

# Threadneedle thinks

## Conference call highlights



**Cormac Weldon**  
Head of US Equities

### US EQUITIES UPDATE – SEPTEMBER 2011

#### **Macro concerns dominate**

Market sentiment has been dominated by macroeconomic and political factors recently. Investor concerns about European sovereign debt and political inertia on both sides of the Atlantic have damaged risk appetite. Meanwhile, an apparent slowdown in economic activity in the US and elsewhere has led to downgrades in corporate earnings expectations.

#### **Downgrading our forecasts**

Having recently lowered our forecasts for US economic growth to 1.5% for both this year and next, we have also reduced our expectations for earnings growth. We are now expecting 8% growth in earnings this year, with next year flat to potentially down. US companies have a good track record of addressing their cost bases to protect margins in tougher times, and they are likely to take similar action on this occasion. Nevertheless, low nominal growth provides a difficult backdrop for aggregate earnings growth.



**Stephen Moore**  
Fund Manager

#### **No sign of QE3 yet**

Injections of liquidity into the financial system have been highly supportive of equities since the financial crisis. Indeed, charting the size of the Fed balance sheet against the level of the S&P 500 shows that the market has struggled to make progress without the tailwind of quantitative easing. The end of QE2 earlier this summer was therefore another factor behind the recent weaker trend in the market. With little imminent threat of deflation, we do not believe a third phase of QE is imminent. However, the authorities have stated that interest rates will be on hold throughout 2012 and further stimulative measures should not be ruled out.

#### **Generational valuation opportunity**

Equities were attractively valued relative to history and to other asset classes before the recent turbulence, and the setbacks of the past weeks have magnified this attraction. For example, using large-cap equity free cash flow yields versus Baa-rated corporate bond yields, equities are as cheap against credit as they have been since the 1950s.

#### **A high quality asset**

Equity valuations patently include a high risk premium at these levels and, while there are genuine challenges facing the market, US companies have demonstrated in the past their ability to grow their profits over the long term. Moreover, compared with previous periods of cheap valuation, equity investors today are buying a much higher quality asset with less debt and better free cash flow generation. As such, we feel that these extreme valuations represent a good long-term opportunity.

#### **Scope to outperform**

With global sovereign risk concerns focused on the eurozone, European equities have underperformed the US, leaving the relative valuation of US stocks versus their European counterparts at above-average levels.

However, the current level is well below previous highs, suggesting that the US could continue to outperform in the absence of a solution to Europe's problems.

### **US banks are better placed**

The US banking sector is much stronger today than it was at the onset of the financial crisis and appears to be in a much better position to deal with the strains created by the sovereign debt crisis. Compared with the same sector in Europe, US banks generally have lower assets in relation to equity, indicating the deleveraging that has already occurred. They also have lower loan to deposit ratios, which means that they are less dependent on wholesale funding than their European equivalents. While we remain cautious on the banking sector, this relative strength should stand the US market and economy in good stead if the eurozone debt crisis intensifies.

### **Current positioning**

For some months we have been positioning our portfolios for a low growth environment and this stance remains in place. We are focused on companies with exposure to secular growth trends; those operating in industries with high barriers to entry or with a product advantage. These characteristics should help to deliver sustainable earnings growth despite the lacklustre economic backdrop. We also continue to look for companies with strong balance sheets where the management is managing capital proactively, for example buying back shares, raising dividends or undertaking sensible corporate activity. Our stock selection efforts in light of these themes are leading to overweight positions in consumer discretionary and technology and underweights in financials, industrials and energy.

### **Funds outperforming year-to-date**

Our flagship American and American Select funds have comfortably outperformed the market over the year to date, with both portfolios benefiting from good sector allocation and strong stock selection. This outperformance is also evident over longer time periods, demonstrating the flexibility of our approach and the team's ability to create value throughout the investment cycle.

### **A highly experienced team**

The recent arrival of Diane Sobin adds another experienced manager to the team. Diane has previously managed a range of portfolios including one dedicated to basic materials. She will be covering this sector, as well as energy, for the team. We have also recently recruited Nafis Chowdhury as an analyst and hope to confirm a third appointment soon. This activity leaves the team fully-staffed and well-positioned to take advantage of the opportunities on offer.

### **Conclusion**

Equity markets have struggled over the summer against a backdrop of macroeconomic, political and sovereign risk concerns. The recent setbacks have left markets trading at attractive valuations relative to history and extremely low levels relative to bonds. Compared with previous times of similar value, equities represent a higher quality asset with low levels of debt and strong free cash flows. Our portfolios are positioned for a low growth world and this positioning has served us well in recent months. The funds' long-term records are equally impressive and we are confident that recent additions to the team will allow us to continue this strong performance.

**For Investment Professionals use only, not to be relied upon by private investors.** Fund performance source Morningstar, bid to bid, gross of charges. Attribution source Factset. Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The mention of any specific shares or bonds should not be taken as a recommendation to deal. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Investment Services Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Authorised and regulated in the UK by the Financial Services Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: 21F ICBC Tower, Citibank Plaza, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPSHKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.