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ICON Insights

Market Commentary - January 2018

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Domestic Equities

The stock market's advance and sector leadership in 2017 made sense to the ICON valuation system. Stock prices generally moved higher, but so did ICON's estimate of their fair, intrinsic values – primarily because earnings grew. Estimated earnings for the S&P 1500 Index for 2017 are 23.5% higher than reported in 2016. Over the course of the last year, we've consistently asserted that stocks in our database, on average, were not demonstrating the kind of overpricing we believe typical of market peaks. With fair value growing, we've argued, prices could move higher. We've rejected the notion that the bull market should have an arbitrary time limitation, such as eight years, or that the P/E ratio for the S&P 500 suggested a peak was imminent. In addition, we wrote that it was premature to worry about the Federal Reserve increasing its target for the Federal Funds rate by quarter point increments.

Table 1

Sector Returns 12/31/16 - 12/31/17	
Information Technology	37.3%
Materials	22.7%
Consumer Discretionary	22.5%
Healthcare	22.5%
Industrials	21.0%
Financials	20.8%
Consumer Staples	13.1%
Utilities	12.2%
Real Estate	9.2%
Telecommunication Services	-1.7%
Energy	-2.1%

Data quoted represents past performance, which does not guarantee future results.

As for sectors, we believe our value readings a year ago were a good guide to the sector performance, seen in Table 1. During the year we did not do much rotating other than to increase exposure to Health Care in February and Information Technology in April. We had less exposure to the poorer performing Energy, Telecommunication Services, Consumer Staples, Real Estate and Utilities sectors.

Looking ahead to 2018, the ICON market value-to-price (V/P) ratio for the broad market is now 1.01, implying that, on average, our estimate of fair value for stocks is about 1% higher than where they are currently trading. Analysts surveyed by Bloomberg are forecasting earnings for the S&P 1500 Index to grow by 10.6% in 2018. The combination of a 1.01 market V/P and earnings growing at over 10% would suggest stock prices, on average, would need to increase 11% to 13% just to keep up with our potential estimate of fair value a year from now.

While some lagging sectors have worked their way up our V/P ranking, the leaders still do not appear over-priced to us. Other conditions we contend accompany theme changes (volatility, for example) are absent, so we are inclined to believe the sector and industry theme of 2017 – a theme highlighted by large gains in the Financials, Information Technology, Health Care and Consumer Discretionary sectors – can continue into 2018. It should be noted that the month of December has been "messy" with regard to industry and sector performance, as some speculators have bought or sold based on anticipation of tax legislation. Once there is certainty in that regard, we expect more normal trading to resume and we hope our data will help guide us toward favored industries and sectors.

International Equities

The market capitalization of the equities in the United States is greater than the market capitalization of equities outside the United States, but in our global equity portfolios last year, we overweighted international stocks relative to domestic equities. That weighting was based on our value assessment and proved beneficial as the MSCI ACWI (ex US) beat the domestic S&P 1500 Index. In addition, our exposure to emerging markets was helpful as the MSCI Emerging Markets Index beat both the 1500 and the ACWI (ex US). Entering 2018, our valuations still favor international equities, with an average V/P for European stocks of 1.24 and a V/P for Asian stocks of 1.06 as of 12/27/17. As noted previously, we do not see conditions we often associate with theme changes. Thus, we begin 2018 positioned much as we were at the end of 2017, but remain open to change if circumstances require.

Bonds

The yield on the 10-year Treasury note hit a high for the year in March and a low in September, but otherwise didn't deviate significantly from the 2.20% to 2.50% range. The 10-year Treasury spent almost the entirety of the final three months of 2017 in an even tighter 2.3% to 2.4% range. We continue to believe, as we have written over the year, that short term and long term interest rates are being set by different variables. It is our opinion that short term rates are influenced by Federal Reserve policy, while long term rates are more a function of inflation expectations. Short term rates are rising while long term rates suggest investors expect inflation to remain low. We agree with these investors, and do not see much upward pressure on long term rates.

Summary

With stocks priced near our estimate of fair value and earnings expected to grow, perhaps even receiving a boost from tax reform, we expect the broad market to move higher over the next year. If the potential ascent is gradual, as it was in 2017, we will most likely continue to hold our current positions, believing over-pricing would be unlikely. If a sharp move higher results in lasting over-pricing, we would hope to sell into that situation. Of course, surprising news events can impact the market, but we believe those are unpredictable.

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Opinions and forecasts regarding sectors, industries, companies, countries and/or themes, and portfolio composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.

Investing in securities involves inherent risks, including the risk that you can lose the value of your investment. An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment. Investments in international securities may entail unique risks, including political, market, regulatory and currency risks. In general, there is less governmental supervision of foreign stock exchanges and securities brokers and issuers. Investing in fixed income securities such as bonds involves interest rate risk. When interest rates rise, the value of fixed income securities generally decreases. High-yield bonds involve a greater risk of default and price volatility than U.S. Government and other higher-quality bonds.

ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

ICON's value-to-price ratio is a ratio of the intrinsic value, as calculated using ICON's proprietary valuation methodology, of a broad range of domestic and international securities within ICON's system as compared to the current market price of those securities. According to our methodology, a V/P reading of 1.00 indicates stocks are priced at intrinsic value. We believe stocks with a V/P reading below 1.00 are overvalued while stocks with a V/P reading above 1.00 are undervalued. For example, we interpret a V/P reading of 1.15 to mean that for every $1.00 of market value, there is $1.15 of intrinsic value which has not yet been realized in the market price.

Price/Earnings (P/E) Ratio is the price of a stock divided by its earnings per share.

The unmanaged Standard & Poor's Composite 1500 (S&P 1500) Index is a broad-based capitalization-weighted index comprising 1,500 stocks of Large-cap, Mid-cap, and Small-cap U.S. companies. The unmanaged Standard & Poor's (S&P) 500 Index is a market value-weighted index of large-cap common stocks considered representative of the broad market. The unmanaged Standard & Poor's (S&P) 1500 Sector Indexes track the performance of sectors that comprise the S&P 1500 Index. The Morgan Stanley Capital International (MSCI) All Country World Index ex-United States (ACWI ex-U.S.) is a leading unmanaged benchmark of international stock performance. The capitalization-weighted index is representative of the performance of securities of companies located in developed and emerging markets outside of the United States. The Fund's emerging market exposure reflects countries that are members of the Morgan Stanley Capital International (MSCI) Emerging Markets IndexSM, a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2007, the MSCI Emerging Market Index consisted of the following 25 emerging market country indexes:Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. Total return for the unmanaged index include the reinvestment of dividends and capital gain distributions but do not reflect deductions for commissions, management fees, and expenses. The Portfolios' composition may differ significantly from the indexes. Individuals cannot invest directly in an index.

10-year Treasury notes are debt obligations issued by the U.S. Treasury that have a term of more than one year but not more than 10 years

The 10-year yield is the benchmark 10-year yield to maturity reflected by the current issue 10 year U.S. Treasury note.

Source: Bloomberg, FactSet

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