Q2 2017 | Equity Outlook

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Equities need more than optimism

We have found numerous undervalued opportunities among U.K. stocks, European cyclicals, and Japanese exporters.

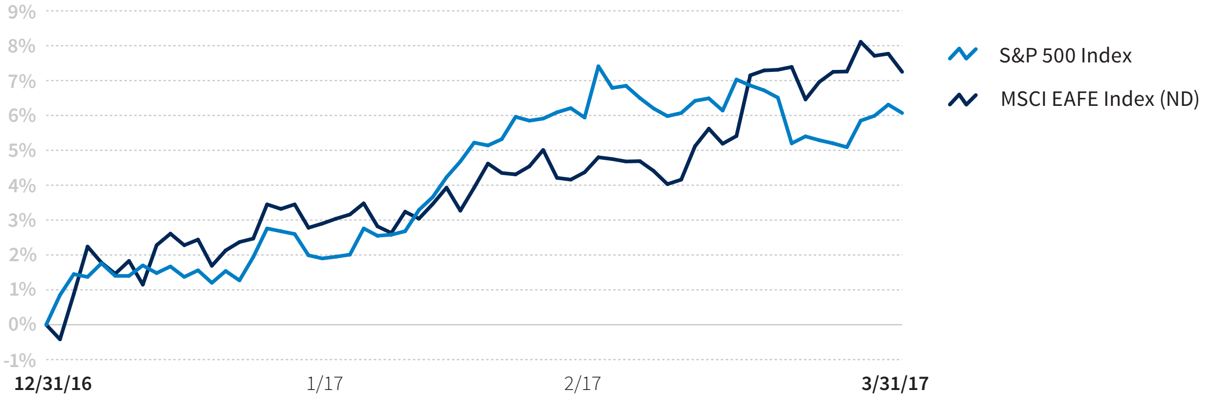
Widespread economic expansion may continue to drive non-U.S. markets, though U.S. policy developments are likely to pose global risks.

Post-election enthusiasm may be enough to keep U.S. corporate profits strong, but progress from Washington would certainly provide additional support.

When measured by index milestones and investor optimism, the first quarter was a stellar one for U.S. equities. The market rally that began on the heels of the U.S. presidential election remained intact through February before retreating somewhat in March. The Dow Jones Industrial Average surpassed the 20,000 level in February, and the U.S. bull market observed its eighth anniversary in March. Outside the United States, stocks surged upward in the quarter, both in developed and emerging markets, as economic growth strengthened around the globe.

A relatively calm advance for equity markets worldwide

Total return performance, 12/31/16–3/31/17



Market scorecard

Select equity index performance as of 3/31/17

Emerging markets soar in a winning quarter for equities worldwide

Index name	Q1 2017 (cumulative)	1 year	3 years (annualized)	5 years (annualized)	10 years (annualized)
MSCI EM Index (ND)	11.44%	17.21%	1.18%	0.81%	2.72%
Russell 1000 Growth Index	8.91	15.76	11.27	13.32	9.13
MSCI Europe Index (ND)	7.44	9.76	-1.51	5.63	0.70
MSCI EAFE Index (ND)	7.25	11.67	0.50	5.83	1.05
MSCI World Index (ND)	6.38	14.77	5.52	9.37	4.21
S&P 500 Index	6.07	17.17	10.37	13.30	7.51
Russell 1000 Value Index	3.27	19.22	8.67	13.13	5.93
Russell 2000 Index	2.47	26.22	7.22	12.35	7.12

Sources: S&P Dow Jones Indices, MSCI, Russell. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not a guarantee of future results.

U.S. equities

Volatility was low and sentiment was high in 2017's first quarter as expectations for a new pro-growth presidential agenda remained intact. Investor enthusiasm over the so-called "Trump trade" only started to waver toward the close of the period, when stocks sold off a bit in the aftermath of the administration's failure to repeal the Affordable Care Act.

Looking ahead, we anticipate an environment in which politics may be the most significant force that drives — or disrupts — U.S. equity market momentum. The first quarter's relatively brief downturn could be an indication of the biggest risk for U.S. equities — that investors will become discouraged by setbacks and a lack of concrete, measurable progress for President Trump's agenda.

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Will earnings grow if legislation stalls?

Despite political uncertainties, we see reasons for optimism, including improving fundamentals for U.S. businesses. Earnings growth has been positive, and we expect it will continue, particularly in light of higher levels of consumer and business confidence. The Trump trade could play a significant role in driving the profitability of U.S. corporations. Unlike the struggles with health-care reform, we may see less resistance to pro-business initiatives such as tax reform, deregulation, and infrastructure spending.

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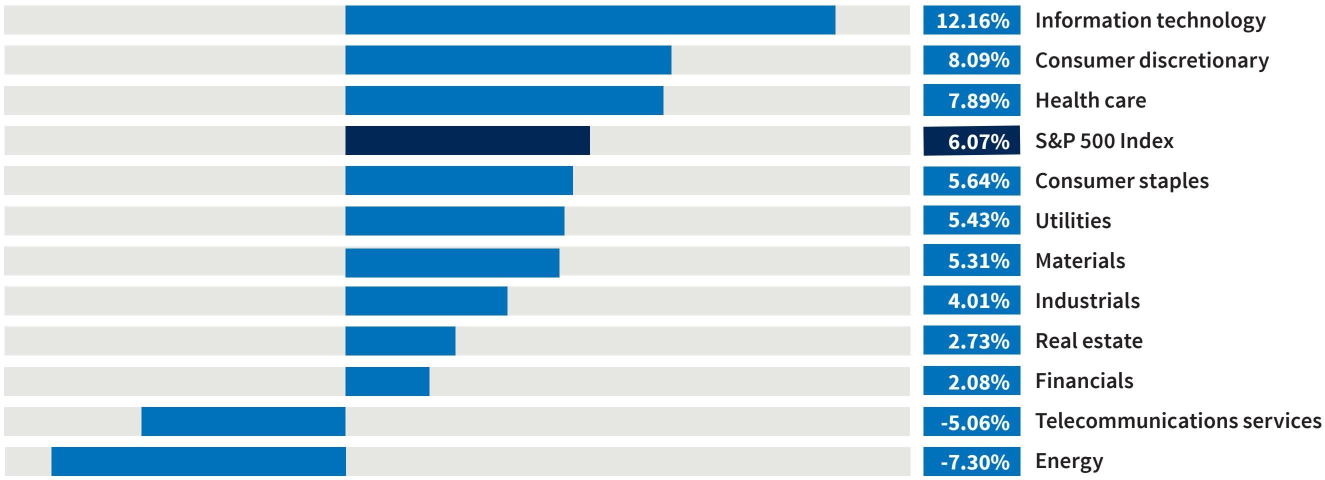
Timing remains an uncertainty. While we have seen a vast improvement in confidence from corporate boardrooms and executive offices, it is unclear when — or even if — that confidence will translate into action, such as capital spending, which has been sluggish since the 2008 financial crisis. The newfound post-election enthusiasm for business growth may be enough to keep corporate profits strong, but progress from Washington on tax reform and deregulation would certainly provide additional support.

Technology leads U.S. equity sectors in first quarter

S&P 500 sector total returns for 3 months ended 3/31/17



Source: S&P Dow Jones Indices.

Also, while corporate earnings are still growing, we need to keep an eye on wage inflation and other potential cost increases for businesses. Other risks to growth include a strengthening U.S. dollar, higher interest rates, and inflation — all of which can signal an end to a growth cycle.

Exuberant investors have made stocks expensive

Earnings growth takes on added importance when considering today's elevated equity valuations. While we wouldn't describe price-to-earnings multiples as alarmingly high, we believe equities are far from cheap. In our view, earnings and equity prices can move higher even with stretched valuations, but fundamental research and stock selection become more critical in this environment.

Investors viewed the Fed's recent interest-rate hikes as validation of economic strength rather than a precursor to the end of a growth cycle.

Among the sectors that interest us heading into the second quarter is financials. The sector had a strong run at the close of 2016, soaring in the post-election rally and returning 20% for the year. Among S&P 500 sectors last year, only energy performed better than financials. Although stocks of financial institutions weakened toward the end of the first quarter, we believe they have room to advance further. In our view, their valuations remain reasonable, and banks in particular are poised to benefit from higher interest rates, strengthening employment, and growing consumer confidence. In addition, the regulatory burden for financial institutions, especially since the 2008 financial crisis, has become immense and expensive. If progress is made with deregulation, which may not involve overly complex Congressional battles, banks would stand to benefit greatly.

Many stocks in the industrials sector — which are leveraged to an improving global growth scenario — may also be well positioned for the months ahead. Conversely, we see few opportunities in the more defensive areas of the market, such as consumer staples, utilities, and real estate investment trusts. In our view, these stocks are much too expensive considering their anemic growth prospects.

Federal Reserve is helping, so far

Sentiment also appears to be positive with respect to Federal Reserve policy, as investors viewed the Fed's recent interest-rate hikes as validation of economic strength rather than a precursor to the end of a growth cycle.

While we do not see catalysts for a severe market correction, we also do not anticipate any significant upside catalysts in the months ahead. However, we believe opportunities are available, especially as equity correlations continued to decline in the first quarter, giving us clearer distinction between winners and losers. In fact, by the end of February, equity correlations — both between sectors and within sectors — had fallen to 2006 levels.

Non-U.S. equities

Non-U.S. stocks surged upward in the first quarter, both in developed and emerging markets. Fuel for this broad-based advance came in part from the post-U.S. election rally and expectations of U.S. fiscal stimulus, but also from better-than-expected global economic data and the prospects of continued benign monetary policy in Europe, the United Kingdom, and Japan.

For much of the past six months, we have seen economic growth strengthen around the globe. While we are optimistic that this strength will continue to drive non-U.S. equity markets, we also think volatility is likely to run higher in the months ahead. Volatility could result in part from disappointment if policies to drive growth remain delayed, particularly in the United States. In addition, while the European Central Bank and Bank of England continued to focus on accommodative monetary policy, their leaders also made some statements to support rising expectations for a normalizing interest-rate environment not too far down the road.

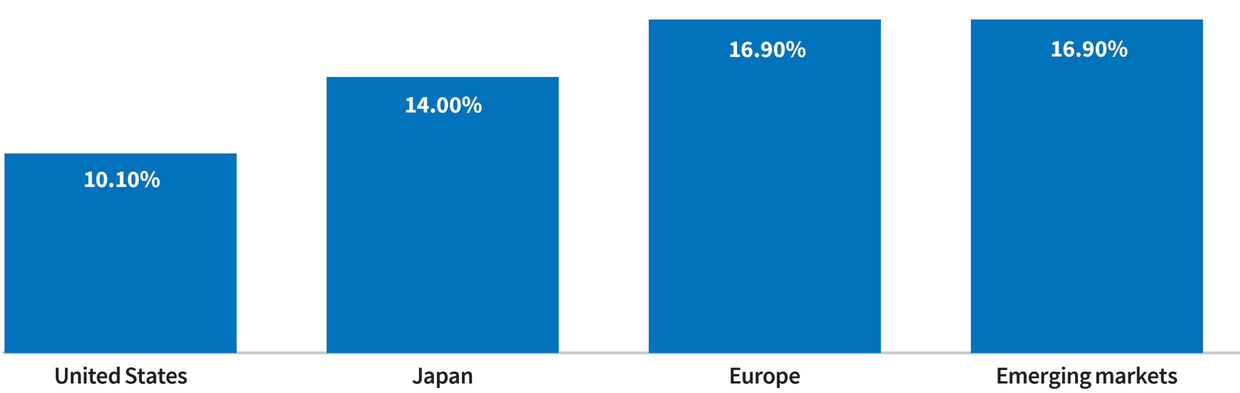
Expectations are high, leaving ample room to fall

As markets learned with U.S. health-care policy in March, the passage from presidential campaign pledge to functional policy is anything but a sure thing. The Trump administration's early failure to make a major policy change with respect to the Affordable Care Act has led many large corporations, including multinationals, to delay any significant investment decisions while they wait out the uncertainty. Will there be a major proposal on corporate tax reform this year? Will it actually benefit large corporations, whose effective tax rates in many cases are already low? Will there be a substantial opportunity for capital repatriation to the United States? When is it likely to occur?

With respect to international trade, the risks of U.S. protectionism appear to have fallen somewhat, and perhaps the Trump administration may indeed step back

2017 earnings growth may be higher outside the United States

EPS growth estimates for 2017



Source: Bloomberg, as of 3/13/17. Index sources: S&P 500; MSCI Japan; MSCI Europe; MSCI Emerging Markets to consider the tradeoffs it is willing to accept if it takes a hard line in this area. If, for example, the United States moves away from using Mexican-produced automotive parts, then perhaps Mexico reacts by not importing as much U.S. corn. While such a scenario might sound good for U.S. manufacturing, constituents within U.S. agriculture might strenuously object. Is such a situation tolerable? Is it desirable for some larger economic result? These are open questions that the administration will have to determine as it pursues its agenda of negotiating bilateral trade agreements.

European improvements, despite political risk

In Europe, the improved local and global economic backdrop in the fourth quarter of 2016 led to better year-end corporate earnings results — and, we expect, it may lead to substantial earnings surprises in the months ahead. A wide variety of companies in Europe's cyclical industries, as well as in the financials sector, should benefit from domestic economic reflation, and we expect that European exporters will continue to benefit from foreign exchange dynamics and relative economic stability in China and the emerging markets.

As we have discussed in prior quarters, politics in Europe continue to pose a threat to the integrity of the European Union. The weak performance of Geert Wilders — the "Dutch Trump" — and his populist Freedom Party in the Netherlands' mid-March general election gives some cause for optimism on this front. And yet, the imminent French presidential elections pose the next risk for markets in a busy political calendar that includes elections in Germany and — potentially — Italy in 2017. Regardless of the outcomes in these elections, EU members will continue to watch the EU/UK negotiations unfold with a mix of apprehension and interest.

Many large corporations, including multinationals, are delaying investment decisions while they wait out U.S. policy uncertainty.

Starting the Brexit clock

On March 29, the United Kingdom's Prime Minister, Theresa May, started the statutory two-year clock for Brexit negotiations. The country's plan to depart the European Union has yet to be felt as a headwind in the U.K. economy, but we note that U.K. consumers are in a worse place today than they were a year ago as higher inflation has collided with relatively stagnant wages. That said, we currently see a variety of compelling investment opportunities in the United Kingdom — for example, among consumer discretionary companies that are either oversold on Brexit fears or not exclusively reliant on domestic U.K. demand. Companies whose management has indicated a willingness to enhance shareholder returns through share buybacks and other measures offer additional attractions.

Whatever the final outcome, the Brexit negotiation is likely to be a complex and risky process. A partial positive for markets is that the British pound sterling and U.K. equity prices are already discounting to some extent a "hard Brexit" — the idea of the United Kingdom making a clean break from its 60-year economic and political involvement in the European Union. This is a stance favored by many on the right wing of the ruling Conservative party. Although it will take time, we think Brexit could ultimately result in a boost to global equities, as it may take some of the prevailing uncertainties — over the terms of trade, the status of London as a global financial hub, and the economic involvement of major multinational companies inside the United Kingdom — off the table.

However, a "soft Brexit" — a deal that results in compromises by the United Kingdom in order to retain access to the EU market — may now be more likely given May's announcement of a snap general election on June 8. May's Conservative party is widely expected to consolidate parliamentary power in a time of opposition-party weakness. This will give her a stronger mandate in relation to three groups: the U.K. voting public, which remains divided over the Brexit issue; the European Union; and, crucially, the more radical elements within her own party. May's enhanced flexibility to negotiate Brexit terms for the United Kingdom may therefore result in a softer Brexit than markets are currently discounting, which would likely be positive for sterling and U.K. domestic assets.

For their part, European policymakers will continue to try to find the right balance between retaining the benefits of access to the U.K. economy and the U.K.'s security inputs, while striking a deal that deters other countries from seeking an exit from the European Union. Political developments in Europe, including the French, German, and Italian elections, will have a major influence on the structure of the European Union going forward and are likely to impact the tone and outcome of Brexit negotiations. By securing herself a new five-year term as Prime Minister, Theresa May would effectively buy herself time to gauge these developments as they unfold and tailor her negotiating strategy accordingly.

Japan: Highly leveraged to global reflation

Turning to Japan, we continue to regard investing in Japanese equities as a highly sensitive play on the global economic recovery. Unlike in the United States or Europe, domestic demand in Japan is not strong enough to drive a sustained economic recovery that could meaningfully impact the government's high debt levels. In the absence of strong domestic demand, Japan must look to external demand to help drive economic growth. For this reason, among others, we continue to believe that Japan's exporting sector holds some of the more interesting near-term opportunities for investors in Japanese stocks.

China's image of uninterrupted growth

In recent quarters, China has consistently posted better-than-expected economic results, which helped boost global markets in the first few months of 2017. While these data likely reflect a real expansion, we also observe that China has a clear political interest in maintaining a semblance of economic stability.

In the fall of this year, China will hold its 19th National Congress of the Chinese Communist Party. At this event, we can expect to see emerge the next lineup of China's national leadership under Xi Jinping. What has become clearer in recent months is that China wants to maintain stability in its economy so nothing will disrupt this important political event. Accordingly, the government raised interest rates in recent months, has taken steps to stabilize commodity prices, and has attempted to rein in excessive bank lending. As the government has clamped down on various market excesses, we have already seen real effects: Iron ore prices have retrenched; auto sales have slowed; and there has been a rash of inter-bank market defaults. For us, these developments underscore how strains still plague the system.

We maintain a cautious stance with respect to China, as well as companies and markets that are highly leveraged to China's growth. And while our longer-term conclusions about risks in China's financial and real estate markets have not changed, we also see a nearer-term risk in China's economic tightening. After applying significant stimulus following the winter of 2015–2016, China's dialing back of economic excess raises the possibility that authorities could inadvertently cool things down too much. This would have a dampening effect on commodity markets and would also put downward pressure on global demand.

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MSCI Emerging Markets Index (ND) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

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Russell 1000 Growth Index is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their growth orientation.

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Indexes assume reinvestment of all distributions and do not account for fees. It is not possible to invest directly in an index.

The views and opinions expressed are those of the authors (Aaron M. Cooper, Chief Investment Officer, Equities, and Simon Davis and Shep Perkins, Co-Heads of Equities) as of March 31, 2017, are subject to change with market conditions, and are not meant as investment advice.

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