MAERKI BAUMANN & CO. AG

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Focus on US equities

Market Comment, August 2018

We would like to elaborate on our focus on US equities and explain why we remain overweight in this segment compared to global equities. Even if it loses some momentum over the next few months, the US economy continues to exhibit above-average growth. US corporate earnings have once again exceeded the market's high expectations for the second quarter, with more than 80% of companies surprising on the upside. Valuation methods do not suggest US equities are overly expensive, particularly not in relation to US bonds. The American stock market can therefore cope with higher interest rates – as long as these are accompanied by solid economic growth, as this would have the effect of boosting corporate earnings. Our US equities module offers promising performance and a diversified way of gaining exposure to the world's leading equity market, which also boasts the strongest earnings growth of any region.

Many investors have viewed US equities as excessively expensive for quite some time now, and are avoiding them accordingly. This has proved a mistake over the last six months, however, as US stocks have long since moved on from their consolidation phase at the end of January. They have performed solidly since the start of the year, even without taking into account the appreciation of the US dollar. In other words, they have yielded an impressive return in local currency too.

A number of uncertainties have weighed on the financial markets this year and remain unresolved. The trade dispute between the Trump Administration on the one hand and China and the European Union on the other is a prominent factor here. Others include geopolitical tensions in respect of Iran and Saudi Arabia in the Middle East, North Korea, and China's military expansion in the South China Sea. Further uncertainties in Europe include the confrontation course that Italy's populist government is pursuing with the EU and a weak British government that has yet to deliver any agreement on the United Kingdom's departure from the EU (Brexit).

US equities are nonetheless performing well, and look set to continue doing so. Why? Firstly, the US is less directly affected by political problems than other countries. Secondly, America remains the world's largest economy. And thirdly, the US is recording by far and away the strongest corporate earnings growth of any region.

Not only have the results of US companies for the second quarter proved some 25% better than expected, they even exhibit the best earnings growth (approx. +15%) in a global comparison after adjustment for the tax cuts resulting from the recent tax reform. Whatever the wider uncertainties, what interests equity investors first and foremost is (and will remain) how impressively companies can increase their earnings.

Well over 80% of all companies have exceeded the market's expectations, a figure that compares very favourably with the historical average of around 66%. In other words, it is not just the so-called FAANG companies (Facebook, Amazon, Apple, Netflix, Google/Alphabet) that are reporting healthy profits. The technology sector as a whole has exceeded earnings expectations, as has the healthcare sector. We remain overweight in respect of biotechnology and the theme of robotics/automation, as well as with regard to US equities generally.

> "The US stock market shows by far the best profit growth of all regions."
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> Gérard Piasko, Chief Investment Officer

Another reason why US equities can hardly be shunned altogether is the fact that they make up a majority of the global stock market (more than 60% of the MSCI World), and not just because the US is the world's largest economy (and, according to Trump, will do everything in its power to remain so). The prerequisites for further earnings growth are very much in place: the US technology sector not only accounts for a large proportion of the overall market, but also impresses with its sheer breadth. In this context, it should be noted that a new equities sector will soon be created in the US. This will be known as "communication services", and is set to encompass parts of

today's IT sector of the cyclical consumer goods sector and telecoms.

The US economy is growing at an impressive rate. So impressively, in fact, that things could quieten down and still be good. In the second quarter, US GDP growth amounted to 4.1% on an annualized basis, which means it could decline to 2.5–3.0% and still be above-average. Which brings us to the US central bank and the question of whether interest rate hikes are impacting US equities. In our ad hoc commentary published at the time of the market correction back at the start of February, we stressed that this was actually a healthy interim consolidation, that US equities retained their appeal, and that there was no reason to panic. A precursor to that development was the rise in long-term US interest rates, specifically the yields on 10-year government bonds, with the Fed having indicated that further hikes in key rates were in the offing. Our view has not changed in the meantime: If US interest rates are rising against a backdrop of healthy economic growth, this points to further increases in corporate earnings, and need not prove a drag on equities. All of this brings us to our final point, namely the valuation of US equities.

In January, i.e. just prior to the interim correction, the US equity market was valued at a price/earnings ratio of more than 19x (based on expected earnings over the next 12 months). Now, however, its P/E valuation is actually some 10% lower than at the start of the year, despite the recent price rises we have seen. Indeed, at around 16.5x, the US equity market is actually in line with the historical average of the last 50 years. When viewed in terms of price-to-sales ratio, which is often important for technology companies, there is also evidence of further upside potential. Moreover, it should also be pointed out that US technology stocks are actually not historically expensive when valued on a P/E basis relative to the market as a whole. Based on its price/book value ratio, the S&P 500 is currently at the same level as it was in 1997, or some 30% below its all-time peak. With this observation we do not mean that we see upside potential of 30%, just that the current valuation can hardly by described as expensive. This is particularly true in a comparison with bonds. The inverse of the price/earnings ratio is known as the earnings yield, and can be compared with the yield on long-term government bonds. Based on this comparison too, the US stock market is more or less trading at its historical average and is therefore hardly expensive.

What's more, following the publication of the results for the second quarter of 2018, US earnings estimates have been revised upwards not just for 2018 as a whole but also for 2019.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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