

# North American Equity Investment Outlook

June 2017

## Economic and market overview

Major North American equity market indices saw divergent performance amid periods of volatility in May. U.S. large-cap stocks, as measured by the broader-market S&P 500 Index,<sup>1</sup> gained 1.41% for the month. Conversely, shares of U.S. small-cap companies, as represented by the Russell 2000 Index, fell 2.03% for the month—its weakest performance since a 4.75% decline in October 2016. The information technology, utilities and consumer staples sectors led the upturn in the S&P 500 Index for the month. Conversely, the energy sector was the weakest performer within the index due to investors' concerns that the Organization of the Petroleum Exporting Countries' (OPEC's) plan to curb oil output would not be enough to drive oil prices higher. The financials and telecommunication services sectors also recorded negative returns and significantly lagged the overall market for the month.

The U.S. political arena was quite crowded again in May. U.S. Deputy Attorney General Rod Rosenstein announced the appointment of former FBI Director Robert S. Mueller III as special counsel for the ongoing investigation into the alleged collusion of members of President Donald Trump's presidential campaign with the Russian government. The move followed published reports that, according to a memo written by James Comey, Trump had asked the former FBI director during a private meeting in February 2017, to end the agency's investigation into former National Security Advisor Michael Flynn's possible ties to the Russian government during Trump's campaign in 2016. The allegations previously had led to Flynn's forced resignation in February of this year; Trump subsequently dismissed Comey from his position on May 9, 2017. The political turmoil plaguing the administration exacerbated investors' concerns that Trump will not be able to push through his agenda of tax reform and reduced regulation of US companies.

Regarding economic news, U.S. payrolls expanded by a generally lower-than-expected total of 138,000 in May. The professional and business services, food services, and healthcare sectors led the gains for the month. The unemployment rate dipped 0.1 percentage point over the month to 4.3%—its lowest level since May 2001—while the labor force participation rate declined 0.2 percentage point to 62.7%, virtually unchanged from the 62.6% rate in May 2016. Furthermore, average hourly earnings rose 2.5% versus the same period a year earlier. The U.S. Department of Commerce raised its estimate of first-quarter 2017 gross domestic product growth from 0.7% to 1.2%. The upward revision from the government's initial assessment was attributable to larger increases in nonresidential fixed investment and in consumer spending, while the decline in state and local government spending was smaller than previously estimated. These positive factors were partially offset by a larger decrease in private inventory investment over the quarter.

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The political turmoil plaguing the Trump administration stoked concerns that he will not be able to push through his agenda of tax reform and reduced regulation.

The U.S. unemployment rate dipped to 4.3% in May—its lowest level in 16 years.

<sup>1</sup> Indices are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

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## Outlook

Nothing occurred in May that would cause us to significantly change our market outlook. We still feel comforted by the state of the macroeconomic environment in the U.S. While we think that growth will likely remain tepid for the balance of 2017, we believe that growth may accelerate into 2018, driven by healthy employment growth and firmer wage increases. We remain concerned about the policy outlook as it seems that the debate concerning healthcare and tax reform has given way to discussion around campaign meddling and other issues that do not have a direct impact on economic growth. Nonetheless, we think that corporate fundamentals remain reasonably strong in terms of revenue growth, margin stability, and cash flow-generation. Equity valuations remain elevated on standard metrics—supported in part by a combination of implied tax cuts, economic acceleration and low discount rates.<sup>2</sup> However, the valuation premium for small caps relative to large caps decreased in May and, at month-end, the Russell 2000 and S&P 500 indices were trading virtually in line with each other. This compares to a historical premium of approximately 8% for small caps versus their large-cap counterparts.

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<sup>2</sup> The discount rate represents the required rate of return to make a business acquisition profitable.

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