While our year-end price target for the S&P 500, currently at 2,060, is under review with a downward bias, we continue to favor the relative attractiveness of equities, particularly following the recent weakness.

S&P 500 monthly price return during midterm election years
(Average for 1930-2010)

Equities have begun the fourth quarter with increased volatility as investors await greater clarity on the progression of company earnings. Our sense is that we are in a “pause that refreshes and resets” phase, but not one that represents the start of a prolonged bear market.

Review of performance
Equity performance in the third quarter and early fourth quarter has been lackluster, negatively impacted by signs of global economic slowing, falling commodity prices, a rising dollar, geopolitical tensions, speculation of future Federal Reserve (Fed) interest rate hikes, as well as seasonal tendencies for underperformance during the dog days of summer.

Important disclosures provided on page 7.
Market and sector performance

<table>
<thead>
<tr>
<th>Index</th>
<th>Price 10/14/14</th>
<th>2013</th>
<th>3Q</th>
<th>QTD</th>
<th>YTD*</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1,877.70</td>
<td>29.6%</td>
<td>0.6%</td>
<td>-6.2%</td>
<td>1.6%</td>
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<tr>
<td>Dow Jones Industrials</td>
<td>16,315.19</td>
<td>26.5%</td>
<td>1.3%</td>
<td>-5.7%</td>
<td>-1.6%</td>
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<tr>
<td>Russell 2000</td>
<td>1,061.60</td>
<td>37.0%</td>
<td>-7.7%</td>
<td>-3.6%</td>
<td>-8.8%</td>
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<td>MSCI EAFE</td>
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<td>MSCI Emerging Markets</td>
<td>992.08</td>
<td>-5.0%</td>
<td>-4.3%</td>
<td>-1.3%</td>
<td>1.1%</td>
</tr>
</tbody>
</table>

Source: FactSet Research Systems. *Data through 10/14/14, excludes dividends.

- **Market and sector performance**: U.S. large capitalization companies continue to lead performance, as evidenced both in the third quarter and on a year-to-date basis. While the S&P 500 traded generally flat, the popular index outperformed the small cap-oriented Russell 2000 in the third quarter by roughly 8 percentage points. It also bested the negative returns of the international-oriented MSCI Emerging Markets and MSCI EAFE indices by nearly 5 percent and 7 percent, respectively. The gap between the S&P 500 and Russell 2000 is even more pronounced on a year-to-date basis as of mid-October.

**S&P 500 positive... Russell 2000 negative...**

<table>
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<tr>
<th>What happens next?</th>
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<tbody>
<tr>
<td>1984 1.4%</td>
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<tr>
<td>1987 2.0%</td>
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<tr>
<td>1998 26.7%</td>
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<tr>
<td>2007 3.5%</td>
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<tr>
<td>2011 0.0%</td>
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<tr>
<td>2014 6.4%*</td>
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- The magnitude of large cap outperformance over small caps is somewhat surprising given that the macro U.S. environment seems to be improving. Typically, small cap companies tend to post favorable performance during periods of economic growth. Heightened geopolitical tensions, concerns of global economic slowing and uncertainties associated with the ending of the Fed’s quantitative easing are perhaps among reasons that investors have favored the liquidity and general visibility of large caps over small caps even though evidence of economic improvement, at least in the United States, appears to be on the rise. As illustrated, based on the comparable performances since 1984 of the large-cap-oriented S&P 500 and small-cap-oriented Russell 2000, the probabilities seem favorable for small-cap performance in 2015.

- The lagging performances of the international-oriented MSCI EAFE and MSCI EM indices can be attributed to the economic challenges in the eurozone and indications of tempering growth in China. Given that expectations are for economic sluggishness in those regions to continue into 2015, it seems plausible that the lackluster performance trends among the MSCI EAFE and MSCI EM indices will continue into year-end.

- Among sectors, performance trends remain inconclusive. The performance of the Healthcare and Utilities sectors stand out, both advancing over 10 percent or more year to date. Healthcare remains a sector for all seasons, having both growth and defensive characteristics. The strong performance of Utilities is somewhat surprising in that, as an interest-rate sensitive sector, it is hard to envision the sector continuing to outperform as the economy strengthens, and if we are indeed approaching a rising interest rate environment. The performance of Information Technology is an encouraging sign that capital expenditure (capex) spending may be increasing—a potential catalyst that could drive the overall equity market higher toward the end of the fourth quarter and into 2015.

- Also noteworthy is the lagging performance of the cyclical-oriented Industrials and Consumer Discretionary sectors, negatively impacted by economic weakness in the eurozone and a rising dollar. It is also hard to envision meaningful broad market upside from current levels without greater participation from the cyclical sectors.

### Macroeconomic backdrop

The “Goldilocks” scenario of moderate growth and restrained inflation has helped buoy equity prices throughout the first three quarters of 2014. On average, the U.S. economy continues to show varying degrees of economic improvement, providing the fundamental basis...
for potentially favorable fourth quarter performance. The macroeconomic environment reflects a U.S. economic environment that appears neither too slow, thus putting pressure on company earnings, nor too fast, implying inflationary pressures leading to price-earnings multiple contraction. At present, the degree to which global slowing is likely to depress earnings of multinational U.S. companies remains unknown and is largely the reason behind the price declines in early October.

- **Employment continues to show progress.** The September nonfarm payroll increase of 248,000, up from the upward-revised 180,000 August level, and unemployment rate decline to 5.9 percent appears to reflect a U.S. economy that is on the mend—an overall positive for equities. Unchanged average hourly earnings, however, suggest that wage inflation remains soft, tempering overall concerns of inflationary pressures and allaying fears that price-earnings multiple contraction may soon be in the offing.

- **Housing remains in recovery mode.** To a degree, housing has been a two-step forward, one-step backward indicator in 2014, with home builder optimism improving, housing starts fluctuating but with an upward bias, and prices remaining generally stable with isolated signs of bubble characteristics, particularly in large metropolitan areas. Compared to single-family units, multifamily home construction remains strong, perhaps the result of a soft jobs market or delayed household formation trends. Importantly, housing remains an important component of the economy. A favorable housing environment adds to employment, confidence, consumer net worth, bank activity and consumer spending.

- **Manufacturing continues to show solid acceleration.** The ISM Manufacturing Index remains in expansion mode, with a September reading of 56.6, modestly below the August reading of 59.0. Readings above 50 typically indicate economic expansion, often setting the stage for increased capex spending and higher company earnings.

- **Sentiment remains guarded.** While the wealth effect associated with higher stock prices has recently diminished, stable home values are key items favorably impacting sentiment. Low energy costs can have offsetting effects to economic growth. The low prices may bode well for upcoming holiday sales levels, which can be a positive to overall growth. Conversely, the low energy prices could dampen capex levels of companies related to the energy patch.

**Fundamental drivers**

While equities, on average, ended the third quarter and have started the fourth quarter with increased uncertainty and a downward bias, we believe the fundamental backdrop remains supportive of still higher equity prices.
• **Earnings are increasing.** While the S&P 500 ended the third quarter near record highs, so, too, are earnings. Importantly, equities appear largely an earnings-driven market versus being propelled to higher levels by Fed-driven liquidity and price-earnings multiple expansion, as has been the case in recent years prior to 2014. We continue to believe this is an earnings-driven market that is connected to economic growth. We need an improving economy to drive earnings, and higher earnings to support higher stock prices.

• **The list of compelling alternatives to equities remains uninspiring.** Compared to other asset classes (such as fixed income, real estate, commodities), we think equities remain attractive, particularly following the recent pullback in equity prices. Additionally, select equities present both income and appreciation potential. As of mid-October, 424 S&P 500 companies pay dividends. More telling, 44 percent (208) of the S&P 500 companies offer dividends yielding above the 10-year Treasury yield of 2.2 percent. With the dividend payout ratio being near historical lows in the 33 percent range, the prospects for dividend increases, share buybacks and acquisitions appear compelling.

• **Interest rates are low.** While Fed commentary is increasingly being directed toward the eventual raising of rates, concerns over economic slowing in Europe and a rising dollar are among reasons to suggest that the initial interest rate hike could get delayed and/or the pace of future rate hikes is likely to be slow and methodical.

• **Inflation remains generally restrained.** While the unemployment rate has trended to 5.9 percent following the September jobs report, with wage growth remaining under 2 percent, and the prospects for the pace of global growth being muted by the economic challenges within the eurozone, it is hard to envision widespread inflation being among catalysts causing price-earnings multiple contraction in the near term.

**Expecting a more challenging “next leg up”**
Looking toward year-end, equities have begun the fourth quarter in somewhat of a “muddle though” zone with a downward bias as investors await greater clarity on the pace of inflation and progression of company earnings. While we continue to expect equities to grind higher into year-end, it is likely that the next leg up will be more challenging, with heightened levels of overall market volatility.

![S&P 500 dividend payout ratio](image)

Source: Strategas Research Partners. Data through 9/22/14.

![Contribution to S&P 500 return: Earnings growth vs. multiple expansion](image)


Important disclosures provided on page 7.
Valuation has improved. The S&P 500 ended the third quarter trading at 16.7 times the consensus 2014 earnings estimate of $119.45, which is modestly above historical averages. While the declines in October are weighing on investor sentiment, ultimately, in our view, a more prolonged downtrend will be a function of deteriorating earnings beyond the eurozone and China, or ramping inflation. At present, inflation is mostly out of sight and the magnitude of downward revisions to earnings is still a work in progress. This continues to imply near-term rotation being within but not necessarily out of equities.

The Fed is likely to impact future volatility. The Fed remains largely transparent and on script, offering its assessment that the economy continues to improve. October marks the end of quantitative easing, and while remaining accommodative, the direction of travel is clear. Questions that are likely to linger into 2015 include, “When will rate hikes begin?” and “At what pace will subsequent rate hikes occur?” The first rate hike will represent a change in trend, which, too, is likely to be accompanied by some market volatility. Looking beyond the first rate hike, subsequent rate hikes are perhaps more concerning over the longer term as higher rates imply inflationary pressures, which are apt to constrict price-earnings multiples.

Geopolitical tensions remain high. Geopolitics remain a wild card, impacted by the Russia-Ukraine conflict, Middle East tensions, Hong Kong-China relations, etc. So far, these conflicts have been politically important but relatively economically small. That said, the economic impact seems to be increasing as economic growth in the eurozone continues to wane, negatively impacting U.S. multinational companies with a sizable european footprint. While the challenges in the eurozone do not appear to have had a meaningful impact on third quarter results, concerns of further weakness in the region are clearly impacting earnings growth prospects for the fourth quarter and early 2015. This explains some of the equity market weakness being experienced in the early part of the fourth quarter.

2014 midterm election outlook

The November midterm elections will undoubtedly impact equity performance in the fourth quarter and presumably in 2015 as well.
Fourth quarter catalysts

The fourth quarter is likely to remain a “noisy” quarter with several potentially market-moving events on the horizon.

- **Third quarter results: earnings remain of primary importance.** As previously stated, 2014 is proving to be a transition year with earnings growth being a prominent driver of higher equity prices. Of concern, Wall Street estimates are proving to be too high for both the fourth quarter and 2015, following recent concerns of slowing global growth. Equity prices are likely to continue to be negatively impacted while consensus earnings expectations are being ratcheted downward following third quarter results.

- **Federal Open Market Committee (FOMC) meetings and statements.** Clearly the Fed’s assessment of the pace of economic improvement (following the October 28-29 and December 16-17 FOMC meetings) will impact investor sentiment leading into 2015.

- **Moving toward higher interest rates.** Expectations for the eventual raising of interest rates will impact equity prices. At present, the popular belief is for the Fed to first raise rates in June of next year. Equity prices are apt to be negatively/positively impacted should inflation pressures accelerate/decelerate in the interim.

- **Midterm elections and beyond.** Despite history reflecting positive equity performance post-term elections, the election process and outcome presents uncertainty surrounding policy initiatives, legislative outcomes, and associated sectors that are likely to benefit or be negatively impacted by the outcomes.

- **Geopolitical turmoil remains a wild card.** Geopolitical tensions are high and are likely to remain so for the foreseeable future. In addition to the human tragedy, heightened geopolitical turmoil is likely to hamper global economic growth.

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**Partisan control: average annual S&P performance**

1933-2013, excluding 2001-2002

![Graph showing average annual S&P performance by partisan control from 1933-2013, excluding 2001-2002.]

Source: Strategas Research Partners. Data as of September 2014.

- **Expecting more of the same.** Partisan control is likely to remain an outcome of the midterm elections. With a Democratic president, consensus thinking is that the two most probable election scenarios are for a Republican Congress, or Democratic Senate and Republican House. In these scenarios, history points toward favorable returns leading up to the presidential election in 2016.

- **Brinksmanship and political wrangling are likely to increase.** To be sure, varying degrees of emotion and controversy are likely to be rekindled leading up to and following the midterm elections. Tax reform, entitlement changes, government-sponsored enterprise (GSE) reform, trade deals, immigration reform, Affordable Care Act reform, etc., are among key initiatives likely to be of focus. Among these initiatives, consensus thinking is that some sort of trade deal has the highest likelihood of passing, regardless of which party controls the Senate.

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Conclusion

Despite the lackluster year-to-date performance of equities, and heightened geopolitical tensions and concerns of global economic slowing, the U.S. economy continues to improve. Earnings are rising (albeit at a moderating pace), valuations appear reasonable and inflation seems restrained, all of which present a favorable backdrop for equities. Of immediate focus is the degree to which the rate of earnings growth may be trimmed due to the economic challenges in the eurozone. While our year-end price target for the S&P 500, currently at 2,060, is under review with a downward bias, looking toward 2015, our preliminary outlook reflects earnings growth in the range of 8 percent, slightly below historical levels, primarily due to expectations of sluggish global growth. We expect to formally introduce a 2015 S&P 500 estimate and price target midway through the third quarter reporting season.

Contributed by:
Terry D. Sandven
Chief Equity Strategist
U.S. Bank Wealth Management

reserve.usbank.com

Investment products and services are:

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<th>NOT A DEPOSIT</th>
<th>NOT FDIC INSURED</th>
<th>MAY loose VALUE</th>
<th>NOT BANK GUARANTEED</th>
<th>NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY</th>
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