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U.S. Equity Markets: Bent But Not Broken

Executive summary
Volatility has returned to the marketplace, which is a noticeable change from the relatively calm price trends of recent years. The 1,000 point intraday decline on August 24 in the Dow Jones Industrial Average was followed by a volatile week of the market trending both up and down. A sense of calming now seems to be in motion. In short, uncertainty and speculation are driving sentiment and market action.

Uncertainty surrounding China and the Federal Reserve are weighing on investor sentiment and market returns. Speculation is that the pace of global growth is accelerating to the downside, led by China, on the eve of a Federal Reserve rate decision. As such, investor angst and concern have been on the rise and are among reasons explaining the recent market volatility.

Our summary views of the situation include:
- On balance, our view is that the macro and fundamental environments remain supportive of equities.
- China is apt to be the swing factor for third and fourth quarter results for many multinational U.S. companies since the country represents an important component of earnings growth, which is a key driver of higher stock prices.
- The recent market volatility, in our view, does not represent the beginning of a prolonged market downturn but, rather, part of the normal ebb and flow within a longer-term, upward-trending market.
- The recent pullback affords investors with tax-loss selling, portfolio upgrade, and dollar-cost averaging opportunities.

- Our recently revised year-end 2015 price target for the S&P 500 is 2,100, based on a price-earnings multiple in the range of 18 times our 2015 earnings estimate of $117.

Impacted by China
China matters. The United States was the epicenter during the financial crisis in 2008. Currently, the rest of the world — China in particular — is now the focal point, and for good reason. Approximately 15 percent of global gross domestic product (GDP) is generated by China. Importantly, China is in transition from an industrial-led economy — characterized by smokestack industries, huge exports and massive infrastructure spending — to one that is driven by consumer consumption — with growth spurred by services, consumer spending and private entrepreneurship. At issue is that the aggregate amount of consumer spending appears to be trending below the amount spent during the phases led by industrial or infrastructure build-out. As the pace of aggregate spending slows, some economists predict economic growth in China may decline from the near 10 percent annual growth rate in recent decades to under 5 percent, which is below the official government target of 7 percent.

China is important to U.S. stocks because, for many multinational U.S. companies, China represents a meaningful component of earnings growth. At present, the United States seems largely an earnings-driven market (as opposed to being propelled higher by Federal Reserve-driven liquidity or price-earnings multiple expansion). As such, an improving global economy is required to drive earnings, and higher earnings are needed to support higher stock prices. If
economic growth in China continues to slow, this reduces the expected upside in both earnings and share prices, particularly as we look toward 2016 and beyond.

- To illustrate, according to Bloomberg, as of August 28, consensus estimates for S&P 500 earnings growth in 2015 over 2014 levels is 5.1 percent. While early, consensus estimates for 2016 over 2015 are more robust, and are projected to advance 10.3 percent. For earnings to increase 10 percent in 2016 over 2015 levels, conditions in China will presumably need to begin to show improvement as we enter 2016. As such, in our view, this implies that China is likely to remain a source of equity market uncertainty and volatility into year-end and 2016.

**Outlook for U.S. stocks**

On balance, our view is that the macro and fundamental environments remain supportive of equities, despite lackluster year-to-date performance and increased volatility.

- Earnings are increasing, albeit at a moderating pace.
- Valuations seem reasonable. The S&P 500 trades at roughly 16.7 times consensus 2015 earnings estimates, which are not near extreme highs. Importantly, inflation remains restrained. And, in the absence of inflation, current price-earnings levels seem both warranted and supported.
- Interest rates are low. The 10-year Treasury yield is roughly 2.2 percent. It is hard to envision interest rates moving meaningfully higher in an environment where global growth is slow and inflation is restrained.
- The list of compelling alternatives to equities appears limited. As of August 28, 45 percent of S&P 500 companies offer dividends yielding above the 10-year Treasury yield. This presents a compelling case for equities. It provides investors with competitive income, appreciation potential, and a degree of support to current price levels.
- Additionally, the classic signs of a frothy market are not evident. Animal spirits, represented by extreme investor optimism, do not seem pervasive throughout the marketplace. Heavy inflows from bonds to stocks are not occurring. In fact, given the recent volatility, it seems outflows from equities will likely occur over the ensuing weeks. And, inflation fears are minimal.

As such, in aggregate, our view is that the current equity market weakness is not the beginning of a prolonged market downturn but, rather, part of the normal ebb and flow within a longer-term, upward-trending market. Additionally, according to Strategas Research Partners, bear markets historically occur in and around recessions rather than in the middle of an economic recovery when inflation is heating up, the Fed is in tightening mode, and investor sentiment is approaching euphoria or extreme optimism.

**Upcoming catalysts**

There are several upcoming catalysts likely to impact equity prices.

- Another round of key economic releases. Among key indicators is the monthly employment report — the granddaddy of all jobs-related reports. From the August employment report, scheduled for release on September 4, focus will be on average hourly earnings as an indicator measuring the extent to which inflation may be creeping into the marketplace, thus serving as justification for Fed action — either to keep interest rates unchanged or begin lift-off.
- Federal Open Market Committee (FOMC) meeting on September 16-17. The current debate is whether the Fed raises rates in September, December or not until 2016. The futures market is currently pointing towards lift-off in December.
  - A December lift-off seems justified, given the low core inflation, falling inflation expectations, rising credit-risk spreads, mixed signals of U.S. manufacturing strength, tenuous retail spending levels, fears of slowing in the pace of global growth and, of course, the current equity market dislocation.
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– A September lift-off is also compelling and seems justified. In aggregate, the U.S. economy seems strong enough to warrant something other than crisis level rates. Also, a rate hike in September would remove the near-term uncertainty associated with timing of the lift-off, and signal from the Fed that the U.S. economy remains on a growth trajectory in an otherwise slow-growth global environment.

– The pace matters most. While much focus is on the Fed rate hike lift-off date, perhaps most important beyond the initial rate hike is the pace of subsequent Fed hikes, which we believe will be in small increments and implemented over a prolonged period.

• Third quarter results, beginning in mid-October. While actual results are important, much attention will be directed toward management comments about the pace of global growth, particularly in China. Third quarter results and management guidance will likely set the tone for performance into 2016.

• Seasonal tendencies for subpar performance in September. September, historically, is the worst performing month of the year. According to Strategas Research Partners, only in 45 percent of the time (dating back to 1950), has the S&P 500 posted positive returns in September. Conversely, October, November and December are among the best performing months of the year. As such, looking beyond September, the odds support favorable fourth quarter performance.

Positioning stocks within portfolios

Determining a prudent course of action during times of heightened volatility and uncertainty can be challenging for many investors. To that end, The Wall Street Journal recently published an article highlighting five things investors should not do during periods when investor angst and concern are elevated:

• Don’t fixate on the news
• Don’t panic

• Don’t be complacent
• Don’t get hung up on the talk of a “correction”
• Don’t think you — or anyone else — knows what will happen next

Additionally, as to what clients should do, among our recommendations, we advocate three strategies (as appropriate):

• Look for tax-loss selling opportunities by offsetting gains with losses.
• Consider portfolio upgrades by switching into investments or companies with compelling longer-term prospects, but whose share prices have pulled back during this recent correction.
• For clients with cash on the sidelines waiting for a good entry point, in our view, the current environment presents an attractive environment to start layering funds into the equity market.

Conclusion

Looking toward year-end and into 2016, our outlook is for equities to continue to trend higher while acknowledging that volatility is apt to remain elevated and the pace of appreciation is likely to lag historical levels as a result of slow global economic growth. As such, with inflation largely restrained, we encourage clients to maintain existing investment plans.

Our 2015 price target for the S&P 500 is 2,100, based on a price-earnings multiple in the range of 18 times our 2015 earnings estimate of $117.
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