

## Capital Market Review & Outlook

June, 2015



**Johnston Investment Counsel**  
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# Executive Summary

## Asset Class Returns

- For the first six months of 2015, international stocks returned 5.5%, outperforming the U.S. stock market return of 1.9%, U.S. bond market return of -0.1%, international bond return of -5.6%, real estate return of -6.2%, and cash return of 0.0%.
  1. Only international and U.S. stocks produced positive returns during the first half of the year.
  2. U.S. bonds and real estate were affected by expectations of rising interest rates, and international bonds by the rising U.S. dollar.
- During the past year (as well as for the 3- and 5-year periods), U.S. stocks have significantly outperformed other investment categories. On a going-forward basis it may be difficult for U.S. stocks to maintain the same level of outperformance.

## Stock Market Returns and Fundamentals

- Year-to-date, international small company stocks returned 10.2%. Other stock market segment returns were: international large (5.5%), U.S. small (4.8%), U.S. large (1.2%) and U.S. mid (2.4%). Emerging market stocks returned 3.0%.
- During the past one-year period, U.S. stocks have soundly outperformed international stocks. U.S. large has led the way with a 7.4% return with mid- and small company stocks returning 6.6% and 6.5%, respectively. International large, small, and emerging market stocks each produced negative returns during the past year.
- The growth investment approach has outperformed value stocks (for both domestic and international stocks) during the first six months of 2015 as well as the past year. The performance difference has been substantial. Growth has also outperformed value during the past three- and five-year periods, but the level of outperformance has been more muted.
- Out of the ten economic sectors, five sectors produced positive returns during the first six months of 2015. However, only three sectors produced returns above 1%. Healthcare stocks were the best performing sector with a return of 9.6% followed by the Consumer Discretionary return of 6.8%. Utilities were the worst performing sector with a -10.7% return followed by the Energy sector return of -4.7%.
  1. During the past year, Healthcare and Energy stocks are the best / worst performing sectors with returns of 24.2% and -22.2%, respectively. Utilities and materials produced negative one-year returns of -2.9% and -1.1%, while consumer discretionary and technology returned 16.4% and 11.1%.
- On page 10 and 11, we show valuation and growth characteristics of the S&P 500. Price / operating earnings, price / book value, and price / sales are all at ten-year highs. Profitability is also at a ten-year high. Growth characteristics are much more modest. During the past year, sales, operating income, and book value growth have all been below 3.0%. Growth has been better (but not robust) during the past three years. However, dividend growth has been quite high with annualized dividends increasing by 13.3% during the past five years. Companies have clearly returned some of their increasing profits to shareholders in the form of dividends.



# Executive Summary

## **Stock Market Returns and Fundamentals (continued)**

- While many believe the stock market is no longer “cheap”, there is wide disagreement on the level of overvaluation. Not surprisingly, one can find data to support your position. We highlight an example on page 12.
  1. A Yale professor named Robert Schiller has gained a wide following by suggesting that earnings should be “normalized” (a fancy term that means averaged and smoothed). In his calculations he uses average earnings over rolling 10-year periods to take out the year-to-year volatility. On page 12, we designate this as PE10. Using the same methodology, JIC calculates and shows 1-year and 5-year normalized earnings that are identified as PE1 and PE5, respectively. What is particularly noteworthy is that professor Schiller has created these datasets back to the late 1800’s.
  2. Using just this measure of valuation, we find that one’s conclusion about over-/undervaluation is dependent upon the time period evaluated.
    - For example, if one looks over the past 25 years, PE1 and PE5 have below average valuations while PE10 is slightly above average (but by no means at extreme levels).
    - However, if one extends the evaluation period to either the post WWII or the full data set (starting in the 1870’s), one can see that we are in the top quartile and, in some cases, in the top decile of valuation.
  3. Why does this matter? Because valuation, as measured by PE10, seems to have some predictive power over **longer-term** stock market returns. On page 13, we plot PE10 multiples on the horizontal axis with **future** 5-year stock returns on the vertical axis. Data starts in 1926 (first year of available stock return data). Interestingly, if one were to draw a “best fit line”, it would slope downward suggesting that lower valuation ratios imply higher future five-year stock market returns (and vice versa). The current PE10 value is near the high end of observed values which implies that future 5-year stock returns may be below average. While no one knows this with any degree of certainty it does have logical appeal that when an out-of-favor investment (low valuation) is purchased, your subsequent return may be higher.
  4. This does not imply that five-year future stock returns will be negative – just lower. However, unless there is substantially higher growth characteristics, we believe low single digit stock returns are the most likely scenario during the next five-year period.
- On page 14, we forecast future large, mid, and small stock market returns in a different way. We simply use consensus earnings estimates for 2016 and apply different multiples to obtain an estimated index value. We then calculate a percent change from current index levels.
  1. Assuming 2016 consensus operating estimates are correct (a big if), large-stocks will produce positive returns between now and 2016 if multiples are 17.5x or higher. Mid and small stocks will produce positive returns only if multiples are 20x or higher.
  2. It is well known that consensus estimates tend to start off high and decline as a year progresses. So what happens if consensus estimates are lowered by 10%? The baseline conclusion is the same – large stocks would produce positive returns assuming multiples of either 17.5x or 20.0x and mid- and small-stocks would only produce positive returns with multiples of 20x or above. It should be noted that, even with a 20x multiple, mid- and small stock returns would just barely be positive.



# Executive Summary

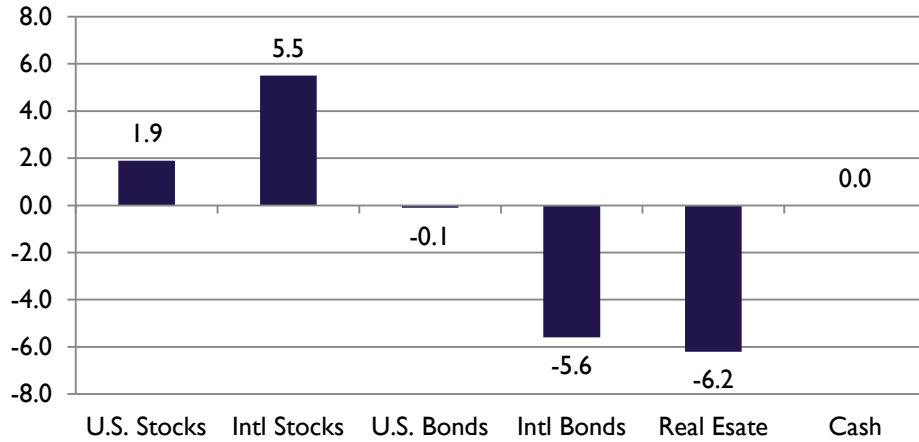
## **Bond Market Returns**

- During the first half of the year, the U.S. taxable and municipal bond market returned -0.1% and 0.1%, respectively – essentially no return. Depreciation from slightly higher yield levels nearly perfectly offset the income return. There was more excitement in other segments as high yield returned 2.5%, international bonds returned -5.6% (primarily due to a rising U.S. dollar), and emerging market bonds (many of which are dominated in U.S. dollars) returned 1.7%.
  1. From a maturity standpoint, long-term maturity bonds were the biggest drag on performance with a return of -4.5%. Short-term bond returns were slightly positive while intermediate-term returns were slightly negative. Corporate bonds produced negative returns while government and mortgage-backed bonds had slightly positive results.
  2. During the past year, the best performing bond segments were U.S. municipal (3.0%) and taxable (1.8%) with emerging market bonds eking out a positive return. High yield and international bonds both produced negative returns.
- The current maturity spread (the yield on the 10-year Treasury less the yield on the 1-year Treasury) is currently at 2.1%. Generally speaking, this is in the range of the past few years and suggests an economy that is growing but not overheating. However, if the FED were to start raising short-term rates (and assuming that would increase the 1-year Treasury yield), the maturity spread would likely narrow. This suggests that, at the margin, longer-term bonds become less attractive versus short-term bonds.
- High yield bonds currently yield 3.8% above A-rated corporates. While higher than a year ago, the quality spread is not as high compared to 3- and 5-years ago. In the current low interest rate environment, it is not surprising that investors, in their search for higher yields, are willing to accept somewhat less compensation than “normal”. While current economic conditions may support an investment in high yield bonds, they tend to be more correlated to stock price movements. This gives us pause.
- The real yield spread (difference between the 10-year Treasury and expected inflation) has been negative for the past several years. This is not a “normal” condition as, from a yield perspective, bond investors have lost purchasing power. It has been a strategy that the FED used (to encourage more risk taking) in the aftermath of the financial crisis.
- The FED has been pretty clear that they expect to raise short-term interest rates – probably by the end of the year. Historically, once the FED starts to raise rates, more increases follow. That is generally the result of trying to slow an overheating economy and curb future inflation. In this environment, due to all of the policy intervention that has occurred, it may be trying to get back to a more “normal” condition – such as providing bond investors with a return above the rate of inflation.
  1. While this first increase has been well-signaled, we believe it is much less clear the speed of subsequent rate increases. Some believe the FED will be “one and done”. Ultimately, we expect the data to drive the decision. If the economy, wage growth, and inflation begin to rapidly accelerate, we believe the FED would be more aggressive in future rate increases. However, given the current worldwide economic climate, it is difficult to make a case for rapid short-term economic acceleration.

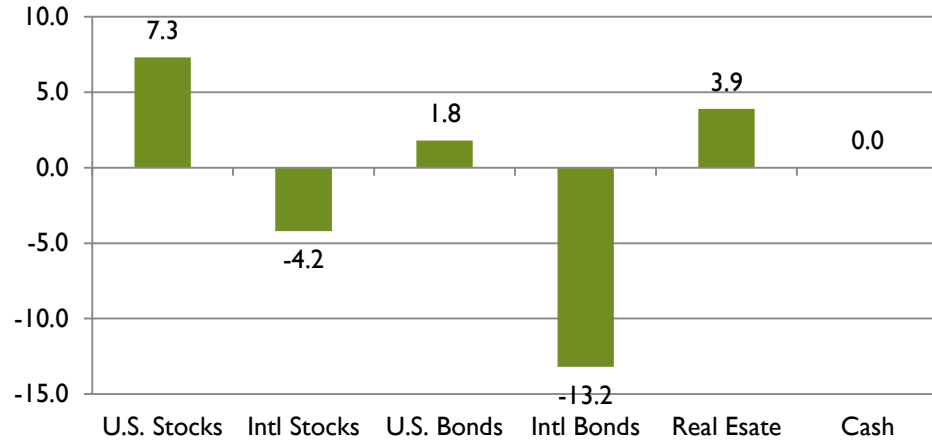


# Asset Class Returns

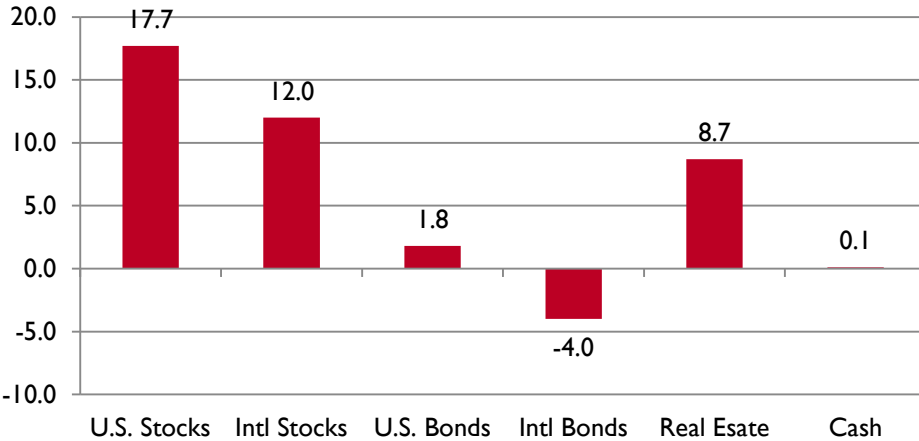
### Year To Date Returns Ending June 30, 2015



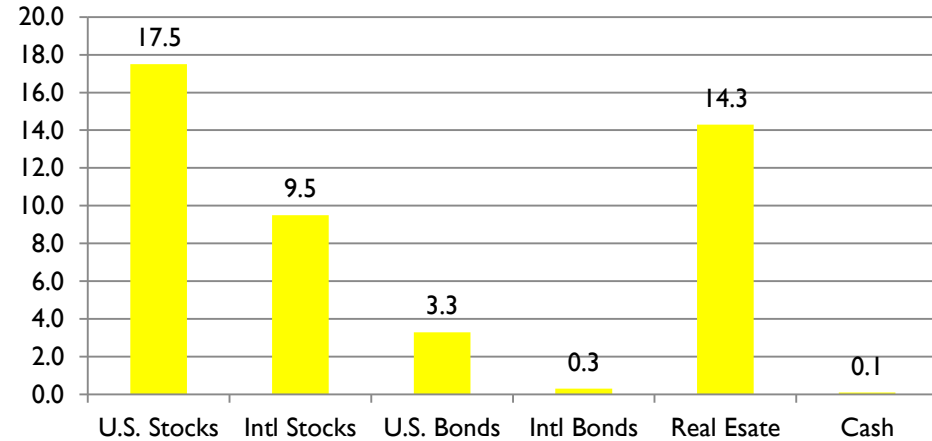
### 1 Year Returns Ending June 30, 2015



### 3 Year Returns Ending June 30, 2015



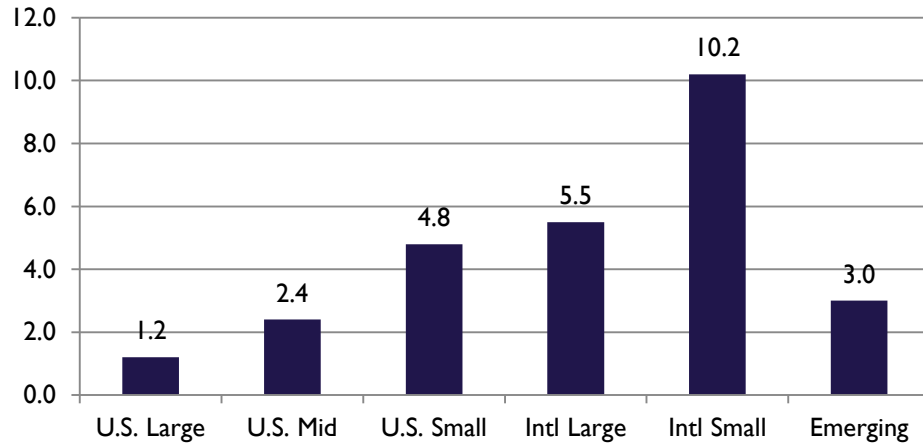
### 5 Year Returns Ending June 30, 2015



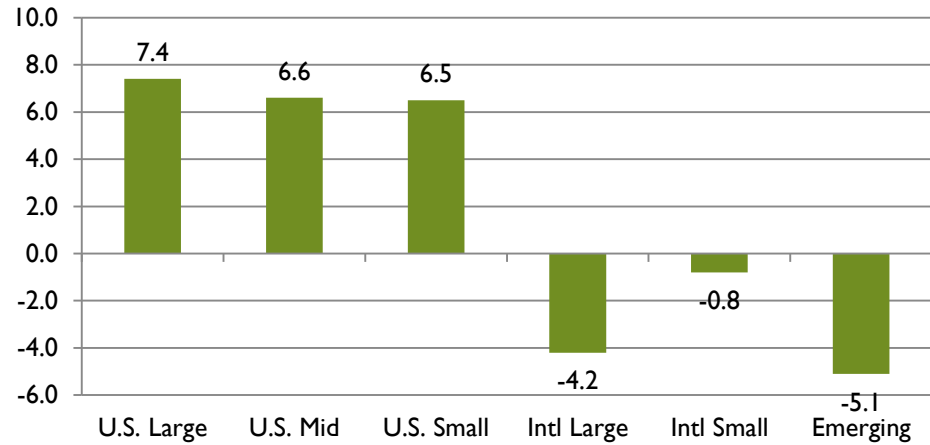
## Stock Market

# Stock Market Returns By Company Size

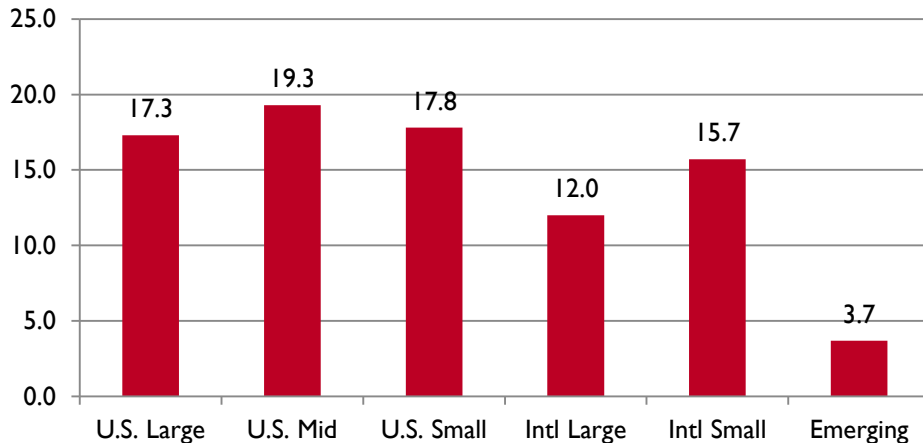
### Year To Date Returns Ending June 30, 2015



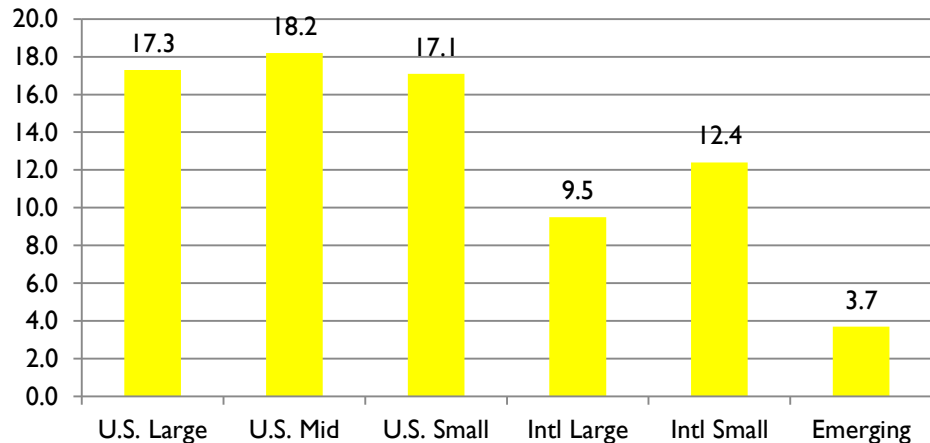
### 1 Year Returns Ending June 30, 2015



### 3 Year Returns Ending June 30, 2015

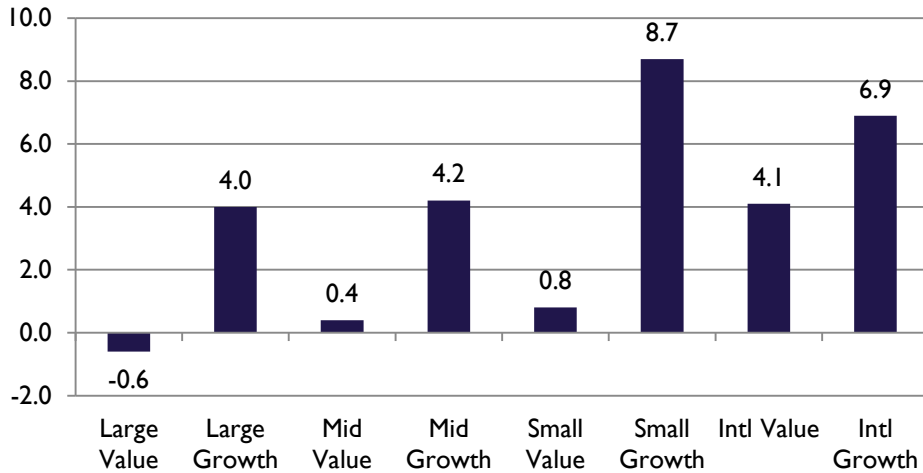


### 5 Year Returns Ending June 30, 2015

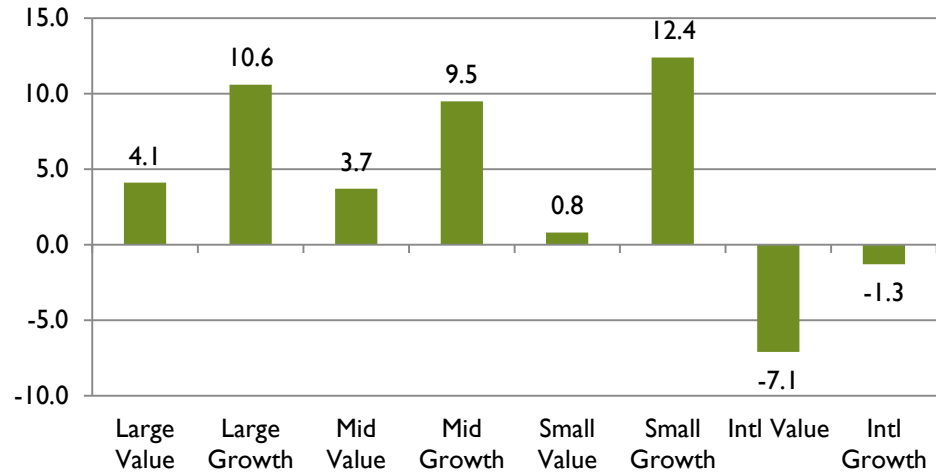


# Stock Market Returns By Investment Approach

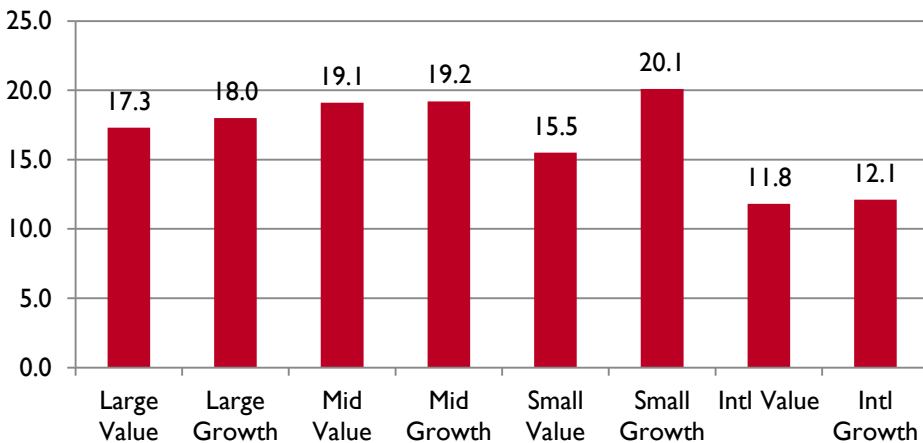
## Year To Date Returns Ending June 30, 2015



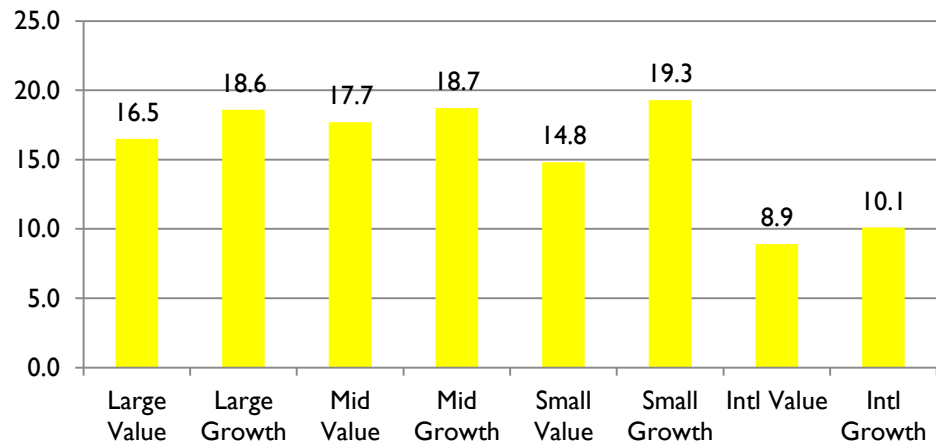
## 1 Year Returns Ending June 30, 2015



## 3 Year Returns Ending June 30, 2015



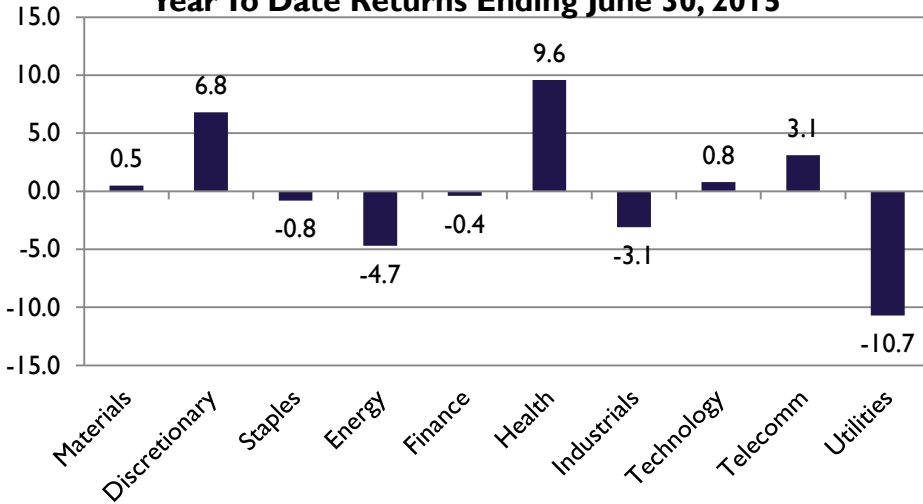
## 5 Year Returns Ending June 30, 2015



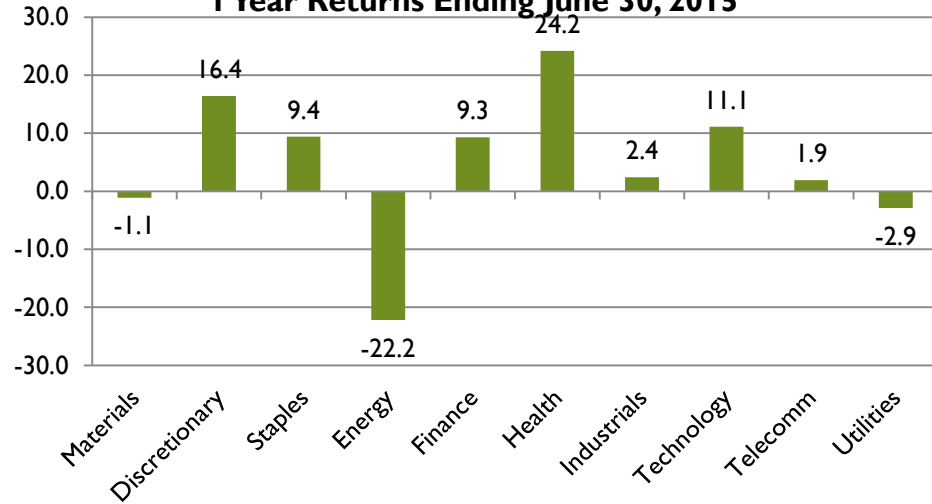


# Stock Market Returns By Sector

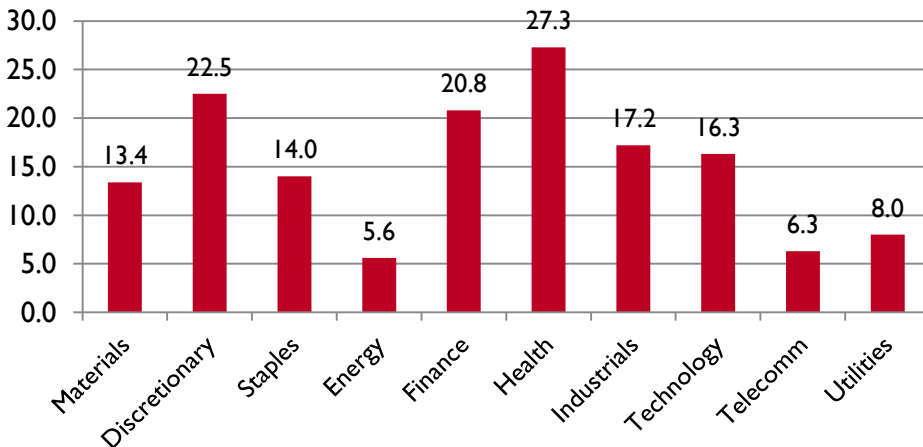
### Year To Date Returns Ending June 30, 2015



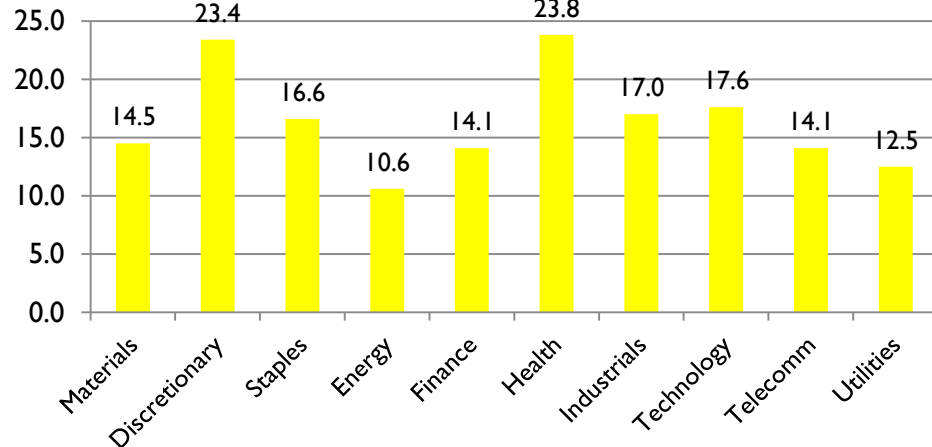
### 1 Year Returns Ending June 30, 2015



### 3 Year Returns Ending June 30, 2015

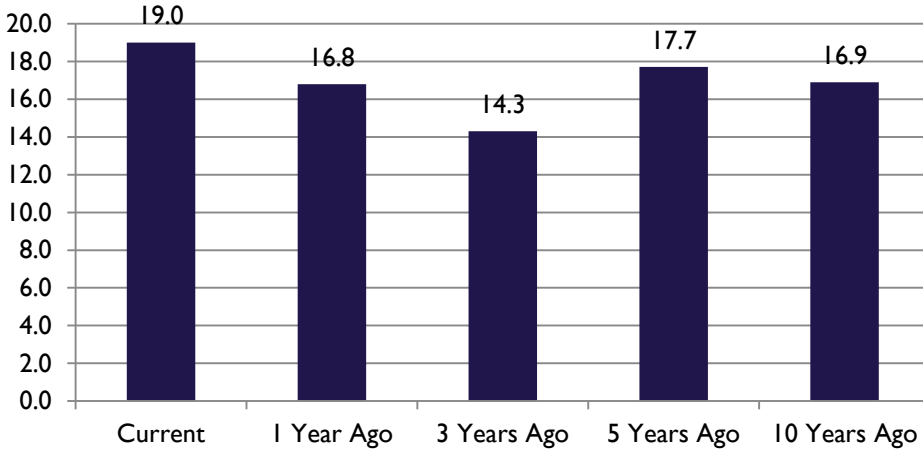


### 5 Year Returns Ending June 30, 2015

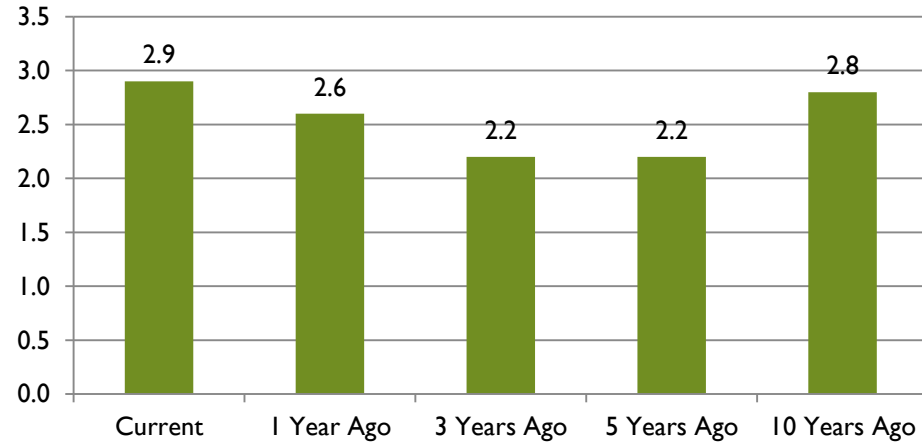


# S&P 500 Valuation & Profitability Characteristics As of March 31,

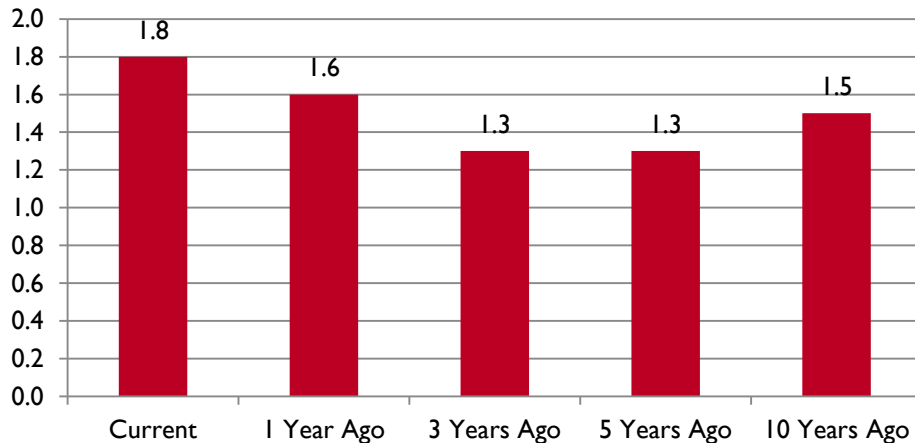
### Price / Operating Income



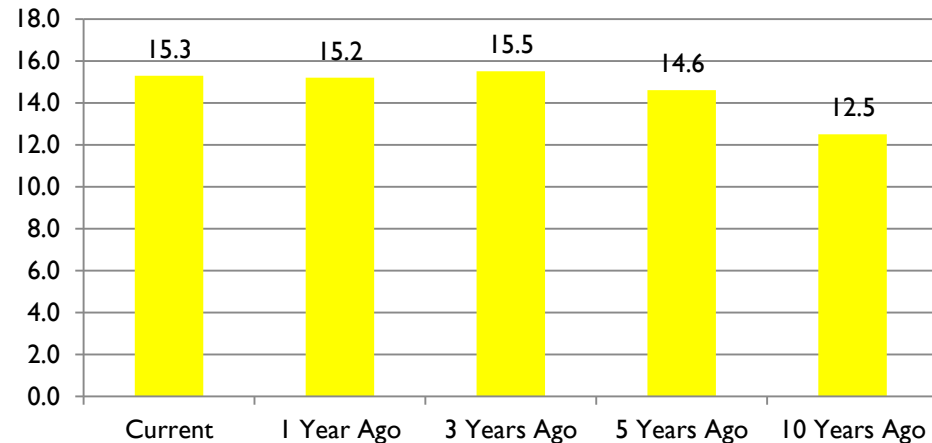
### Price / Book Value



### Price / Sales

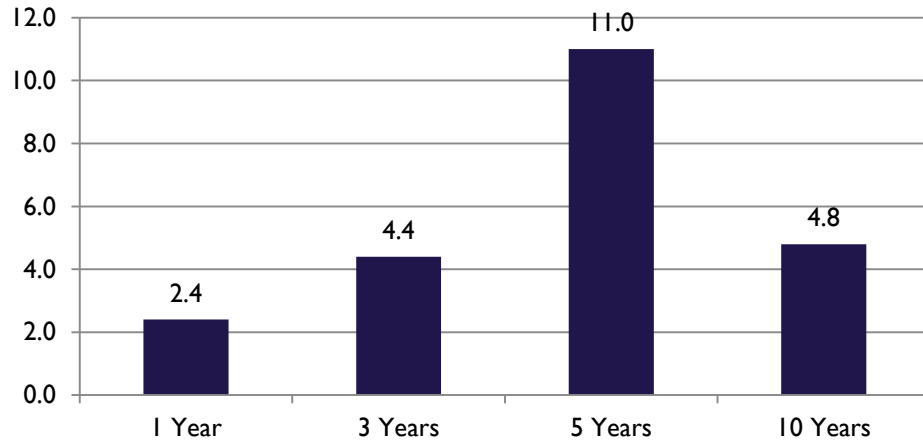


### Return On Equity (Operating Earnings)

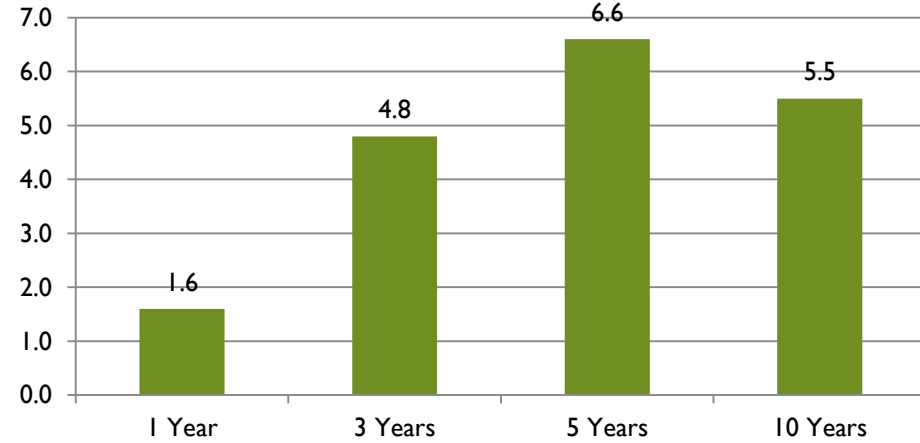


# S&P 500 Growth Characteristics Ending March 31, 2015

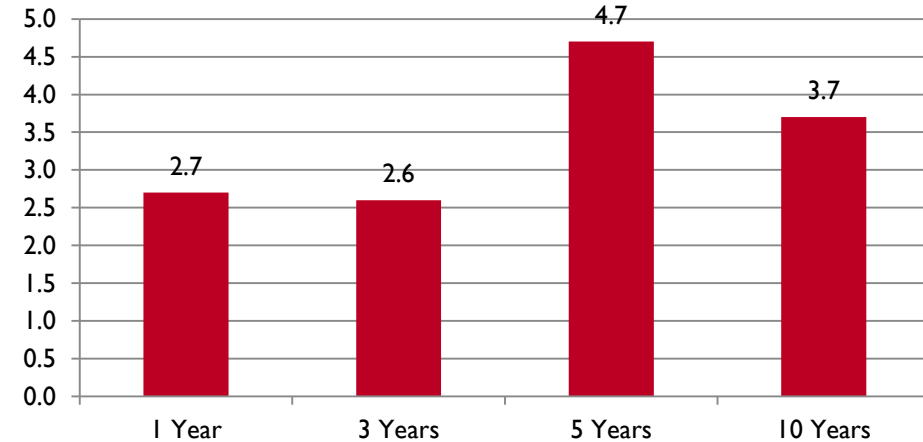
### Operating Income Growth



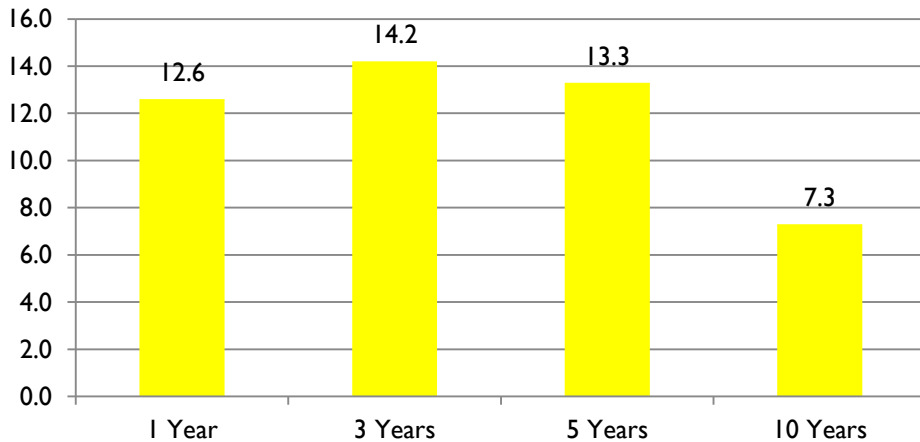
### Book Value Growth



### Sales Growth

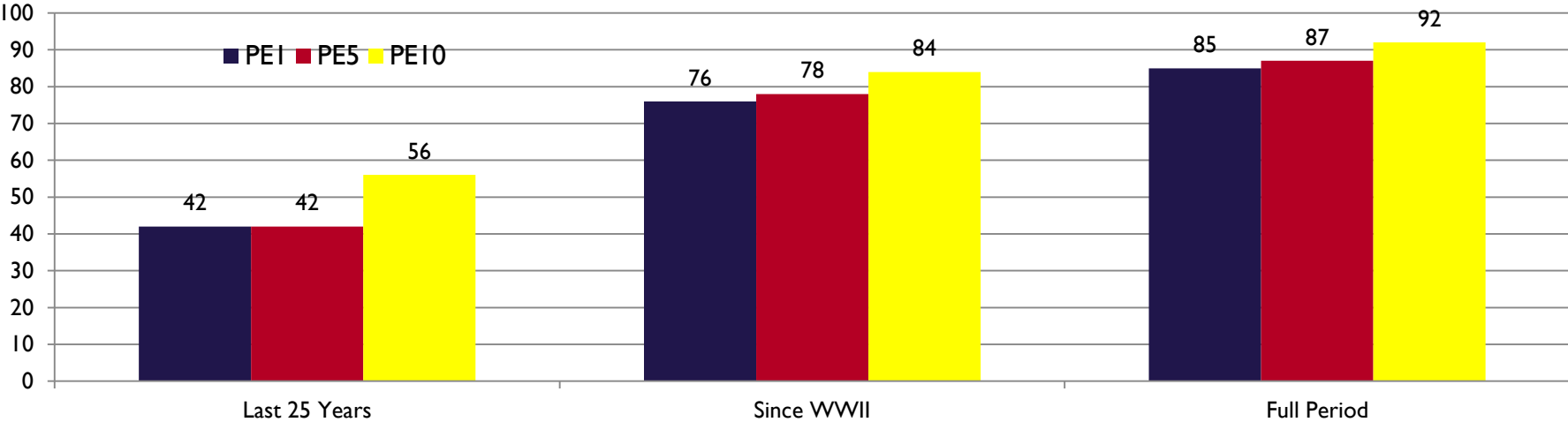


### Dividend Growth



# PE Rankings Over Different Measurement Periods and Earnings Normalization

## Using Normalized Earnings Over 1, 5, and 10-Year Periods

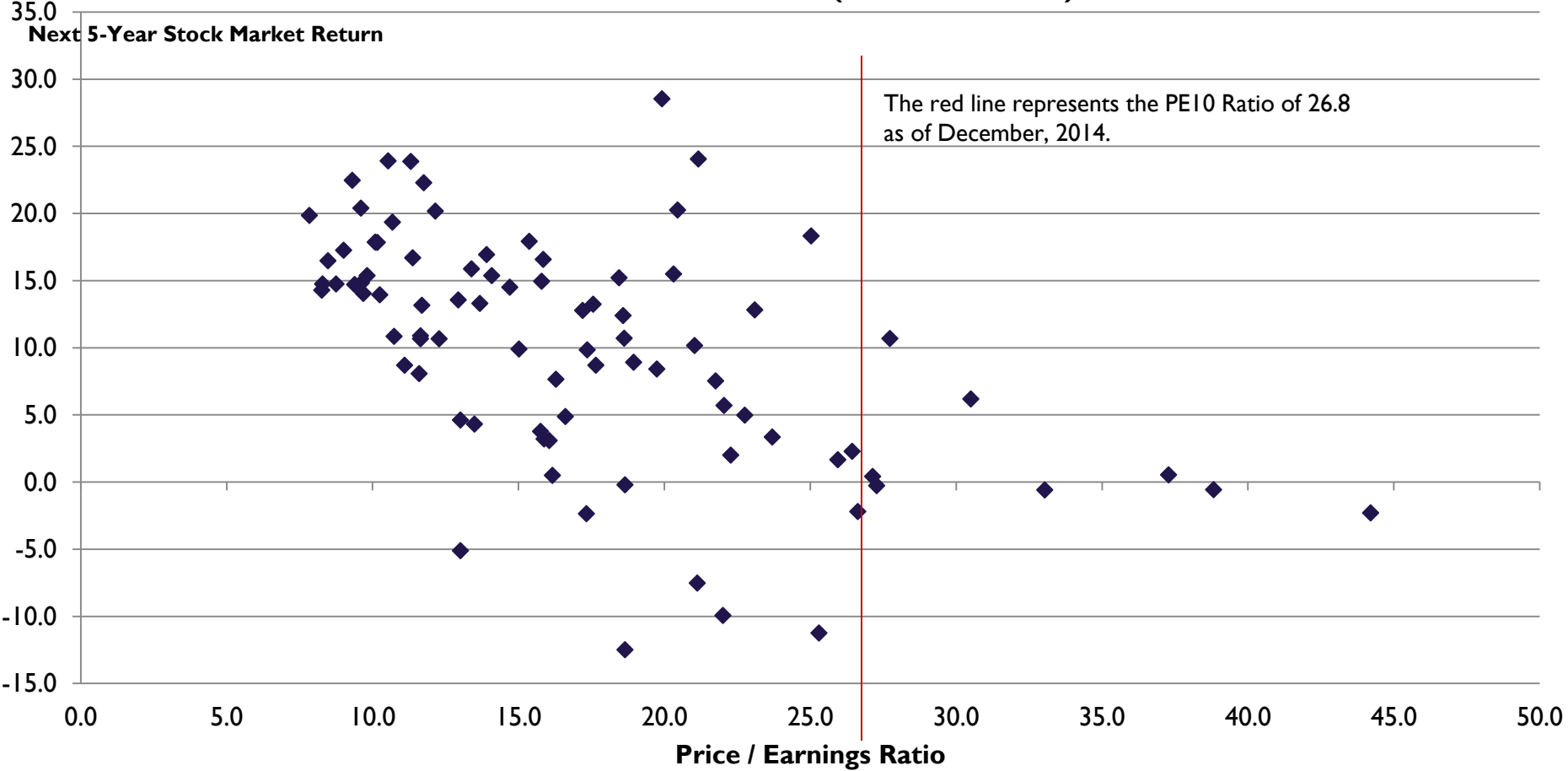


Note: Rankings range between 1 and 100. Lower (higher) rankings imply more (less) value. A ranking of 50 is the median.



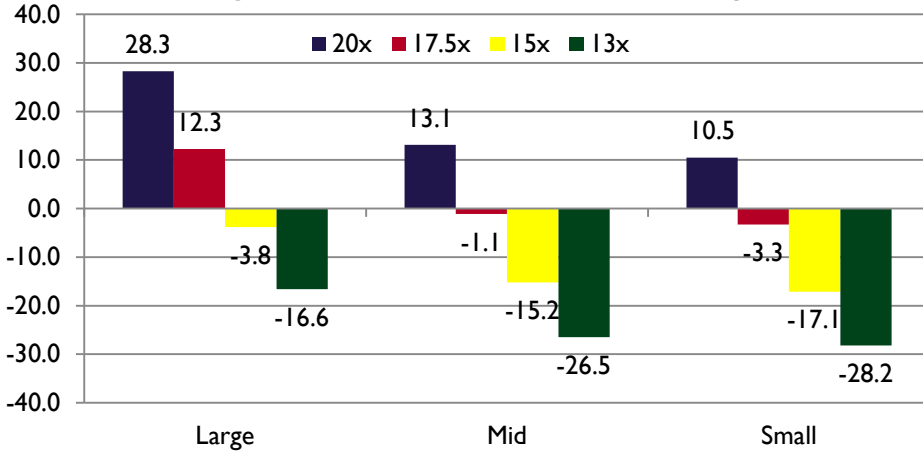
# PE Ratio vs. Next 5-Year Stock Market Returns

## Price / Earnings Ratio (10-Year Normalized Earnings) vs. Next 5-Year Stock Market Return Calendar Year Data (1925 to Present)

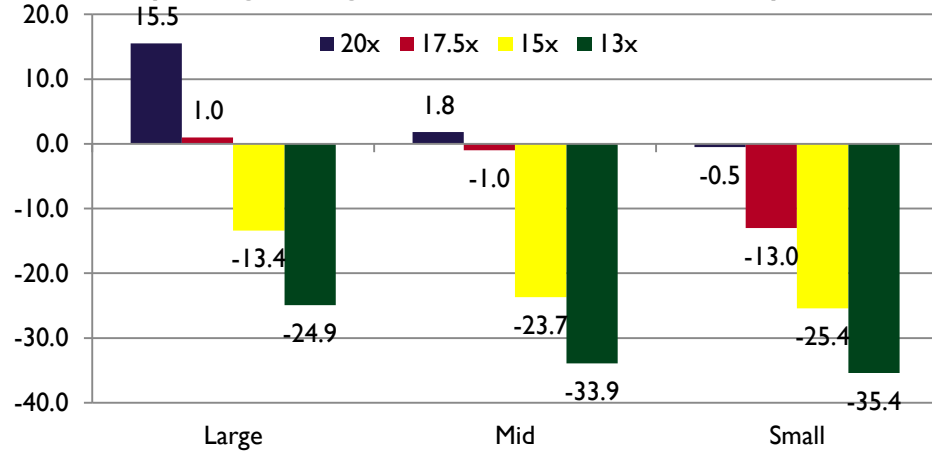


# S&P 500 Growth Characteristics Ending March 31, 2015

**Possible 2016 Returns Using Consensus 2016 Operating Earnings Estimates & Different Valuation Multiples**



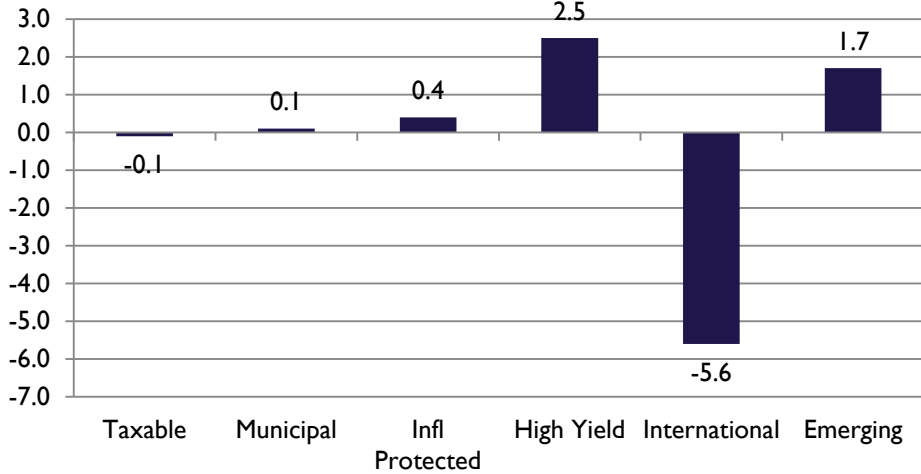
**Possible 2016 Returns Using 10% Below Consensus 2016 Operating Earnings Est. & Different Valuation Multiples**



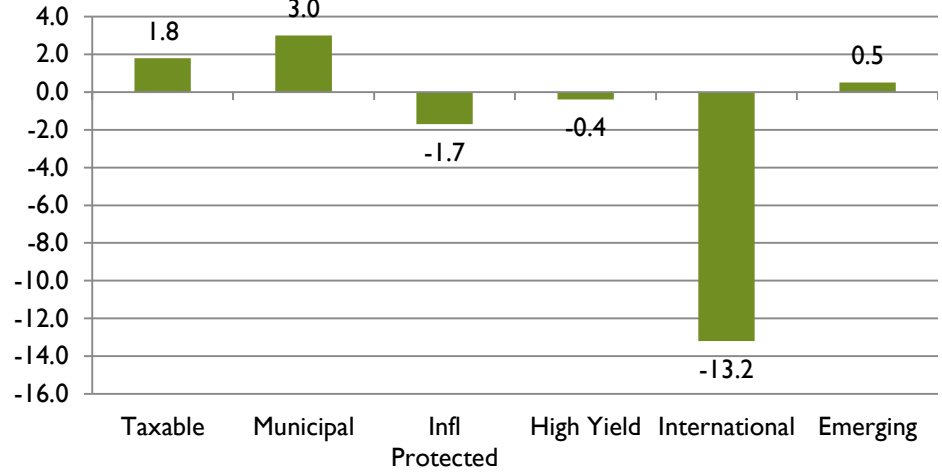
## Bond Market

# Bond Market Returns

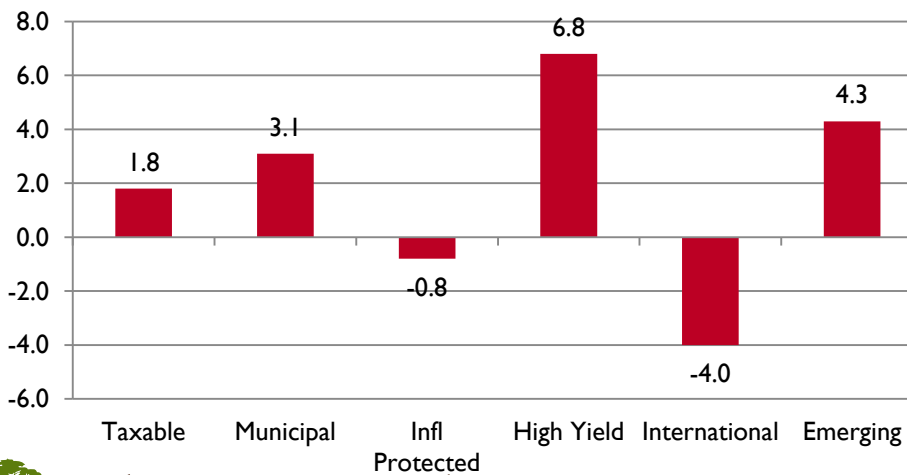
### Year To Date Returns Ending June 30, 2015



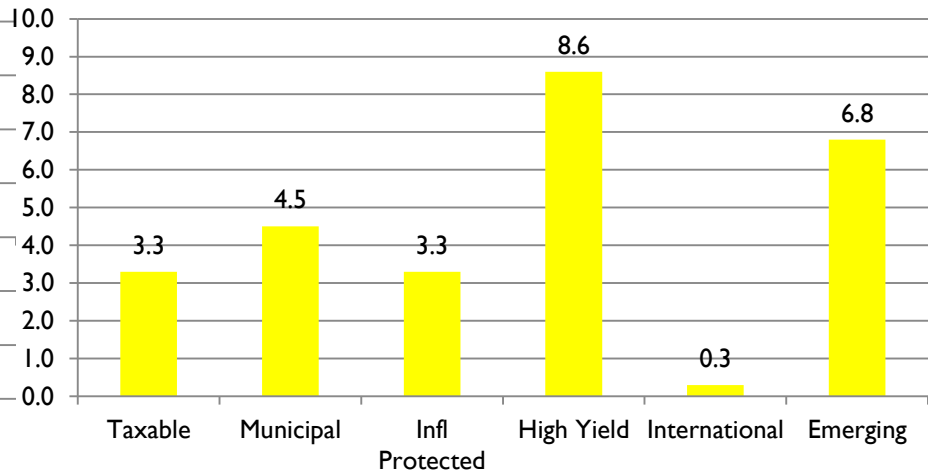
### 1 Year Returns Ending June 30, 2015



### 3 Year Returns Ending June 30, 2015



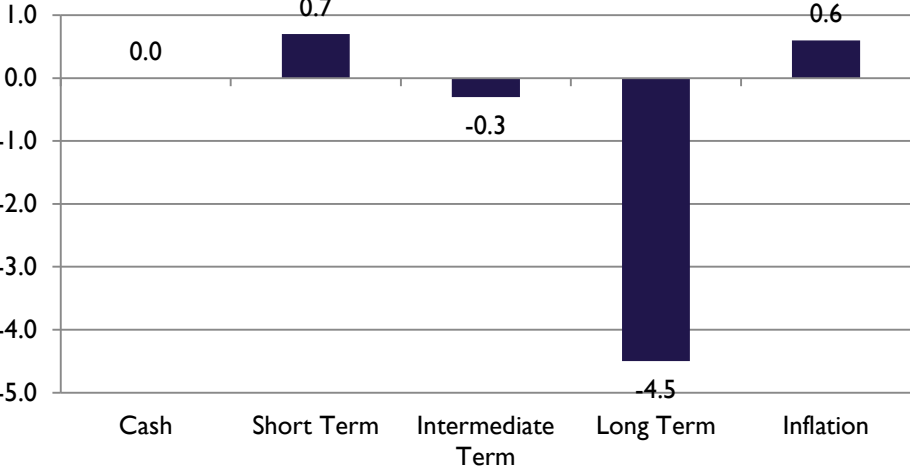
### 5 Year Returns Ending June 30, 2015



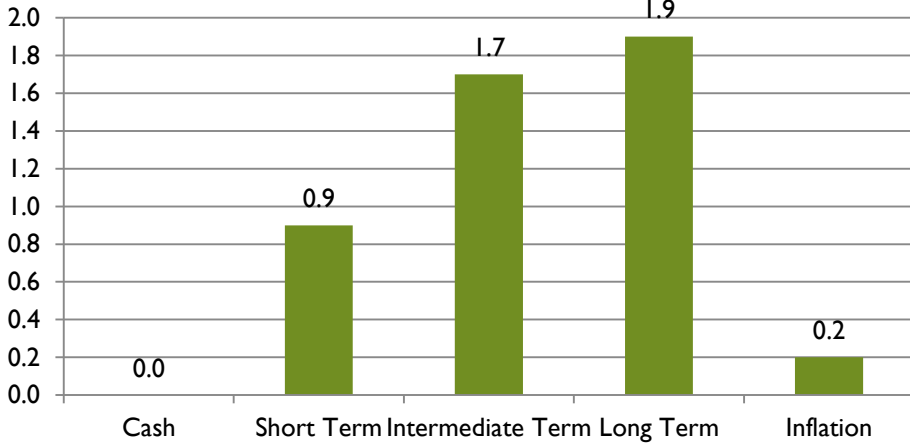


# Bond Market Returns By Maturity

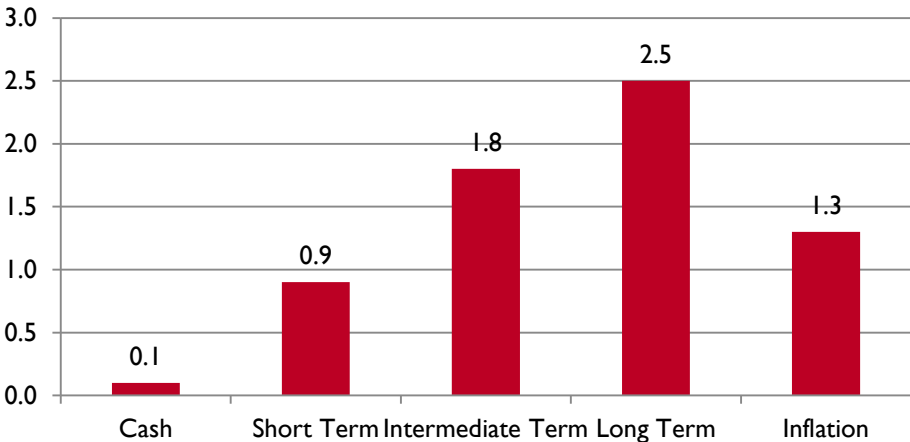
**Year To Date Returns Ending June 30, 2015**



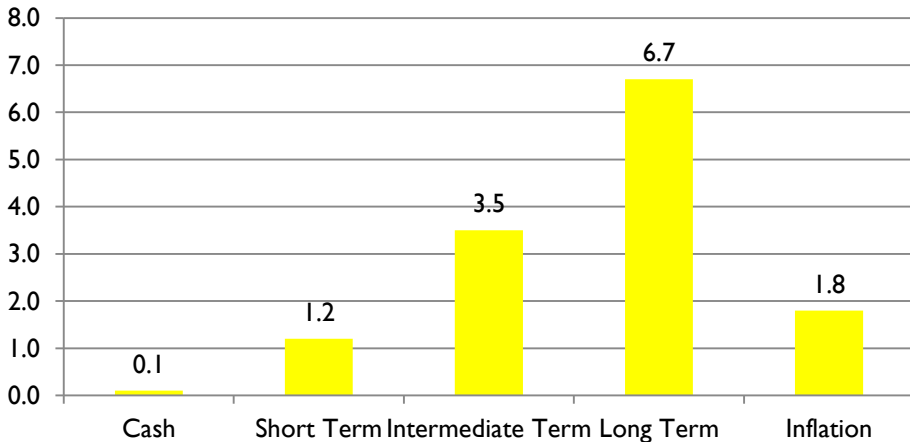
**1 Year Returns Ending June 30, 2015**



**3 Year Returns Ending June 30, 2015**

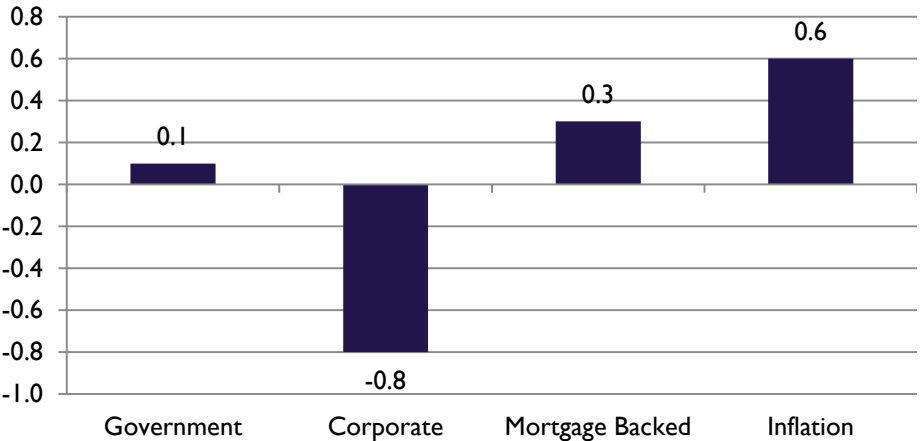


**5 Year Returns Ending June 30, 2015**

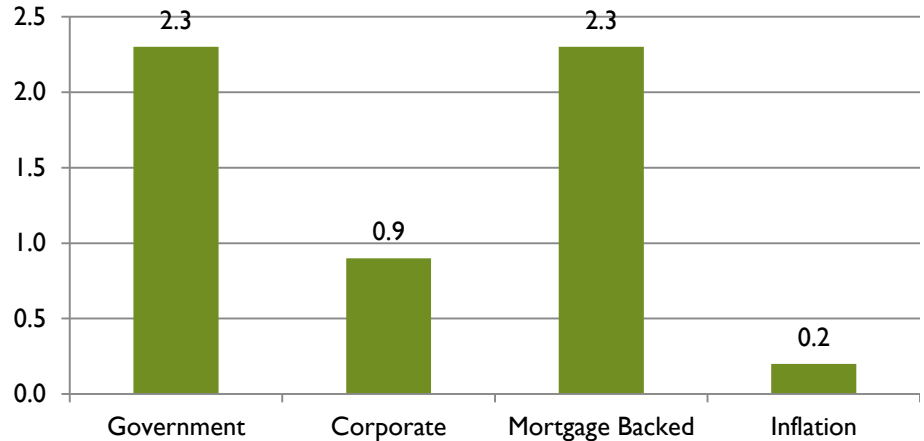


# Bond Market Returns By Sector

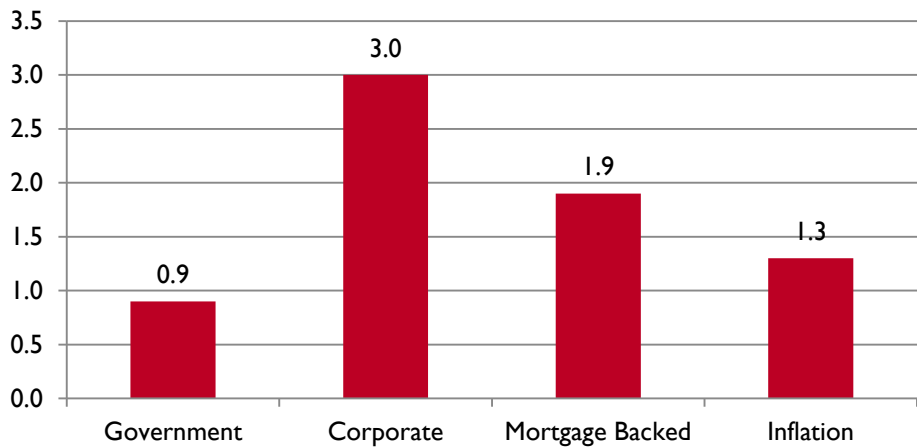
**Year To Date Returns Ending June 30, 2015**



**1 Year Returns Ending June 30, 2015**



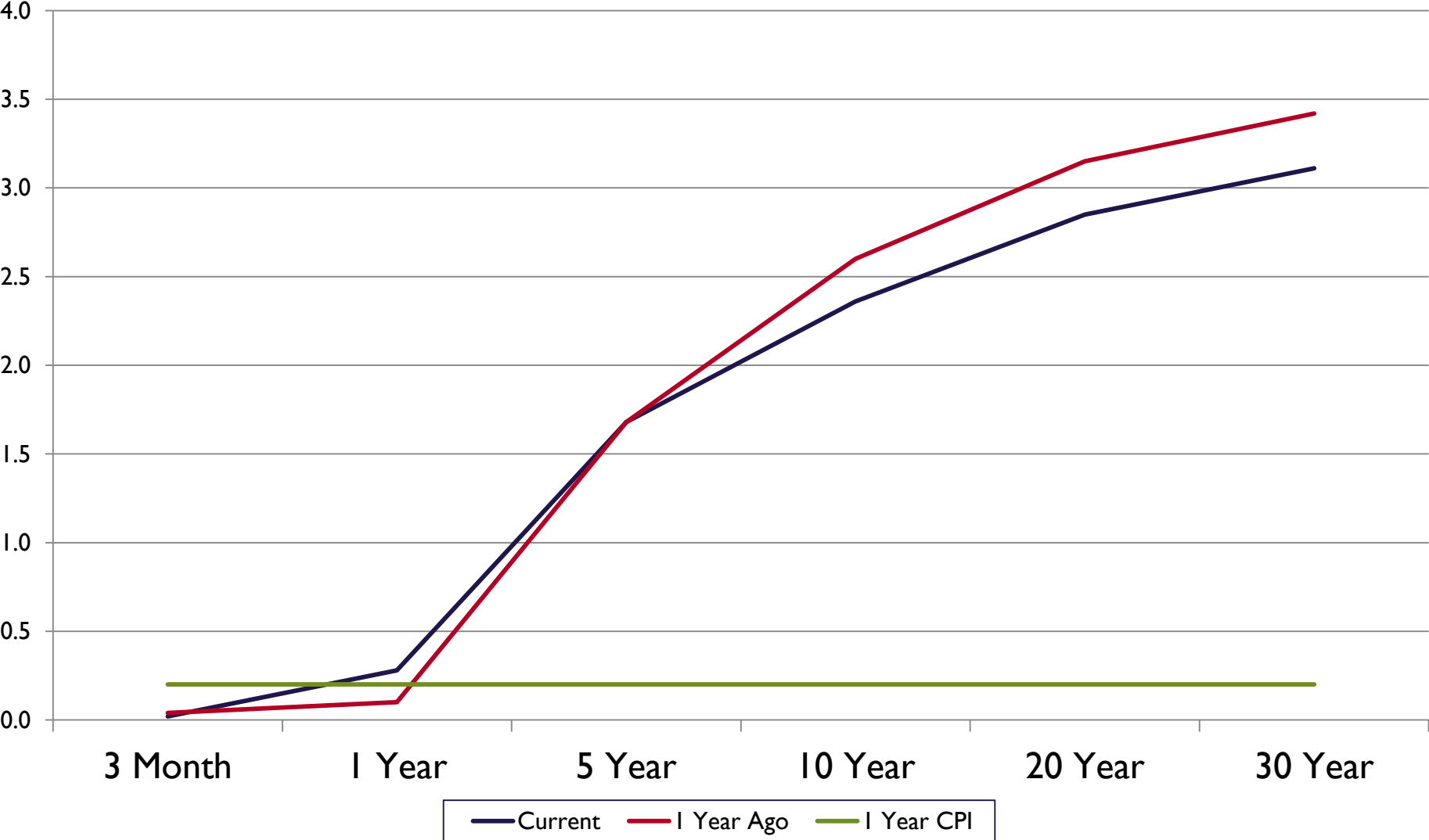
**3 Year Returns Ending June 30, 2015**



**5 Year Returns Ending June 30, 2015**

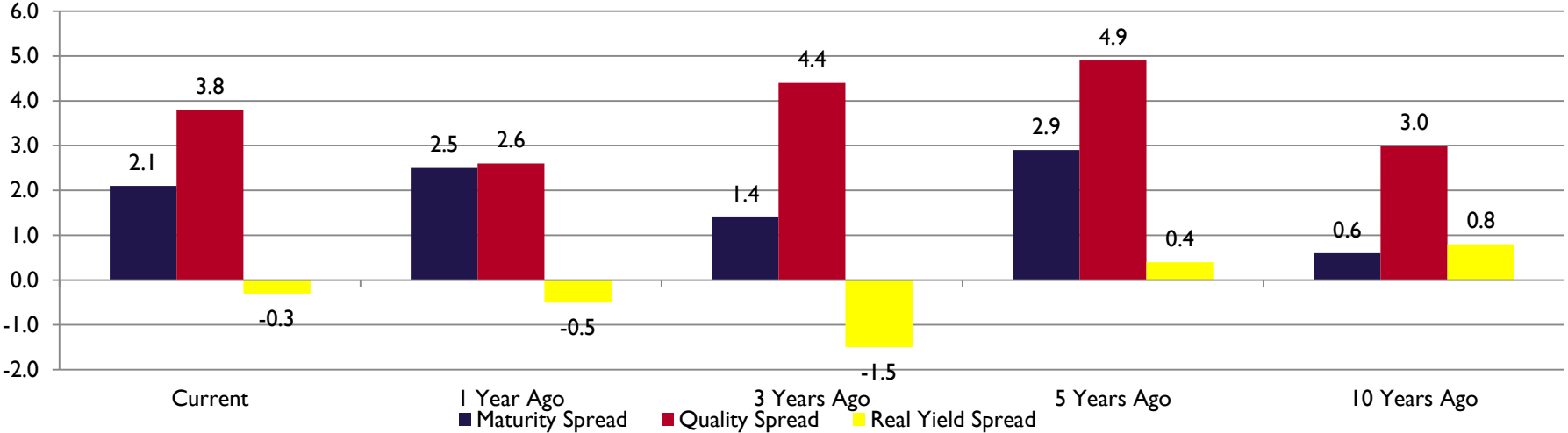


# Treasury Yield Curve vs. Inflation



# Bond Yield Spreads

## Maturity, Quality, and Real Yield Spreads



## Economic Conditions

## Economic Conditions

	Current Assessment	Type of Value	Current / 3 Month	1 Year	3 Years *	5 Years *	10 Years *	As Of Date
<b>General Economy</b>								
Gross Domestic Product	+	Percent Change	0.0%	2.9%	2.2%	2.2%	1.5%	March, 2015
Industrial Production	+	Percent Change	-0.4%	1.5%	2.8%	3.1%	1.0%	June, 2015
Baltic Dry Index	0	Percent Change	32.9%	-5.9%	-7.3%	-19.8%	-13.2%	June, 2015
Corporate Profits after Tax	+	Percent Change	2.9%	9.0%	4.2%	5.5%	4.8%	March, 2015
Leading Economic Indicators	+	Percent Change	1.7%	5.5%	4.9%	4.4%	0.1%	June, 2015
Phili Fed: General Activity - vs. Prior Month (Diffusion)	+	Diffusion	15.2	19.6	-10.9	15.4	-1.4	June, 2015
Phili Fed: New Orders - vs. Prior Month (Diffusion)	+	Diffusion	15.2	14.4	-15.8	9.1	3.5	June, 2015
Phili Fed: General Activity - 6 Months Ahead (Diffusion)	+	Diffusion	39.7	51.0	24.4	39.1	30.4	June, 2015
Phili Fed: New Orders - 6 Months Ahead (Diffusion)	+	Diffusion	44.9	53.5	33.6	34.0	36.8	June, 2015
<b>Consumer</b>								
Consumer Sentiment	+	Actual Value	96.1	82.5	73.2	76.0	96.0	June, 2015
Retail Sales	0	Percent Change	0.7%	0.6%	3.5%	4.4%	2.3%	June, 2015
ECRI Weekly Leading Index	0	Percent Change	0.6%	-1.4%	3.2%	1.9%	0.0%	June, 2015
Real Personal Income	+	Percent Change	0.5%	4.2%	2.6%	2.8%	2.0%	May, 2015
Real Disposable Personal Income	+	Percent Change	0.4%	3.5%	2.0%	2.2%	1.9%	May, 2015
Real Personal Expenditures	+	Percent Change	1.0%	3.4%	2.7%	2.4%	1.8%	May, 2015
Real Personal Expenditures: Durable Goods	+	Percent Change	4.8%	7.5%	7.4%	7.0%	4.0%	May, 2015
Auto and Light Truck Sales	0	Percent Change	0.2%	1.5%	6.4%	8.5%	-0.5%	June, 2015
<b>Business</b>								
ISM Manufacturing: Purchasing Managers Index	+	Actual Value	53.5	55.7	51.3	56.4	52.4	June, 2015
ISM Manufacturing: New Orders Index	+	Actual Value	56.0	59.1	51.5	60.0	55.7	June, 2015
ISM Non-Manufacturing: NMI Composite Index	+	Actual Value	56.0	56.3	53.5	54.6	--	June, 2015
ISM Non-Manufacturing: Business Activity Index	++	Actual Value	61.5	59.2	54.7	59.4	60.7	June, 2015
ISM Non-Manufacturing: New Orders Index	+	Actual Value	58.3	60.4	55.5	57.6	59.2	June, 2015
Manufacturers' New Orders	0	Percent Change	0.5%	-6.3%	-0.2%	3.3%	1.8%	May, 2015
Manufacturers' New Orders For Durable Goods	0	Percent Change	1.0%	-3.1%	1.3%	4.1%	1.0%	May, 2015

\* Percent change data is annualized.



## Economic Conditions

	Current Assessment	Type of Value	Current / 3 Month	1 Year	3 Years *	5 Years *	10 Years *	As Of Date
<b>Labor</b>								
Unemployment Rate	+	Actual Percent	5.3%	6.2%	8.6%	10.1%	5.0%	June, 2015
Manpower Employment Outlook (Net % Hiring)	+	Actual Percent	16.0%	13.0%	9.0%	6.0%	21.0%	May, 2015
4-Week Moving Average of Continued Claims	+	Percent Change	-4.0%	-12.3%	-12.0%	-13.1%	-1.4%	June, 2015
Job Openings: Total Private	+	Percent Change	4.2%	16.1%	13.6%	14.0%	3.4%	May, 2015
Hires: Total Private	+	Percent Change	-0.7%	3.3%	4.1%	5.1%	-0.6%	May, 2015
<b>Banking</b>								
Consumer Loans at All Commercial Banks	+	Percent Change	1.3%	4.4%	3.4%	1.2%	5.8%	June, 2015
Real Estate Loans at All Commercial Banks	+	Percent Change	1.0%	4.0%	2.0%	0.3%	3.2%	June, 2015
Commercial and Industrial Loans All Commercial Banks	+	Percent Change	2.6%	12.4%	10.5%	9.7%	6.8%	June, 2015
Delinquency Rate on All Loans (%)	+	Actual Percent	2.5%	3.3%	5.3%	7.5%	1.6%	March, 2015
Nonperforming Total Loans (%)	+	Actual Percent	1.8%	2.5%	4.2%	5.6%	0.8%	March, 2015
<b>Real Estate</b>								
Housing Starts	+	Percent Change	23.1%	26.6%	15.8%	17.0%	-5.5%	June, 2015
New One-Family Homes for Sale	+	Percent Change	1.0%	6.2%	12.7%	-0.9%	-7.5%	May, 2015
New One-Family Houses Sold	+	Percent Change	0.2%	19.5%	13.8%	14.3%	-8.2%	May, 2015
Median Sales Price of Homes Sold	+	Percent Change	5.0%	7.9%	10.1%	6.1%	2.6%	December, 2014
Median Number of Months on Sales Market	+	Actual Value	3.9	3.4	5.7	12.8	3.8	May, 2015
<b>Prices / Commodity</b>								
Consumer Price Index	+	Percent Change	0.9%	0.2%	1.3%	1.8%	2.1%	June, 2015
Consumer Price Index Less Food and Energy	+	Percent Change	0.6%	1.8%	1.8%	1.8%	1.9%	June, 2015
Producer Price Index	+	Percent Change	1.8%	-2.5%	0.8%	2.0%	2.5%	June, 2015
Producer Price Index Less Food and Energy	+	Percent Change	0.7%	2.2%	1.9%	2.1%	2.1%	June, 2015
CRB Commodity Spot Index	+	Percent Change	2.0%	-14.7%	-3.8%	0.1%	3.7%	June, 2015
Gold Price	+	Percent Change	-1.3%	-11.0%	-9.9%	-1.2%	10.4%	June, 2015

\* Percent change data is annualized.



## Economic Conditions

	Current Assessment	Type of Value	Current / 3 Month	1 Year	3 Years *	5 Years *	10 Years *	As Of Date
<b>Stock Market</b>								
S&P 500 Earnings	0	Percent Change	-3.4%	2.1%	5.6%	15.0%	5.7%	December, 2014
AAll Survey: Stock Allocation	-	Actual Percent	67.2%	67.0%	58.8%	52.9%	67.0%	June, 2015
AAll Bull/Bear Investor Sentiment Spread	-	Actual Percent	13.9%	16.1%	-15.7%	2.0%	16.4%	June, 2015
AAll Percent Bullish 8-Week Average	0	Actual Percent	26.8%	35.6%	28.8%	36.9%	43.6%	June, 2015
CBOE Volatility Index	0	Actual Percent	18.2%	11.6%	17.1%	34.5%	12.0%	June, 2015
CBOE Russell 2000 Volatility Index	0	Actual Percent	20.1%	16.4%	21.9%	40.5%	16.7%	June, 2015
SP 500 Put/Call Ratio	-	Actual Value	2.0	2.3	1.1	--	--	June, 2015
VIX Put/Call Ratio	-	Actual Value	0.5	0.4	0.9	0.9	--	June, 2015
<b>Interest Rates</b>								
1 Year Treasury	+	Actual Percent	0.3%	0.1%	0.2%	0.3%	3.4%	June, 2015
10 Year Treasury	+	Actual Percent	2.4%	2.6%	1.6%	3.2%	4.0%	June, 2015
30 Year Treasury	+	Actual Percent	3.1%	3.4%	2.7%	4.1%	0.0%	June, 2015
ML AAA	+	Actual Percent	2.8%	2.5%	1.9%	2.9%	4.5%	June, 2015
ML A	+	Actual Percent	3.0%	2.7%	3.0%	4.2%	4.7%	June, 2015
ML BBB	+	Actual Percent	3.9%	3.4%	4.0%	5.0%	5.2%	June, 2015
ML High Yield	+	Actual Percent	6.7%	5.3%	7.4%	9.0%	7.7%	June, 2015
Bond Buyer 20-Bond Municipal Bond Index	+	Actual Percent	3.8%	4.4%	3.9%	4.4%	4.2%	June, 2015
Maturity Spread (10 Year - 1 Year Treasury)	+	Actual Percent	2.1%	2.5%	1.4%	2.9%	0.6%	June, 2015
Quality Spread (ML High Yield - ML A Corporate)	0	Actual Percent	3.8%	2.6%	4.4%	4.9%	3.0%	June, 2015
Real Yield Spread (10 Year Treasury - Expected Inflation)	-	Actual Percent	-0.3%	-0.5%	-1.5%	0.4%	0.8%	June, 2015

\* Percent change data is annualized.

