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Equity Outlook: So far, so good

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Not to sound like a broken record, but the economy and the markets are playing out pretty much as we have been forecasting for the better part of a year. A traditional cyclical recovery has taken hold, putting equities on a plodding upward course, driven by rising corporate profits, strengthening economic fundamentals and attractive valuations relative to bonds. At 60% stocks, our benchmark moderate growth allocation model is at a healthy 8% equity overweight relative to bonds—80% of our maximum overweight—and we recently raised our 12-month price target on the S&P 500 to 1,350 from 1,300.

To be sure, the economy faces headwinds. Passage of the massive health reform bill will add significantly to spending commitments down the road at a time public debt already is at a record and worsening. We may have seen the impact of these mounting obligations in late March, when lukewarm government auctions sent Treasury prices plunging and yields to near cycle highs. State and local governments' fiscal conditions aren't any better, and battered household balance sheets will take years to repair. Finally, housing continues to troll along the bottom—the worst may be over but a sustained recovery there has yet to take hold.

These longer-term secular negatives are being swamped by nearer-term cyclical positives, brightening consumer psychology and the market's mood. The reaction to health-care's passage is a case in point. Casting aside concerns about potential long-term implications, equities rallied on at least improved clarity around what was going to be done in this sector of the economy, allowing investors to focus on improving fundamentals: an accommodative Federal Reserve; a labor market that's on the verge of adding jobs again; a consumer who is picking up the pace of discretionary spending; a cash-heavy corporate sector that's ramping up capital spending, M&A activity and dividend increases; and a manufacturing sector that's expanding.

Profit outlook keeps improving

All of this is helping to boost the outlook for corporate profits, which have surprised to the upside for three straight quarters. We'll get a clearer read on this year's 1st quarter in the next few weeks when the numbers start to roll in, but it's worth noting that there's been a relative dearth of negative guidance. Thomson Reuters projects 1st quarter S&P 500 earnings to run 37% above a year ago, roughly five times the historical average, and forecasts revenue to rise a second consecutive quarter. We believe this story will continue the rest of the year and into 2011, abetted by a recovery that is likely to be "Stronger for longer" (see our March 9, 2010 piece). All told, we see earnings this year beating the consensus by as much as $10 on the S&P 500 (to $90), with further strength into 2011. This makes for a very positive environment for equities.

Growth vs. value

We slightly favor value over growth in our benchmark stock-bond model but are significantly overweight in both categories and are nearing the point where our bias may begin to shift to growth. During a recovery's early stages, beaten-down value stocks tend to rise faster than growth stocks as the worst-case scenario passes. But as economic growth settles onto a higher and more consistent plane—as we believe is the case now—conditions tend to favor growth stocks as earnings momentum builds.

Large vs. small

We are overweight in both large-cap and small-cap domestic stocks, though on a relative basis, small-caps are slightly favored. As with value stocks, small caps tend to do better than large caps earlier in a recovery because they are more sensitive to incremental changes in the economy. But as is also the case with growth vs. value, we are nearing a point in the recovery where our bias may start to shift to large-cap stocks.

Domestic vs. international

We are a substantial 8% overweight in domestic equities for reasons outlined above, but we also have a large overweight on emerging-market stocks, a reflection of the robust growth and low-debt positions of Latin America and Asian countries relative to the fiscal mess that is much of Europe. We are underweight large-cap develope international.

Commodities

We have a modest overweight in commodities—our revamped stock-bond model allows for new target allocations to nontraditional stock-bond asset classes, such as real estate, cash and commodities—because emerging-market countries have the highest growth rates and are disproportionate consumers of commodities. Also, we believe some of the massive liquidity injected in to the marketplace at the height of the global financial crisis will end up feeding commodity price inflation.

Views are as of April 1, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Asset allocation and diversification do not assure a profit or protect against a loss.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

International investing involves special risks including currency risk, increased volatility of foreign securities, political risks, and differences in auditing and other financial standards. In addition, prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Small company stocks may be less liquid and subject to greater price volatility than large capitalization stocks.

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