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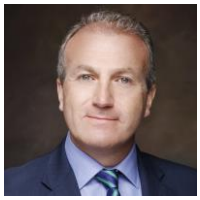
U.S. EQUITIES: HOW LONG CAN THE GOOD TIMES ROLL?



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How long can the good times roll? This is a question that an increasing number of U.S. investors are asking in the wake of a turbulent summer on equity markets. While much of the recent volatility can be attributed to the escalating U.S.-China trade tensions, there is little doubt that volatility has generally increased in 2018. At the same time, with U.S. market valuations running at above-average levels and interest rates starting to rise, there are some who believe that the U.S. "Goldilocks" period is nearing its end. While risks around trade and inflation have become more prominent, it is ultimately within the data, both macro and micro, that all tends to be revealed.

IS THE U.S. EXPANSION PHASE NEARING ITS END?

With the U.S. economic expansion now in its 10th year—the second-longest growth phase in U.S. history—investors are understandably concerned that the clock is counting down and that the next recession is potentially just around the corner. However, the robustness of U.S. data, both economic and corporate, suggests that we are still some way from the end of the cycle. This is usually associated with rising inflation, aggressive monetary policy, and deteriorating company profit margins. So far, we have seen limited signs of these things in the U.S., and while interest rates have started to rise, this is from a very low base, and the environment remains accommodative.

Interestingly, at a macro level, we have seen a shift in the pattern of global growth in 2018. Economic growth in the rest of the world appears to have peaked in early 2018 and has decelerated modestly since then. In contrast, the pace and strength of U.S. growth are conspicuous, with the economy expanding a further 2.8% (year over year) during the second quarter of 2018. Meanwhile, near-term data suggest that the growth momentum should continue into 2019. Consumer and business confidence remain upbeat, while the U.S. labor market is in excellent shape—the jobless rate is at multi-decade lows, and for the first time on record, there are more job openings than there are unemployed. Wages are improving, which should help to underpin robust consumer spending.

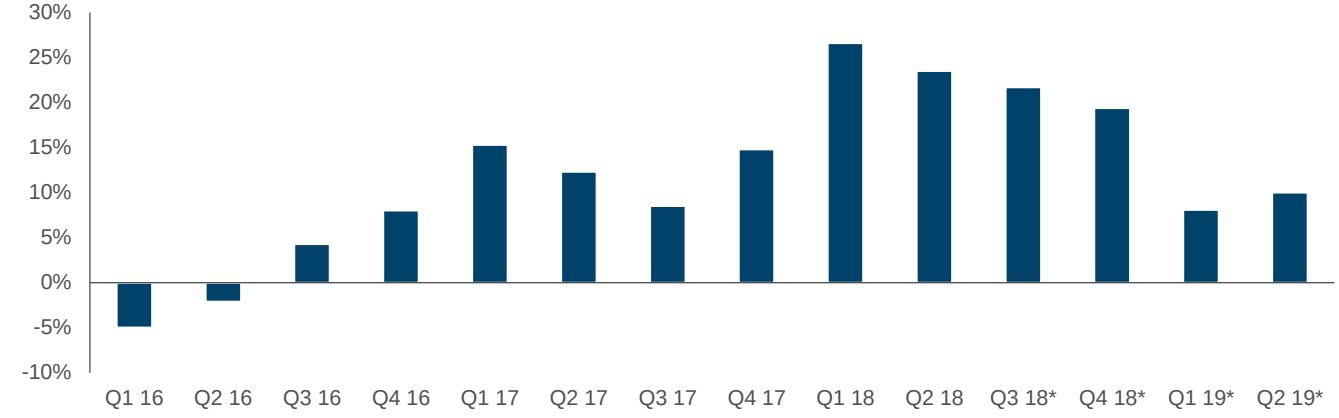
U.S. CORPORATE EARNINGS GROWTH HAS LIKELY PEAKED BUT IS FAR FROM OVER

At the corporate level, despite trade-related concerns, U.S. companies continue to deliver outstanding results, with a high proportion meeting or exceeding earnings expectations. While U.S. earnings growth probably peaked in the first half of 2018, coming in at a stellar 23%–24%, the current consensus for Q3 and Q4 of 2018 is for a further 22% and 19% growth, respectively. Looking ahead to 2019, consensus expectations are for a more moderate 10% earnings growth, which is still above the long-term average of 7% annual earnings growth (Figure 1).

From a valuation perspective, the U.S. equity market is currently trading at above-average levels. However, given the strong earnings results that we are seeing, the current price/earnings multiples do not look especially stretched in our view.

Figure 1: **S&P 500 Index Year-on-Year Corporate Earnings Growth**

As of July 31, 2018



*Denotes consensus estimated earnings.
Past performance is not a reliable indicator of future performance.
Source: Thomson Reuters I/B/E/S.

The second quarter earnings season was a strong one for a number of large, growth-oriented companies. In the information technology sector, for example, names like Microsoft and Alphabet even saw a slight reacceleration in revenues and profit performance, which was duly reflected in their respective share prices. A clear exception to this was Facebook, which fell some 20% after the company recently downgraded its revenue growth expectations. While the decline was dramatic and headline-grabbing, Facebook is still expected to show an earnings growth rate of more than 20%, which is remarkable for such a large company.

INFLATION RISK IS STILL LOW BUT RISING

Perhaps the main risk to our positive outlook for U.S. equities is higher-than-expected inflation and the subsequent policy response from the Federal Reserve. If the Fed were to hike interest rates too quickly, causing the yield curve to flatten, this could negatively affect equities as the monetary brakes may be too forcefully applied, potentially tipping the U.S. economy into recession. However, such an outcome seems unlikely in our view, as the Fed has been very measured in its approach to rates so far, and there seems to be little reason for it to change tack and adopt a more aggressive stance. Meanwhile, as long as earnings growth persists, we think equities will continue to do well.

Despite the turbulence that we have seen in 2018, the S&P 500 Index has continued to progress, up by around 6% year-to-date as new highs are tested. Clearly, sentiment has not been too badly affected by the recent uptick in volatility. While we can expect a higher level of volatility to be the norm going forward, with more potential pullbacks along the way, we remain confident that the U.S. market cycle has further to run. Economic growth is strong, corporate earnings continue to impress, and valuations, while above average, are not at extreme levels, either. On this basis, our view of the U.S. equity market, and the general direction it is headed, is little changed.

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