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WEEKLY INVESTMENT COMMENTARY

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With Stocks Vulnerable, Think Big (Cap) for Value

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A Rough Week for Stocks Despite Little News

Stocks sold off last week, despite a lack of major news—outside renewed concerns over European banks—and even positive signs of some stabilization of the situation in Iraq. Globally, stocks lost roughly 1.50%. In the U.S., the Dow Jones Industrial Average fell 0.19% to 16,943, the S&P 500 Index dropped 0.90% to 1,967 and the tech-heavy Nasdaq Composite Index lost 1.57% to close the week at 4,415. Meanwhile, the yield on the 10-year Treasury fell from 2.64% to 2.52%, as its price correspondingly rose.

In a pattern eerily reminiscent of what we saw in April, the more expensive segments of the market experienced the greatest losses. In particular, U.S. small caps, biotech and Internet stocks floundered most. Several of the more richly valued Internet names, like Twitter (TWTR) and Pandora (P), were hit particularly hard.

The events last week provide a good illustration of an important fact of the markets today: A big multi-year advance has left stock valuations stretched, and as a consequence, vulnerable to bad news, even when it is relatively minor as was the case last week. This, in turn, reinforces our preference for a value bias through large- and mega-cap stocks.

Performance Getting Ahead of Fundamentals

An all-too-common theme in the markets today is stock performance outpacing fundamentals. Small caps are Exhibit A in this phenomenon. Despite lagging large caps year-to-date, small caps are actually the more expensive asset now. The reason? Small-cap earnings have seen weaker growth relative to large caps, which means investors are paying more per dollar of earnings. Illustrating this point, the small-cap Russell 2000 Index now trades at over 26x current earnings, versus 16.5x for the large-cap S&P 500.

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But this trend is not limited to stocks in the United States. Recently, we've seen a similar development in Europe. Stocks there have dropped roughly 5% from their June peak, but are still up nearly 20% over the past year. Again, the market's recent vulnerability may stem from the fact that the past year's gains have outpaced earnings growth. On a price-to-book basis, European equity valuations are up 25% over the past year and 60% from their 2012 lows. European stocks are actually still inexpensive relative to the United States, but they are no longer that cheap on an absolute basis.

Fed Still Supportive Even as QE Ends

Part of the explanation for what we are seeing is that monetary policy remains extraordinarily accommodative. While recent economic data give the Federal Reserve (Fed) more latitude to start normalizing monetary conditions, recently released minutes from the Federal Open Market Committee (FOMC) suggest that the Fed still appears willing to wait. The Fed is on course to end its bond buying program (known as quantitative easing) in October. However, the central bank appears in no hurry to raise interest rates.

With rates stuck at zero, and likely to stay there for the remainder of the year, money continues to flow into bond funds as investors struggle to find yield. For the latest week, bond funds took in an additional $3.6 billion, with much of the money going into investment-grade products.

Stick With Value

In a world in which stretched valuations leave stocks dependent on the Fed's cheap money policies and vulnerable to bad news, we'd continue to emphasize a value bias. For domestic stocks, this suggests leaning toward large- and mega-cap names, which have outperformed small caps by roughly 6% year-to-date. Outside of the United States, investors, particularly those with little exposure, should take another look at emerging markets (EM) stocks. Since the April lows, EM stocks have modestly outperformed developed markets and inflows continue. For the week ended July 9, EM equities garnered another $1.4 billion. If nothing else, we read this as a sign that investors are aware that stocks in the developed world are looking pricey.

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