Large-Cap Growth Stocks Still Hold Luster

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by John Kimelman

Large-cap growth stocks, the darling of the bull market over the past 10 years, still hold promise for clients despite some elevated risks, according to advisors and market observers.

Large-cap growth funds have proven winners in industries such as online retail, computer software, smartphones, and social networking that can be compelling for long-term investors despite recent volatility, rising trade tensions between the U.S. and China and seemingly high valuations, according to Robby Greengold, a fund analyst with Chicago-based research firm Morningstar.

To be sure, some advisors are steering away from some names they see as being overbought. David Kotok, the chief investment officer and co-founder of Cumberland Advisors, a Sarasota, Florida-based financial advisory firm, is underweighting large-cap-growth in the ETF portfolios his firm designs for clients.

He is particularly troubled by market-weighted large-cap funds whose performance is skewed toward mega-cap stars that have had outsized runs in the past year. Investors interested in capturing large-cap growth without heavy exposure to the FANG stocks (Facebook, Amazon, Netflix and Google) should consider equal-weight funds, he said, pointing to the Invesco S&P 500 Equal-Weight Technology (RYT) fund as one example.

That concern is justified, but investors sometimes understand they have to take additional risk if they want exposure to the market upside, said David Karp, co-founder of PagnatoKarp, a Reston, Virginia-based registered investment advisory firm.

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Difficult Quarter for Eurozone Stocks

Eurozone equity markets have encountered significant headwinds in the second quarter of this year despite continued robust economic growth above estimated potential for most Eurozone economies.

The continued strength of the Eurozone economies is emphasized in this month's "OECD Economic Surveys: Euro Area."[i] These economies have been growing since 2014. "GDP growth is expected to slow somewhat, but to remain strong by the standards of recent years," the survey states. OECD projects Eurozone GDP to grow by 2.2% this year and 2.1% in 2019, compared with 2.5% in 2017. Factors driving this growth are the continuing expansion of the global economy, a very accommodative monetary policy, and a mildly expansionary fiscal policy. Among the reforms cited by the OECD that are needed to strengthen the resilience of these economies are a rapid resolution of the continuing nonperforming loan situation, a reduction of financial fragmentation across national borders, and improvement of the European fiscal framework.

The European Central Bank (ECB) also expressed a positive view of the Eurozone economies on June 21 as it presented its plan for scaling down its monthly quantitative easing bond purchases during the remainder of the year and concluding its Asset Purchase Program at year-end. The ECB indicated that its policy rates will remain at the present levels at least through the summer of 2019.

The HIS Flash Eurozone Purchasing Managers' Index for June indicated that business activity regained some momentum after growth hit a one-and-a-half year low in May. The service sector was responsible for this improvement as manufacturing activity slowed further. Business expectations are depressed, with trade-war and political uncertainties cited as the biggest concerns.

Indeed, it is these concerns that have created the headwinds for equity markets during the second quarter. The worsening trade relations between the Eurozone and the US are a greater concern for Eurozone equity markets than for the US's, as the Eurozone is more dependent on trade and on the maintenance of the rules-based international trading system. While Europe will respond in kind to trade restrictions imposed by the United States, its scope for doing so without harming itself are limited. If the trade war continues to escalate, the effects on the region will be dire.

Political developments in Europe also have created uncertainties that undermine investor confidence. The election of a populist government in Italy is seen as a threat to European institutions and increases the difficulty of reaching an agreement on an EU-wide solution to the immigration issue. While the election of the centrist Macron in France last year led to optimism that the populist tide had turned, populist, EU-sceptic parties have gained ground not only in Italy but also in Eastern Europe. Even in Germany, where Angela Merkel has been able to extend her leadership of the country, she is confronted with the difficult task of finding a position on migration that is acceptable to her coalition partner, the Bavarian CSU party, which is seeking to ward off competition from the right-wing populist AfD in regional elections in October. Polls indicate that immigration is the most pressing issue in the region and is a major driver of EU populism. An "immigration summit" of EU leaders last weekend was unable to make any progress.

Another source of political uncertainty is the negotiations on Brexit: Major issues remain unresolved, and time is running out.

It is not surprising, therefore, that Eurozone equity markets have experienced heavy going this quarter, despite the positive macroeconomic situation. Over the last 90 days through June 25th, the return for iShares MSCI Eurozone ETF, EZU, is -5.11%, which compares with a positive return of 2.22% for the SPDR S&P 500 ETF Trust, SPY. Within the Eurozone there is considerable variation in returns over this period, ranging from positive gains of 3.48% for the Global X MSCI Portugal ETF, PGAL, and 2.54% for the iShares MSCI Ireland ETF, EIRL, to large losses, with returns of -10.21% for the iShares MSCI Italy Capped ETF, EWI, and -12.53% for the iShares MSCI Austria Capped ETF, EWO. For the first and second largest economies, the iShares MSCI Germany ETF, EWG, returned -5.79%, while the iShares MSCI France ETF, EWQ, performed less badly at -2.65%. Trade tensions are likely to determine whether these markets are able to recover in the second half of the year.

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[i] http://www.oecd.org/eco/surveys/economic-survey-european-union-and-euro-area.htm
Sources: OECD, HIS Markit, CNBC, Bloomberg, Goldman Sachs Economic Research

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Eurozone Economy Robust Despite Equity Market Correction

Eurozone equity markets have declined in step with global markets in a widely expected market correction. While there has been some recovery in the first two days of this week, it is not yet clear that the correction has run its course. Concerns that interest rates in both the United States and Europe will rise faster than had earlier been expected appear to have been a trigger, with technical factors amplifying market swings. Following a correction in early 2016, equity markets climbed steadily, until they fell off the cliff at the end of January. The market gains in 2017 were exceptional. The US equity market gained 21.8% as measured by the SPDR S&P 500 ETF, SPY; and equity markets outside of the US gained even more, 27.8%, as measured by the iShares MSCI ACWI ex US ETF, ACWX. A correction was long overdue.

Eurozone equities peaked on January 26th in sync with the U.S. and other major markets. In most cases, however, the subsequent declines in the Eurozone were more moderate. While SPY was down 2.02% year-to-date at the end of last week, the iShares MSCI Eurozone ETF, EZU, lost 1.24%. Several Eurozone markets performed considerably better. The iShares MSCI Spain Capped ETF, EWP, declined only 0.31%; the iShares MSCI Belgium Capped ETF, EWK, still had a positive year-to-date return of 1.90%; and the iShares MSCI Italy Capped ETF, EWI, registered a 4.14% year-to-date gain. German equities, in contrast, underperformed. The iShares MSCI Germany ETF, EWG, was down 2.85%. Monday Eurozone equities followed the recovery in the US and Asia, but then fell back a bit on Tuesday. Market volatility remains high.

Fundamental factors suggest the lengthy bull market in Eurozone equities still has legs. The future prospect of higher interest rates represents the greatest risk to this outlook. The European Union has raised its growth forecast for the Eurozone economy in 2018 to 2.3%. Recent strong data for both industrial production and retail sales support this forecast. One of the best leading indicators, the HIS Markit Eurozone Composite Purchasing Managers' Index (PMI), stood at 58.8 for January, the highest reading for this indicator since June 2006. Economic output growth was strong in all the major Eurozone economies, with France registering the strongest growth and Germany, Italy, and Ireland close behind. Business confidence is reported at an 11-month high.

The strong growth is beginning to put some pressure on prices. Input and output costs are both rising. The strong euro is likely to have a moderating effect on import prices.

Nevertheless, if inflation does gather pace significantly, particularly in the second half of the year, monetary policy would then very likely become more hawkish, with the European Central Bank advancing its schedule for reducing its bond purchases and eventually raising policy interest rates. This would follow the tightening of monetary policy already well underway in the US and recently threatened by the Bank of England. At present, however, the European Central Bank continues to signal that it will maintain substantial monetary ease in the coming months, which will be a positive for Eurozone equities as long as this policy stance is maintained. Other positives for Eurozone equities are the strong earnings momentum, easing fears of populism, and continued robust economic growth in the markets for the Eurozone’s exports.

We are maintaining our Eurozone positions in our International and Global Equity portfolios while closely monitoring inflation developments.

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Sources: Bloomberg, CNBC, Oxford Economics, Financial Times, HIS Markit, Goldman Sachs Economic Research

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