First Trust

Quarterly Market Overview

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Robert F. Carey, CFA
Chief Market Strategist

Mr. Carey has more than 30 years of experience as an Equity and Fixed-Income Analyst and is a recipient of the Chartered Financial Analyst (CFA) designation. He is a graduate of the University of Illinois at Champaign-Urbana with a B.S. in Physics. He is also a member of the CFA Society of Chicago and the CFA Institute. Bob is the Chief Market Strategist at First Trust Advisors L.P., and has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC and on Chicago's WBBM Newsradio 780's Noon Business Hour. He has been quoted by several publications, including *The Wall Street Journal, The Wall Street Reporter, Bloomberg News Service, and Registered Rep.*

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

Optimism over the U.S. economy reopening in the 1H'21 helped boost small- and mid-cap stocks in November and December

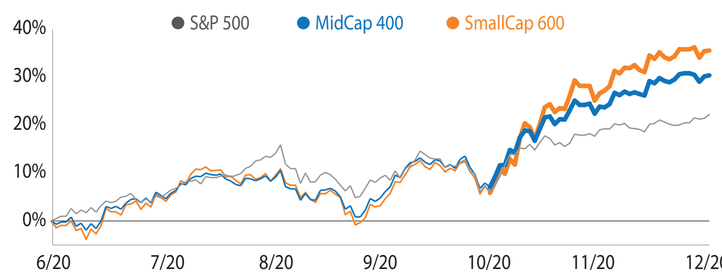
Even before the two COVID-19 vaccines were officially approved by the Food and Drug Administration the financial media was hard at work reporting on where investors should direct their capital to exploit the potential reopening of the broader U.S. economy. Some have referred to the new normal adopted since mid-February 2020 as the tale of two economies: Those companies that benefitted from the various lockdowns and shelter-in-place mandates from state and local governments, such as select technology and consumer discretionary firms, and those that suffered greatly, such as leisure and entertainment and oil and gas companies. One common method for how to potentially exploit times like these is to simply buy the areas (subsectors) of the stock market beaten up the most and wait for the turn. That strategy would have worked in 2020.

When you look at the worst-performing subsectors (industries) that comprise the S&P 500 Index from its 2/19/20 peak through the close of October and then compare those results to the last two months of 2020, you would find that investors who bought what was beaten up the most were rewarded handsomely, according to data from Bloomberg. From 2/19/20 through 10/31/20, the worst-performing subsector in the S&P 500 Index was Oil & Gas Equipment, down 51.26% on a total return basis. Over that same period, Hotels were the sixth-worst performing subsector, down 42.21%. From 10/31/20 through 12/31/20, the top-performing subsector was in fact Oil & Gas Equipment, with a total return of 50.77%. Hotels had the eighth-best showing at 37.67%. While it is not a bad system to follow, chasing subsectors is probably not for everyone.

Believe it or not, it is hard enough to convince some investors to allocate a sizable percentage of their capital earmarked for equities to small- and mid-capitalization (cap) stocks. Even with history on their side. From 1926 through 2019, the S&P 500 Index posted an average annual total return of 10.20%, according to Morningstar/Ibbotson Associates. The Ibbotson® Small Company Stock Index, however, returned 11.91% per year, on average, over those 94 years, or an extra 171 basis points of return annually. That is a solid risk-reward relationship, in our opinion. Unfortunately, it does not offer data on the long-term performance of mid-cap stocks. Investors love their large-caps, especially when they have been performing well, as has been the case over the past few years (see chart on page 2).

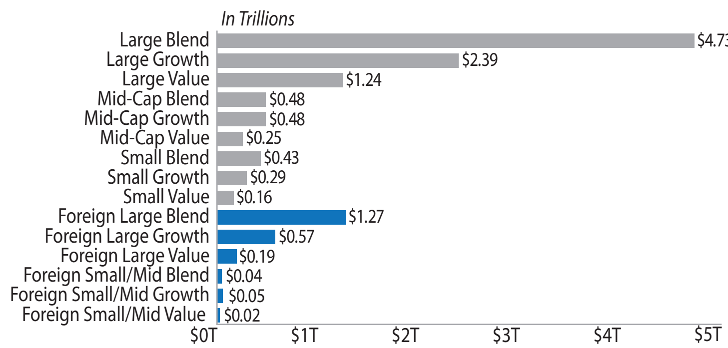
The chart at the right featuring total mutual fund and exchange-traded fund (ETF) assets by equity style/market cap tells the story. As of 11/30/20, the three U.S. large-cap categories held a combined $8.36 trillion in assets, compared to $1.21 trillion and $0.88 trillion for the three U.S. mid- and small-cap categories, respectively. The large cap categories hold nearly 10 times (9.5x) what is invested in the small-cap categories even though small-caps have delivered higher average annual total returns over the past nine-plus decades. Even after factoring the inherent additional risk that one would assume investing in mid- and small-cap stocks, we believe that many equity investors could be significantly underweight both mid- and small-cap stocks.

S&P 500, MidCap 400 & SmallCap 600 Total Return Indices (2H'20)



Source: Bloomberg, 6/30/20 - 12/31/20. **Past performance is no guarantee of future results.**

Total Net Assets In Large-, Mid- & Small-Cap Mutual Funds/ETFs



Source: Morningstar (U.S.-based fund categories) as of 11/30/20.

Some points of interest for small-, mid- and large-cap stocks

- S&P updated its valuations of large-, medium- and small-cap companies on 12/8/20, raising them to $9.8 billion in market cap or more for the S&P 500 Index, $3.2 billion to $9.8 billion for the S&P MidCap 400 Index and $700 million to $3.2 billion for the S&P SmallCap 600 Index. (U.S. News & World Report)
- As of 12/31/20, 76.2% of the companies in the S&P 500 Index paid a dividend, compared to 60.0% of S&P MidCap 400 companies and 46.9% of S&P SmallCap 600 companies. (S&P Dow Jones Indices)
- Small- and mid-cap companies in the U.S. tend to be more reliant on the strength of the U.S. economy for their success, while larger U.S. companies (multinationals) may also be influenced by the state of the global economy.
- In the current millennium (12/31/99-12/31/20), the S&P SmallCap 600, S&P MidCap 400 and S&P 500 Indices have posted average annual total returns of 9.86%, 9.68% and 6.61%, respectively. The higher the risk, the greater the return. (Bloomberg)

Past performance is no guarantee of future results.

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Outperformance in the equities markets often entails multi-year runs

We just spent the first half of our newsletter discussing whether or not investors are potentially overweight U.S. large-cap stocks and underweight small- and mid-cap stocks. Now, we would like to ask the following question: How much foreign equity exposure is optimal for a U.S. investor based on the performance results featured in the adjacent table? We'll leave that to the investor. The adjacent table features 5-year cumulative total returns. Five years has historically been considered a long-term investment period. As you can see, it has been all U.S. since the end of the 2006-2010 period. The leadership role in the global equity marketplace shifted from the emerging markets, which dominated most of the first decade of this millennium, to U.S. mid-caps, then to U.S. small-caps, followed by U.S. large-caps. In case you did not notice, developed market foreign equities failed to outperform even one 5-year period. In our opinion, that is important to consider when trying to decide how much to allocate to emerging markets versus developed nations.

While U.S. investors experienced positive returns most of the time by having exposure to foreign stocks from 2007 to present, the fact of the matter is, in hindsight, they did not enhance their overall portfolio return by said exposure. We do need to acknowledge that investors may have had foreign stock holdings, such as a country or region fund, that outperformed the major U.S. stock indices over a five-year span since 2007. Still, the returns in the table speak volumes. Since we know that outperformance can entail multi-year runs, one wonders what catalyst(s) will come along to knock the U.S. off its throne.

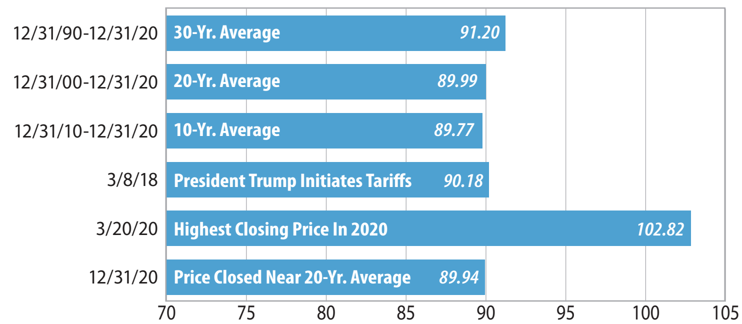
This is the point where we need to mention the influence that the U.S. dollar can have on performance. The U.S. dollar can be a catalyst for change, in our opinion. A weaker U.S. dollar can boost returns for U.S. investors holding positions in unhedged foreign securities, and vice versa. From 2000-2009, the U.S. Dollar Index declined by 23.57% – a nice tailwind for foreign holdings, according to Bloomberg. From 2010-2019, the index appreciated by 23.80% – a notable headwind for foreign holdings. In 2020, the index declined 6.69% to a reading of 89.94, just slightly below its 20-year average reading of 89.99. Will the U.S. dollar continue to decline from its long-term average or will it rise? If it falls, it could help shift the leadership role back to foreign stocks.

5-Year Cumulative Total Returns *(Domestic & Foreign Equity Indices)*

Period	S&P 500	S&P MidCap 400	S&P SmallCap 600	MSCI Daily TR Net World ex-U.S. (USD)	MSCI Daily TR Net Emerging Markets (USD)
2000-2004	-10.98%	57.73%	73.09%	-3.77%	23.65%
2001-2005	2.75%	51.09%	66.71%	27.16%	139.54%
2002-2006	35.03%	67.69%	80.14%	103.36%	225.03%
2003-2007	82.86%	111.81%	110.39%	171.57%	382.95%
2004-2008	-10.47%	-0.40%	4.48%	9.94%	44.65%
2005-2009	2.11%	17.46%	6.97%	22.07%	105.65%
2006-2010	11.99%	32.16%	25.48%	16.18%	82.44%
2007-2011	-1.24%	17.72%	10.10%	-18.86%	12.63%
2008-2012	8.59%	28.51%	28.46%	-15.99%	-4.49%
2009-2013	128.19%	169.04%	163.37%	80.12%	99.33%
2010-2014	105.14%	114.97%	121.81%	28.93%	9.22%
2011-2015	80.75%	66.06%	72.15%	14.75%	-21.83%
2012-2016	98.18%	104.03%	115.67%	34.29%	6.55%
2013-2017	108.14%	101.20%	109.94%	43.29%	23.72%
2014-2018	50.33%	34.01%	35.96%	1.71%	8.52%
2015-2019	73.86%	54.07%	57.85%	30.22%	31.39%
2016-2020	103.04%	79.00%	79.20%	44.49%	82.70%

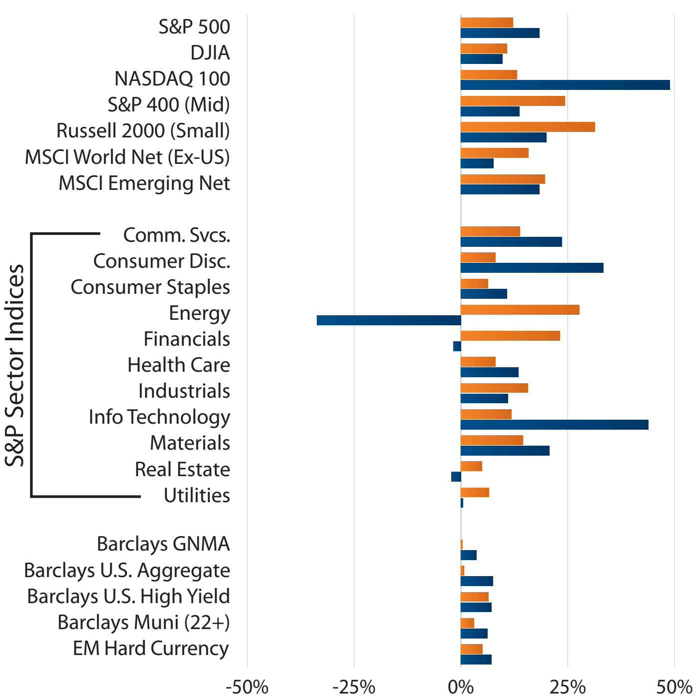
Source: Bloomberg. **Past performance is no guarantee of future results.**

U.S. Dollar Index *(Key Days & Averages)*



Source: Bloomberg.

Total returns for Q4 and past 12 months (12/31/20)



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 (per share). The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.

Index (Weighting In S&P 500)	**Q1'21E**	Q1'20A	**Q2'21E**	Q2'20A	**2021E**	2020E
Communication Svcs. (10.8%)	**2.08**	1.70	**2.29**	1.58	**9.49**	7.43
Consumer Disc. (12.7%)	**6.56**	3.97	**9.11**	4.19	**35.85**	26.09
Consumer Staples (6.5%)	**7.42**	7.35	**7.99**	7.94	**33.10**	32.37
Energy (2.3%)	**1.24**	-9.16	**2.11**	-8.25	**9.34**	-19.01
Financials (10.4%)	**8.35**	-1.09	**8.18**	7.65	**33.33**	26.38
Health Care (13.5%)	**19.50**	13.89	**19.61**	15.12	**79.09**	61.09
Industrials (8.4%)	**5.81**	3.87	**7.68**	2.08	**31.47**	15.76
Information Tech. (27.6%)	**18.52**	14.29	**18.88**	14.48	**82.64**	65.87
Materials (2.6%)	**4.95**	3.28	**5.98**	3.62	**21.67**	15.18
Real Estate (2.4%)	**1.03**	1.65	**1.10**	1.14	**4.52**	4.76
Utilities (2.8%)	**4.42**	3.40	**3.69**	3.80	**17.01**	15.28
S&P 500 Index	**37.04**	19.50	**39.70**	26.79	**164.40**	120.25
S&P 400 Index (Mid-Cap)	**25.88**	16.68	**27.18**	9.00	**114.25**	71.08
S&P 600 Index (Small-Cap)	**11.36**	-19.74	**13.07**	-5.95	**55.86**	-4.73

Source: S&P Dow Jones Indices (12/30/20). Sector weightings as of 12/31/20. There is no guarantee past trends will continue or projections will be realized.