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.

# The earnings estimates and valuations for U.S. small-cap stocks look attractive relative to large-cap stocks

Here we go! In the first five months of 2016, investors liquidated an estimated net $51.9 billion from U.S. Equity mutual funds and exchange-traded funds, and that was before the Brexit vote on 6/23/16, according to data from Morningstar. This happened despite the fact that the S&P 500 Index was up in the period, posting a total return of 3.57%, according to Bloomberg. We should note that Utilities and Telecommunication Services, which are considered to be defensive in nature, were the top two performing sectors. They also tend to offer stock dividend yields above the yield on the S&P 500 Index, and have higher yields than a lot of debt securities at the present time. The dividend yields on the S&P 500 Utilities, S&P 500 Telecommunication Services and S&P 500 indices were 3.21%, 4.25% and 2.18%, respectively, as of 6/30/16, according to Bloomberg. For comparative purposes, the yield on the 10-year Treasury Note stood at 1.47% as of 6/30/16.

The U.S. economic recovery turned seven years old at the close of June, according to the National Bureau of Economic Research. The current bull market in U.S. stocks (3/9/09-6/30/16) turned seven years, three months and 22 days old at the close of June. That comes to 2,671 days, ranking it as the second longest bull market since 1942, according to Bespoke Investment Group. The longest ran from 12/4/87 through 3/24/00, or 4,494 days. That is 1,823 days longer than the current bull market. From 3/9/09 through 6/30/16, the S&P SmallCap 600 Index posted a cumulative total return of 327.4%, compared to 262.2% for the S&P 500 Index, according to Bloomberg. For the more risk-averse investor, the cumulative total return on the BofA Merrill Lynch 7-10 U.S. Treasury Index was 42.7%, according to Bloomberg.

As noted, this is the second longest bull market since 1942, but it might also be one of the least appreciated, in our opinion. Those investors who sold out of their equity positions after getting knocked off their proverbial horse in the 2008-2009 financial crisis and opted to sell out of the stock market, and remain out, have missed an opportunity to potentially garner a substantial amount of capital appreciation. We still believe there is life left in this bull market, and potentially a lot of life left as discussed in the preceding paragraph. In the current bull market, small-capitalization (cap) stocks have outperformed their large-cap counterparts. That should not come as a surprise since more risk should be accompanied by more return over time, though it is never guaranteed.

A study from Bank of America U.S. Trust found that 77% of the firm's clients rose from the middle class and poorer backgrounds to become high net worth (HNW) individuals by building their wealth slowly over time, according to Yahoo! Finance. HNW clients have at least $3 million in investable assets. The study also revealed the following about HNW individuals: 86% of those polled said they made their biggest gains through long-term buy and hold strategies; 89% via traditional stocks and bonds; and 83% benefitted from a series of small wins versus taking big investment risks. Sounds like a solid action plan to us, even if it involves taking the slow road.

***Our take on the data referenced in the tables...An argument for investing in Small-Caps***

#1: Data suggests that small-cap stocks are potentially under-owned by the average investor.
#2: Small-caps have outperformed large-caps by nearly 200 basis points per year since 1926.
#3: In the past 90 years, small-caps have only posted four more negative total return years than large-caps.
#4: In the same period, small-caps outperformed large-caps in nearly (59%) six out of every 10 years.
#5: On price-to book basis, as of 6/30/16, the S&P SmallCap 600 Index was trading at a relative valuation to the S&P 500 Index of 72.14%, close to where it was (71.88%) in 6/09. Small-caps are not overpriced.
#6: On a P/E basis, the 2016 and 2017 estimates for the S&P SmallCap 600 Index are just modestly higher.
#7: The 2016 and 2017 earnings growth rate estimates suggest that smaller companies are doing quite well in this modest economic growth climate.

| Assets Under Management (Funds & ETFs) | |
|---|---|
| Small-Cap Funds | $586 Billion |
| U.S. Equity/Sector Funds | $6.82 Trillion |
| Small-Cap Share | 8.6% |
| *Source: Morningstar (5/16)* | |

| Average Annual Total Return (1926-2015) | |
|---|---|
| U.S. Small Stocks | 11.98% |
| S&P 500 Index | 10.02% |
| Small Stock Advantage | 1.96 percentage pts. |
| *Source: Ibbotson Associates/Morningstar* | |

| # of Negative Total Return Yrs. (1926-2015 = 90 Yrs.) | |
|---|---|
| U.S. Small Stocks | 28 (31%) |
| S&P 500 Index | 24 (27%) |
| Large-Cap Advantage | 4 less |
| *Source: Ibbotson Associates/Morningstar* | |

| # of Years of Outperformance (1926-2015) | |
|---|---|
| U.S. Small Stocks | 53 |
| S&P 500 Index | 37 |
| Small Stock Advantage | +16 |
| *Source: Ibbotson Associates/Morningstar* | |

| Price-to-Book Ratios | |
|---|---|
| S&P SmallCap 600 Index | 2.02 |
| S&P 500 Index | 2.80 |
| Small/Large (Relative Value) | 72.14% |
| *Source: Bloomberg, as of 6/30/16* | |

| 2016 & 2017 Est. Price-to-Earnings (P/E) Ratios | |
|---|---|
| S&P SmallCap 600 Index | 20.70 & 17.87 |
| S&P 500 Index | 18.31 & 16.12 |
| Large-Cap Advantage | 2016 & 2017 |
| *Source: Bloomberg, as of 7/13/16* | |

| 2016 & 2017 Consensus EPS Est. Growth Rates | |
|---|---|
| S&P SmallCap 600 Index | 21.21% & 15.84% |
| S&P 500 Index | 8.83% & 13.56% |
| Small-Cap Advantage | 2016 & 2017 |
| *Source: Bloomberg, as of 7/13/16* | |



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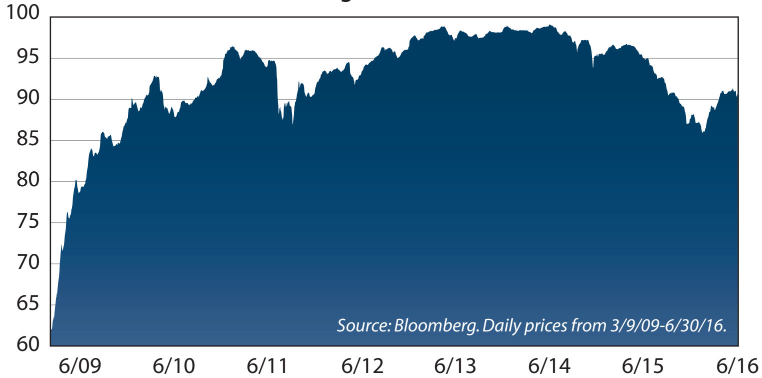
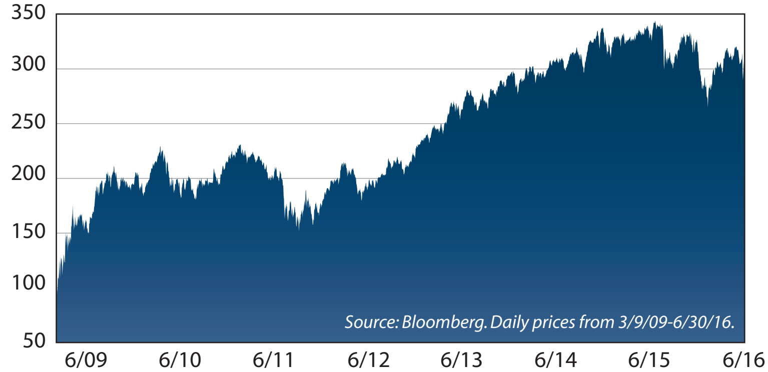
# Waiting in the wings for higher interest rates

**S&P/LSTA U.S. Leveraged Loan 100 Index** *(Price Chart)*




**S&P 500 Financials Index** *(Price Chart)*




The Federal Reserve raised the upper bound of its federal funds target rate from 0.25% to 0.50% on 12/16/15. Prior to that move, the Fed had not raised rates since 6/30/06. Due to the absence of any significant inflationary pressures and a slowdown in global economic growth, the Fed opted to refrain from raising its benchmark lending rate in the first half of 2016, despite its stated intentions at the start of the year to raise it as many as four times in 2016.

Why is this relevant to the performance of leveraged loans (senior loans)? The interest paid by leveraged loans tends to float in the direction of a short-term benchmark lending rate, such as the 3-month LIBOR (London Interbank Offered Rate) rate. Historically, the 3-month LIBOR rate has tended to track the direction of the federal funds rate over time. The rate was 0.65% on 6/30/16. With interest rates near historically low levels, particularly short-term rates, it would be logical for income-oriented investors to favor fixed-rate bonds over floating-rate loans. It is one of the reasons why the S&P/LSTA U.S. Leveraged Loan 100 Index stood at a 9.24% discount to par value on 6/30/16, according to S&P Dow Jones Indices.

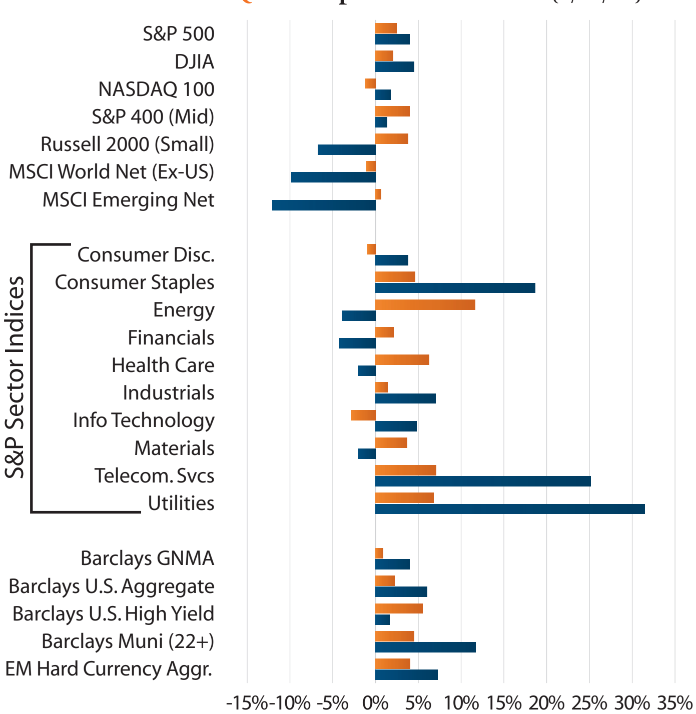
The performance of leveraged loans can also be impacted by the direction of interest rates further out on the yield curve. In 2013, the yield on the 10-year Treasury Note rose from 1.76% to 3.03%, according to Bloomberg. As indicated in the chart, leveraged loan prices rose. One of the reasons for this is that some investors likely sold some of their fixed-rate bonds and shifted at least some of that capital to leveraged loans. In 2013, Bank Loan mutual funds that invest in these loans reported net inflows totaling $61.3 billion,

The recovery in the U.S. banking industry has been slow, but relatively steady following the 2008-2009 financial crisis. The big banks were at the epicenter of the mortgage-induced crisis. In addition to the new regulations and standards imposed by the Wall Street Reform and Consumer Protection Act (Dodd-Frank), which was signed into law in July 2010, many banks have seen their loan portfolios come under pressure in the low interest rate climate. The net interest margin for all FDIC insured institutions stood at 3.10% in March 2016, down from recovery-period high of 3.84% in March 2010, according to Bloomberg. Insurance companies, which tend to make their money off of investing the premiums they take in from policyholders, could also potentially benefit from a rise in interest rates.

The Federal Reserve reported at the end of June that the 33 biggest banks had increased their common equity by more than $700 billion since 2009, raising the ratio of high-quality capital to risk-weighted assets from 5.5% to 12.2%, according to MarketWatch. It also noted that 31 of the 33 banks estimate their common equity will increase between the third quarter of 2016 and the second quarter of 2017. All of the banks passed the latest stress test, which assesses a bank's ability to withstand severe financial and economic shocks. Most banks are now permitted to increase stock dividends and buybacks.

As of 6/30/16, the S&P 500 Financials Index stood 39.48% below its 10-year high, according to Bloomberg. In June, Financials contributed 16.36% of the dividend payout of the S&P 500 Index, the most of any sector, according to S&P Dow Jones Indices. Keep in mind that bank stock dividends could go higher, in our opinion.

## Total returns for Q2 and past 12 months (6/30/16)




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

## A Look Ahead:

### The outlook for earnings (year-over-year comparison in $)...

| | **Q3'16E** | Q3'15A | **Q4'16E** | Q4'15A | **2016E** | 2015E |
|---|---|---|---|---|---|---|
| Consumer Discretionary | **8.96** | 8.08 | **9.30** | 8.34 | **34.26** | 30.44 |
| Consumer Staples | **6.67** | 6.23 | **6.78** | 6.00 | **25.32** | 24.32 |
| Energy | **2.25** | -4.52 | **2.25** | -8.20 | **2.92** | -13.71 |
| Financials | **5.53** | 5.97 | **5.69** | 5.03 | **22.08** | 23.01 |
| Health Care | **13.22** | 9.59 | **13.05** | 9.30 | **49.51** | 38.72 |
| Industrials | **7.70** | 7.73 | **7.64** | 7.09 | **28.90** | 28.00 |
| Information Technology | **10.26** | 8.98 | **13.04** | 10.99 | **40.64** | 37.97 |
| Materials | **3.92** | 1.25 | **3.91** | 0.35 | **14.08** | 8.49 |
| Telecom. Services | **3.14** | 2.86 | **2.87** | 3.46 | **11.83** | 12.15 |
| Utilities | **4.46** | 4.28 | **2.93** | 0.16 | **14.08** | 11.25 |
| S&P 500 Index | **30.33** | 25.44 | **31.69** | 23.06 | **114.31** | 100.45 |
| S&P 400 Index (Mid-Cap) | **19.94** | 15.81 | **21.38** | 10.50 | **72.65** | 55.49 |
| S&P 600 Index (Small-Cap) | **9.50** | 4.59 | **10.41** | 4.69 | **33.47** | 19.66 |

*Source: Standard & Poor's (6/29/16)*