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A Podcast Series by Kayne Anderson Rudnick

Episode 18

A Market Review of the First Quarter of 2015, and an Outlook for the Rest of the Year

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Len: Welcome to KayneCast. My name's Len Hirsh, and I'm the Assistant Director of Marketing Communications for Kayne Anderson Rudnick Investment Management. Today our guest is Doug Foreman, the Chief Investment Officer of Kayne Anderson Rudnick. Doug is joining us to give a market review of the first quarter of 2015, as well as his outlook for the rest of the year. Hey Doug, thanks for joining us.

Doug: My pleasure, Len. Thanks for having me today.

Len: So, Doug, could you give us an overview of what happened in the stock market during the first quarter?

Doug: Sure, Len, in the first quarter of 2015, the S&P 500 managed to eek out a small gain of about 0.95%. In particular though, small-cap stocks, as measured by the Russell 2000 Index, actually advanced 4.32%, eliminating some of last year's underperformance as they caught up.

As far as outside the U.S., international stocks, as measured by the MSCI EAFE Index, appreciated almost 5% and emerging-markets stocks, as measured by the MSCI Emerging Markets Index, rose 2.24% for the quarter. This is after some very poor performance over the last couple of years.

Len: Alright, and how about fixed income, Doug?

Doug: Well, the 10-year bond yield continued to defy expectations as yields declined from 2.17% at the beginning of the year to 1.92% at the end of the first quarter. The broad U.S. bond market, as measured by the Barclays Capital U.S. Aggregate Bond Index, actually advanced 1.61%. High-yield bonds, as measured by the Bank of America Merrill Lynch U.S. High Yield Index, gained 2.54%, and emerging-markets bonds increased slightly more than 2%.

Len: Okay, Doug, I'm wondering what we should make of Wall Street's consistent reductions in 2015 earnings expectations in the first quarter.

Doug: Well, good question, Len. This is the first time we've had downward earnings revisions in the S&P 500 in many years. We may have actually flat-to-negative year-over-year comparisons for the S&P 500 over the next two to three quarters, but it's important to understand what's behind the reductions in the earnings outlooks for many of these large multinational companies that heavily populate the S&P 500 Index.

First, weather, which hurt us last year, also hurt us again this year, hurt economic activity and should prove to be temporary just as it was last year, but more importantly, there's significant strength in the value of the U.S. dollar and this hurts many of the large multinational companies who have to report lower earnings and sales in overseas markets purely due to accounting translation effects. These same companies are seeing little to no impact on their foreign unit volumes or market share, but have reported lower sales and profits due to the U.S. dollar's strength. We don't worry too much about translation. It's purely an accounting mechanism and typically tends to reverse once the currency stabilizes, which it seems to be doing as we speak.

Conversely, exporters of commodity products, where there are many substitutes of comparable quality available to foreign buyers, are truly experiencing operational difficulties in the form of declining unit volumes and a loss of market share.

Len: Do you think these trends will persist?

Doug: Well, I think [in] areas that are more commodity-like like mining, materials, and energy, the dollar and the currency headwind will continue to be a problem as we go forward, but with most other companies we believe it will prove to be temporary. Even energy prices seem to have found some stability at the end of the first quarter in the $45 to $55 per barrel range, and small-cap stocks, on the other hand, that have much more of a domestic focus and are less impacted by currency have outperformed relative to large-cap stocks since the dollar has been appreciating over the last six to nine months.

Len: Yea, this substantial appreciation in the U.S. dollar has me wondering whether the Fed could hold off even longer in raising short-term interest rates.

Doug: Well, Len, that's entirely possible. The Fed this quarter finally removed the word "patient" from their communications to market participants. And most observers believe the Fed will modestly increase short-term interest rates in either June or September of this year. There is a small minority that believes it will be early 2016. However, I would point out the Fed has made it crystal clear that any future increases in interest rates are going to be data dependent. Obviously, the job markets and inflationary trends are going to be the key variables the Fed is going to monitor going forward before they decide on any future course of interest rates. It should be noted, however, that the Fed has plenty of leeway given the strong currency of the U.S. dollar and the fact that 10-year yields—although they're still very low by historical standards—are still way above other developed markets such as Germany and Japan.

Len: Okay, well speaking of other developed markets, can you talk a little about what's going on in Europe?

Doug: The euro declined 10% this quarter, which is a pretty big move, as the European Central Bank finally embarked on a Quantitative Easing Program, which we believed was going to happen late last fall. So far it has be thrilled with the results that it's seeing. European sovereign bond yields, which were already low by historical standards, have declined even further with the 10-year German yield down to 0.15% at quarter's end. European stock markets have rallied sharply in local currency and most of them are up on the order of double digits during the first quarter.

Len: Do you think Greece could be an issue going forward?

Doug: Well, some progress was made on the debt situation in Greece, and I think any potential exit from the Euro at this point seems pretty remote. It is possible that Greece reverses courses and exits the Euro, but unlike [the] 2010/2011 timeframe, even if that happened today I think the banking system and the Euro itself are very well prepared. So I think the impact of that will be minimal even if it does happen, and I think it's very low odds that it will happen. We're increasingly confident that European economic growth will at least stabilize, if not show some actual modest growth, this year.

Len: Well, that's a helpful review of the first quarter, Doug. So what's your outlook for the rest of the year?

Doug: Well Len, innovation is still significant in a variety of industries, such as health care, technology, and energy, and this is helping to maintain significant investor interest in equities. Cash, which has been earning zero on all these corporate balance sheets, is continuing to pile up, and corporate boards are finally blessing mergers and acquisitions as well as meaningful stock buybacks and dividend increases which have already been material this year.

So, despite a slow economic start to the year, we still believe that the U.S. will grow GDP in the 2.0% to 2.5% range this year due to strength in consumer net wealth and government spending, which should turn up for the first time in the last five to six years. International economies—which we mentioned at year-end needed to show some stability—particularly Europe and China, are providing that stability and should provide some additional support for growth throughout 2015.

So we believe that reported domestic profit growth on a constant currency basis—this is assuming a flat dollar from here—still looks likely to grow in the mid-to-high single-digit range, which should result in equity return on the order of five to ten percent.

With all of that being said, our strategy will be to continue to invest for our clients in high-quality businesses which can do well in good and bad times.

Len: Alright, well thank you for your insight and your time, Doug. And thank you to everyone who listened in. Again, we hope you are enjoying the series so far, and we always encourage you to get the most up-to-date episodes by either downloading a podcast app on your mobile device and subscribing to the KayneCast feed via iTunes, or by just listening to the KayneCast player on our website, which is at kayne.com.