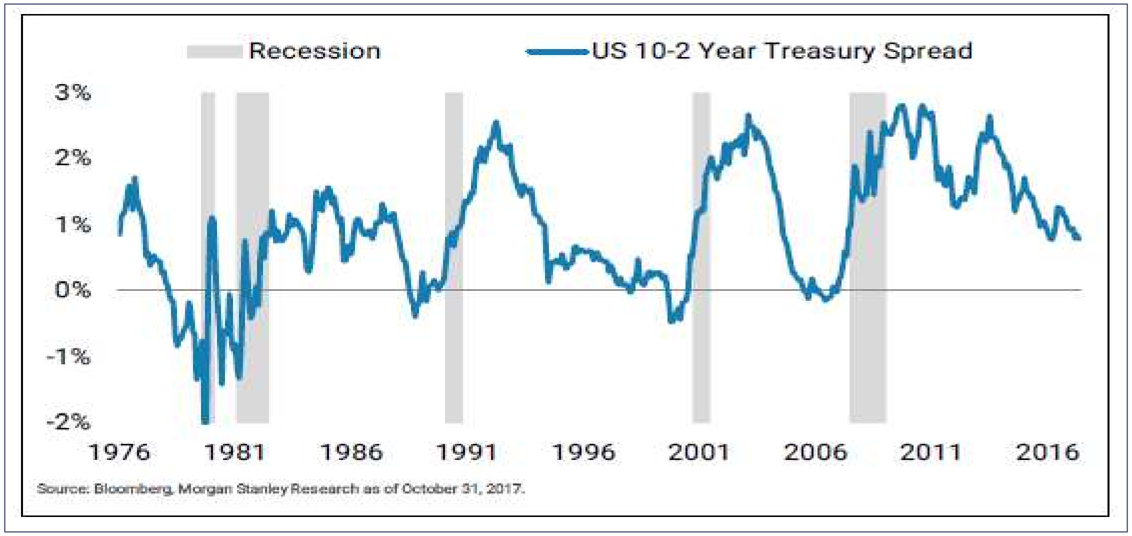
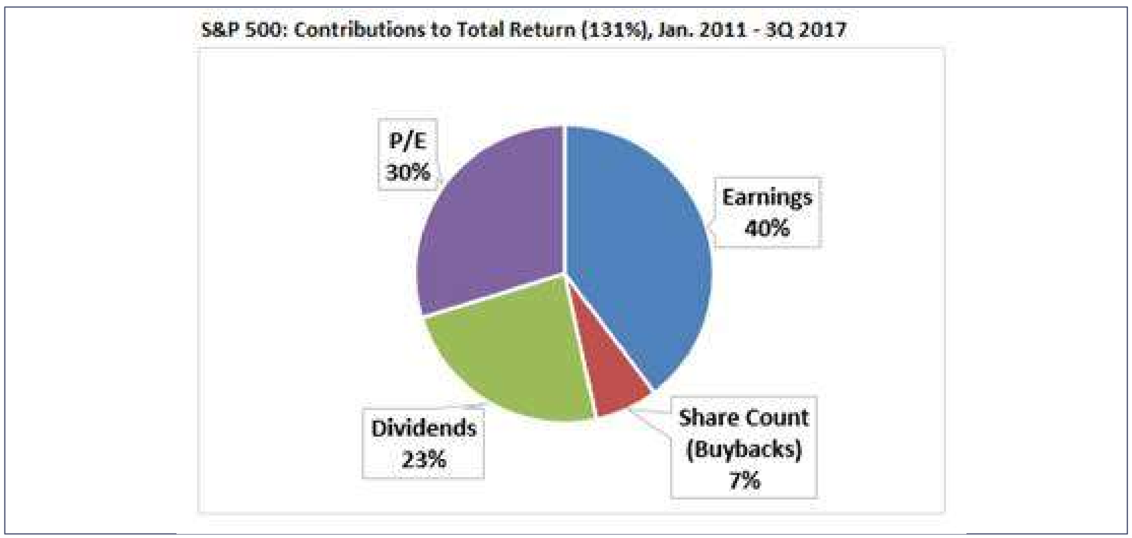
Market Recap

The U.S. Yield Curve Continues to Flatten



Source: Morgan Stanley

Underlying Drivers of Stock Market Returns



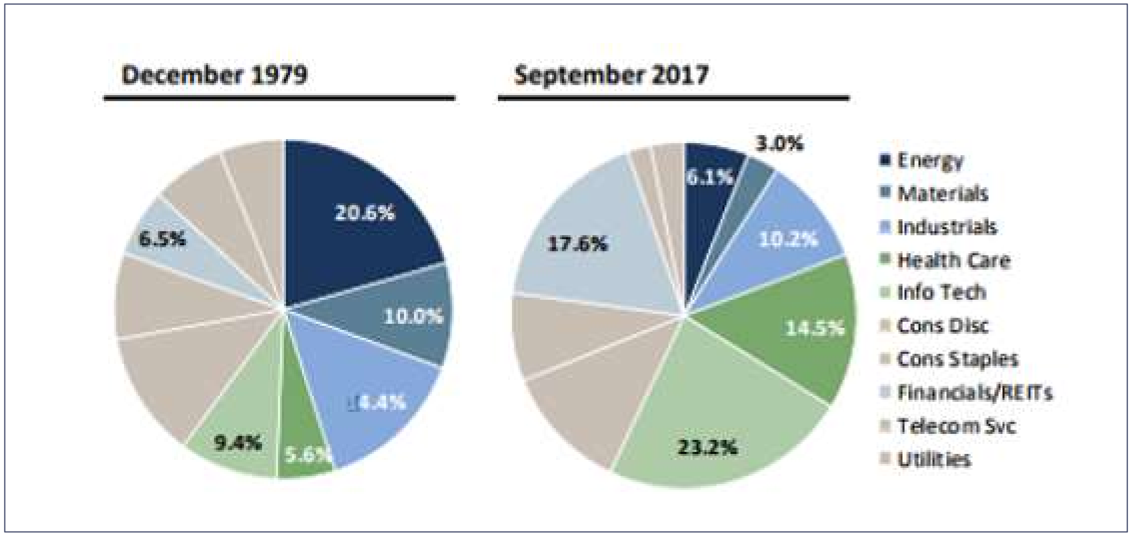
Source: Morgan Stanley

The difference in yield between a 10-year U.S. Treasury and a 2-year U.S. Treasury is referred to as the yield curve. It is often used as a signal to assess the current stage of the business cycle, with a rising yield curve associated with the early stages of a recovery and a falling yield curve associated with the latter stages of an expansion. An inverted or negative yield curve typically occurs near the end of the cycle, just before a recession. The inversion occurs when short-term interest rates exceed long-term interest rates, often when the Federal Reserve tightens monetary policy in anticipation of future inflation. The yield curve has continued to flatten over the past year as the Fed has gradually raised short-term interest rates. Nevertheless, this is less attributable to inflationary pressures and more attributable to a slow and steady rise in short-term rates after hovering near zero for the past eight years. As a result, we are less alarmed by the movement of the yield curve at this stage.

The fundamental levers driving equity market returns are growth in corporate earnings, valuation levels, and shareholder distributions (dividends and share buybacks). Dividends and share buybacks tend to be static – Thus, growth in corporate profits, and what people are willing to pay for that growth, are the primary variables over the course of an economic cycle. Over the past 7 years, growth in earnings has been responsible for 40% of the total S&P 500 return, while rising valuations have been responsible for another 30%. Given that we remain in an environment characterized by easy liquidity conditions, low inflation, and improving global growth prospects, it is no surprise that rising valuations have contributed substantially to market returns over that timeframe. That said, current valuation levels now stand above longer-term averages, and it is unlikely that further multiple expansion will meaningfully contribute to stock market returns over the next few years.

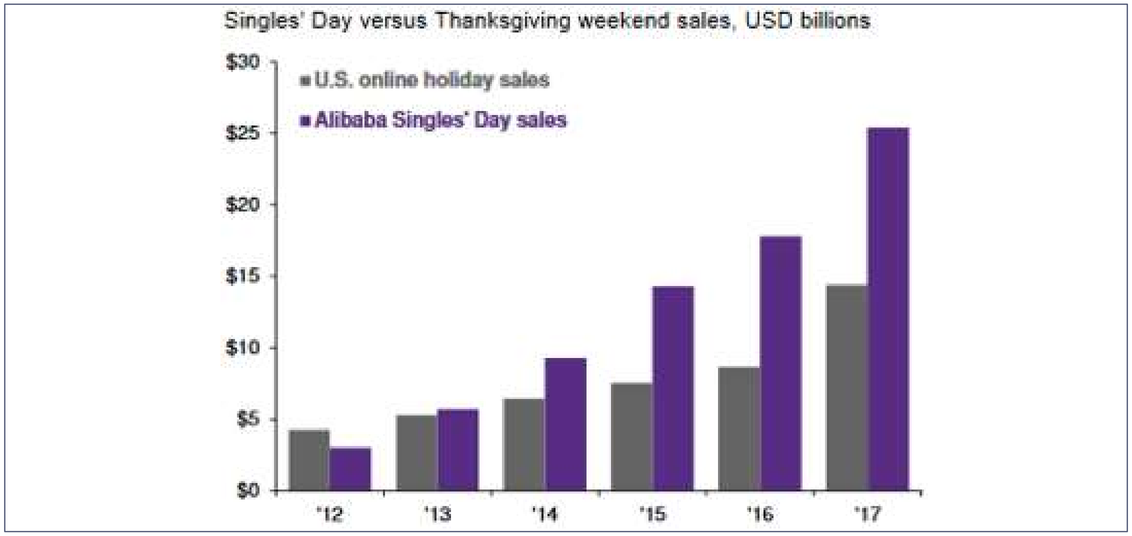
Market Recap

Shifting Sector Weights Reflect a Changing U.S. Economy



Source: GMO

Chinese E-Commerce is Gaining Steam



Source: JP Morgan

The sector composition of the S&P 500 has changed significantly over the past 40 years, reflecting a broader transition in the U.S. economy. Over time, the economy has evolved to rely less on manufacturing and become increasingly services-based. This persistent trend has unfolded as increased business outsourcing and rising imports from China have hurt domestic manufacturers. As a result, employment in the U.S. manufacturing sector has declined from 18 million jobs in 1990 to just over 12 million jobs today. In tandem with this shift, the sector weights of more cyclical, manufacturing-oriented sectors like Energy, Industrials and Materials have shrunk significantly (from 45% to 19% of the S&P 500), and been supplanted by more service-driven businesses like Financials, Healthcare and Technology (from 15% to 38%). While sector weightings do tend to fluctuate throughout the economic cycle, there is a clear structural bent to the longer-term trend.

Within the U.S., traditional "bricks and mortar" retailing continues to post moderating growth, while online retailing (i.e. e-commerce) continues to rise rapidly. This channel shift away from traditional retailing and towards e-commerce is well established in the U.S., and is most evident during the busy holiday shopping season. In China, the same channel shift towards e-commerce is occurring at an even faster rate. Although the Chinese economy is relatively less developed than the U.S., it is now the second largest economy in the world. At the same time, rising standards of living and rising incomes are leading to increased consumption by its population – online penetration within the Chinese retail market is estimated to grow approximately 9% per year and reach 23% by 2020.

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