Market & Investment Insights

Taking stock of a 2013 rotation to equities

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Article Highlights:

- After years of shunning stocks and piling into bond funds, retail investors reversed course in 2013, allocating more than $100 billion to stocks through September.

- While the broad U.S. stock market set new all-time highs this year, equities appear to have room to run as the U.S. economy continues to improve.

- Macroeconomic events continue to influence markets, although equities are moving less in lockstep, enhancing opportunities for stock pickers.

- Emerging markets equities appear undervalued as they have broadly underperformed in 2013, though the outlook varies greatly by country.

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Retail investors seemingly gave up on stocks after the 2008 market meltdown, allocating more than $1 trillion to bond funds while pulling more than $500 billion out of equities over the five years ending in 2012 (see Exhibit 1). After years of elevated market volatility, a decade of lost equity returns and a succession of asset bubbles, it appeared that Main Street investors lost faith in equities as the return drivers of their portfolios.

Exhibit 1

Investors typically return to stocks when markets improve but that did not happen after the end of the last recession in 2009: Stock prices more than doubled from
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the March 2009 bottom to April 2011, but investors largely stayed away, preferring bonds as the uneven U.S. economic recovery and uncertainty continued to cloud the outlook.

Investors reversed course in 2013, however, as the U.S. economy strengthened, equity markets produced double-digit gains and bonds became increasingly volatile. With the housing and job markets improving and consumer confidence rising, many retail investors have come back to the stock market. For the first time in over five years, retail bond funds experienced net outflows while stock funds experienced net inflows (see Exhibit 2).

Exhibit 2

Although the reversal of asset flows is noteworthy, the flow into stock funds hasn’t been dramatic, and certainly not yet the “great rotation” that some pundits have predicted. The amount flowing into stock funds pales in comparison to the outflows experienced after the crisis. Market indexes recorded all-time highs this year, but the heaviest flows in 2013 have been to money market mutual funds, indicating that many investors are still on the sidelines and may be skeptical that the current rally has room to run. With a positive outlook on the U.S. economy and corporate earnings, the current may still have legs.

Equity valuations remain attractive in the U.S.

With an improved outlook and rising positive sentiment, the S&P 500, a broad measure of the U.S stock market, has risen about 30% year to date as of November 22, with lower volatility compared to recent years. For investors on the sidelines, this could cause some trepidation about how much further this rally has to go. The market has risen rapidly, though it appears to have room to run. With economic growth in the U.S. expected to pick up next year, our view is that corporate earnings should continue to expand in 2014, which makes a case for higher valuations. The price-to-earnings ratio of the S&P 500 was around 17 times a share in October, which is roughly its long-term average, but far below levels from previous market peaks in 2000 and 2007 (see the purple line in Exhibit 3). Corporate earnings have continued to expand in 2013 to record levels, as shown by the blue line in Exhibit 3.
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One measure to look at for assessing the general value of stocks is the 10-year Treasury yield, which is around 2.7%. When the yield rises, it makes equities less attractive. We think the yield would need to rise from its current level to about 3.25% before it would detract materially from the attractiveness of stocks. Because an increase of this size, were it to occur, would likely be gradual, we see potential for stock prices to rise further.

Europe looks promising, while emerging markets appear undervalued

Equities in other parts of the world are also compelling, though for different reasons. Emerging markets have broadly underperformed to date this year. Some underperformance in emerging markets may be attributed to rising U.S. interest rates and a strengthening dollar, but there are also many country-specific issues to consider, such as a growth slowdown in China.

Many investors repositioned their portfolios in response to the 10-year Treasury yield, which began rising in May on improving U.S. economic news. While emerging markets appear undervalued as a whole, the prospects for individual countries widely vary. China, the largest emerging market, has hit some rough patches this year, but the economy looks like it has bottomed and is poised for stronger, more stable growth—if the government is successful implementing reforms and reducing a dramatic rise in private sector credit, which has grown to more than 200% of gross domestic product (GDP).

European stocks appear to be slightly overvalued, although Europe’s economy has emerged from recession and has continued to grow, though very slowly. The economic picture there remains positive with expectations of improving economic data.

Japanese equities have led the world this year as investors cheered Prime Minister Shinzo Abe’s economic policies and reforms. Japan has experienced much needed inflation, but a plan to raise sales taxes in April have created some skepticism over its future economic prospects. Japanese companies with significant exports that aren’t solely dependent on the domestic market will continue to be attractive for investors. Companies that are nimble, have broad international exposure and not
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overly dependent on the country that they’re based in—are the ones that will outperform not only in Japan, but everywhere.

Exhibit 4

Macro events continue to influence markets

Macroeconomic factors such as the recent federal government shutdown, the Federal Reserve’s plan to “taper” its monthly bond purchases, and the debt ceiling debate, among others, have driven the direction of equity markets at times in recent years, rather than fundamental factors such as corporate earnings. During this period, equity correlations spiked, and have remained elevated since 2008. When correlations are high, it means stock prices are generally moving in tandem, either up or down, which makes stock picking challenging for active managers. A correlation of “1” indicates that all stocks are moving up or down in perfect lockstep. Equity correlations have remained high this year versus historical levels, but have dropped noticeably since last year (see Exhibit 5), which means conditions for fundamental stock selection, while not ideal, have improved. Recent episodes of rising correlations have tended to be short-lived. Markets may continue to be swayed by macro events in the coming months, though we see opportunities improving for active managers with strong fundamental analysis to find undervalued companies. Equity correlations should fall further as the economy continues to improve and investors are less swayed by dramatic events in the U.S. and international markets.
Room to run

Our view is that the U.S. equity market has not peaked in the current cycle. The U.S. economy continues to improve, albeit slowly and unevenly. Job growth has increased in recent months, while the outlook for the housing sector continues to improve, both of which support further room to grow for equity valuations.

U.S. stocks have risen considerably in 2013, but we do not see bubble conditions at the market or sector level. We also see potential for greater investor flows into stocks in the coming months as medium and longer-term interest rates are poised to rise, and while shorter-term rates and money market yields remain grounded near zero. Price-to-earnings valuations should continue to expand in 2014 as the economy improves, corporate earnings grow and macroeconomic issues continue to fade from view. Rough patches will likely persist, though these could present opportunities for investors to add exposure to companies with strong fundamentals, including those with strong free cash flow, strong profitability and leading market share positions.