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THE U.S. EXPANSIONARY PHASE STILL HAS SOME PETROL LEFT IN THE TANK

We are at an interesting point is the U.S. market cycle. With the current expansionary phase now in its ninth year in the U.S., many are suggesting that stock valuations are cause for concern. However, while we are clearly in the later stages of the cycle, the macroeconomic environment continues to be supportive in our view, underpinned by synchronised global growth and low inflation.

Capex is returning across the corporate spectrum

Within the U.S. itself, domestic economic growth is still solid. Significantly, we are seeing a return of investment into capital projects across the small, medium and large corporate spectrum. This is something that has so far been missing during this expansionary phase. This may be a direct consequence of the recent tax reforms pushed through by President Trump. Whatever the root cause, company management teams in the U.S. are beginning to reinvest in their domestic businesses, looking to grow local manufacturing and industrial production, rather than investing offshore in tax-advantageous places like Luxenberg or Dublin.

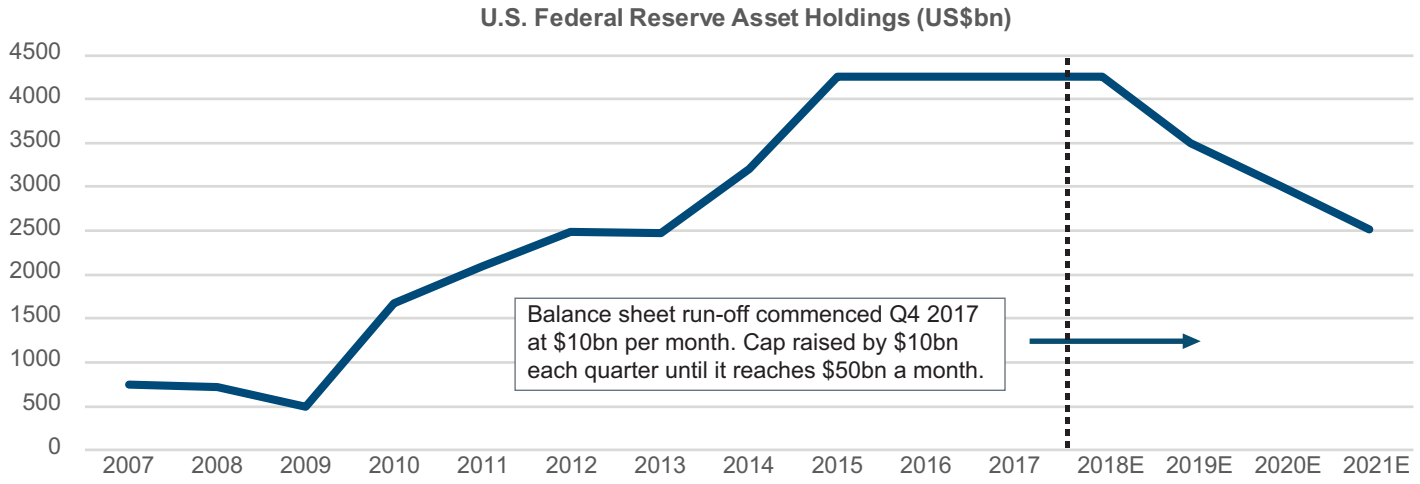
Inflation problem or inflation perception problem?

That said, in those instances where economies have undergone major tax reform overhauls like the U.S., we have generally seen higher levels of growth generated, as the investment is refocused domestically. This can, however, be a curse as well as a blessing. Given we are late into the U.S. economic cycle, 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 a sharper-than-expected acceleration in inflation. The Federal Reserve has, at the margin, become a little more hawkish at their most recent meeting so even though we have not seen a rise in inflation, just the fear of higher inflation could be enough to change investors' perception of equity market valuations.

A European stumble could prove calamitous

Another key risk revolves around the removal of quantitative easing. This is not so much a U.S. problem as it is a European one, but with potentially major ramifications for global markets. If we use the analogy of a sick patient, the U.S. is already off the operating table and well on the way to recovery. Quantitative tightening at the U.S. Federal Reserve started in October 2017 (Figure 1) and

FIGURE 1: U.S. balance sheet debt is declining



Source: Federal Reserve, Thomson Reuters, Capital Economics, as of Dec 2017

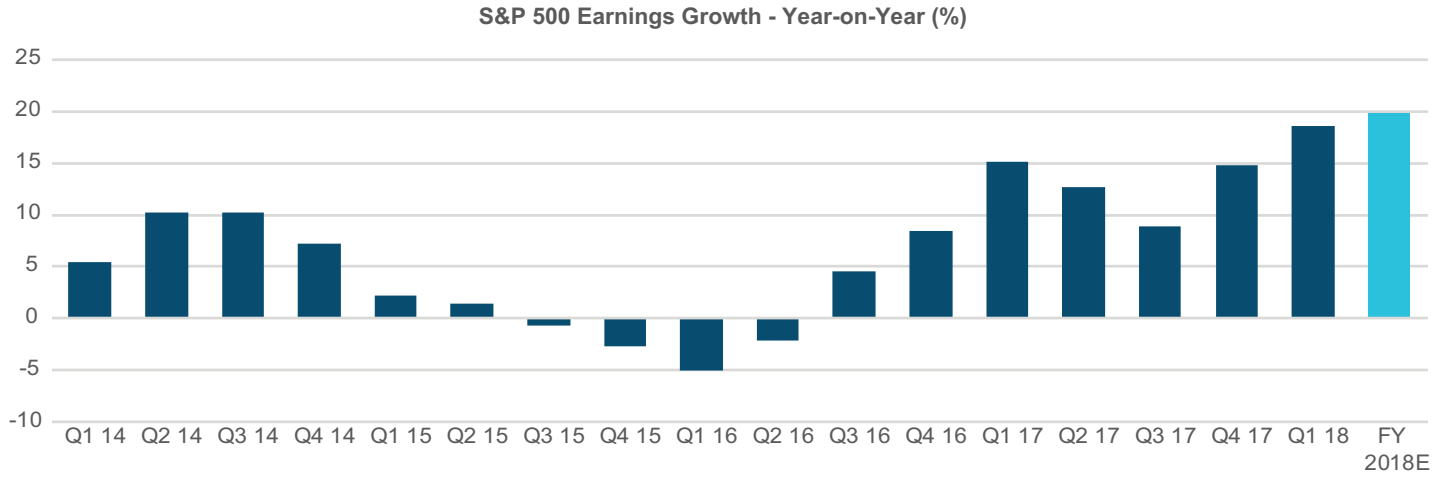
interest rates are beginning to rise and possibly normalise. And while we don't know the ultimate end destination of interest rates, we can at least take some comfort in knowing the direction of travel. Compare this with Europe, where the European Central Bank balance sheet is still expanding real clarity around policy, policy direction is unclear and so the patient effectively remains bedridden on life support. What we simply don't know is, once all the stimulus is removed, what state of health the patient is likely to be in.

The fact is that relationships have been artificially forged between certain assets over the past decade and we don't know how these assets, and economies, will perform once the support of quantitative easing is removed and interest rates start to rise. Therefore, if Europe's progress to recovery was to stutter, this would potentially be a risk to equity markets globally as equity risk premiums would likely rise almost irrespective of the healthy state of the U.S. economy.

Unconventional cycle argues for an extended run

More positively, from a corporate earnings perspective, U.S. companies continue to do well and we are still seeing revenue growth, which is a little odd given we are in the later stages of the market cycle. During a conventional market cycle, you normally see revenue growth pick up in the early stages, then margins improve, until margins eventually peak and you get the tail end of the cycle. What we have seen in this cycle is revenues improving during the early post-recession period, then an improvement in margins before flattening out, but now we are seeing revenues increase again towards the end of the cycle. This is a strange development as far as companies are concerned but one that argues for an extended market cycle in the U.S. (Figure 2). Certainly, President Trump seems intent on keeping as many balls

FIGURE 2: Corporate earnings remain strong



Source: Thomson Reuters, as of 1 April 2018

rolling as possible to try and extend the cycle. The recently passed tax reform bill is a major step in this direction.

Of course, geopolitical tensions are an ongoing risk, but who would have thought that negotiations between the U.S. and North Korea would have been possible as little as six months ago? This is indeed a positive for the global macroeconomic outlook. Having said this, should things turn sour at any stage, the risk of escalation is certainly a significant one. And the market tends to factor in the potential downside risk to a greater degree than it does factoring in the upside of the current improving relations.

An escalating trade war is a key risk

Similarly, with the recent announcement that U.S. tariffs on an initial round of Chinese products are moving ahead, U.S.-China trade tensions have the potential to escalate. The immediate economic impact of the recent announcement is expected to be minimal, however the risk is that the U.S. and China become locked in an escalating retaliation cycle with neither side willing to back down. For now, it looks as though the main U.S. interest is still in a negotiated deal, and that this latest move is an attempt to bring China to the table rather than seeking a full-blown trade war.

> "We may be some nine years into this expansionary phase, but we still think there is some petrol left in the tank."

We are clearly in the later stages of the U.S. market cycle but that is not to say that the end is near. Equity valuations appear adequately supported at current levels, given the ongoing global growth and low level of inflation. U.S. corporate earnings show little sign of weakening, particularly given the boost from U.S. tax reforms. However, even excluding this contribution, on a fundamental basis we are still seeing improving top-line growth. Of course, there are risks to the outlook, including a sharper-than-expected rise in inflation and the possibility of an escalating trade war with China. Similarly, the risk of destabilization in Europe, once support measures start to be withdrawn, is also a concern, not only for the U.S., but globally. However, these risks aside, we remain broadly upbeat about the U.S. macro environment and the outlook for U.S. equities. We may be some nine years into this expansionary phase, but we still think there is some petrol left in the tank.

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