Viewpoint

threadneedle investments

US equities – March 2015

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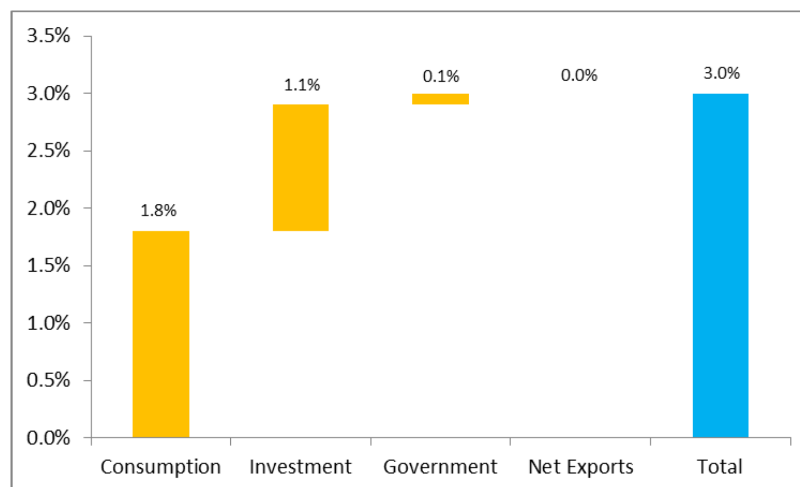
Recovery moves up a gear as consumers step on the gas

In the Q&A session below, Nadia Grant addresses some of the questions currently on the minds of US equity investors. Overall, she believes that US stocks are attractively valued in relation to other markets and will gain support from a broad-based economic recovery.

Last year we saw relatively strong economic growth in the US, but a slowdown elsewhere, while oil prices have now halved and the US dollar has surged. Given those developments, how sustainable is the US recovery and will the shape of that growth be affected?

We think the US economic recovery is broadly based and are forecasting GDP growth in 2015 of around 3%, which should provide a very supportive backdrop for equities. We expect the consumer to account for around two-thirds of this growth, at about two percentage points, up from 1.6 percentage points in 2014. The collapse in the oil price is benefitting US consumers enormously. They were paying an average US$2.14 a gallon, and just US$1.80 in some states* at the beginning of the year, rather than US$3.50 before the oil price drop. These extra dollars provide a considerable boost to lower-income workers, who have a significant propensity to spend. Thus, the lower gasoline price is highly stimulative for the economy.

Figure 1: Consumption and investment to drive growth in 2015



Source: Threadneedle Investments as at 31st December 2014.

We expect investment to contribute about one percentage point to overall growth, a level which is also higher than last year. This may appear surprising given the headlines generated by the shale energy revolution and the belief that investment in oil and gas has been a significant contributor to the US recovery. Surely, many investors ask, the oil price slump will hurt investment and hence growth? But while oil and gas may have been the fastest-growing segment of investment, only 8% of overall investment is oil and gas related. Moreover, we believe that investment in capital equipment will grow rapidly, given that capacity utilization is 79%, a level that typically prompts a significant increase in capital expenditure. We also believe that residential construction, another major component of investment, will pick up

sharply and expand at a double-digit pace, having been a major drag during the early years of the US economic recovery. Our optimism is informed by increasing mortgage availability, with banks having restored their balance sheets and showing a much greater willingness to lend, having also loosened very tight credit standards. Lastly, we believe that the government's contribution to growth will not be negative as has been the case for the past few years.

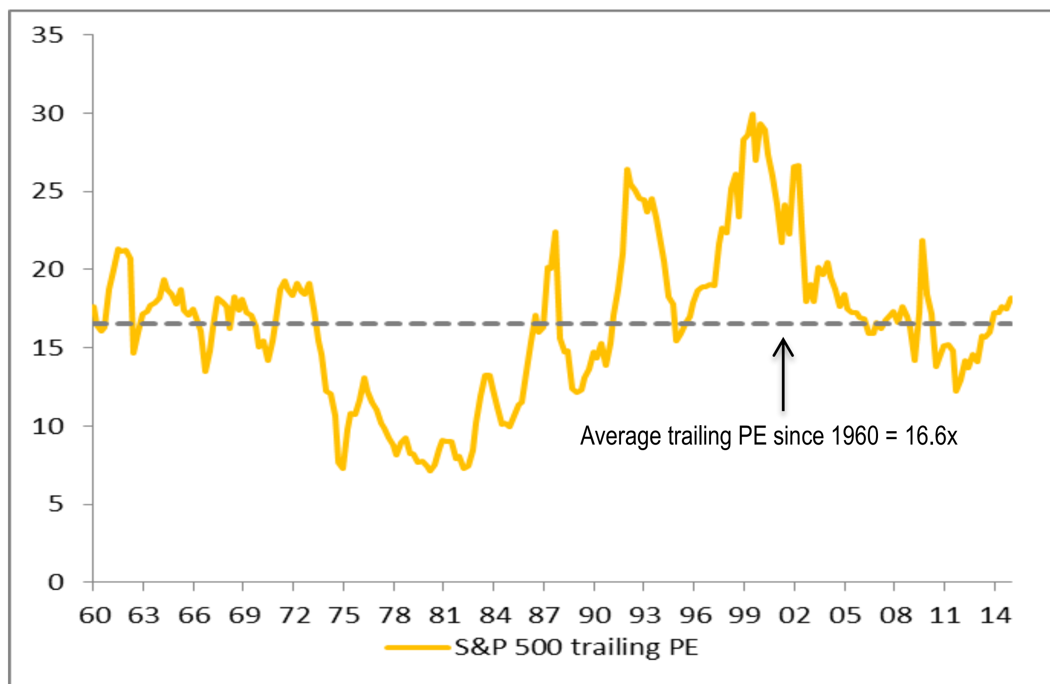
Interest rates have not risen in the US for nearly nine years but the Federal Reserve has been guiding investors to expect a rise at some point this year. Do you think that this is a reason for US equity investors to be fearful?

No, we do not think investors should be concerned. The Federal Reserve's guidance reflects the fact that interest rates are abnormally low by historical standards, and more importantly, that the US is on the path to a self-sustainable recovery and thus a normalisation of interest rates. A rise in interest rates would provide concrete evidence of the Federal Reserve's confidence in the recovery and that view should also support equities. Historically, the market tends to anticipate the first rate hike six months in advance of it taking place and tends to be a lot more volatile during this period. However, historical evidence indicates that rising interest rates have no material impact on the market six months to a year after the first rate hike.

US equity market valuations were at the top of investors' minds in 2014. Our view was that valuations were quite reasonable and that earnings growth would drive market gains and this proved largely correct. What is your view of current valuations?

The market has not re-rated but has simply grown in line with earnings and we expect this trend to continue in 2015. The consensus is that equities will be trading at about 15 times PE by the end of the year, which is in line with the market's long-term historic average. Thus, we think that US equities are neither expensive nor cheap. Given that the US is the sole engine of global growth and given how sound the recovery is, we believe US stocks are reasonably valued in relation to other markets.

Figure 2: US equity valuations are close to their historic average



Source: Bloomberg as at 31st December 2014.

Moreover, low inflation means the rate at which equity cashflow is discounted is also low and historically this has been very supportive for the market. Economic fundamentals and earnings growth should underpin expectations for 2015. As mentioned, we are forecasting 3% GDP growth, which translates into low to mid-single digit revenue growth, some profit margin expansion and buybacks of around 1%. Thus, we anticipate mid to high single-digit earnings growth in 2015, which is attractive by historic standards.

How are you positioning the American Fund for 2015 and could you provide examples of stocks in which you have the highest conviction?

We focus on companies that are uniquely placed in terms of having secular growth drivers and pricing power. Consequently, in the American Fund we are overweight in the technology and healthcare sectors, which are home to companies that have disruptive new technologies as well as pricing power. Meanwhile, we are underweight in energy and telecoms. We believe energy prices have yet to find a floor, yet the stock price of companies within the sector does not reflect the fall that we have seen in the oil price, while the telecoms sector is subject to intense competition and price erosion, in other words the complete opposite of what we seek.

Turning to individual businesses, we like Electronic Arts in the technology sector. This gaming company has secular growth drivers. It benefits from the console cycle with the launch of new gaming consoles driving demand for its video game titles, while revenue from mobile devices, including smartphones and tablets, is rising sharply. Profit margins are much higher on digital downloads to mobile devices than in its traditional business. We also favour Vertex Pharmaceuticals in the healthcare sector. It is developing a drug to treat cystic fibrosis that passed a critical phase of clinical trials last year. The drug also has `orphan drug' status, which brings a variety of financial incentives, and has strong pricing power.

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