CAMPBELL CN NEWMAN
Asset Management, Inc.

More Questions than Answers

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Reflections & Perceptions

The current bull market is now five and a half years old, making it the fourth longest bull market on record. Although the S&P 500 achieved a new all-time high in September, signs of market flux increased during the third quarter and, in some cases, raised questions without providing ready answers. For example, large caps outperformed small by a wide margin, with the S&P 500 posting a gain of 1.13% in the quarter compared to the Russell 2000's negative 7.65% return. Is the sell-off in small caps, which tend to be higher multiple stocks of companies with more leveraged balance sheets, a sign of: 1.) A change in market leadership to more defensive names, 2.) An effect of tighter money due to the wind-down of quantitative easing, or 3.) A short-term trend that will be reversed over the next three to six months?

Among the large caps, the S&P 500's sector returns showed considerable divergence, another indication of market flux. The Healthcare sector, up 5.46%, had the best performance in the quarter and was led, to a large degree, by "growth" biotech names like Gilead (+28.39%), Amgen (+19.23%) and Regeneron Pharmaceuticals (+27.63%). This is not necessarily what one would expect to see in a "risk-off" environment. At the other end of the spectrum, the S&P 500 Energy sector reported the worst quarterly performance, with a return of negative 8.62% and costing the Index close to one full percentage point of return. Energy stocks struggled as the price of oil fell by over 16%, from $113/bbl for Brent crude in late July to $94/bbl at the end of September. It is somewhat of a conundrum to see oil prices drop precipitously as tensions in the Middle East appear to be escalating. Has the commodity sold off over concerns of slowing economic activity in Europe and China? Is it that the balance of power in the energy market has shifted due to the significant increase in domestic production over the past several years? Or, could it be that the Saudis are currently amenable to cutting prices but not production, which has altered the short-term pricing dynamics for crude oil?

While these areas have appeared to be in transition, others continue to make progress along the same lines or show improvement. For example, on a macro level, second quarter 2014 GDP growth bounced back to 4.2% following the first quarter weather-induced slow down. Employment rolls continue to grow, with September representing the sixth month in a row of 200,000+ job growth. Third quarter S&P 500 quarterly earnings are on track to reach a new all-time high of almost $30 and company managements continue to reward shareholders with higher dividend payments. As of September 30, 423 (85%) of the S&P 500's constituents paid a dividend. We have seen a consistent trend of improvement in this metric since the dividend cuts of 2008-2009. Aggregate price/earnings ratio valuations in the large cap sector of the market remained basically flat during the quarter as earnings estimates for this year and next for the S&P 500 held steady.

Despite a muddling domestic economy, the prospect of tighter monetary policy, growing concerns emanating from China, Russia, Europe and Middle East, the S&P 500 Index achieved a new all-time high level in September. While the Federal Reserve will indeed be winding down its Quantitative Easing program this month, we believe that the Fed will remain cautious and raise rates only as the environment permits. One other factor to keep an eye on is the recent appreciation of the dollar versus our major trading partner's currencies. This move in exchange rates has the potential to hamper exports and thus revenues and crimp profits due to negative translational effects.

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We continue to believe that stock prices can move higher alongside earnings growth. With third quarter earnings season right around the corner, investors will receive their next surge of data as it relates to the state of the current year's corporate profit growth trajectory. Six months of earnings is already in the books and as a result it appears that third quarter earnings reports should continue to support the consensus view that $120 is an achievable earnings number for the S&P 500 in the current year. This will mark yet another record year of higher earnings since the 2009 trough. Price earnings ratios have expanded during the bull market as stock prices moved up faster than earnings grew. Going forward investors should expect future returns to be influenced more by earnings growth and dividends than by the impact of expanding price earnings multiples. That being said, we think stocks are able to grind higher, over time, with earnings and dividend growth and an occasional correction along the way.

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