Keeping the faith with US equities

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Even to the most casual observer of financial markets, US equities appear to have come a long way since their post-crisis nadir more than six years ago. Now the arguments against the rally continuing are starting to mount and so it is hardly surprising that global asset allocators are turning away from the US and paying more attention to other regional markets such as Europe. With the latter having outperformed over the last twelve months, the case against the US has hardened.

However, a number of critical drivers behind US equities might well prove more robust than presently assumed. This could extend the rally even if only for long enough to support a short to medium-term position in portfolios. Indeed, emphasising US equities is a tactical position we have recently adopted with good effect in portfolios both through call options and selective outright exposures. Nonetheless, it is worth considering the basis for the bears' caution. Four issues in particular rank high among the list of concerns; higher interest rates, stock market valuations, the strength of the US dollar and the state of the economy.

Monetary policy

Tighter monetary policy is the first and most pressing issue. The fear is that with Fed will start tightening as soon as September with the result that higher interest rates will quickly drain liquidity, shunt the bond market into a steep decline and negatively impact sentiment and investor confidence. We regard this view as overly pessimistic. Upcoming policy moves will be the most well-flagged in Fed history and appear to be well discounted among market participants. What's important to recognise is the Fed's reluctance to risk a 'policy error' by applying the brakes too early (just as the ECB did in 2011) so they are more likely to let inflation run ahead a little than choke off the recovery too soon. We should therefore assume that when they come, neither wage pressures nor capacity constraints will be a threat in the short run and automatically lead to rate rises.

When the time does come for interest rates to rise, this is likely to manifest very gradually and at a pace the equity market can easily absorb. Past episodes of monetary policy tightening in 1994, 1999 and 2004 show that equities can still perform if the Fed's strategy is well managed and communicated. The lesson of the 2013 'taper-tantrum' debacle has probably been well learnt by now. We should also remember that outside the US, monetary conditions should remain highly accommodative for some time to come. European, Japanese and Chinese policymakers are publicly committed to reflating their respective economies through quantitative easing (QE) programmes designed to keep bond yields low. This in turn leaves US bond yields relatively high, drawing investors in and pushing yields back down. In other words, QE should help to keep a lid on US bond yields even as the deposit rate rises.

Valuations

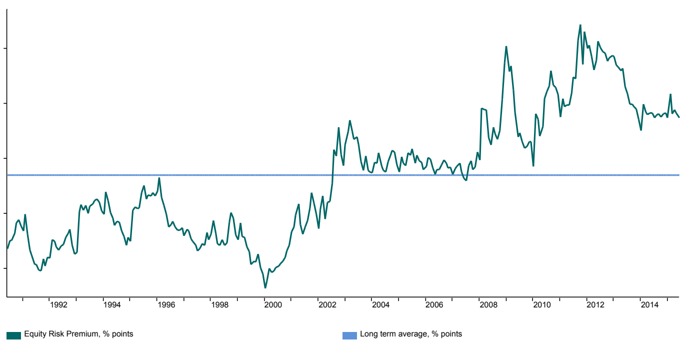
Current valuations are a second key concern, with the fear of 'fair value at best' or 'priced to perfection' looming large. We would accept that the US market is far from cheap but that's part of the attraction since it reflects the broader economy's strength and the fact that corporates have, on the whole, performed too well to justify any sizeable discount. But apart from certain sectors (eg healthcare) and some specific stocks, the market still trades on reasonably attractive metrics. The most recent S&P forward earnings yield is 5.6%, which is not far off longer-term averages, while the Equity Risk Premium (defined here as forward equity earnings yield minus 10yr US Treasury yield) at 3.5% is much more rewarding than its 25 year average of 1.4% and suggests significantly better value than bonds.

Other valuation measures such as the Shiller CAPE at 27x suggests a somewhat pricey market, as does Tobin's Q. But their predictive power over the short term is notoriously unreliable and tradeable divergences from what 'ought to happen' can persist for much longer than many investment horizons.

The point is not to confuse valuations with potential upside. The US and global economy function very differently to that embedded in longer-term valuation measures while dispersion across stocks should also provide ample scope for seasoned investors, used extensively in our global portfolios, with an aim to add meaningful value over and above the market return.

The Equity Risk Premium suggests equities are cheap vs bonds

25 May 1990 to 29 May 2015



Source: Bloomberg

US dollar strength

A third legitimate worry is the US dollar – partly due to the significant appreciation that has already taken place over the past year and partly where it's headed next. Divergences in monetary policy and economic growth rates between the US and its major trading partners suggest that dollar strength will continue. The fear is that this will squeeze the profitability of US multinationals while improving that of overseas competitors.

But lost in the debate is the double-sided nature of the dollar's strength. Yes it does hurt those US exporters who mis-manage their FX exposure. Earlier this year, the Federal Reserve Bank of St. Louis's James Bullard was famously unforgiving of such firms, pointing out that large companies could use hedging to dampen the revenue implications of adverse currency movements. But the strong dollar also benefits many companies by way of cheaper input costs and operational leverage. In addition, it is an attractive feature for overseas investors in US stocks who welcome a strong currency as an additional comfort over and above the merits of the market itself. One only needs to look at how difficult it is for countries with weak currencies to sustain overseas investors to see how US dollar strength might have more positive than negative implications.

US economy – doom or boom?

Fourth, question marks abound over the health of the US economy with the concept of 'secular stagnation' particularly in vogue amongst certain academics. Our take on the data is that the US is healthier and more resilient than many of its competitors who typically threaten rather than produce trend growth. Admittedly there has been a sharp slowdown in the energy sector, with the state of Texas in outright recession now. And more recently, weather-related spending deferrals have hit some measures of growth.

But the financial sector is in remarkably good shape, corporate investment is on the rise and the all-important consumer is considerably more confident given improvement in wages and lower fuel prices. Consequently, consumer spending is growing and we anticipate further acceleration in this area could be the big surprise factor later in the year when the impact of lower energy bills finally inspires Americans to hit the shops. We know from previous economic cycles that consumers' reluctance to spend the energy windfall is not unusual.

Nor is a return to higher energy prices following the recent bounce an inevitability. We are unlikely to see a demand-led surge and even less chance of a supply shock given the strong incentives for major exporters to maintain production and the ever-falling breakeven oil price needed for shale producers to profitably drill. Cheaper oil looks like it is here to stay for some time and should therefore underpin a resurgent US consumer. Our portfolio strategy has positioned for this by emphasising consumer-facing stocks including homebuilders and entertainment.

Conclusion

Finally, and more broadly, the attraction of US equities is really only part of a bigger story of the relative attraction of equities in general. QE and the global savings glut have distorted bond yields to such a degree that equities are now in pole position as the asset class of choice. Over the short term, bond investors might well stomach poor nominal returns in the name of safety. But in the longer run there is more of a psychological barrier to buying bonds at low yields, or corporate credits with wafer thin spreads, than investing in equities that may on some historical metrics seem fully valued. In the case of bonds, there is a ceiling on price much more in evidence than that applied to real and growing businesses that innovate, produce earnings and pay dividends. Equities, and those of the US in particular, should continue to benefit from this structural bias, which we believe has much further to run as investors implement the asset allocation shifts and changes to investment time horizons this implies.

This is not to say the journey will be uneventful. Volatility can and does materialise, with Greece, Ukraine and the Middle East all sources of potential upset. However, for those able to take a more considered view, US equities make compelling sense. As Warren Buffet once famously remarked, *"It's never paid to bet against America. We come through things, but it's not always a smooth ride."*

Source: GAM unless otherwise stated.