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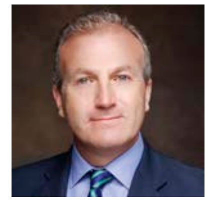
The State of US Equities: GROWTH STRATEGIES HAVE RUN A GOOD RACE—BUT IT'S NOT OVER



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Where next for the U.S. equity market? That is the question more and more of our clients are now asking. Certainly we are in the late stages of the cycle and U.S. stock valuations are clearly at the top end of their historical range. However, we believe synchronised global growth and very low inflation supports these valuation levels.

CORPORATE EARNINGS SHOW NO SIGNS OF WEAKENING

U.S. corporate earnings continue to prosper, boosted by the recent U.S. tax reforms. Even without the contribution from the tax cuts, we are still seeing improving top-line growth, the tech sector being a standout example. The Q4 2017 earnings season was very positive, with more than 80% of U.S. companies either meeting or beating expectations.[1] So far in 2018, the positive trend has continued; we're seeing record levels of positive earnings guidance, helped in no small part by the recent tax reforms.

In similar instances of major tax overhauls, we have generally seen higher levels of growth as investment is refocused domestically.

THE TAX BENEFIT IS SIGNIFICANT – BUT WHICH COMPANIES WILL KEEP IT?

The windfall from recent tax reforms is benefiting U.S. companies on an immediate basis, particularly more domestically-focused businesses. But it is important to understand which companies can keep hold of that benefit. For example, a company in the highly-competitive retail industry might be tempted to exploit this windfall by offering price concessions to customers to try and win market share– thus giving much of the benefit away.

Contrast this with a company like Boeing, the leading player 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. They don't need to entice customers or build their profile, so they can keep the whole tax saving (roughly 15%). 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 into 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 favourable tax treatment. This is particularly supportive of the U.S. domestic economy as companies invest back into the U.S. and in U.S. jobs. In similar instances of major tax overhauls, we have generally seen higher levels of growth as investment is refocused domestically.

1 Source: Factset "Earnings Insight", as of 16 March 2018.

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INFLATION REMAINS A KEY RISK

Of course, this can be a curse as well as a blessing. Encouraging substantial investment in a late-cycle economy that is already running close to full capacity could have significant inflationary implications. One of the key risks to the U.S. market outlook is the prospect 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 between the U.S. and China is another key risk to the U.S. market outlook. Investors should be wary of its impact, both economically and on the markets.

SIGNS OF RECESSION?

From a U.S. growth perspective, one of the things that we misjudged in 2017 was our expectation of a steeper U.S. yield curve (based on where we thought growth and inflation were headed). What we saw instead was a flattening of the curve. When we have seen this kind of yield compression in the past it has usually been a lead indicator of recession. However, amid global synchronised growth, positive global PMIs, 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 to the past; this too is potentially not as reliable an indicator as it has been in past cycles.

ARE TECH STOCKS OVERPRICED?

Following a growth strategy in the U.S. has been very successful recently, with large-cap growth stocks up 30.2% in 2017 versus +13.7% for U.S. large cap value.[2] This is a significant variation within one country. While certain value-oriented sectors clearly underperformed in 2017, the gap is largely attributable to the performance of the tech sector, which was up by 38.8% for the year.

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, and one them is technology! (The other two are healthcare and telecoms). If tech stocks don't appear cheap right now, neither are they particularly stretched. We think it is still 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 by solid growth and low inflation. Meanwhile, corporate earnings show no signs of weakening, given an extra boost by US tax reforms.

Strong employment data obviously gives rise to concerns that this will feed through to wage inflation. However, this is being partly offset by various secular factors including cost-reductions from new technologies and lower drug/healthcare prices.

Overall, we believe economic growth globally and earnings growth in the U.S. make U.S. equities a solid stayer in investors' portfolios.

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