Executive Summary

- The U.S. equity market is attractively valued at 15x next year’s earnings and a 2.2% dividend yield that compares favorably to global bond yields.
- We believe earnings growth will resume and be modestly positive as many of the past year’s headwinds subside.
- Pockets of extreme under- and overvaluation at the sector and security levels create opportunities for valued-added relative to the indices.

Earnings drive the performance of equities, and since the beginning of 2015, earnings growth has stalled as economies overseas disappointed, the U.S. dollar strengthened and energy prices fell precipitously. Point-to-point, there has been little change in U.S. equity prices from the beginning of 2015 to the end of the first quarter of 2016, but this span has been punctuated by periods of volatility as investors navigate this uncertain economic and policy environment. We believe this uncertainty is resolving in favor of a resumption of earnings growth and higher equity prices as the headwinds of the past 18 months subside. Improving earnings, attractive valuations in the aggregate and opportunities at the sector and security levels should lead to robust total returns for equities over the next year.

The U.S. economy continues to grow modestly with low inflation, and forward indicators support a continuation of that trend. Overseas conditions have been less favorable with weakness in many emerging markets, deflation concerns in Europe and Japan, and slowing growth in China. Uncertainty about China reached a crescendo in the first quarter of 2016 as China changed the manner in which it manages its currency and created significant concern about the state of its economy.

We believe the weakness in global growth has been fully discounted and that the trend will inflect higher, supporting the earnings of large-cap companies. We expect improving growth in developed economies as the impact of aggressive monetary policies and the lagged impact of weaker currencies support the real economy. Emerging economies also appear to be showing signs of improvement after a prolonged period of adjustment resulted in significant underperformance and currency weakness. In addition, China has demonstrated a commitment to growth with a combination of stimulative fiscal and monetary measures designed to ease the economy’s transition from export- to consumer-driven. This stimulus has resulted in improvement in more recent data as well as a decline in the volatility of China’s capital markets. While this journey will be bumpy at times, China has sufficient resources to manage this transition while avoiding a hard landing.
We expect that U.S. economic growth will also improve on its subpar first-quarter performance. The environment remains highly stimulative for the consumer-led U.S. economy, with low energy prices, low unemployment, low inflation and low interest rates. The Federal Reserve has signaled its intention to pursue a policy that is ‘just right,’ eliminating discussion of negative interest rates and talk of two or more tightening moves. Thus, the Fed continues to lean toward gradual normalization with a dovish tilt that can be justified in a low-growth, low-inflation environment. With greater clarity on monetary policy, equities should react favorably to strengthening economic growth and earnings expectations in the U.S.

Divergent growth and monetary policy between the U.S. and overseas economies have resulted in a much stronger U.S. dollar over the past two years. This has been a drag on earnings of large-cap companies, resulting in roughly a $10 hit to earnings per share for the S&P 500 in 2015. In addition, management teams used fairly conservative estimates for foreign currency levels in 2016 earnings. However, the dollar’s trend recently changed, and it has fallen several percent from its mid-January highs (Exhibit 1). While we would not expect the dollar’s weakness to turn into a rout, the shallow trajectory of interest rates is likely to lead to a weaker dollar than many companies and analysts expected. In addition, this gradual normalization is positive for the Chinese yuan and takes the risk of a disruptive Chinese devaluation off the table. This will contribute positively to earnings over the course of 2016.

Exhibit 1: Dollar Headwinds Are Fading

[Graph showing DXY Index]

Source: Bloomberg, 1/1/14 - 3/22/16

While energy prices do not solely depend on the U.S. dollar, the currency’s rapid rise in 2014 and 2015 arguably added to the challenges faced by oil, a dollar-based commodity. However, the primary driver of the tumble in energy prices has been oversupply. After two years and a greater than 60% decline, the forces of supply and demand are being brought into balance. Of course, the weakness in the underlying commodity led to declining earnings for the Energy sector. Indeed, the drop was so severe that energy-related losses were enough to result in an earnings decline for the S&P 500 as a whole, despite positive results in other sectors.

We believe the energy market will come into balance this year and that oil prices will recover in the face of increasing demand (Exhibit 2). In turn, oil will likely return to $50 to $60 a barrel, a price at which the sector will gradually return to profitability and lead to higher earnings for the market as a whole. The silver lining to the oil-price decline — one that we believe has yet to be fully reflected in growth or earnings — is its positive impact on the U.S. consumer. Lower oil prices effectively act as a tax cut on the U.S. consumer. We expect consumer spending to be an important driver of growth for the U.S. economy and large-cap earnings.
Our forecast for the broad market is for high-single-digit total returns, composed of a 2.2% dividend yield and mid- to high-single-digit earnings growth. Equities are fairly valued, but low-inflation/low-interest-rate environments often coincide with above-average multiples. Value stocks are particularly attractive and are trading at levels experienced only a handful of times over the past three decades. Often these distressed valuations coincide with recessions — suggesting that this cohort of stocks has discounted severe weakness in the economy (Exhibit 3). We believe the probability of recession in our investment horizon is low, and that these securities will outperform the broad market as global economic growth improves.

**Exhibit 2: Oil Recovery Helps Earnings**

Source: Bloomberg, 12/31/13 - 3/22/16

**Exhibit 3: Value at Compelling Levels**

We are particularly enthusiastic about opportunities at the sector and security levels, where valuation dispersions are as wide as we have seen them in decades. The post-recession period has been characterized by the pursuit of safety, which has driven the valuations of many yield- and quality-oriented investments to unsustainable levels. Bonds and bond-like equities will offer very low and, in many cases, negative real returns over the next several years. Other sectors with more cyclical exposure have seen their valuations decline as investors have pursued the safety trade — at any cost. Utilities and Financials (Exhibits 4 and 5) are primary examples of sectors that represent these trends. While it can be difficult to be overweight Financials and underweight Utilities in any given quarter, we believe that expensive sectors with low earnings growth will underperform inexpensive sectors with compelling earnings potential over time. We are as excited about the opportunities for security selection as we have been in several years.

Exhibit 4: Utilities Sector Valuations Are Unattractive

![Utilities Sector Valuations](image)

Source: Fundstrat, 2/5/2016. Price-to-Earnings Ratio LTM.

Exhibit 5: Financials Sector Valuations Are Attractive

![Financials Sector Valuations](image)

About the Authors

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Brian is the senior portfolio manager on The Boston Company’s Dynamic Large Cap Value strategy, a position he has held since 2003. He also functions as the team analyst responsible for the Health Care and Financials sectors. Brian has been with the firm since 1997. Brian joined The Boston Company as a research analyst on the Small and Mid Cap Opportunistic Value team, focusing on financial services and consumer-related stocks. In 2000, he became a portfolio manager of the firm’s Mid Cap Value strategy at the time of its successful launch. Before joining the firm, he was a research analyst on the Vanguard Windsor Fund at Wellington Management. Prior to that, he was an assistant director of General Electric Capital Corp.’s corporate treasury group and graduated from GE’s Financial Management Program. Brian received a B.A. in economics and international relations from Bucknell University and an M.B.A. with a concentration in finance from Columbia Business School.

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