

Q4 2015 » Putnam Perspectives

# Equity Outlook

**Robert D. Ewing, CFA**  
Co-Head of U.S. Equities

**Nick C. Thakore**  
Co-Head of U.S. Equities

**Simon Davis**  
Co-Head of International Equities

**Shep Perkins, CFA**  
Co-Head of International Equities

## Key takeaways

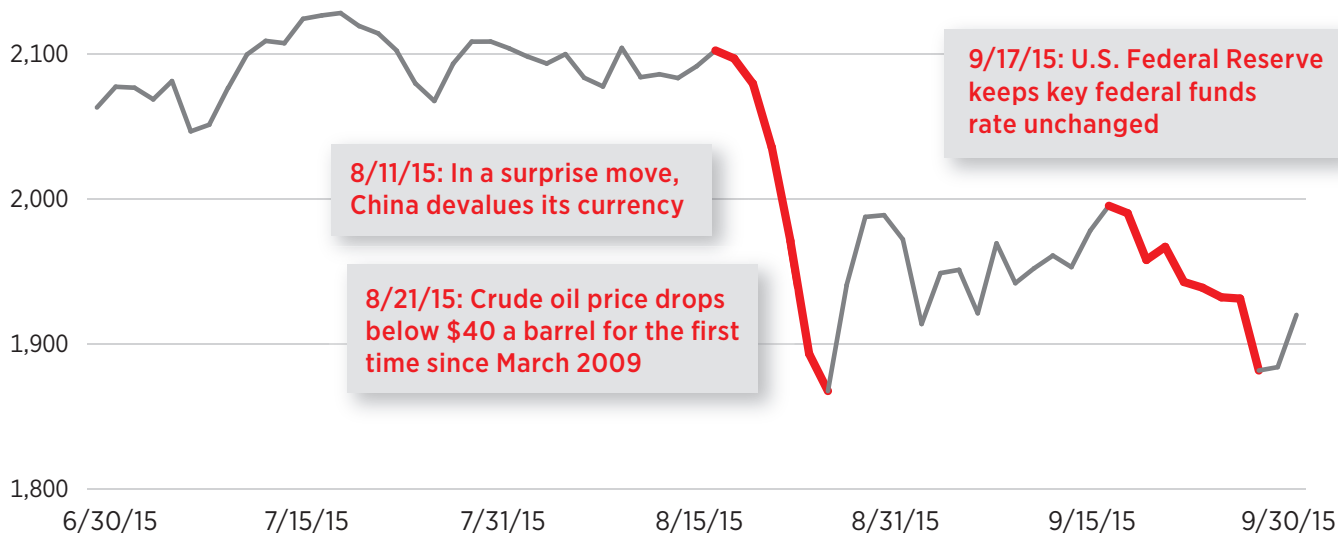
- While the U.S. market took investors for a bit of a wild ride, the downturn was not particularly surprising.
- China's economic slowdown has exposed economic vulnerabilities across emerging and developed markets.
- Among U.S. equities, we see many investment opportunities that were nonexistent just a few months ago.
- Amid growing risks in emerging-market economies, stocks still appear relatively cheap — particularly in relation to bonds.

## The long-anticipated correction arrives for U.S. investors

U.S. equities endured their most challenging quarter in years, and the market's extraordinary advance of previous quarters came to an end with significant volatility. The turbulence peaked in August with some of the biggest swings in the history of the market, including a historic 1,000-point intraday plunge for the Dow Jones Industrial Average on August 24. For the first time since 2011, major U.S. equity indexes experienced a correction, defined as a decline of 10% or more from a recent high. Stocks recovered from their August lows and ended the quarter with a decline of 6.44%, as measured by the S&P 500 Index. While many U.S. equity investors were unnerved by the sharpness and speed of the third-quarter decline, we believe the downturn was more notable for the length of time it took to arrive.

## U.S. equity market swings were triggered by a number of events

*S&P 500 Index for three months ended 9/30/15*



## Market scorecard

Select equity index performance as of 9/30/15

*Global markets endured a difficult third quarter, with EM and growth stocks leading the decline*

Index name	Q3 2015 (cumulative)	1 year	3 years (annualized)	5 years (annualized)	10 years (annualized)
S&P 500 Index	-6.44%	-0.61%	12.40%	13.34%	6.80%
Russell 1000 Value Index	-8.39	-4.42	11.59	12.29	5.71
MSCI World Index (ND)	-8.45	-5.09	8.58	8.29	4.73
MSCI Europe Index (ND)	-8.69	-9.33	6.03	4.28	3.31
MSCI EAFE Index (ND)	-10.23	-8.66	5.63	3.98	2.97
Russell 2000 Growth Index	-13.06	4.04	12.85	13.26	7.67
MSCI EM Index (ND)	-17.90	-19.28	-5.27	-3.58	—

Sources: Standard & Poor's, MSCI, Russell.

### China leads global stocks astray

China's surprise currency devaluation sparked the recent selloff in global equities, but market observers are still struggling to gauge the level of China's economic distress. Ominously, the Chinese government tried various policy tactics, including interest-rate cuts, stock market interventions, and more spending, but these efforts to restimulate growth and calm investors generally failed to halt the market rout. So it is difficult to say if the worst is over, but we do expect more volatility in global markets in the months ahead.

## U.S. equities

### A turbulent, but not unexpected, market shift

It was the first eventful quarter in some time for the U.S. equity market, which had a correction — and a considerable dose of volatility — in August and September. The downfall was swift after a relatively calm first half of 2015, when the U.S. equity bull market entered its seventh year and the S&P 500 Index reached a record high close on May 21. While the market took investors for a bit of a wild ride in the third quarter, the downturn was not particularly surprising.

For several quarters, we have observed that equity valuations were approaching the top quartile of their historical averages, and we believed that investors should be cognizant of the risk of a market correction. However, it is not unusual to have downturns of this magnitude during bull markets. The S&P 500 had gone 1,326 calendar days without an official correction, defined as a decline of 10% from a recent high. Not only was it overdue, the decline was likely a healthy development. We now see many investment opportunities that were nonexistent just a few months ago.

### Late-summer turmoil delivers valuation opportunities

Small-cap growth stocks had the steepest losses for the quarter, posting a double-digit decline, while large caps endured the turbulence best. In terms of sectors, materials and energy were among the hardest hit, due largely to struggling commodity prices, while health-care stocks, and biotechnology in particular, also suffered significant declines. In the wake of these losses come opportunities for investors with patience and a commitment to fundamental research. At the midpoint of 2015, we observed that stocks had become expensive in most of the sectors we cover in our equity research, and in some cases valuations were stretched. This has eased quite a bit, and valuations have become more reasonable or, in many cases, compellingly cheap.

## ***In the wake of U.S. equity losses come opportunities for investors with patience and a commitment to fundamental research.***

### **Cheapness and controversy: Sectors we are watching**

In today's market, no sector is more controversial, or beaten down, than energy. Even before the third quarter, stocks whose performance was closely tied to energy and commodity prices were struggling considerably. According to some estimates, they now rank in the bottom percentile of historical valuation measurements. As one of the most attractively valued sectors in the equity universe, energy continues to be an area we are monitoring closely. Energy companies have dramatically cut oil exploration and production activities and capital expenditure plans, with the goal of protecting their cash flows. We do not believe prices as low as \$45 per barrel will be in place for the long term, but it will be a challenging time, fundamentally, for these businesses over the next 6 to 12 months. While we must proceed with caution, energy should be an area of focus, particularly for value investors. The challenge, however, continues to be in the timing, as oil price volatility has been with us throughout 2015.

Also notable for its third-quarter plunge was the biotechnology sector, where stocks fell into correction territory after a remarkable multiyear advance. Biotech had been one of the best-performing sectors of 2015, with key biotech indexes reaching all-time highs in July. In the third quarter, however, they plunged quite dramatically,

especially in September as U.S. presidential election rhetoric intensified around prescription drug costs. For growth stocks in particular, we had been focusing our research on biotechnology well before the recent correction. In our view, while more turbulence is likely for the sector, stocks of many large-cap biotech companies are offering significant, sustainable growth prospects along with reasonable valuations, which have recently become even more attractive. In addition to the unprecedented innovation and solid pipelines of drugs in development, the health-care sector continues to offer powerful secular growth trends.

### **Is the news any better for corporate profits?**

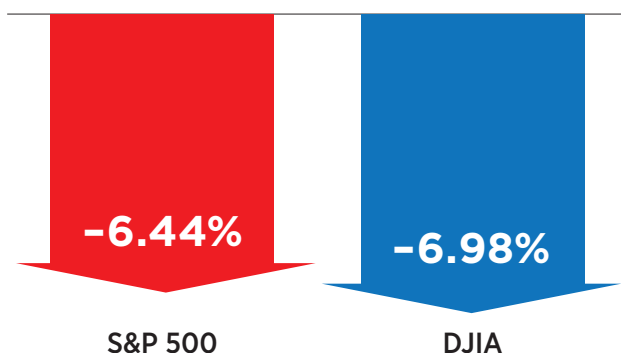
As we anticipated, 2015 is shaping up to be a fairly weak year in terms of earnings growth for U.S. corporations. So far, profits for S&P 500 companies have been flat to modestly positive. The two greatest pressures on profitability have been the strong U.S. dollar and weak oil prices. More than 40% of the profits of S&P companies come from international markets. The strong dollar has hurt many of these businesses, which rely on revenues from markets with much weaker currencies. And the negative effects of plummeting oil prices can expand beyond oil and gas companies to the wide array of industries that provide products and services to them. For now, the days of extremely strong corporate earnings growth may be behind us, but in our view, the overall health of U.S. businesses remains solid.

Our outlook for U.S. stocks remains mixed as we head into the closing months of 2015. It is quite likely that volatility may persist as we face a few headwinds, including concerns over struggling emerging markets, especially China, the world's second-largest economy. At the same time, the U.S. economy continues to strengthen, unemployment is at its lowest rate in years, and consumer spending has increased, thanks in part to lower commodity costs.

The equity market continues to wrestle with uncertainty over the timing and potential impact of an interest-rate hike by the U.S. Federal Reserve. We believe it is pretty clear that the Fed wants to raise interest rates, but also wants to ensure it is done at a time when the U.S. economy

### **Toughest quarter in years for U.S. stocks**

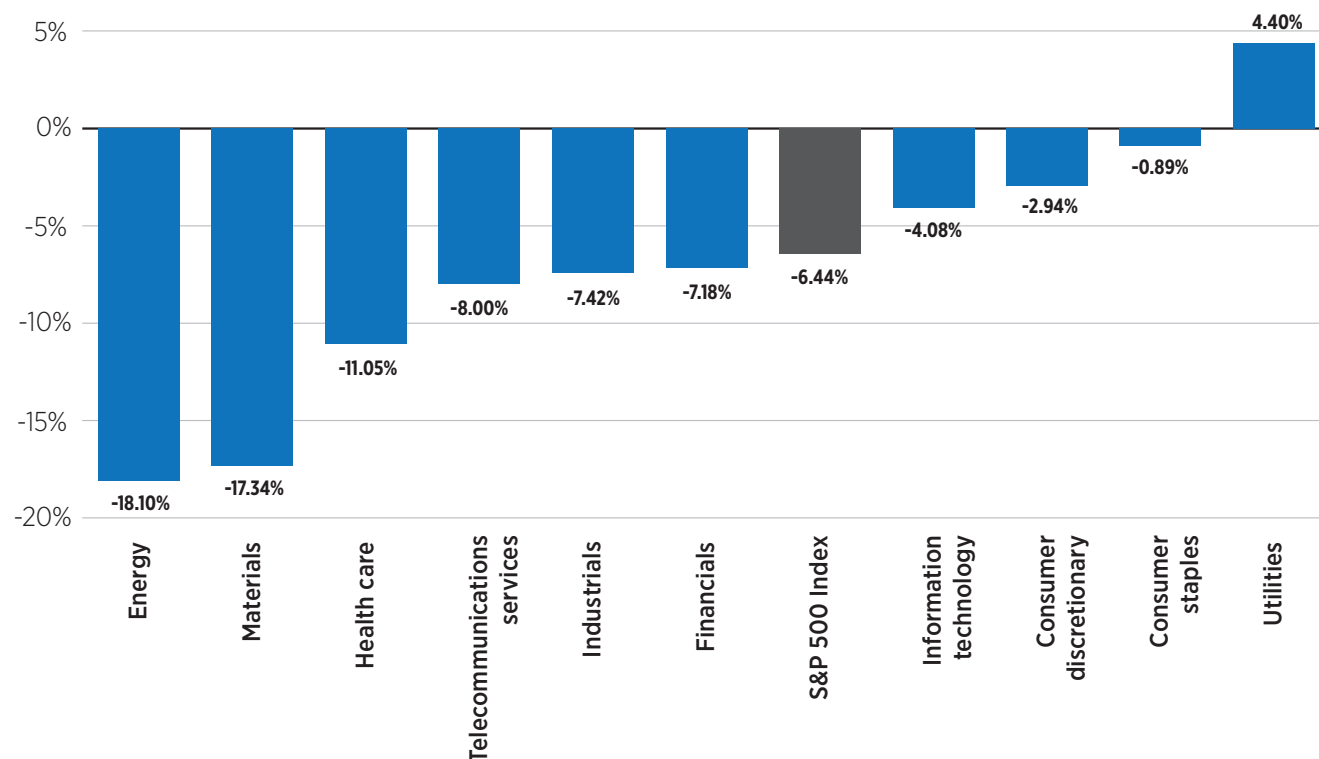
*Equity index returns for three months  
ended 9/30/15*



*The worst quarter for both indexes since Q3 2011*

## Most sectors felt the pain of the third-quarter downturn

*S&P 500 sector total returns for three months ended 9/30/15*



Source: S&P Dow Jones Indices.

can support it. As we approach the next several Fed meetings, it will be critical to monitor U.S. gross domestic product growth, inflation pressures, and the strengths and weaknesses of non-U.S. economies. There are many variables in the equation, and it is a considerable challenge for the Fed. As for the impact of a rate increase on stocks, we could see some short-term volatility at the outset. However, history shows that equities tend to perform well when interest rates are rising from very low levels.

## Non-U.S. equities

### A slowing China has been with us for some time

While it poses a significant risk to the global economy, slower growth in China should come as no surprise. For at least four years, Chinese policymakers have been attempting to shift the economy from fixed-asset investment to consumption-led growth, and we have long known that this would not unfold smoothly.

The aftermath of China's response to the global financial crisis is making this transition both more urgent and more difficult. Their policies involved massive fiscal stimulus via bank lending, including lending to local governments to fund unnecessary projects, which has led to overcapacity in a number of industries. Now, these investment problems in China are coming home to roost, particularly the problem of excessive credit growth.

### Expanding leverage in China

Investors sometimes point to the Chinese consumer and argue that the consumer is not leveraged in the same way as, say, the U.S. or European consumer. But this view overlooks the fact that Chinese interest rates are much higher than U.S. or European rates. Thus, while the absolute debt level carried by the average Chinese consumer is not that high, this leverage is comparable to Western consumers' debt burdens by virtue of China's higher interest rates.

***Some of the implications of a Chinese contraction are knowable and hence easier to model; others are much harder to predict.***

Second, Chinese corporates are highly levered while their profit profiles are, in many cases, uninspiringly flat to negative. Lastly, local governments have spent years financing large infrastructure projects, but are having a hard time generating revenues outside land sales, which is not a sustainable dynamic. The good news is that, unlike the financial crisis of 2008, which spread relatively quickly, China has given rise to an economic contagion that has spread more slowly. Some estimates suggest China's debt increased by nearly \$20 trillion since 2008, but the vast majority of that debt is owned domestically; consequently, the ability for financial contagion to spread quickly is low.

**The uncertainties of China's impact**

Some of the implications of a Chinese contraction are knowable and hence easier to model; others are much harder to predict. Apropos of this uncertainty, the surprise yuan devaluation in August had a relatively unanticipated impact on S&P 500 companies. The health-care sector, for example, was particularly hard hit as the increase in equity volatility caused by China led to selling in the sector. In addition, investors who had long positions relative to the U.S. dollar and short positions relative to the euro — which was a common trade — were hurt as the dollar sank while the euro strengthened following China's currency move.

The Chinese slowdown has had increasingly large effects on the country's key trading partners — most notably, Asian emerging markets and Brazil. When China was stronger, the internal fragilities of a country like Brazil — including problems of corruption and poor governance — were hidden by the country's powerful commodity-focused trade with China. Once China's demand for commodities fell, commodity price declines exposed the fractured nature of Brazil's economy and currency.

The larger question is whether China's deceleration will spell disaster for the country or whether policymakers can manage the slowing growth and the ongoing transition of their growth model. Although China poses a risk to global markets, we do not think its economic slowdown will derail the ongoing recovery in other areas around the globe, particularly in the developed markets of Europe, Japan, and the United States.

**European stocks display more value**

Even before the advent of what we would characterize as the largely indiscriminate selloff in the third quarter, European stock valuations looked attractive in relation to other markets and asset types. After the selloff, that difference has only intensified, in our view.

In addition, we have seen significant restructuring at the company and industry levels in Europe. In other words, European company managements have not wasted the crisis they have faced over the past few years, and have focused on profit margins, outsourcing production to lower-cost economies and achieving better pricing and improved returns.

**Ireland, the rising star**

Ireland continues to stand out among countries in a recovering Europe for a variety of reasons. Its economy has largely recovered and appears poised to grow by mid single digits for 2015. In addition, the country is now playing host to a significant number of U.S. tech companies, which have taken advantage of real estate values, tax benefits, and the language parity of Ireland relative to the United States to expand their European footprint in Ireland.

Among sectors, we particularly like Irish banking, which should continue to see improvements in pricing over the medium term following industry consolidation. Consequently, we feel strongly that the remaining Irish banks will be able to generate attractive returns for shareholders.

**Long-term trends in Japan raise flags**

Several long-term trends are working against Japanese policymakers' current attempts to shore up the country's economic growth and inflation. Unfortunately for Japan, the country has a shrinking workforce, a low birth rate, and entrenched political and cultural opposition to immigration. This is not a good recipe for long-term economic growth because such trends are very difficult to change. The country is also saddled with a large amount of debt that has accumulated since the Japanese real estate bubble burst around 1990.

Some of these negative trends can be offset by productivity improvement — as you might find with high levels of innovation and efficiency in manufacturing and technological sectors — but the long-term prospects for Japan's economy, we think, are beset by risks. Having said that, in the short to medium term, we would say that Japan presents international investors with a variety of interesting and even compelling opportunities.

In international and global portfolios, we have generally preferred to invest in Japanese companies that stand to benefit from the depreciation of the yen versus other global currencies. Thus, export companies rather than domestic consumption-focused companies have been at the core of our Japan exposures. Another factor driving Japanese stocks has been the government's incentive to companies to improve their return on equity for investors. This country-specific development has been beneficial for a variety of Japanese stocks and should continue.

## Proceeding with caution as 2015 comes to a close

The consensus view is that the dollar will continue to rise. Unless China decides to move further to loosen the dollar peg, this would also exert upward pressure on China's currency, the yuan, which would consequently depress China's export sector. That may cause more trouble for China's growth outlook, and thus contribute to more volatility across global markets.

Investors should also be aware that the era of European austerity has led to political polarization, with the proliferation of far right as well as far left parties. In addition, the huge wave of refugees from places like Syria, Iraq, and Eritrea has put and will continue to put added pressure on the political environment in Europe. In our view, this amplifies certain risks for investors in European stocks — including, most prominently, the risk of an increasingly fractured eurozone.

Overall, however, there are reasons for optimism. We expect, for example, that economic data will slowly continue to improve in the United States, Europe, the United Kingdom, and Japan. In this context, and given attractive valuations, we remain open to adding new positions in our international and global portfolios whenever our fundamental research uncovers compelling investment opportunities.

### Index definitions

**MSCI EAFE Index (ND)** is an unmanaged index of equity securities from developed countries in Western Europe, the Far East, and Australasia.

**MSCI Emerging Markets Index (ND)** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

**MSCI Europe Index (ND)** is an unmanaged index of Western European equity securities.

**MSCI World Index (ND)** is an unmanaged index of equity securities from developed countries.

**Russell 1000 Growth Index** is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their growth orientation.

**Russell 1000 Value Index** is an unmanaged capitalization-weighted index of large-cap stocks chosen for their value orientation.

**Russell 2000 Index** is an unmanaged index of the smallest 2000 securities in the Russell 3000 Index.

**Russell 2000 Growth Index** is an unmanaged index of those companies in the small-cap Russell 2000 Index chosen for their growth orientation.

**S&P 500 Index** is an unmanaged index of common stock performance.

Indexes assume reinvestment of all distributions and do not account for fees. It is not possible to invest directly in an index.

**Putnam Equity Outlook reflects the views of the senior investment leaders supported by the fundamental insights of Putnam's global equity research analysts.**

**Simon Davis**

Co-Head of  
International Equities  
Investing since 1988  
Joined Putnam in 2000

**Robert D. Ewing, CFA**

Co-Head of U.S. Equities  
Investing since 1990  
Joined Putnam in 2008

**Shep Perkins, CFA**

Co-Head of  
International Equities  
Investing since 1993  
Joined Putnam in 2011

**Nick C. Thakore**

Co-Head of U.S. Equities  
Investing since 1993  
Joined Putnam in 2008

**Active management,  
fundamental research, and new  
insights to capture the growth  
potential of equities**

Equity investing at Putnam features a tenured and talented team of portfolio managers backed by an integrated group of research analysts with worldwide reach. Our research organization is structured to focus fundamental analysis on the factors that matter most in global equity markets.



The views and opinions expressed are those of the authors (Simon Davis and Shep Perkins, Co-Heads of International Equities, and Robert D. Ewing and Nick C. Thakore, Co-Heads of U.S. Equities) as of September 30, 2015, are subject to change with market conditions, and are not meant as investment advice.

**Consider these risks before investing:** International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Bond investments are subject to interest-rate risk, which means the prices of a fund's bond investments are likely to fall if interest rates rise. Bond investments also are subject to credit risk, which is the risk that the issuer of the bond may default on payment of interest or principal. Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds, which may be considered speculative. Unlike bonds, funds that invest in bonds have ongoing fees and expenses. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. Commodities involve the risks of changes in market, political, regulatory, and natural conditions.

**Investors should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus, or a summary prospectus if available, containing this and other information for any Putnam fund or product, call your financial representative or call Putnam at 1-800-225-1581. Please read the prospectus carefully before investing.**

#### Market update

[putnam.com/equity](http://putnam.com/equity)



#### Research

[putnam.com/perspectives](http://putnam.com/perspectives)  
[putnam.com/white-papers](http://putnam.com/white-papers)

#### Find us



Putnam Retail Management

[putnam.com](http://putnam.com)

CM0300 297081 10/15