ICON Insights

Market Commentary - July 2017

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Domestic Equities

In late June 2016, voters in the United Kingdom surprised investors by voting to exit the European Economic Union. In the following two business days, Friday June 24 and Monday June 27, the S&P 1500 Index dropped 5.5%. The return off that Monday low through Friday June 23, 2017 has been an impressive 24.6%, while registering an all-time high in June. During that run, we have had two different markets the second half of 2016 and the first half of 2017.

Quarter-over-quarter real GDP grew at a pace of 3.5% and 2.1% for the third and fourth quarters of 2016, respectively. With that base the yield on the 10-year Treasury note rose and cyclical and financial stocks rallied. First quarter of 2017, however, GDP slipped to a dismal 1.2% pace. Cyclical and financial stocks gave up their leadership role. Information Technology and Healthcare have been the best two performing sector indexes as investors apparently doubted the ability of cyclical companies to grow in a slow growth economy. With the drop in longer term interest rates, the S&P Financials index posted just a small gain while the Utilities Sector was among the leaders. This behavioral switch has shown up in other measures beyond sectors. For example, in 2017 small-cap stocks have lagged large cap stocks while stocks some observers label as "value stocks" have lagged "growth stocks" in a dramatic reversal from late 2016.

In August 2016 – and again April 2017 –we increased exposure to Information Technology and in February 2017 we bought Healthcare. All moves were based on value and have been productive in the short run. We are not going to attempt a "top down" economic forecast as to whether GDP will pick up and if the "value stock" theme of late 2016 will return. Value is not guiding us to sell any existing sector positions. Our two largest sector positions, Financials and Information Technology, are solid "holds" according to our system with their V/Ps at or near the top of our value rankings. Energy has been the worst performing sector this year as the price of oil has dropped. We hold no Energy in the portfolio at this time, but that sector has worked its way up our value rankings. It may become eligible for purchase later in 2017.

While various indexes and averages have hit all-time highs in June, we do not see the broad market as over-priced. In fact, we begin the second half of 2017 with a market value/price ratio of 1.02, indicating stocks in our database, on average, are priced about 2% below our estimate of fair value. Prices have moved higher in 2017 but underlying fair value has grown. Based on value, we would expect stock prices, on average, to move modestly higher over the next year. In other words, the market's advance in 2017 appears sensible and sustainable to us from a value perspective.

International Equities

The dismal first quarter GDP growth appears to have affected currencies as well as domestic stocks. The US Dollar had been strong in late 2016 but weakened in 2017. The drop in the US Dollar has given a boost to the returns of international equities.

As regions, Europe and Asia have higher V/Ps under our system than the U.S.A. Based on value, we believe international equity prices, on average, can move higher over the next year. Our value readings continue to favor developed European countries and emerging Asian countries. In February we increased exposure to emerging markets mainly based on V/P readings in China, Indonesia, South Korea and Philippines. Financials and Information Technology are among our favorite sectors internationally, just as they are domestically.

Bonds

While we have thus far been correct in our view that long term interest rates would not rise in 2017, we are surprised by how low rates have dropped. The yield on the 10-year Treasury note, for example, ended June in the 2.15% range – down from its short-term peak near 2.60% registered in December and March. In March, we stated that we thought inflation expectations were the most important determinant of long term interest rates and that investors would view the increased target for the overnight Federal Funds rate as a fight against inflation. Therefore, we did not think long term rates would rise as the Federal Reserve raised the Federal Funds target. We continue to hold that belief.

Summary

This bull market has been going for eight plus years dating back to the March 9, 2009 market bottom. We believe it can continue another one to three years. A year ago we wrote, "With a market V/P of 1.09 to begin July, we would expect the market to break out of this range to the upside over the next year." Our domestic V/P of 1.02 is not as attractive as the 1.09 of a year ago, but still adequate in our opinion to support modestly higher stock prices over the next year.

The data quoted represents past performance, which is no guarantee of future results.

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.

Gross Domestic Product (GDP) is the total value of goods and services produced in the national economy in a given year. It is the primary indicator of economic growth.

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) Composite 1500 Sector Indexes track the performance of sectors that comprise the S&P Composite 1500 Index. 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.

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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