Taking the pulse of the bull market

2016 investment outlook: US growth stocks

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Our belief for several years now is that we're in a secular bull market - with the S&P 500 Index rising over a multi-year period with only short intervening declines. As we look forward, considering today's evidence, we believe the bull market will continue, but is likely moving into later stages. As sales continue to grow, profit margins remain high, and valuation growth slows, annual equity market returns in the mid-to-high single digits seem more likely than outsized gains.

As we move into 2016, here is what we're seeing:

- We see evidence that the US is continuing its steady recovery, de-coupling from most global growth trajectories.
- We may also be seeing a more decisive shift to quality leadership, where businesses that have sustainable growth – and the balance sheets to self-fund that growth – outperform lower-quality companies.
- Additionally, we see fewer companies projecting continued high revenue growth. In our view, long-term winners with sustainable advantages have emerged, and we believe these companies will become even more recognizable in 2016. While this concentration of growth is especially true in large caps, we believe the impacts will ripple through supply chains and have a similar effect on mid and small caps.
- The sparks of 2015 stimulus in China and Europe will take time to materialize in the real economy, but in our view, conditions are positive for certain cyclical growth companies, especially those that would benefit from any reacceleration of global gross domestic product.

Two types of growth opportunities

There are certainly risks to the secular bull market thesis and equities in general. But importantly for our clients, we see many positive secular and cyclical growth themes that offer high-conviction investment opportunities, with potential reward well beyond that of the broad market. In particular, we see opportunity in two types of US growth:

- **Long-term secular growth.** This includes innovation, new mobility product cycles, on-demand digital content, market share shifts to e-commerce and social media advertising, and demographic shifts as baby boomers retire and echo boomers begin to earn and spend.
- **Near-term cyclical growth.** This includes capital expenditure cycles for hospitals, the continuing housing recovery and its ripple effect on consumer durable spending, the strengthening of US consumers' credit availability and spending, and the commercial aerospace cycle.

The bull market's mid-life crisis – clearing the way forward

The market's late 2015 correction was healthy and we were due for a pull-back. Three fears coalesced to drive the correction. We believe that two of them will resolve soon, allowing the secular bull to resume its path:

- **China's hard landing**
  - China has been an engine of growth for the global economy in recent years, and the market seems concerned that its transition to a consumption economy has failed, resulting in a no-growth "hard landing." China has implemented significant stimulus measures, and we believe any improvement in global trade should improve export growth so that GDP of 4% to 5% over the next several years seems reasonable – maybe not the 7% level that's been reported, but not 0% either. **We believe concerns here will moderate soon.**

- **Fed tightening cycle**
  - Many investors assume rising rates will negatively impact equity market valuations. But historical rate tightening cycles, where the Federal Reserve hikes interest rates fairly consistently, have often seen stocks rise well into the cycle. In seven of the last nine tightening cycles, the S&P 500 Index had a positive return 12 months after the first hike.[1] Also, since 1964, the S&P 500 Index has historically experienced its highest P/E multiples when rates were between 3% and 5%.[2] Given the exceptionally low rates today we believe there is room for stocks to appreciate and P/E multiples to expand. **The market's infatuation with the impact of a first interest rate increase should resolve for 2016.**

- **Biotechnology valuations**
  - There is true innovation occurring in biotechnology, and the potential of personalized medicine to cure untreatable conditions is being unlocked today. However, the companies that are working to engineer these miracles do not all succeed – in fact, the majority still fail. The valuations of small and mid-cap biotechnology companies have reached extremes that are unsustainable, and there are good reasons for valuations to pull back. Record capital has been raised – in 2014 there were over 70 initial public offerings (IPOs), exceeding the previous peak in 2000.[3] In 2015, biotech IPOs raised almost as much capital in the first nine months as in all of 2014.[3] While large-cap biotechs have more reasonable valuations and sustainable revenue growth prospects, their pricing model is being attacked publicly and politically, which will keep a lid on valuations, in our view. **We think we may have finally peaked in performance in biotechnology, especially in small and mid-caps.**

With these opportunities in mind and an understanding of the risks, we remain constructive on the market.

[1] Source: Bloomberg, November 2015. Based on 12-month period beginning with the initial Federal Reserve interest rate hikes occurring in 1972, 1974, 1977, 1980, 1983, 1986, 1991, 1999 and 2004.
[2] Sources: RBC, Federal Reserve, S&P; 1964 – November 2015.
[3] Source: Credit Suisse Securities Research & Analytics, October 2014

Important Information

Price-earnings (P/E) ratio, also called multiple, measures a stock's valuation by dividing its share price by its earnings per share.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

Past performance is no guarantee of future results.

Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Growth stocks tend to be more sensitive to changes in their earnings and can be more volatile.

The health care industry is subject to risks relating to government regulation, obsolescence caused by scientific advances and technological innovations.

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