Equity Outlook: Summer doldrums sign of hope, not complacency

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While extremely low headline volatility of late may be putting some investors to sleep, beneath the surface, there has been a healthy and ongoing rotation among market sectors that should continue into the fall, pulling the S&P 500 ever higher toward our near-term 2,500 and long-term 3,000 targets. The reasons are three-fold: the economic backdrop is still solid; credit and liquidity conditions remain good; and politics and the Fed appear set to work together and revive the "Trump trade" in coming months. So stay long stocks. Add to industrials, financials and health care. And don't abandon tech yet—there's more to come in the next 12 months. Now for some specifics:

- **Market volatility is higher than it looks** and this is a good thing. Right after the election, we had a big leg up, driven by financial stocks. That trade gave way to big internet stocks, dominated for most of this year until early June. Recently, they are taking a breather and the health-care stocks are popping. All told, we now have five sectors up 20% or close to it (tech, financials, health care, industrials and materials) since Nov. 1, 2016, even though the weeks in which they achieved this have been quite different. In my experience, rotational markets like this tend to be a sign of strength, not concern. They often come as part of a broad market advance.
- **Despite recent modest softening in some indicators**, the domestic growth outlook remains favorable and most overseas economies are stable to accelerating. For sure, U.S. numbers are a bit lighter, especially in autos, but also in durables, retail sales and even housing somewhat. But all are lighter off strong levels, while confidence gauges—an important forward indicator—remain elevated. Overseas, the numbers are better, especially for Europe and China, the two biggest economies next to ours. With employment low and inventories across the economy reasonably tight, there is little to no reason to expect an economic slowdown in the next 12 months, making for a supportive backdrop for stocks.
- **Politics in Washington could soon be reviving** the Trump trade, giving the market another leg up. Despite all the noise, I like what I am seeing. The Senate leadership seems determined to go forward with the health-care vote. Obviously, this is going to be very difficult and it's possible the vote fails. But for the market, there are two key takeaways: If the Republicans manage to forge a compromise measure acceptable to both the moderate and conservative wings of the party, the outcome is not going to be so dramatic that it destroys health-care stocks; if they can't get a measure through, they are going to move on to tax reform. That is what the market wants, and especially if they fail on health care, they will be all the more under pressure to pass tax reform. That is becoming increasingly clear and is very supportive of earnings in 2018.
- **The Fed and the other central banks in Europe and Japan** also are helping in their own peculiar ways. Since the start of the year, the yield on the 10-year Treasury is down almost 50 basis points, suggesting even in "tightening mode," the Fed's innate dovishness combined with the continued liquidity infusions from overseas central bank means the upward path of interest rates this cycle will be slow and gradual, not fast and dramatic. That is key for the equity bull market. As long as rates rise slowly, they do more good than harm for the economy and markets. Retirees start earning some money on those bank savings, banks start earning some money on their lending activity and investors stop heavily discounting equities for the potential of another major bout of deflation or depression. With Chair Yellen's term ending soon and her legacy at stake, we expect the Fed to hike again in September, getting us back to what she would view as "normal" levels on the short curve. And with that accomplished, she can begin the long balance sheet-shrinking process in December, which she has already signaled will be ever so gradual. We think this kind of Fed tightening is ideal for the market, supporting earnings in one of its largest and cheapest sectors (the banks), while being low and slow enough to not negatively impact the market multiple.
- **Cautious sentiment, high cash levels and continuing M&A activity** are all equity supportive. Judging investors by what they do and not what they say, the Wall of Worry a market needs to fuel a rise remains very much in place. Though not at all-time highs, retail and institutional cash levels remain elevated. Virtually all the clients I speak with are cautious and, frankly, under-invested in the market. And in the real economy, companies remain awash in cash, credit spreads are low, and mergers and acquisitions are very much alive and well. All of this is suggestive of a market that grinds higher, not lower.
- **Valuations are not excessive** by any stretch. A well-kept secret that few people talk about is that most of the market's 200% rise off the 2009 lows has been bought and paid for with earnings growth of a like magnitude. On consensus earnings for the next 12 months, the S&P is trading at an 18 forward P/E. And against Federated's

expectations for 2019 earnings, the market is trading at 16.5 multiple. While not dirt-cheap, these levels are neither expensive nor remotely excessive given the strong fundamental backdrop. Our forecast of 3,000 on the S&P by sometime in late 2018 or 2019 implies a stock multiple at 20 P/E, which is reasonable as long as interest rates rise in the slow and gradual pattern we expect. Bottom line, valuations do not imply we are anywhere near a market top.

So go ahead and worry about an extremely low VIX, the recent mini tech sell-off, an aging recovery, even political gamesmanship. The reality is that sometimes, we get too caught up in the machinations of the overall market and forget it is simply a collection, or average, of stocks. And a number of stocks look very attractive at the moment—that's what keeps us very optimistic. Even with the year-to-date returns we've already booked, there are many stocks with relatively cheap valuations, strong balance sheets and solid growth prospects across a range of sectors.

While complacency is never a good thing, try not to worry too much. We are climbing the Wall of Hope now, and whatever brief storms the summer winds may blow in, we are likely to be higher up that wall by year-end.

Stephen Auth, CFA
Chief Investment Officer, Equities, overseeing all of
Federated's equity and asset allocation products globally

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Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

Federated Global Investment Management Corp.

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Federated®
Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900