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PRICE POINT

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Timely intelligence and analysis for our clients.

U.S. Equities.
STICKING TO YOUR PRINCIPLES TO DEAL WITH VOLATILITY.



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EXECUTIVE SUMMARY

U.S. stock markets have performed well as signs of economic recovery and better corporate earnings have helped equity prices. However, at the same time, concerns over the global economic recovery and the potential path for interest rates have increased volatility.

In this Price Point, Larry Puglia, portfolio manager for T. Rowe Price's U.S. Large-Cap Core Growth Equity Strategy, shares his current market views, but he also explains why sticking to your investment principles is the best way to manage through volatility and different market cycles. He also explains why we are now entering a more complex and stock/industry-specific environment, one where proprietary research will be rewarded.

MACROECONOMIC ISSUES HAVE DOMINATED

U.S. equities have outpaced most global markets, as better economic news and stronger corporate earnings have been rewarded with higher share prices. However, concerns over the likelihood of a sustainable recovery has meant that even in times of optimism, equity markets have seemed to climb a wall of worry. This has resulted in sharply increased volatility within markets.

More recently, we have seen a recovery as worries about global growth have been assuaged somewhat by central banks signaling their willingness to take further policy action to support growth. At the same time, we have also seen some better-than-expected corporate results, while the continuing boom in large M&A deals has also helped market sentiment. Investors also increasingly appear more sanguine about the prospect of official borrowing costs rising by the end of the year, reasoning that it will remove uncertainty about the first such move in nearly a decade.

WHAT IS A FED TO DO?

We would concur with this view. Many investors have been overly focused on whether the U.S. Federal Reserve (Fed) would raise rates in 2015 or not. However, given the robustness in the U.S. economy, a normalization in monetary policy is likely overdue, and indeed the Fed has continually signaled that any rate rise would just be the first step in what would be a very shallow rate rise trajectory. In other words, a lower-for-longer scenario.

The Fed has indicated that a December rate hike is likely, but the expectation is that it will be a modest increase, and the pace of future rate hikes will be determined by the strength of the economic data.

It is important to remember, however, that when interest rates do eventually begin the normalization process, this will not necessarily be bad for stock prices. Higher rates often coincide with improved economic conditions, which, in turn, are supportive of corporate profit growth and, subsequently, equity prices. History also shows that market valuations can rise along with nominal interest rates.

FOCUS ON THE FUNDAMENTALS

As fundamental investors, it is important to assess the impact that the top-down macroeconomic environment can have on individual stock holdings while at the same time understanding the factors that determine a company's growth potential. For example, for some companies with large export-orientated businesses, the continued strength of the U.S. dollar, which has risen strongly on a trade-weighted basis for over two years now, is now beginning to have a negative impact on earnings. There are also companies that are suffering because of the continued slowdown in emerging markets. At the same time, lower commodity and energy prices are providing a tailwind for many domestic-orientated companies. This reflects some of the bifurcation within the market, and, therefore, brings us back to the need to do your research to help identify the companies that can deliver the best results.

WHERE ARE WE FINDING GROWTH?

Stock prices have generally performed well, supported by robust corporate fundamentals, despite the reality of an economy that is growing at a subdued pace, certainly compared with past economic recoveries. Housing has regained some ground, unemployment has declined, but capex spending has remained weak and the global economic environment is still challenging.

So where can growth investors find investment opportunities in this low-growth environment?

We utilize fundamental bottom-up research to identify companies operating in fertile growth fields that can best grow sales and earnings. Durable and sustainable earnings and free cash flow growth drive investment returns over time, and strong management teams who skillfully reinvest cash flow can significantly enhance company performance.

There are a number of structural themes that are driving significant change in today's corporate landscape, thereby creating attractive investment opportunities. We are focused on three main areas: health care, technology, and some areas of the consumer sector.

Longer term, we are optimistic about future innovation in health care. The sad reality is that there are many medical conditions for which there is no effective therapy today. The mapping of the human genome and other advances in medical research have enabled biotechnology and pharmaceutical companies to develop and bring to market more effective treatments. As the wave of innovation continues, there is great potential for significant breakthrough developments over the next decade. Whether it is in cancer treatments, gene replacement technology, drugs to help combat Alzheimer's, or in other disease states, there is real potential to make a meaningful improvement to patients' survival rates. We use in-depth research to identify those companies that are developing a broad pipeline of drugs, which have the potential to be commercially successful and where the valuations remain attractive.

At the same time, there are companies within the health care services area which help manage the costs of the health care system through the cost-effective distribution of products and services.

For us as growth investors, information technology has been an important area for many years. The pace of innovation has been very rapid, and it is important to be constantly looking out for disruptive technologies that will shape the landscape going forward. The ongoing convergence of communications and computing, leading to a ubiquitous and experience-rich Internet, continues to offer up interesting investment opportunities. We are building positions in companies that can benefit from the long-term shift to public cloud computing and those that can effectively benefit from the demand for social media. In an increasingly connected and mobile world, we are also looking for companies that can monetize opportunities, whether that is in Internet search and advertising companies, or those that stand to benefit from tailwinds in the global electronic payments space.

We also have to remember that the consumer makes up the largest part of the U.S. economy. Although the current recovery has been more subdued than in the past, we sense that the consumer is feeling more buoyant. Household balance sheets are healthier, while the improving economy and lower energy prices have generally bolstered confidence.

We do, however, remain selective in our investment approach, and rather than invest broadly in the consumer, we are focused on those companies that are set to benefit from underlying longer-term trends in changing spending and consumption patterns. For example, we are interested in companies benefiting from the shift to online retail, and from expansion in demand for travel and leisure.

FOLLOW YOUR INVESTMENT PRINCIPLES

It is important to remember that, within markets, there will also be winners and losers. Identifying a theme or a trend does not necessarily make a successful growth investment. Stock returns within the same sector or industry can exhibit notable dispersion. Therefore, it is important to dedicate a great deal of your research to figuring out who really is winning in these marketplaces. This will help to refine stock-picking ideas. It also highlights the importance of meeting companies face-to-face. It cannot be stressed strongly enough the value of meeting company management, visiting their stores, factories, etc., but also visiting their competitors at the same time. This is fundamental to properly evaluating companies, which brings us back to our belief that investors should not take a broad approach to buying stocks, but instead focus on buying individual stocks that can deliver in differing cycles.

WHAT HAPPENS NEXT?

The current environment is less supportive of broad corporate earnings growth given the uneven pace of economic growth. The U.S. economy continues to grow at a moderate pace, but slower growth in China and Europe, a stronger dollar, and the extreme stress in the commodity complex is resulting in a broad profit recession within industrials. Nevertheless, consumption—the largest part of the U.S. economy—appears to be performing well, and many companies exposed to those areas continue to deliver impressive earnings growth. Given these factors, we remain reasonably constructive but expect a more subdued earnings growth environment for the market overall.

Given that backdrop and the strong returns seen since the market bottomed in 2009, the overall market is likely trading at fair valuations. Therefore, it is vital to continue to focus on investing in “all season” growth companies—those with leading market positions and seasoned management teams that are well versed in allocating capital and managing expenses and whose growth is not heavily reliant on the overall direction of the economy.

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