US Equities – July 2013

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America – the re-emerging market

The US economy has been severely tested over the past five years and has endured a very difficult period with many pundits, certainly at the beginning of the financial crisis in 2008, arguing that the country was in terminal decline. However, we always believed that the opposite was true and that US equities offered excellent value.

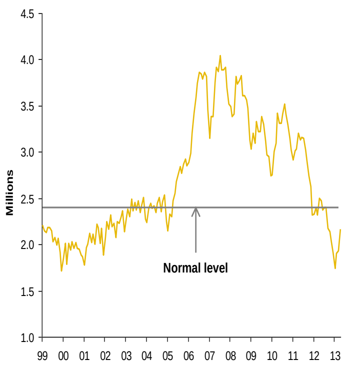
That conviction has been well rewarded and we now believe that the bull market is entering its final phase as capital is drawn back to the US. This reflects the fact that the US has seen very low levels of investment in the past five years, given the pressures facing the economy, and is now in dire need of capital spending. Thus, the US now needs to go through a full investment cycle and that will help to drive growth. The opposite is true in other parts of the world, including China and Europe, which has seen over-investment.

The US fiscal shortfall has also never been a matter of concern for us. We believed that the deficit would come down and will indeed look very reasonable in a few years' time. There are various other positive factors driving the US economy. The recovery in the housing market is one of the most significant developments. Critically, real estate is very cheap. By comparison, house prices are at all-time highs in every other major economy in the world, even in those which are underperforming. This suggests that US house prices have the potential to rise strongly. The recovery in the housing market should translate into rising jobs and spending on consumer goods.

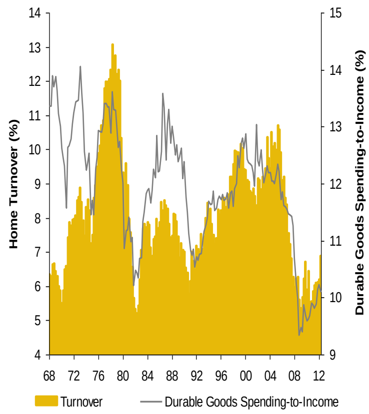
The fall in the number of homes with negative equity is already having a big impact on consumer spending. Households in negative equity have great difficulty obtaining credit and just a small rise in house prices can thus have a large impact on consumer spending. The shale boom, which is driving down energy costs, is also good news for consumer spending.

Figure 1: Housing market healing – positive for employment and the consumer

Existing home inventories[1]



Turnover of new and existing homes and durable goods spending as a share of disposable income 1968 through September 2012[2]



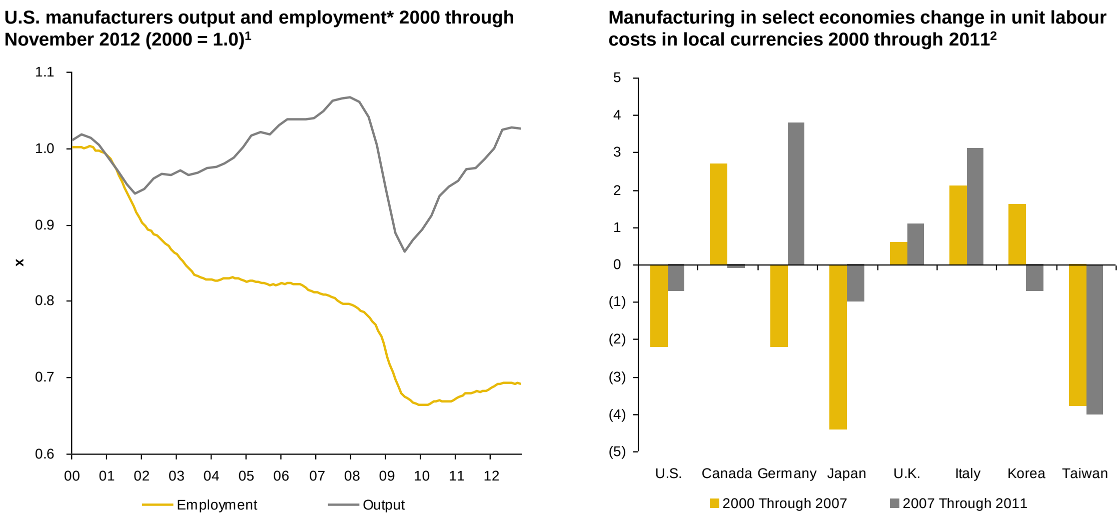
1 Source: National Association of Realtors (Latest Revision), House Tracker , Bloomberg, 30 April 2013.
2 Source: National Association of Realtors, Census Bureau, U.S. Department of Commerce, Emprical Research Partners Analysis, 31 October 2012.

Shale revolution driving manufacturing revival

Importantly in terms of employment, jobs are being created where they are really needed, particularly among the lower income groups, who suffered most during the financial crisis. Quantitative easing (QE) was good for people who owned their own home or had financial assets but was less beneficial for those in lower income groups.

In addition, employment is being generated among non-skilled workers, in areas such as energy and housing, a fact that is not lost on the Federal Reserve and is one of the factors behind their recent signals on tapering QE.The shale revolution is also boosting jobs in other areas such as chemicals and manufacturing. In terms of the chemical industry, the impact of shale gas has been to decrease the costs of both raw materials and energy. The price of ethylene, for example, which is widely used in the chemical industry, has fallen dramatically (see figure 2) and the US now has a significant advantage over producers in other parts of the world.

Figure 2: An industrial renaissance is underway



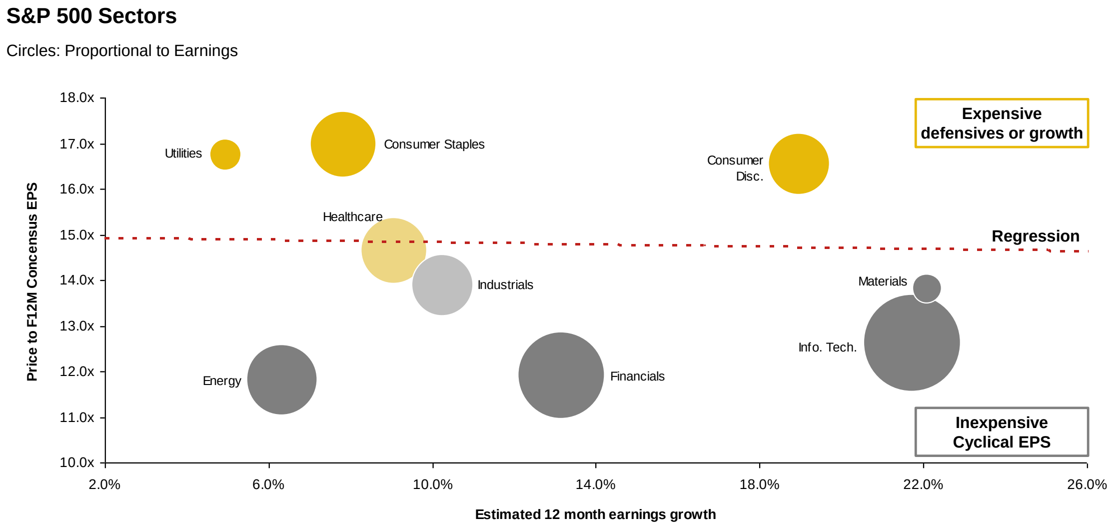
1 Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Empirical Research, January 2013.
* Seasonally-adjusted data
2 Source: Bureau of Labor Statistic, Empirical Research, January 2013.

Active managers can still find opportunities

If the US economy is undergoing an industrial renaissance and the economy is set for sustained growth, which begs the question of how to exploit these developments. In recent years, investors have been very keen on defensive areas of the market. Two factors have driven this trend: the yields are attractive, given the very low returns offered by government bonds, while investors have also feared that equities could fall and thus have been keen to focus on defensive areas of the market.

The critical flaw in this argument is that defensive stocks are now very expensive as figure 3 overleaf shows. Moreover, as interest rates begin to go up these stocks are likely to appear increasingly unattractive, while the economy and prospects for cyclicals are improving. In addition, we can find particular value in certain cyclicals such as financials and technology.

Figure 3: The growing price of safety



Source: Bloomberg, 1 May 2013.

Financial and technology offer good value

In terms of financials, the rise in housing prices provides a very strong tailwind for the sector. Rising net interest margins are also highly positive for the banks, which are additionally now very well capitalised. Yet the sector is disliked and stocks are cheap.Technology stocks, meanwhile, have also struggled with issues around government spending on technology and as a result now offer very good value. The lack of dividends in the sector has also been a factor. Yet technology companies are now starting to issue dividends and steady free cash flows suggest that these will be well supported. Overall, we are very positive on the outlook for US equities. The market is still cheap and we believe that it will continue to outperform given the factors that are driving the economy and place the US in an increasingly strong position relative to the rest of the world.