Running the US Bull Market Marathon

It's been called the "most hated bull market" of modern times. Bearish sentiment has accompanied its upward path through a sluggishly slow economic recovery. And yet, it's now the second longest, second strongest bull market in US equities history. Where do we go from here? For a rising dividends perspective and growth opportunities viewpoint, we welcome Donald Taylor and Grant Bowers to this RoundTable. Here's what they have to say about this seemingly tireless market.

Donald G.Taylor
CPA
Chief Investment Officer,
Portfolio Manager
Rising Dividends
Strategies
Franklin Equity Group
New York City,
New York, USA

Grant B. Bowers
Vice President,
Portfolio Manager
US Growth
Franklin Equity Group
San Mateo, California,
USA

"This very slow economic recovery has been a generally favourable environment for stocks…."

- Donald G. Taylor

Q: What kind of shape is this bull market currently in?

Donald Taylor: For the past several years, there's been a lot of talk about what might go wrong. While respecting bearish arguments, the fact is we've been experiencing a stable, although somewhat fragile, environment where the economy muddles along with gross domestic product (GDP) at about 2%. This very slow economic recovery has been a generally favourable environment for stocks, stretching out the market upturn. Right now, I don't see pieces in place for that dynamic to change much in the near to intermediate term.

Grant Bowers: Just because a bull market is old, doesn't mean it's losing strength. We expect the upward trend in US equities to continue, supported by stable economic growth, strong corporate earnings and benign inflation and interest rates. I think markets have behaved rationally thus far in 2017, responding to good news. Consider that this year, the S&P 500 Index has reported the first two consecutive periods of double-digit earnings growth since the latter half of 2011.

For the first time in a long time, we're also seeing positive global GDP growth. For instance, Euro area GDP outpaced the US economy over the last year and corporate profits in the region have been accelerating. We see that region as being in the middle stage of a multi-year growth cycle, which should have positive effects for the US economy and equity markets.

Q: With valuations at such heights, has the market become too expensive?

Donald Taylor: Given the current track of a stronger growth environment, better corporate earnings and low inflation, I think multiples could even expand further. The mathematically expensive market becomes relevant if there's a meaningful pickup in inflation or a clearly weaker economy. With neither of those on the immediate horizon, I don't see risks to the markets because stock prices are too high. In this muddling-along world, stocks with the largest multiples will attract investors. They'll be the companies with the stronger growth profiles.

Grant Bowers: Market valuations are no longer what we'd consider to be discounted; but as a short-term measure, they say little about the future direction of equities. I agree that US equities can continue to climb for a few reasons. Factors such as healthy consumer confidence and improving employment are being reflected in strong end-market demand for many industries. We see this backdrop as supportive of strong corporate earnings growth in the future. In our view, earnings are actually "growing up" to substantiate current valuations.

As bottom-up stock pickers, we distinguish between market valuations and valuations for current or prospective portfolio holdings. Though the broad market may have reached historical highs in terms of price/earnings multiples, we see pockets of opportunity in select stocks in specific sectors, especially Information Technology and Health Care.

Q: Can you elaborate?

Grant Bowers: Information Technology stocks, for instance, currently make up more than 40% of our growth-focused portfolio. A key theme underpinning this commitment is our belief that tech spending and investment by companies—once considered discretionary—is now more necessary to keep pace in the evolving global economy. For example, to remain relevant, consumer-oriented companies must continually invest in software to improve customer experience and grow performance. In our view, this changing reality has given tech companies their unexpected resiliency.

In this slower growth, post-Global Financial Crisis world, investors have placed a premium on resilient companies with the ability to grow revenues in a vacuum. Companies such as Amazon.com Inc., Apple Inc., Facebook Inc., Microsoft Corporation and Google Inc. are represented in the portfolio. While these companies are no longer undiscovered investments in the market, they remain innovators disrupting large global markets.

Financial services firms MasterCard Incorporated and Visa Inc. are also long-term holdings. They form a virtual duopoly in payment processing infrastructure. Both are investing in growth and improving operating efficiencies as the global movement from cash to electronic transactions gains ground.

Donald Taylor: To have confidence in a company's long-term dividend growth, you have to believe it has sustainable secular revenue and earnings growth. Today, the portfolio includes more companies with a technology focus. Analog Devices Inc. is a relatively recent addition to the portfolio. Microsoft Corporation and Texas Instruments Inc. are now prototypical rising dividends companies. Together, they reflect those parts of the technology sector that have migrated to our rising dividends world. It's a marked shift from the post-dotcom days when few such companies embraced dividends, never mind growing them consistently over the long term.

Firms such as Visa Inc. represent a similar evolution in progress. We also like the electronic payment theme and the company's fundamentals. It's starting to meet our screening criteria more consistently and we've a small position in the stock.

Q: What are your expectations for dividend increases?

Donald Taylor: Overall, with an estimated 8% to 9% increase year over year, the portfolio is outpacing its S&P benchmark. Within the portfolio, dividend increases vary with strong double-digit performers and some single-digit contributors. Looking at the firms with lower increases, we see sound business-building reasons for their having diverted cash away from dividends. In some instances, it's acquisition-focused; for others, it's splitting off parts of a company; for yet others, it's strong tailwinds warranting aggressive investment back into the business.

In this muddling-along economy, organic growth is hard to come by. So companies are manoeuvring, changing their business structure to generate growth—top or bottom line, or both. We expect that, for the affected firms, this period will pass and we'll be watching for strengthening dividend increases.

Q: What are your thoughts on market volatility for the closing months of 2017?

Grant Bowers: The Volatility or "VIX" Index has been hovering near all-time lows for some time now and that's a challenge for our strategy. For us, market sell-offs create opportunities to buy high-quality companies with strong competitive advantages and long-term growth trends. Such sell-offs have been few and far between.

Our outlook for US equity markets remains positive. However, if we see earnings disappointments, we'll likely see more market volatility. Investor sentiment could also dim appreciably if meaningful tax and regulatory reform does not materialize or due to ongoing geopolitical tensions, particularly in Asia. At the same time, we believe that as long as US and global economic growth remain reasonably solid, any market pullback would likely be temporary.

Donald Taylor: It's been a long time since we had a sharp drawdown. There could be one next week. But all things being equal, I think the kind of market we've been experiencing is the environment we'll experience for the foreseeable future—perhaps not producing the 12% to 13% annual return of the last five years, but respectable nonetheless.