First Trust

Quarterly Market Overview

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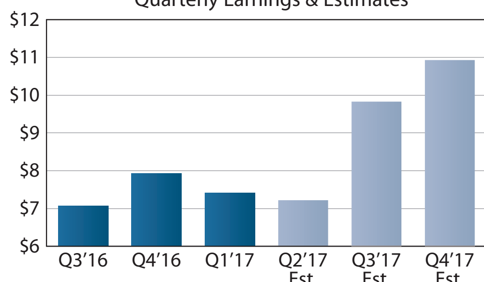
We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

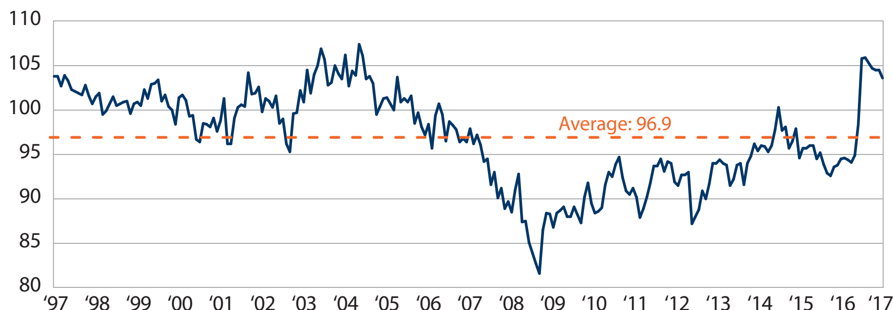
We see the potential for another second half rally for Small-Cap stocks...

S&P SmallCap 600 Index:
Quarterly Earnings & Estimates



Source: Bloomberg consensus estimates as of 6/30/17. There can be no assurance that any of the projections cited will occur.

NFIB Small Business Optimism Index (20 Years)



Source: National Federation of Independent Business (NFIB) and Bloomberg. Data from 7/31/97 - 6/30/17.

In the July 2016 edition of this very newsletter we put forth an argument for why we believed small-capitalization (cap) stocks looked attractive relative to large-cap stocks heading into the second half of 2016. As it turned out, from 6/30/16 through 12/30/16, the S&P Small-Cap 600 Index posted a total return of 19.14%, compared to 7.82% for the S&P 500 Index, according to Bloomberg. We believe the outlook for earnings is attractive enough for investors to give new consideration to the small-cap space at the midpoint of 2017.

As indicated in the chart above, the Q3'17 and Q4'17 consensus earnings estimates (analysts surveyed by Bloomberg) for the S&P SmallCap 600 Index reflect a sharp rise from the amount earned in Q1'17, as well as the estimate for Q2'17 (earnings reporting season is underway). Earnings also look attractive on a year-over-year basis. The estimates for Q3'17 and Q4'17 were $9.83 and $10.93 per share, respectively, as of 6/30/17. That is a significant increase from the $7.07 and $7.93 earned in Q3'16 and Q4'16, respectively.

On a valuation basis, the trailing 12-month price-to-earnings (P/E) ratio on the S&P 600 Index stood at 26.25 on 6/30/17, according to Bloomberg. While that is slightly higher than its three-year average P/E of 25.03, consider that the index posted a total return of 22.47% for the 12-month period ended 6/30/17, according to Bloomberg. Rising price-to-earnings multiples are not uncommon during bull markets. Multiples expansion occurs when investors are willing to pay more for a dollar's worth of earnings – and earnings are expected to rise.

As of 6/30/17, the National Federation of Independent Business (NFIB) Small Business Optimism Index stood at a reading of 103.6, up from 94.5 on 6/30/16. The average for the 20-year period depicted in the chart above was 96.9. The highest reading over the period was 107.4 (11/30/04), while the low point was 81.6 (3/31/09). This suggests that small business owners are optimistic heading into the second half of 2017, in our opinion.

As part of its survey, the NFIB seeks to identify the "single most important problem" facing small business owners. The top three responses given in the June 2017 survey were the same as the ones given in June 2016 – taxes (#1), government regulations (#2) and quality of labor (#3). The last one is particularly interesting because small business owners are hiring, but are struggling to find qualified workers. The June 2017 survey revealed that 46% of small business owners reported few or no qualified applicants for the positions they are attempting to fill. With respect to addressing the issue of taxes, House Speaker Paul Ryan wants to pass a "tax overhaul" by the end of this year, according to CNBC. Ryan believes that the U.S. cannot achieve a 3% real GDP growth rate without tax reform. The U.S. economy has grown at a 2.1% clip in the current recovery (Q3'09-Q1'17), according to data from the Bureau of Economic Analysis.

If economic growth in the U.S. were to accelerate toward the 3.0% rate targeted by Paul Ryan, it is conceivable that interest rates could also rise. Keep in mind that the yield on the 10-year Treasury note closed at 2.31% on 6/30/17. That level is historically low. Its 25-year and 50-year averages were 4.35% and 6.48%, respectively, as of 6/30/17, according to Bloomberg. Also keep in mind that the Federal Reserve has increased the federal funds target rate (upper bound) from 0.25% on 12/16/15 to 1.25% today. If the yields on U.S. bonds rise moving forward, we believe it could result in a stronger U.S. dollar, provided bond yields in the U.S. remain above most developed foreign countries, as is the case today. While a strong U.S. dollar can present a challenge to those U.S. multinational corporations that garner a large percentage (40%-plus) of their sales from overseas, small-cap companies tend to conduct the bulk of their business in the U.S.

Investing in small-cap stocks is inherently more risky than investing in large-cap stocks, which is why investors expect more return from small-caps. The beta on the S&P SmallCap 600 Index stood at 1.213 on 6/30/17, according to Bloomberg. Beta is just one way of measuring an index's volatility relative to that of the broader market (S&P 500 Index beta is 1.000). At the end of June 2017, the S&P SmallCap 600 Index was 21.3% more risky, based on its beta of 1.213, than the S&P 500 Index. In the current bull market (3/9/09-6/30/17), the S&P SmallCap 600 Index has posted a cumulative total return of 423.43%, compared to a 327.23% gain for the S&P 500 Index.

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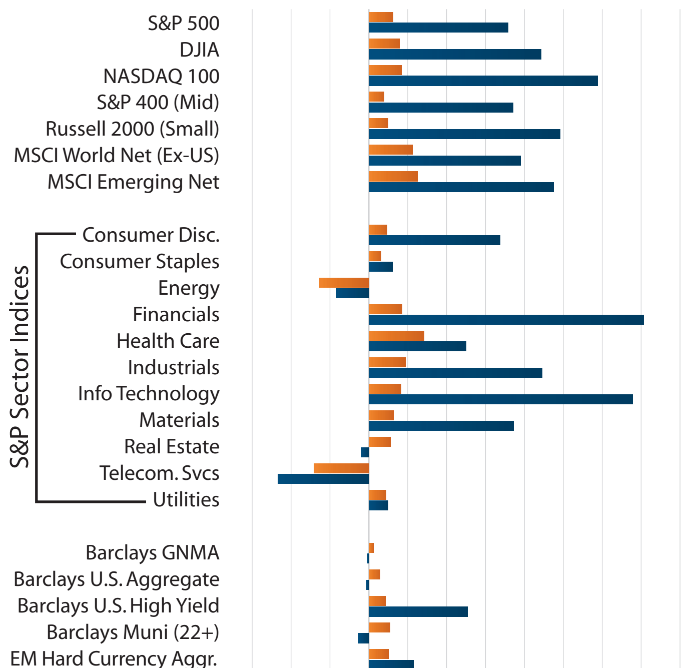
Time can play a constructive role in shaping performance expectations

We have noted in past editions that we believe that the "X factor" in investing is time. It is the biggest unknown, in our opinion. How long will it take to move from one stage of an economic cycle to another? How long will the Federal Reserve keep interest rates low? How long can the current bull market in stocks last? Will Congress finally provide some fiscal stimulus to the recovery? A good example of this last question is the effort underway to get President Donald J. Trump's campaign policies through Congress. We know that the Trump administration would like to repeal and replace the Affordable Care Act ("Obamacare"), reduce the tax burden on corporations and individuals, reduce regulations ("red tape") plaguing businesses, and increase spending on infrastructure, but none of them have happened yet. President Trump has been in office more than five months now, and despite his pledge to work quickly from day one it is safe to say that things have not gone as planned. The good news is there is still time to enact legislation before next year's midterm election season kicks in. From the vantage point of the investor, the U.S. stock and bond markets have performed well since Trump won the election. From 11/8/16 through 6/30/17, the S&P 500 Index posted a total return of 14.78%, while BofA Merrill Lynch's U.S. High Yield Constrained and U.S. Corporate bond indices returned 6.91% and 1.94%, respectively, according to Bloomberg. Those are impressive results considering few political pundits thought Trump would even win the election. While it could be said that the markets appear to be suggesting that investors are expecting some or all of President Trump's pro-growth agenda to eventually get the support of Congress, only time will tell. If nothing gets passed by year-end, and the markets sell-off, we'll have a better idea that the Trump rally had some validity, in our opinion. If nothing passes and the markets do not sell-off, perhaps the gains in the markets were more a reflection of the fundamentals. Time has a tendency to test the patience of even the most disciplined of investors, but we believe history has shown that time has rewarded the patient investor. Understanding its role and influence on the markets can help shape performance expectations, in our opinion.

Here are a few benchmarks and points of interest forged over time that investors can use when establishing goals or formulating strategies:

- ***Economic Cycles*** – From 1945 through 2009, the average U.S. economic expansion lasted 58.4 months, or just under five years, while the average recession lasted 11.1 months, or just under one year, according to the National Bureau of Economic Research. Expansions have tended to last much longer than recessions. The current expansion, which began in July 2009, has lasted 96 months, or eight years.
- ***Stocks, Bonds & Inflation*** – From 1926 through 2016, the S&P 500 Index, U.S. Small Stocks and U.S. Long-Term Government Bonds posted average annual total returns of 10.04%, 12.12% and 5.55%, respectively, according to Ibbotson Associates/Morningstar. The U.S. Consumer Price Index (Headline Rate) averaged 3.0% over the same period, according to the Bureau of Labor Statistics.
- ***Bull Markets*** – The current bull market in stocks is the second-longest in U.S. history, according to Bespoke Investment Group. As of 6/30/17, the bull market stood at 3,035 days (3/9/09-6/30/17). The longest bull market spanned 4,494 days (12/4/87-3/24/00), or four years longer than the current bull market.
- ***Bear Markets, Corrections & Pullbacks*** – In U.S. bull markets dating back to 1945, on average, the S&P 500 Index experienced a *pullback* (a decline of 5.0% to 9.9%) once a year, a *correction* (a decline of 10.0% to 19.9%) every 2.8 years and a *bear market* (a decline of 20% or more) every 4.7 years, according to Sam Stovall, Chief Investment Strategist at CFRA and S&P Global.
- ***Buy & Hold Investing*** – The S&P 500 Index has never failed to fully recover from a bear market in stocks, no matter how severe. The index has always rebounded and gone on to set new highs. As of the close of June 2017, the index's all-time high of 2,453.46 on 6/19/17 marked the 24th all-time closing high for the index this year, according to Bespoke Investment Group. It notes that the S&P 500 Index has registered over 50 closing highs in a calendar year just four times since 1929. The most closing highs (77) was set in 1995.

Total returns for Q2 and past 12 months (6/30/17)



Sources: Bloomberg and Barclays. Past performance is no guarantee of future results.

A Look Ahead:

A year-over-year earnings comparison in U.S. dollar terms. The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.

Index (Weighting In S&P 500)	Q3'17E	Q3'16A	Q4'17E	Q4'16A	2017E	2016A
Consumer Disc. (12.3%)	**8.77**	8.54	**9.51**	8.50	**34.79**	33.30
Consumer Staples (9.0%)	**7.21**	6.79	**7.22**	6.53	**27.07**	25.33
Energy (6.0%)	**4.45**	0.87	**4.52**	0.41	**16.43**	-3.49
Financials (14.5%)	**7.03**	7.00	**7.20**	5.86	**27.76**	23.78
Health Care (14.5%)	**13.54**	10.69	**13.46**	10.32	**50.65**	42.45
Industrials (10.3%)	**8.52**	7.50	**8.32**	6.55	**30.98**	27.07
Information Tech. (22.3%)	**12.13**	9.23	**15.45**	12.45	**48.94**	37.99
Materials (2.8%)	**4.10**	3.73	**4.15**	2.71	**17.69**	13.01
Real Estate (2.9%)	**1.21**	1.48	**1.33**	1.83	**5.12**	7.38
Telecom. Services (2.2%)	**3.11**	2.60	**2.80**	2.54	**11.67**	9.86
Utilities (3.2%)	**4.92**	4.93	**2.92**	2.40	**14.60**	13.67
S&P 500 Index	**33.40**	28.69	**35.04**	27.90	**128.26**	106.26
S&P 400 Index (Mid-Cap)	**22.43**	18.63	**23.49**	16.25	**84.37**	64.53
S&P 600 Index (Small-Cap)	**10.20**	7.14	**11.36**	6.47	**37.76**	25.60

Source: Standard & Poor's (7/5/17). Sector weightings as of 6/30/17.

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