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PRICE POINT

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U.S. equities.
STEADY AS SHE GOES!

EXECUTIVE SUMMARY

U.S. stock markets have continued to rise, with the S&P 500 and Dow Jones recently setting new all-time highs.

In this Price Point, Helen Ford, U.S. equities portfolio specialist, shares our current market views and explains why we believe conditions are supportive for further stock gains, albeit more modest ones than in previous years. At the same time, she also highlights why the environment remains complex with various headwinds and tailwinds to contend with.

U.S. equities have continued to climb higher, as an improved economic environment and robust corporate earnings, have been reflected in higher share prices. While the current bull market is entering its 7th year, the reality however is that the markets have been climbing a “wall of worry” while navigating various global macro and geopolitical events, which has muted investor confidence. We have continually witnessed bouts of risk aversion with investors’ seeking to hide out in bonds and high-yielding investments rather than equities.

STRONG COMPANY FUNDAMENTALS HAVE BEEN REWARDED

Much of the market move reflects the sharp recovery in corporate profits from the recessionary lows. Corporates have managed to squeeze business models to deliver record profitability, in spite of what has been somewhat of an anemic recovery in economic growth.

During the recession, U.S. companies aggressively cut costs and boosted productivity. Companies have also benefited from lower energy prices and subdued wage growth. The combination of these factors has all helped to push profit margins to historically high levels (Figure 1). As to whether this level of profitability is sustainable, there are various factors at play. Wage inflation has bottomed and the strong dollar will undoubtedly have an impact, but lower commodity costs will help to counteract those headwinds.

U.S. equities are not in extreme over-valuation territory, and continue to remain attractive compared to U.S. treasuries.

Company balance sheets have also generally remained strong with good levels of cash. Over the past couple of years, managements have focused on returning capital to shareholders through share buy-backs and increased dividends, as well as increasing capital expenditure. Interestingly, in 2014 there was a notable pick-up in M&A activity, reflecting increased management confidence as well as financial wherewithal (Figure 2). Only time will tell whether these deals create value for shareholders, but bid activity can provide support for the market in the meantime.

EQUITY VALUATIONS: CHEAP OR EXPENSIVE?

We believe valuations are best described as 'reasonable' for where we are in the economic cycle, although we would stress that this view is premised on the continued delivery of earnings growth. Figure 3 reflects valuations on a forward-looking P/E basis versus history. With U.S. equities trading around 17-times forward earnings, the days of extreme low valuations are firmly behind us. However, compared to an average of 16.2-times and highs of over 25-times, the market is not in extreme over-valuation territory. Equities also remain attractively valued when compared to U.S. treasuries. In addition, there have also been few signs of extreme capital flows that usually signify a bubble.

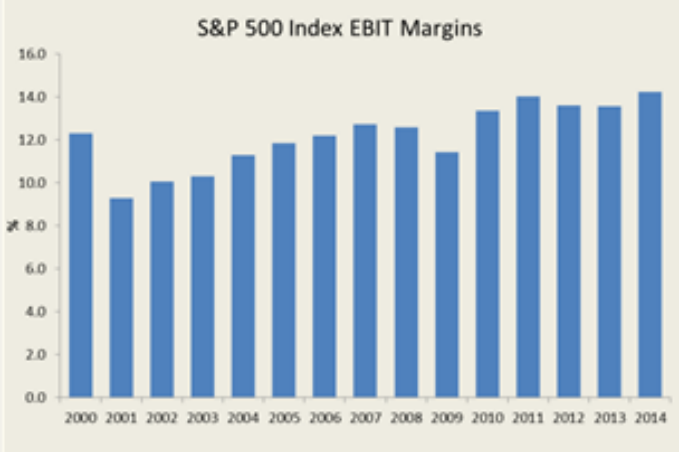
The risk of a crisis disrupting equity markets is ever present however, with Greece's unsustainable debt burden and Russia's economic and political stresses creating genuine causes for concern. These are risks, together with the evolution of corporate profits, which should be continued to be monitored closely.

U.S. ECONOMIC RECOVERY REMAINS ON TRACK

An important factor underlying our outlook is that the U.S. economy continues to improve. Average job growth in 2014 was the strongest since 1999, and this strong employment growth has led to the first signs of a pick-up in wage inflation. Meanwhile, lower consumer debt is supportive of higher consumption. Stronger growth has also been reflected in the improved budget deficit, and government spending is now increasing. This has deepened our conviction in the self-sustaining nature of the recovery. However, as capacity utilization and unemployment approach 2007 levels, the focus of the debate has now shifted to when we

FIGURE 1: Corporate Profit Margins Are Still At Near-term Peak Levels

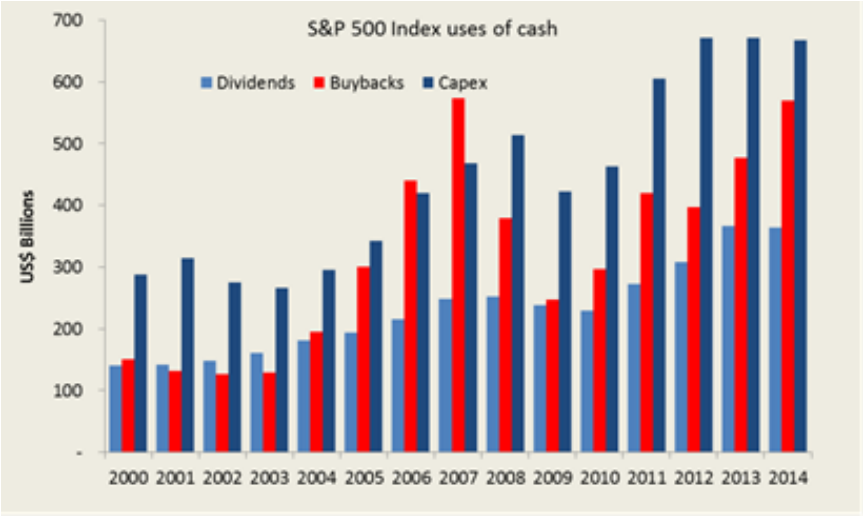
EBIT Margins = Earnings before Interest and Taxes. Where data is not yet reported, Institutional Brokers' Estimate System (IBES) estimates are used.





Sources: Factset, Standard & Poor's

FIGURE 2: Resurgence Of Deals Following Period Of Capital Return
As of December 2014



Sources: Citi Research, Factset, Deutsche Bank US Equity Strategy, ISI, Standard & Poor's

will see a hike in interest rates.

Historically, given the unemployment picture coupled with the bottoming of wage inflation, the U.S. Federal Reserve would have already started increasing interest rates. However, given the severity of the global financial crisis and concerns over the delicate nature of the economic recovery, it was necessary for policymakers to take a different approach. As the U.S. recovery continues, however, we are moving ever closer to the first rate hike. Minutes though from the recent Federal Reserve meeting reflect a division over exactly when to begin raising interest rates. Many officials have said they fear a “premature” rise in rates could dampen the apparently solid economic growth and labor market recovery. However, the trend of U.S. economic improvement should not be overlooked.

Either way, when the Federal Reserve does raise rates, it is most likely to be at a more measured pace in order to assess the potential reverberations through financial markets and impact on growth.

RISING RATE ENVIRONMENT GOOD FOR STOCKS

It is important to remember, however, that when interest rates do eventually normalize this will not necessarily be bad for stock prices. Higher rates often coincide with improved economic conditions, which typically bode well for equities. History shows that market valuations usually rise along with nominal interest rates. Over recent decades, 6% to 7% nominal 10-year Treasury yields have appeared to be the ceiling for P/E multiples, and while that ceiling may prove to be lower in the current environment, upside potential remains (Figure 4).

WHAT ABOUT THE STRENGTH OF THE GREENBACK?

The U.S. dollar has risen strongly on a trade-weighted basis for much of the last 18 months. Lower commodity prices, emerging market stress, and divergent monetary policies help to explain the dollar's ascent. What is important for us as equity investors is that dollar strength does have the potential to become problematic for

FIGURE 3: Equity Valuations: Cheap Or Expensive?



Sources: Factset, T. Rowe Price

some S&P 500 companies, where a large part of their profits are derived from overseas. The impact will likely be seen throughout the year, and may cause some volatility in the share prices of impacted companies.

IMPORTANT TO DO YOUR HOMEWORK IN THESE MARKETS

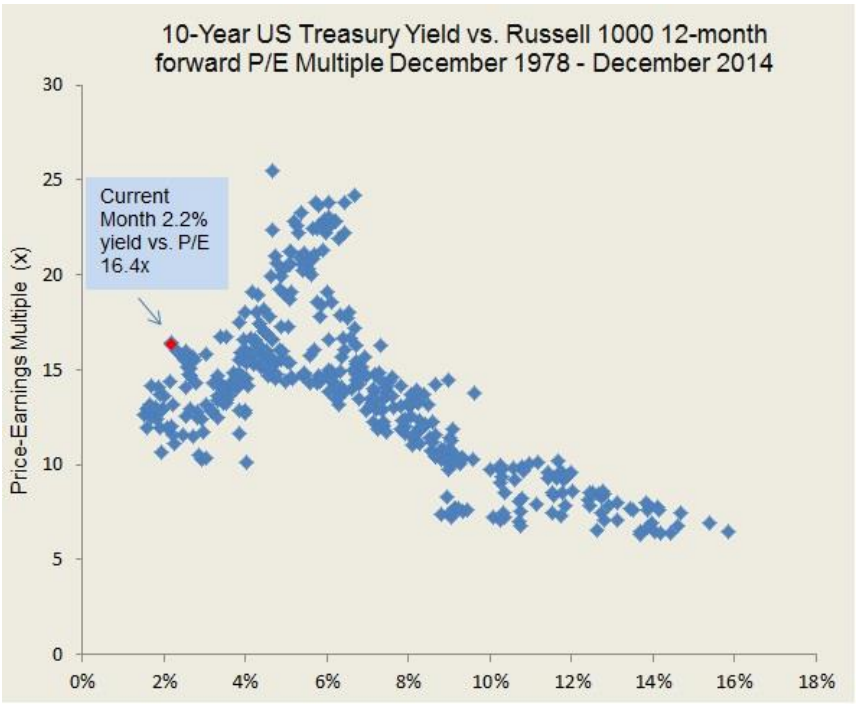
As we witnessed in 2014, sentiment is likely to ebb and flow over the coming months. Therefore, for patient long-term investors, 2015 is again likely to present opportunities to invest in fundamentally attractive companies on bouts of stock-specific volatility. Fundamental, in-depth bottom-up research will be key to identifying those attractive long-term investment opportunities.

WHERE DO WE GO FROM HERE?

The market continues to face some challenges. Questions remain over global growth, and whether the U.S. can sustain its growth rate if conditions worsen overseas. The Federal Reserve is on course to begin monetary tightening at some point this year, and while we view this as indicative of strengthening economic growth, this change in monetary policy may impact investor confidence.

On the positive side, the corporate sector remains in robust shape and the U.S. is home to many industry leading innovative companies. Equity prices are though more likely to move in line with earnings growth rather than through any meaningful expansion in valuations. Importantly, conditions are still supportive for further gains, although the upside is likely more limited due to fair valuations and already high profit margins.

FIGURE 4: Stocks Have Typically Performed Well In Previous Rising Rate Environments



Sources: Factset, T. Rowe Price

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