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August 2018

Quality stocks take a bite out of momentum

"Shark Week" may be a late summer television staple, but stock investors have seen plenty of FAANGs throughout this entire year. The tech and internet heavyweights—Facebook, Amazon, Apple, Netflix and Google—swim at the top of the stock market food chain, but recent earnings stumbles have raised doubts about their future dominance.

As the economic cycle evolves, momentum may begin to fade while fundamentals rise to the surface. That makes stock selection more crucial for returns as, historically, quality companies are positioned to potentially outperform in more difficult market conditions.

Market leadership appears to be shifting from momentum to quality stocks.

Earnings growth is coming from a diverse range of sources.

Quality growth stocks tend to perform well at this point of the economic cycle.

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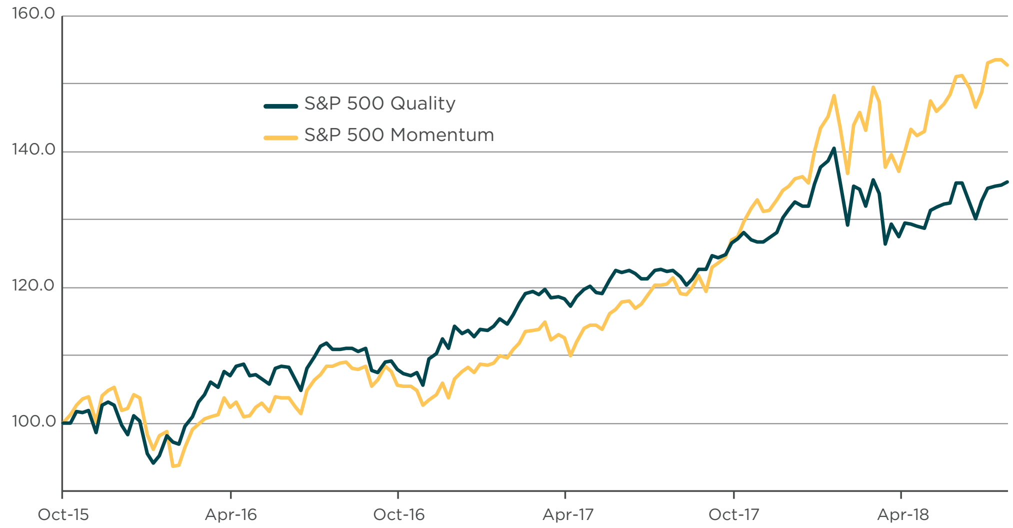
- Year-to-date stock market gains have been driven almost exclusively by a handful of fast growing and well-known technology firms.
  - The combined total return of the FAANG stocks outperformed the S&P 500 Index ("S&P 500") as a whole in the first half of 2018, 3.38% vs. 2.65%, respectively.
  - If you take out the six-month return contribution of these five stocks from the S&P 500, the rest of the index would be in negative territory for the first half of the year.
- Recent stumbles from these market leaders show that momentum may be losing steam and stocks appear to be trading more on fundamental factors.
  - While the narrow band of market leading stocks may be testing the limits of their growth potential, stocks of companies with stable earnings and strong balance sheets are poised to likely contribute more to future stock market growth.

Chart 1: S&P 500 Index quality stocks vs. momentum stocks

October 2015 to July 2018



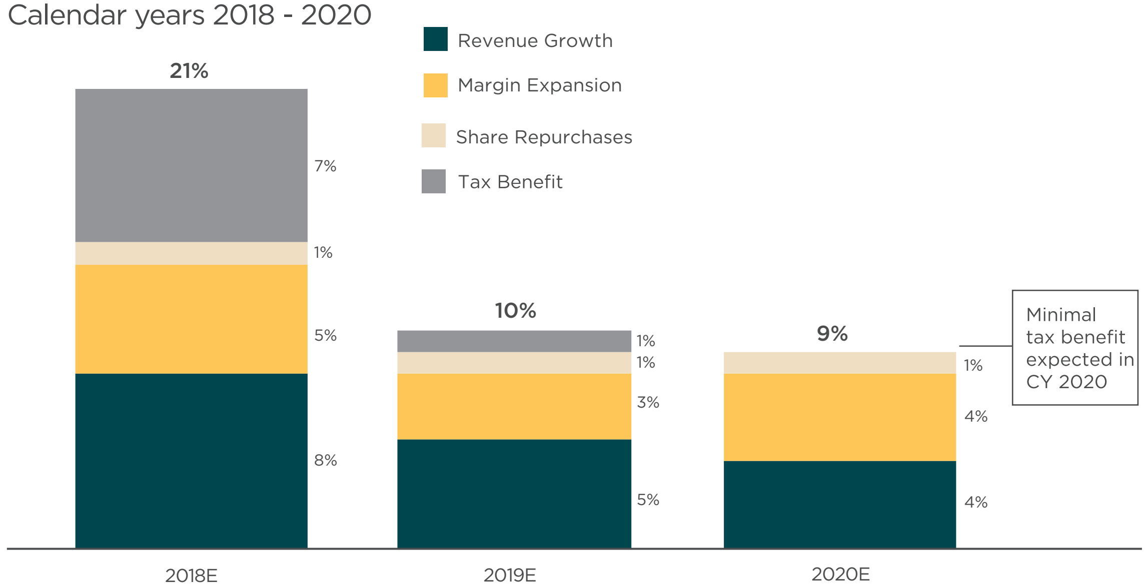
Source for chart data: FactSet. Past performance does not guarantee future results.

Earnings growth is coming from a diverse range of sources.

- FactSet estimates Q2 earnings growth from S&P 500 companies will continue to rise at a year-over-year rate of 21.3%; and if so, marking the second quarter in a row when earnings growth comes in at an annualized rate of more than 20%.
  - The tandem rise in earnings growth and the stock market serves as a good reminder that corporate earnings are the primary driver of stock market performance, not simply momentum.
- It's not all about tax reform—recent strength in earnings growth has more to do with fundamentals than tax reform.
  - Of the 21% earnings growth rate expected for Q2, the majority (17%) is coming from fundamental sources such as revenue growth and margin expansion.
  - Even factoring out the contributions from lower corporate taxes and share buybacks, earnings growth would still be at a healthy rate in the mid-teens—indicating that most earnings strength is not coming from the "sugar rush" of tax reform.
  - Projections of future earnings growth for the next two years also indicate a continuation of ongoing strength in the fundamental drivers of earnings and a waning influence from tax reform.

Chart 2: Contributions to earnings growth, estimated

Calendar years 2018 - 2020



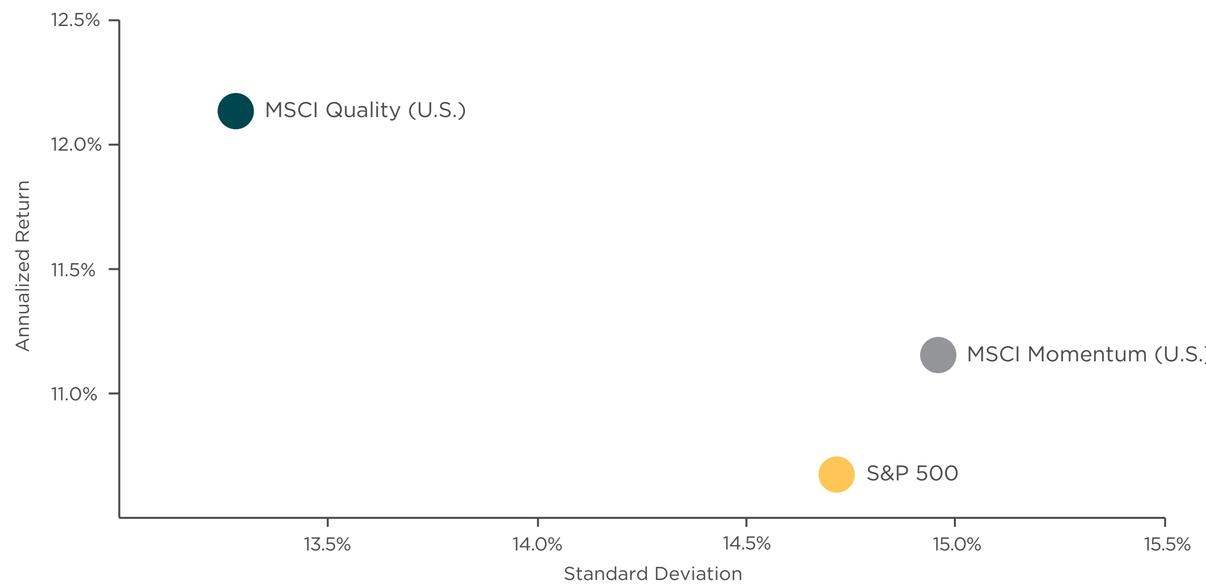
Source for data: FactSet, Nationwide estimates (August 2018)

Quality growth stocks tend to perform well at this point of the economic cycle.

- Quality growth can be defined as companies that historically exhibit stable earnings, good cash flow, a strong balance sheet and a defensible competitive position in the marketplace.
- Perhaps more crucial, quality growth companies are those that have multiple levers they can pull to sustain performance and profitability as the economic cycle evolves and business conditions change.
- Earnings growth may become more difficult for companies to achieve in the later stages of the expansion cycle—that's why quality companies that have strong fundamentals and greater flexibility appear better poised to outperform momentum stocks.
  - As fundamentals move to the forefront, stock selection and active portfolio management become more important to achieving consistent returns.

Chart 3: 10-year risk/return comparison

July 2008-July 2018



Source for chart data: Morningstar. Past performance does not guarantee future results.

Key takeaways

Stock investors have been smitten with the FAANG stocks this year, but their recent stumbles may be a sign of a market in transition. Earnings growth may become more difficult for companies to achieve in the later stages of the expansion cycle—that's why quality companies that have strong fundamentals and greater flexibility appear better poised to outperform momentum stocks.

- Look for market leadership to shift as the economic cycle continues to evolve.
- Earnings may continue to be strong and drive stock returns, especially as momentum factors fade and higher quality companies become more meaningful later in the economic cycle.
- Include exposure to quality companies in your equity allocation to position your portfolio for the rising importance of fundamentals.

For more help or information, contact your financial advisor.

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S&P 500 Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

MSCI US Index: A free float-adjusted market capitalization weighted index that is comprised of equity Real Estate Investment Trusts (REITs). The index is based on the MSCI USA Investable Market Index (IMI), its parent index, which captures the large, mid and small cap segments of the USA market.

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