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Julian Cook
U.S. Equities Portfolio Specialist

U.S. Equities

U.S. GROWTH STRATEGIES HAVE RUN A GOOD RACE—BUT IT MAY NOT BE OVER

KEY POINTS

- U.S. growth strategies have generally rewarded investors handsomely in recent times. That said, we are clearly in the late stages of the market cycle, and U.S. stock valuations are towards the top end of their historical range.
- However, the current environment of synchronized global growth and low inflation remains supportive of these valuation levels, in our view.
- U.S. corporate earnings continue to come through strongly, boosted by recent U.S. tax reforms. However, even excluding the contribution from these tax cuts, on a fundamental basis, we are still seeing improving topline earnings growth from U.S. companies.
- One of the key risks to the U.S. market outlook is that of a sharp acceleration in inflation. However, the influence of secular factors—for example, the cost reductions derived from new technologies—are, in part at least, having an offsetting impact on inflation.

Where next for the U.S. equity market? That is the question that more and more of our clients have been asking us recently. Certainly, we are in the late stages of the market cycle, and U.S. stock valuations are towards the top end of their historical range. However, the current environment of synchronized global growth and very low inflation is supportive of these valuation levels, in our view.

CORPORATE EARNINGS SHOW NO SIGN OF WEAKENING

U.S. corporate earnings continue to come through strongly, boosted by the recent U.S. tax reforms. However, even excluding the contribution from recent tax cuts, on a fundamental basis, we are still seeing improving topline growth, with the tech sector being a standout example. The fourth-quarter 2017 earnings season was very positive, with around 80% of U.S. companies either meeting or beating expectations.[1] And, so far in 2018, the positive trend has continued. Of the 103 S&P 500 companies to issue earnings guidance so far in the first quarter (to March 16, 2018), 52 have done so positively, one of the highest quarterly rates ever recorded[2] helped in no small part by recent U.S. tax reforms.

TAX REFORM IS SIGNIFICANT AND FAR REACHING

As mentioned, recent U.S. tax reform measures are also significant. The windfall has benefited U.S. companies on an immediate basis, particularly more domestically focused businesses. Crucially, however, it is important to understand which companies are actually likely to keep hold of that tax benefit. For example,

[1]FactSet, "Earnings Insight," as of December 31, 2017.
[2]FactSet, "Earnings Insight," as of March 16, 2018.

a company in the highly competitive retail industry might be tempted to utilize this windfall by offering price concessions to customers to try and win market share—thus giving much of the benefit away. Contrast this with the example of a company like Boeing, the leading player (in revenue terms), in what is effectively a global aerospace duopoly. The company has a six- or seven-year backlog of aircraft already sold to customers at agreed prices. It doesn't need to entice customers or build its profile, so it can keep the whole, roughly 15%, tax saving. These are two stark examples of how the same tax benefit can mean very different things to different companies.

Meanwhile, the tax reforms also bring the U.S. more in line with the tax regimes of many other countries. This is significant as it means that many U.S. companies will no longer need to go offshore in search of more favorable tax treatment. This is particularly supportive of the U.S. domestic environment as companies invest back into the U.S. and in U.S. jobs. Indeed, in those instances where economies have undergone major tax reform overhauls like this one, we have generally seen higher levels of growth generated, as the investment is refocused domestically.

INFLATIONARY PRESSURE REMAINS A KEY RISK

Of course, this can be a curse as well as a blessing. Given we are in a late-cycle economy, encouraging substantial investment in the domestic economy in this way, when it is already running close to full capacity, could have significant inflationary implications. Certainly, one of the key risks to the U.S. market outlook is that of a sharp acceleration in inflation. So far, we have seen a rise in inflation expectations, but not in actual inflation.

The possibility of a trade war developing between the U.S. and China is another key risk to the U.S. market outlook, and developments here will need to be monitored carefully. More generally, the prospect of a general growth slowdown in China is another real risk to the U.S. outlook, in our view. In January 2018, we met with 38 industrial companies in China, and 32 of these indicated that they expected a slowdown in their business in 2018 compared with 2017.

LEAD INDICATOR OF RECESSION?

From a U.S. growth perspective, one of the things that we misjudged in 2017, given where we thought growth and inflation were headed, was our expectation of a steeper U.S. yield curve. What we actually saw instead was a flattening of the curve. Previously when we have seen this kind of yield compression, it has usually been a lead indicator of recession. However, again, given the environment of global synchronized growth, positive global purchasing managers' indexes, tax cuts leading to greater capex, and robust earnings growth, we are reluctant to believe that a flatter yield curve this time around suggests impending recession. Today's post-financial crisis bond market is also very different from the past, and so this is potentially not as reliable an indicator as it has been in past cycles.

ARE TECH STOCKS OVERPRICED?

Following a U.S. growth strategy has been very successful recently, with U.S. large-cap growth up 30.2% over the 12 months ending 2017. Meanwhile, U.S. large-cap value was up 13.7% over the same 12-month period.[3] This is a significant variation within the same market and, while certain value-oriented sectors clearly underperformed in 2017, is largely attributable to the performance of the tech sector, which was up by 38.8% for the year.[4] Another question we are continually asked by clients is: Are tech stocks overpriced? In fact, when we look at the relative valuation of U.S. sectors, versus their 20-year history, only three currently stand out as being clearly valued below their 20-year average, namely technology (IT), health care, and telecoms. So yes, tech stocks might not exactly appear cheap currently, but neither are they particularly stretched, compared with history. As such, we think it is still a little too early to suggest that the tech sector has run its race.

In summary, we are clearly in the late stages of the cycle, and while stock valuations are looking relatively full, they appear adequately supported at such levels by solid growth and a very low inflation rate. Corporate earnings expectations have increased noticeably in 2018, boosted by U.S. tax reforms, but even excluding this contribution, on a fundamental basis we are still seeing improving topline growth, the tech sector being a standout example. Strong employment data obviously give rise to concerns that this will feed through to wage inflation. However, this overlooks the influence of various secular factors—for example, the cost reductions coming from new technologies and from lower drug/health care prices—which are, at least in part, having an offsetting impact.

[3]Russell 1000 Growth index versus Russell 1000 Value index. Russell Investment Group is the source and owner of the trademarks, service marks, and copyrights related to the Russell indexes. Russell® is a trademark of Russell Investment Group.

[4]MSCI USA Information Technology Index, as of 31 Dec 2017. Source for MSCI data: MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

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