

The case for US equities

AT A GLANCE

- The US has materially outperformed emerging and other developed markets since the start of the year.
- This has been part of a wider sentiment shift from emerging to developed markets.
- Investors have been drawn to the US's blend of ultra-loose monetary and fiscal policy and its stronger-than-expected economic and corporate sector recovery.
- Fund flows turned strongly away from emerging markets and into US equities in the first quarter of 2011.
- M&A activity has picked up particularly well in the US which is a positive signal of the health of the corporate sector and a good support for the equity market.
- The US should continue to benefit from macroeconomic supports at a time when they are diminishing in other economies.

"In equities, the US is my preferred asset class within the multi-asset funds due to the ultra-loose monetary and fiscal stimulus being delivered to the economy. In short, the US is going for growth at a time when other economies are implementing fiscal austerity measures."

Trevor Greetham, Asset Allocation Director

With all the talk of China and emerging markets in recent years, it pays to occasionally stand back from the hyperbole and remember a few simple truths. The US is still the biggest economy in the world (by some margin) and home to many of the best companies.

Indeed, most lists of the world's 'best 200' firms remain dominated by US companies. The opportunities are sufficient enough to give Warren Buffett - one of the most successful investors in a generation – little cause to stray too far from US shores. So, it should come as no surprise that the recent pick-up in the US economy and stock market has prompted significant inflows into US equity funds. Here, we consider the case for the US at a time when the authorities are steering the economy towards growth via ultra-loose macro policy.

THE US IS GOING FOR GROWTH...

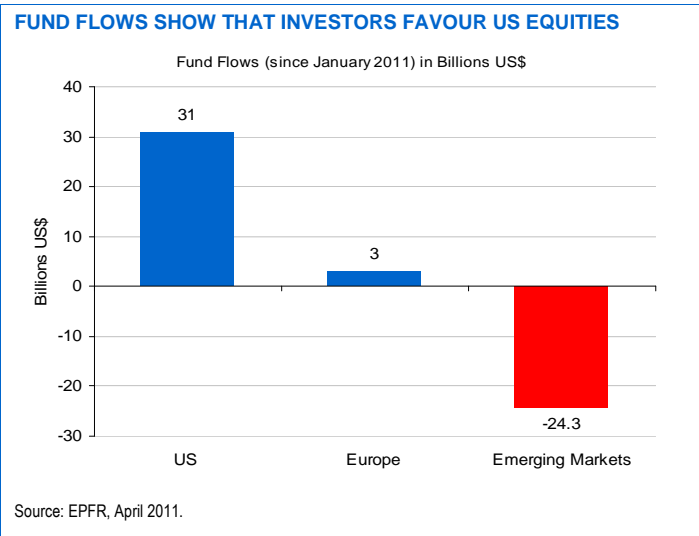
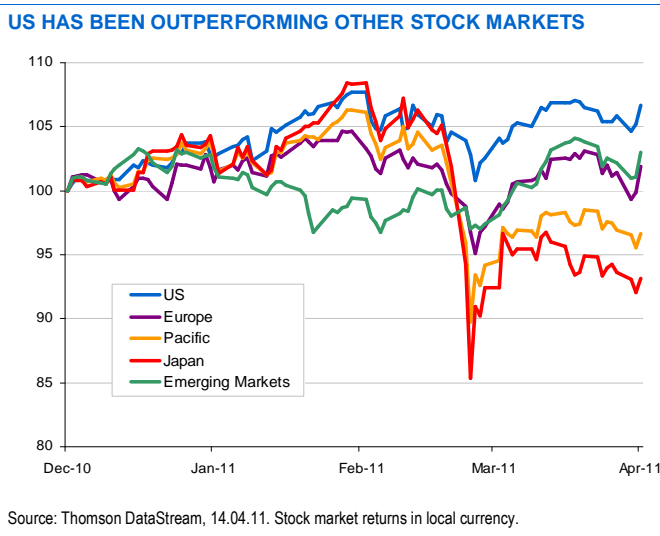
At a time of fiscal austerity in much of Europe, the US is unashamedly going for growth. In most key regards, the US has had to deal with similar problems in the aftermath of the financial crisis: high public and private sector indebtedness; recapitalising a broken financial sector; and re-energising a moribund housing market.

While the problems may be familiar to European politicians, the course of action is the opposite. The US is unashamedly seeking to grow its way out of trouble via incredibly easy fiscal and monetary policy. This loose policy is likely to remain in place for now, in spite of the fact that they are delaying public debt problems for future administrations. This latter point prompted Standard & Poor's to downgrade the long-term rating outlook for US sovereign debt from stable to negative – the first time since 1941 that the AAA-rated issuer has been put on negative watch.

...AND IT'S WORKING

The signs are that the US approach is working. Annualised GDP growth in Q4 2010 was 2.6%. Industrial production has picked up strongly and leading indicators of activity such as the Philadelphia Fed's manufacturing outlook survey suggest business confidence is buoyant; the index hit its highest level since 1984 in March. Translating that bare index reading into GDP growth suggests annualised growth as high as 5%. While housing remains weak, this might be over-optimistic, but there are signs of a bottom being put into that market, which supports the medium-term outlook. Importantly, the unemployment rate has peaked, dropping from around 10% in 2010 to 8.8% more recently, as the US economy shows healthy signs of job creation.

What happens to the US economy is important for the rest of the world. The US economy is not just the largest economy in the world, it is greater than the second, third and fourth largest economies in the world combined (IMF 2010 GDP data). However, growth and policy differentials are key; the fact that the US is going for growth at a time when other countries are tightening monetary or fiscal policy makes the case for US equities compelling.



"Credit ratings agencies tend to lag and not lead market developments; the US market is proving to be resilient, growing much faster than other developed markets, and it does not have the structural issues of Europe. It is important to make the distinction that the US market is driven by global trends and not just by the US economy. Furthermore, following the November elections, Congress is much more serious about dealing with the structural deficit which is very encouraging and the current strength in the economy should ease the pain of such decisions."

Aris Vatis, Portfolio Manager, US equities

VERY LOOSE FISCAL POLICY

US fiscal policy has been a law unto itself for some time, reflecting the special standing of the US economy, the polarised political system and the willingness of successive administrations to delay the painful medicine needed to cut a growing fiscal deficit. Indeed, prior to the financial crisis, the US ran a government deficit that fluctuated between 2 and 5% of GDP - significantly larger than other triple-A rated sovereigns. The government response to the credit crunch of 2007-8 resulted in an unprecedented fiscal stimulus that saw the deficit balloon to 11% in 2009.¹ The extension of the Bush tax cuts and a business-friendly agenda from the Obama administration since the mid-term elections have only served to exacerbate the lop-sidedness of the US fiscal balance sheet.

So, the current direction of policy is stimulative, which is supportive of economic growth in the short to medium term and, in turn, corporate earnings growth. The fact that Standard & Poor's fired a shot across the White House's bows by downgrading the long-term outlook for government bonds has raised a few eyebrows about the 'risk-free' assumption these investments have always carried. But, in reality, the US is in no immediate threat of losing its AAA-rating or of being unable to fund itself, given current yield levels. Although the longer-term problem is a lingering concern for the US administrators, it takes little away from the positive medium-term case for US equities based on the strength of the economic recovery and the robust state of corporate balance sheets. Indeed, nominal economic growth is by far the best way to fix budget deficits.

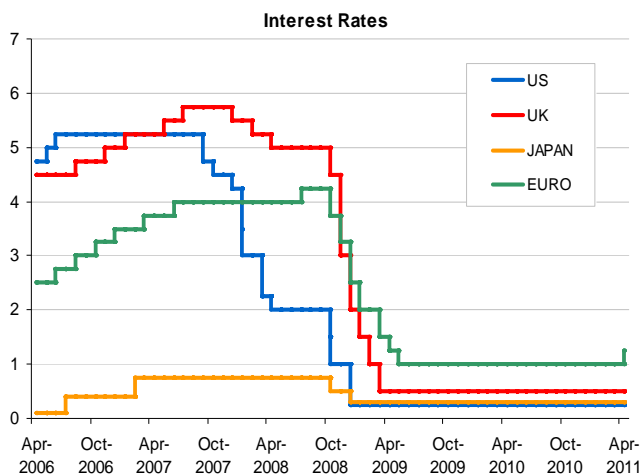
VERY LOOSE MONETARY POLICY

In the aftermath of the collapse of Lehman Brothers, the US authorities began a massive, and largely experimental, easing in monetary policy, fearing a deflationary spiral in the domestic economy. It was unprecedented in terms of its scope and size as nominal interest rates were cut to 0.25% (effectively zero in real terms) and a program of quantitative easing was implemented to expand the money supply.

This first round of quantitative monetary stimulus averted a worse deflationary outcome than many had predicted, although the recession that followed was still sharp and nasty. The second round of quantitative easing (QE2) was aimed at getting the US economy back onto a sustainable growth path. And by most yardsticks, QE2 has been a rip-roaring success for the US. The stock market bottomed when Fed Chairman Ben Bernanke announced its introduction in August 2010 and the abundant liquidity it has created has facilitated a global rally in stock markets which many commentators believe has further to run.

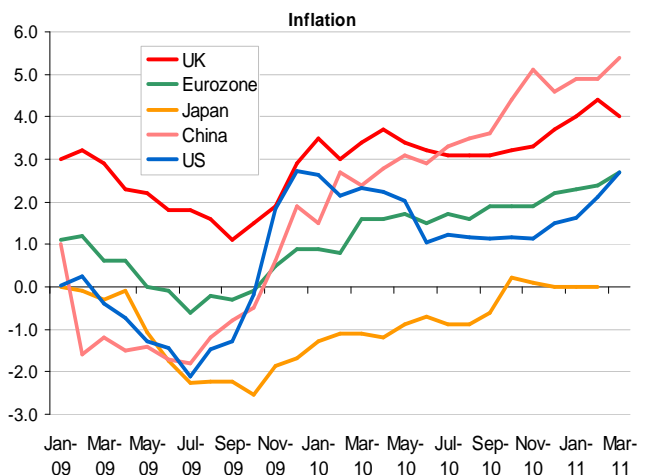
The by-product which many feared - inflation - has begun to rear its head in recent months, but the real villains of the piece are actually higher food and energy prices. The Fed takes little account of such cyclical and uncontrollable factors in its planning, expecting them to mean revert over longer time periods. Relative to other countries, consumer price inflation in the US is not a significant problem at current levels and core inflation, in particular, remains contained.

LOWER LONGER: US TEND TO EASE FIRST, TIGHTEN LAST



Source: Thomson DataStream, as at 14.01.11.

INFLATION IS NOT CURRENTLY A SIGNIFICANT PROBLEM



Source: Thomson DataStream, as at 14.01.11.

"The US equity market has been performing well yet there are still good opportunities available where growth prospects are largely underappreciated. Examples include eBay and Expedia whose current valuations undervalue their longer-term earnings prospects."

Adrian Brass, Portfolio Manager, US equities

LOWER FOR LONGER: EQUITIES STRONGER

Investors are now weighing up the impact of an anticipated end to asset purchases by the Fed, with the exit of QE2 earmarked for the end of June. However, it is worth remembering that the Fed remains committed to keeping interest rates low. This need not be inflationary either. The Fed argues that as long as there is spare capacity in the economy (and unemployment remains relatively high) then they should be in no hurry to raise rates.

Indeed, economists at Societe Generale believe US rates may not be raised before mid-2012. At a record low of 0.25% since the end of 2008, the Fed has effectively been running a 'Zero Interest Rate Policy' (ZIRP) in terms of the impact on the real economy. As the chart above demonstrates, the US was the first to cut interest rates in October 2007, entering into a monetary easing cycle earlier than other developed nations. They also cut most decisively by a larger margin (100 basis points) during the concerted rate cuts in October 2008.

Relative to other markets, the willingness of US authorities to maintain interest rates at low levels for longer raises the attractiveness of their equity market. Unlike the one-dimensional ECB, they are willing to take account of factors like unemployment in their decision-making. At a time, when other developed countries are raising rates (Euro-zone, Australia) and many emerging markets are well into tightening cycles to contain higher inflation levels, this remains a huge plus point for the US equity market regardless of the removal of QE2.

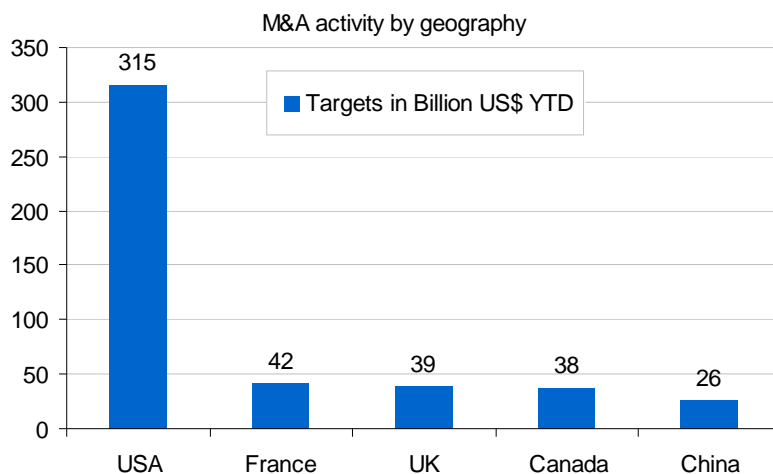
CORPORATE ACTIVITY IS ALSO SUPPORTING THE US MARKET

Merger and acquisition (M&A) activity has been picking up from relatively low levels in recent months. Cash-rich companies are seeking to take advantage of opportunities at this stage of the economic cycle, when economic growth is improving but interest rates are still historically low, meaning balance sheets are healthy. Global M&A activity increased by nearly 30% in the first quarter of 2011 – a very positive sign for the ongoing recovery. The US market has been by far the biggest beneficiary, accounting for 45% of the global M&A market year to date. While companies are keen to take advantage of relatively attractive valuations, they are not ready to invest at any price – the focus, at present, is on value creation and profitability.

"I am finding plenty of attractive opportunities in the market, which I believe are attractively valued in the context of their longer-term growth prospects. For instance, in fast-growing areas such as mobile data growth and smart phones, I believe companies like Cisco Systems and Qualcomm have good prospects. Likewise in energy, stocks like Transocean and National Oilwell Varco can reap the benefits afforded by a high oil price making more oil projects commercially viable."

Aris Vatis, Portfolio Manager, US equities

M&A ACTIVITY IS AND WILL CONTINUE TO BE A PARTICULAR SUPPORT TO US EQUITIES



Source: Bloomberg, SG Cross Asset Research

CONCLUSION

The US equity market is fast becoming a standout market for investors. This is partly a function of its relative attraction versus other markets where macroeconomic supports are dwindling quickly. Most emerging markets are tightening monetary policy in the face of high and sticky inflation numbers, while the Euro-zone central bank recently increased interest rates despite the well-advised problems in its own peripheral member states, such as Portugal, Ireland, Greece and Spain.

The US, in contrast, still benefits from a very supportive macroeconomic landscape. Monetary policy is still ultra-loose, even looking beyond the end of unconventional QE2 measures.

Investors can focus on interest rates that are likely to remain at unprecedented lows for the foreseeable future. The Fed's commitment to a 'zero interest rate policy' is leading many commentators to the conclusion that 'lower for longer' makes US equities stronger. Added to this is the fact that fiscal policy is likely to remain loose this year and next due to the political environment in the US, despite the best urgings of international credit agencies.

Both of these factors should continue to support economic growth and provide an accommodative environment for the corporate sector, where companies are still growing their earnings and undertaking increasing levels of M&A activity – another support for equities. The final piece of the jigsaw is that fund flows have turned strongly positive indicating a change in investor sentiment on an asset class that appears to be stepping back out of the long shadows cast by emerging markets in recent years. With anecdotal evidence suggesting many investors are under-exposed to the US, but generally well-exposed to Asia, perhaps investors need to 'Go West' to achieve genuine portfolio balance and avoid missing out on the developing US equity story.

Notes

1. Source: Standard & Poor's, 18.04.2011
2. Source: SG Cross Asset Research,



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