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US bull market still intact

Dominic Rossi, Fidelity's Global Chief Investment Officer – Equities, explains why he thinks the five-year-long US equity bull market still has further to run.

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Although it is true that risks are becoming more balanced than in the past, I remain firmly of the view that the current five-year-long US equity bull market remains intact and has further to run. I think this view is supported by four key elements:

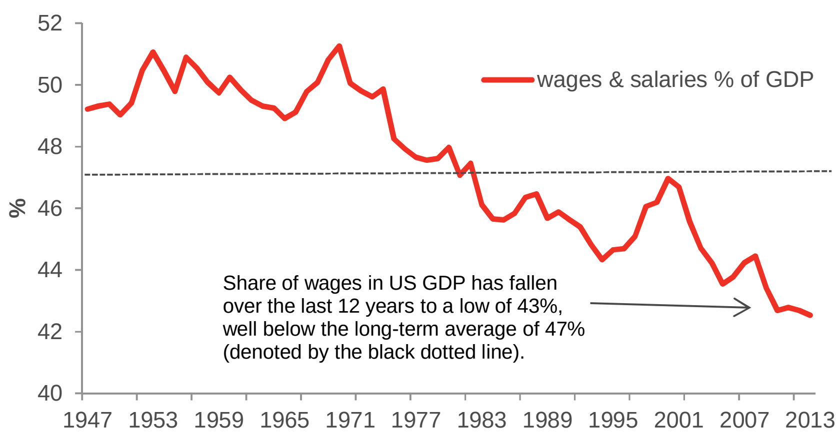
US economic outlook – The US economy continues to grow at a healthy pace and, importantly, despite five years of quantitative easing, there is little sign of inflationary pressure. This gives the US Federal Reserve the scope to normalise monetary policy in a controlled manner. Even when US interest rates rise (probably around the middle of next year), this shouldn't be a lasting concern for equities. While we may see a sell-off in the market, it should be a road-bump rather than a road-block and we will see further equity market progress. Indeed, history shows that stock markets typically make progress in the early stages of an interest rate tightening cycle, particularly when rates are moving off such a low base. It is not until the rate cycle becomes much more mature that it becomes a headwind for equities.

Market volatility also remains anchored by the robust economic outlook for the US. The ongoing improvement in the US fiscal and current account deficits has allowed valuations to expand. This robust fundamental outlook continues to support US equities.

Earnings and valuations – With US corporate earnings recovering significantly in the post-crisis period and profit margins at historically high levels in many industries, some sceptics have been anticipating a mean reversion in profits. I disagree with this – I think profits can stay high and have the potential go even higher in the future supporting further valuation expansion. In particular, I think there are some powerful structural factors at work in the US economy that will continue to support corporate profit margins.

Over the last 12 years, we have seen a shift in the distribution of wealth in favour of companies and capital and away from labour. This is reflected in the share of profits in US GDP rising to record high levels at the expense of a structural decline in the share of wages (see chart below). This relationship shows little signs of reversing – I think profit margins have move onto a structurally higher plane. In this light, US valuations remain reasonable, particularly when you consider the higher returns on equity typically generated by US firms.

The declining share of wages in US GDP



Source: US Bureau of Economic Analysis, September 2014

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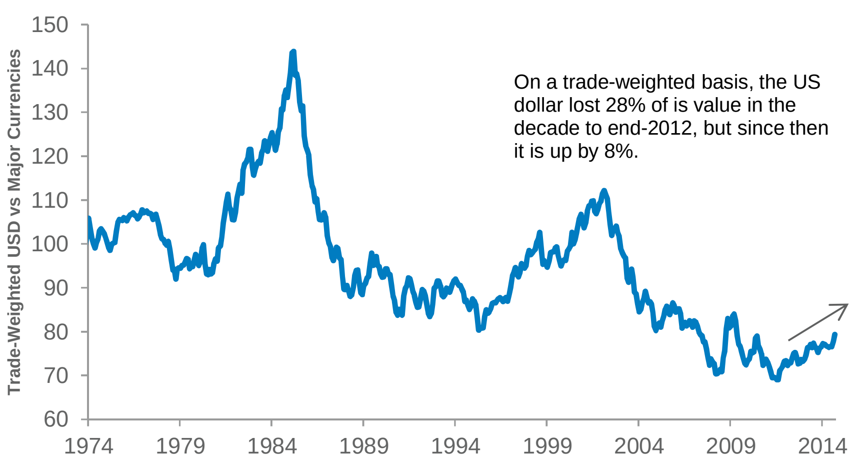
On the labour side, I think this can be attributed to the increasing globalisation of labour markets and reduced collective bargaining power. Meanwhile on corporate side, leading US brands have benefited from globalisation and improved emerging market spending power. Just as critically, this has been supported by industry trends towards the greater consolidation and monopolisation of market niches – I tend to view the current M&A boom, which is a market-supportive factor in itself, as consistent with this broader trend.

Perhaps less controversially, it is also clear that US companies have been remarkably adept at maintaining and enhancing earnings, allocating capital effectively and using technology to enable them to extract more profit per unit of capital employed. In the long run, with the continued application of automation and robotics in many industries, this trend is likely to be sustained, with further consequences for labour.

The global savings argument – We presently have a glut of savings in the global financial system. With policy interest rates near zero and bond yields near record lows, this wall of money effectively has no 'pricing power', forcing investors to put their money to work to achieve a decent return. It is difficult for asset prices to deflate in the presence of such ample liquidity. This has been reflected in the yields on many financial assets being pushed lower. Within a broad global asset class context, dividend-paying equities still look attractive versus other assets such as bonds, and should continue to attract inflows from investors. Indeed, despite their strong performance over the past few years, the yields on equities have held up very well thanks to improving corporate performance that has enabled dividend payments to grow significantly.

A stronger US dollar – For some time now, I have been arguing that in contrast to the 2000s, we are heading into a period of US dollar strength. The dollar has started to strengthen recently and we could be in for a sustained and significant move higher. Divergent monetary policy will encourage US investors to repatriate capital back into US dollar-denominated assets as was the case in the 1990s.

All the building blocks are in place for a stronger US dollar



Source: Datastream as at 29.09.2014

More specifically, I think the US dollar should be supported by the reversal of three key factors that caused it to be weak in the past.

- Firstly, thanks to the shale energy boom, the US is now well on the road to achieving energy self-sufficiency in the next 10-15 years – the steady reduction in demand for imported energy will be supportive of the US current account position, which in turn should support the US currency.
- Secondly, as mentioned earlier, the US budgetary position has improved considerably; the deficit has moved from a peak of 12% to 4% and I believe the Obama presidency could end with a budget surplus.
- Thirdly, we are now in a period on global monetary policy divergence – in marked contrast to the Bank of Japan and the European Central Bank, the US Federal Reserve will end its QE purchases in October and this is likely to be followed by the first rate hike by June 2015. With policy diverging in this way, interest rate differentials will also favour the US dollar.

SUMMARY

In summary, while the risks are becoming more balanced, I remain of the view that the five-year-long US equity bull market has further to run. In particular, I am encouraged by the fact that the US economy continues to expand at a healthy pace with little sign of inflationary pressure. In this context, I am confident that current high US corporate profit margins can be sustained in the future, helped by structural factors such as declining labour market power and improving technology. In addition, I think the global savings glut supports demand for attractive income-generating assets, including US equities, and I expect the US dollar should continue to strengthen owing to global monetary policy divergence.

On a broader level, while other markets can also continue to perform well, I do not see a fundamental change in leadership in this bull market, particularly given the prospect of a stronger dollar, which is traditionally a headwind for commodity-dependent emerging markets or those that still have significant dollar liabilities. In my view, the bull market of 2003-8 was about earnings growth, Chinese leadership, and emerging markets outperforming developed markets with strong commodities thanks in part to a weak dollar. However, today's continuing bull market is about valuation expansion, US leadership, and intellectual property sectors like pharmaceuticals, biotech and technology outperforming hard assets against the backdrop of a firmer dollar.

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