EQUITY

A Few Words on Equity-Market Volatility

October 26, 2018

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October has lived up to its reputation as a volatile month as concerns about rising US interest rates, slowing growth in China and upcoming US midterm elections have spooked many investors. Franklin Equity Group offers a few words on the recent turmoil, why volatility can unlock compelling opportunities and why the investment team still sees a compelling case for technology companies.

By Franklin Equity Group

Uncertainty related to trade tensions, concerns about global growth (as China's recent gross domestic product report disappointed market participants), and the pace and magnitude of future interest rate increases have contributed to market volatility over the past few weeks.

In addition, upcoming US midterm elections and geopolitical news events may be influencing investor behavior.

We continue to believe that the global economy provides a supportive environment for corporate fundamentals, as evidenced by revenue, earnings and cash flow growth across myriad industries.

Across our US investment strategies, we seek to invest in companies we believe have strong platforms, are competitively well-positioned, and have long-term growth prospects that are underappreciated or not recognized by the market. In doing so, we attempt to look through short-term market volatility to opportunistically take advantage of market weakness within our portfolios.

We consistently revisit our positions to ensure our investment theses remain intact and determine whether adding to or reducing our holdings is warranted.

October's market selloff in the United States has been broad-based, with returns of -8% or below across all sectors with the exception of traditionally defensive Utilities and Consumer Staples, both of which posted positive low-single digit returns month-to-date through October 24, 2018.[1]

Cyclically-oriented Materials (-13.0%), Energy (-12.5%), Consumer Discretionary (-12.2%), and Industrials (-11.6%) sectors have underperformed the broader US market (S&P 500 Index: -8.76%) month-to-date.[2]

We've received a number of inquiries about the information technology sector in particular, which is well-represented within several of our strategies. The S&P 500 Information Technology sector was up 20.62% year-to-date through September 30, 2018; the sector was down 10.76% month-to-date through October 24, 2018.[3]

Our view on the long-term fundamentals supporting this sector has not changed. We are seeing a continued "digital transformation" theme, where technology companies are increasingly impacting traditionally non-technology markets, along with lower taxes and the need for greater productivity in a tightening labor market as key drivers for the sector going forward. Rationale for our view includes:

- A key leading indicator for enterprise technology investment is incremental change in corporate profitability. As a result of the reduction in the US corporate tax rate, US corporations broadly are expected to post higher profitability metrics in 2018. While this increased profitability is reportedly appearing in increased capital returns and even employee bonuses, we are also starting to hear companies outside of the tech sector saying they will be investing more in technology because of the tax cuts.
- In addition to lower tax rates, the tax bill which went into effect in the United States resulted in foreign-domiciled earnings returning to the country, and we expect improved capital returns in the form of increased share repurchase activity and dividend increases.
- Technology investment is often about productivity. With a tightening labor market, we believe companies will be compelled to lean more heavily on technology to drive greater output.

Should these themes fail to materialize in the coming months, it could result in further volatility in the technology sector as investors reevaluate the long-term impacts of tax reform and technology investment.

There are many technology companies that we feel are well positioned for growth regardless of what happens with broader economic conditions. Consistent with our investment philosophy and process, we believe volatility often presents compelling investment opportunities in strong companies that are being mispriced by the market over the short term for investors with a disciplined, long-term outlook.

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What are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors or general market conditions. The technology industry can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants as well as general economic conditions.

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1. Source: Morningstar Direct, month-to-date through October 24, 2018. Based on S&P 500 Index sector classifications. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.

2. Ibid.

3. Ibid.