# US equities: Picking winners before the end of cheap money

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## In Brief

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**Geetu Sharma, Senior Fundamental Analyst, Global Quality Equities**

- Cheap money since the US Federal Reserve launched quantitative easing and slashed rates has had a more pronounced effect on equity valuations than increases in companies' operating cashflow.
- With US interest rate increases on the horizon, valuations may be at risk.
- The winners are likely to be companies whose operating returns are set to outpace any rise in the cost of capital.

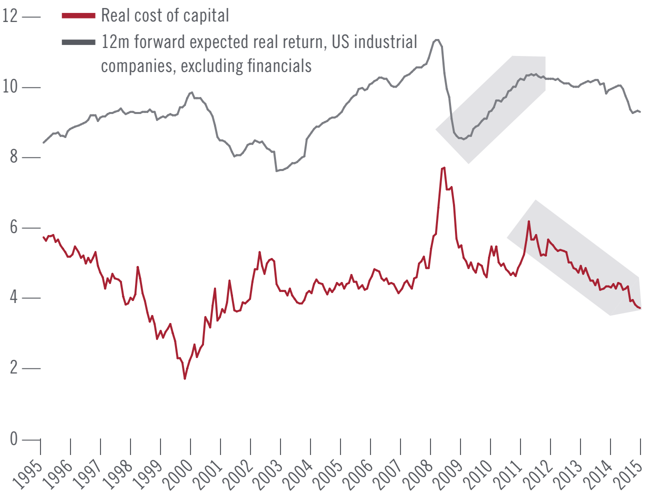
**Many investors fear that the party is over for US equities – the US Federal Reserve is expected to start raising interest rates in the near future, ending the era of cheap money underpinning developed stock markets since 2009. Not so fast, says Geetu Sharma, senior fundamental analyst for the Pictet-Quality Global Equities fund. There are plenty of companies that have used the abundance of cheap capital to invest and innovate, leaving them well placed to ride out a hike in rates.**

Corporations create value by earning returns in excess of the cost of capital. If a firm's cost of capital is 6 per cent and it posts a return of 8 per cent on the capital it invests, it has created value. Similarly, if the return on its investments is less than 6 per cent, it has destroyed value. Looking at the return on assets generated by US companies over the past five years and comparing this with the cost of capital it is clear that the spread between the two – the excess return – has increased significantly since 2009. Figure 1 shows that during the early part of the up-cycle – which lasted until mid-2011 – the excess return was the result of improving corporate performance, a sign of recovery. Since 2011, however, the return on capital has remained flat while the cost of capital has declined, thanks to the Fed, which means cheap money has boosted valuations rather than an underlying increase in operating cash flow or productivity.

In aggregate, then, US corporates appear to have failed to seize the opportunities offered by low capital costs to invest in expansion and innovation. Figure 2 shows the total asset growth rate for companies has remained in low single digits since the 2008-2009 financial crisis, unlike in the past when economic recovery was accompanied by strong investment growth.

**FIGURE 1 – RALLY DRIVEN BY LOWER COST OF CAPITAL, NOT HIGHER RETURNS**

US – real return on assets versus market implied real cost of capital, %




Source: Credit Suisse HOLT, Pictet Asset Management

**FIGURE 2 – ASSET GROWTH REBOUND SEEN IN PAST RECOVERIES IS LACKING THIS TIME AROUND**

US total asset growth, (%)

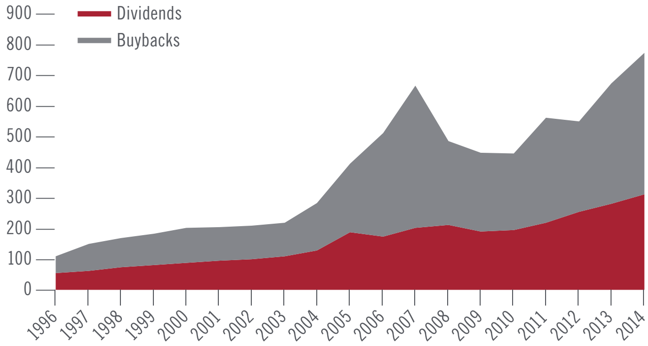

Source: Bloomberg, Worldscope, Pictet Asset Management

This time around, instead of investing in growth, many companies have opted to reward shareholders by borrowing cheaply to buy back equity, thereby boosting valuations and earnings per share. Figure 3 shows that the amount of share buybacks since 2009 has increased exponentially, as have dividend payments. However, there has also been a steady increase since 2009 of debt as a percentage of total assets, illustrating the extent to which companies that borrowed in order to reward their shareholders are exposed to any hike in the cost of capital.

In part this also reflects the fact that economic recovery remains fragile and companies continue to be reluctant to boost capacity without evidence of significant growth in demand, preferring instead to hoard cash.

**FIGURE 3 – LOW YIELDS HAVE LED TO REWARDING SHAREHOLDERS OVER INVESTING**

US dividends and buybacks, USD billion




Source: Bloomberg, Worldscope, Pictet Asset Management

## Europe, not so different

As Europe marches on its own path of QE, a widely held view is that, as the region is at a less advanced stage in the economic cycle than the US, European stocks will see a US-like increase in their valuations.

This may be simplistic, however. The ultra-easy monetary policies of the Fed had a knock-on effect around the world. So even though the ECB kept interest rates higher and delayed QE until 2015, European corporates, especially large multinationals, still had access to cheap capital. In other words, access to cheaper capital is already reflected in the valuations for European stocks. And unlike the US, returns for European companies are much lower and have not really recovered from 2009 lows. What is more, we have yet to see a material improvement in the underlying operating performance of European corporates that ultimately will be key for valuations to sustain in the equity markets.

## Identifying opportunities for the next phase of the market cycle

Key to picking the right stocks set to outperform in a world where interest rates are rising – making capital more costly to come by – is identifying companies that are investing in ways likely to boost productivity. This means that returns should continue to improve at a rate that outpaces any increase in the cost of capital. The tech sector is a good place to look for opportunities, therefore, as it offers a broad range of companies set to start reaping the rewards of past investment and innovation. Healthcare is another area as a raft of new drugs are poised to come on line which could have a positive impact on earnings.

On the other hand, a higher cost of capital will present challenges and there will be casualties. Companies whose returns are low and leverage is high will find their margins come under pressure when interest rates go up, making it more expensive to service their debts. Some energy companies fall into this category, along with mining groups, many of which have invested heavily but are now encountering falling demand for their products.

To conclude, the rise in equity valuations owes more to low rates than increasing corporate cash flows. So some stocks are likely to suffer some uncomfortable withdrawal symptoms when rates go up. Investors can, however, minimise the impact of that by investing in companies that have exploited the availability of capital wisely, investing in expansion and innovation leaving them well placed to benefit from better top line performance.

**Geetu Sharma, Senior Fundamental Analyst, Global Quality Equities**

Geetu joined Pictet Asset Management in 2014 as a Senior Fundamental Analyst for the Global Quality Equities fund.

Before joining Pictet Asset Management, Geetu spent the last five years at Credit Suisse, first working as an equity analyst with a long only natural resources fund, and then as a sector specialist covering healthcare and materials with Credit Suisse HOLT. Previously, Geetu has worked with Standard & Poor's in India as a credit analyst, covering pharmaceutical and telecom sectors. She also has corporate finance experience in a paper manufacturing company.

Geetu holds an MBA from the London Business School.

## PICTET-QUALITY GLOBAL EQUITIES

- An unconstrained, diversified global portfolio investing in companies with high returns, attractive valuations and resilient through the cycle performance.The fund is currently overweight US equities.
- The strategy combines proprietary quantitative models and in-depth fundamental techniques to select 150-200 quality companies.
- Defensive characteristics that aim to limit losses during down markets.

**Contact details**

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