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HANGING TOUGH

Sentiment towards US equities has swung wildly in recent months, exacerbated by growing concerns that earnings forecasts are too optimistic. The US Federal Reserve Board's dramatic reversal on its interest rate stance has further altered market dynamics. Having rallied some 18% from its December 2018 low, investors are now asking whether 2019's rally is over. Or are we headed even higher?

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US equity investors have experienced (enjoyed?) an exhilarating roller-coaster ride over the past twelve months. Having rallied strongly throughout 2017, US equities hit an early 2018 brick wall - falling some 8%.

But, dazed investors quickly recovered as President Trump's tax cuts rode to the rescue; profit forecasts surged. "Onwards! Upwards!" was the rallying cry.

This renewed confidence was destined not to last. Approaching the final quarter, investors grew increasingly skittish about the potential fall-out of a possible trade war with China, the implications for world growth of a slower growing Chinese economy and perhaps, most significantly, fears of a tighter US monetary policy, as US growth remained strong with subdued inflationary pressures. Equities slumped over 15% during the final quarter of 2018[1].

An unexpected development broke the investor malaise in early 2019; the US Federal Reserve performed a backward somersault on interest rates. Rates would not rise as fast as feared. Sufficient liquidity would exist to support the financial markets. The Fed "Put" was back. Not unexpectedly, US equites once again rallied.

Following 2019's early bounce-back, many investors are now asking, "Is this the start of the next rally or is it a 'dead cat bounce' in an extended sell-off?"

This is clearly a critical question for us as investors. There are compelling reasons for arguing that we are at the start of the next leg of a rally (not only in the US but also in select emerging markets).

Equity valuations[2], for example, are significantly more supportive than they were a year ago when investor fervour (boosted by the tax cuts and IT mania) had dragged them into what many would regard as expensive territory (Fig.1).

TODAY, THE PICTURE IS ENTIRELY DIFFERENT.

While equities are not as cheap as they were at early January's lows, the market valuation remains comfortably within the "Fair-value" range. The technology sector is again flirting with "Fair" value, and looks far better value based on the prospective price to earnings ratio alone. Bank valuations have slumped and are again not only bouncing along their historical lows but also are just shy of "Very Attractive" valuations.

It is difficult to escape the conclusion that US equities look good value especially as the fundamental outlook seems solid. For example:

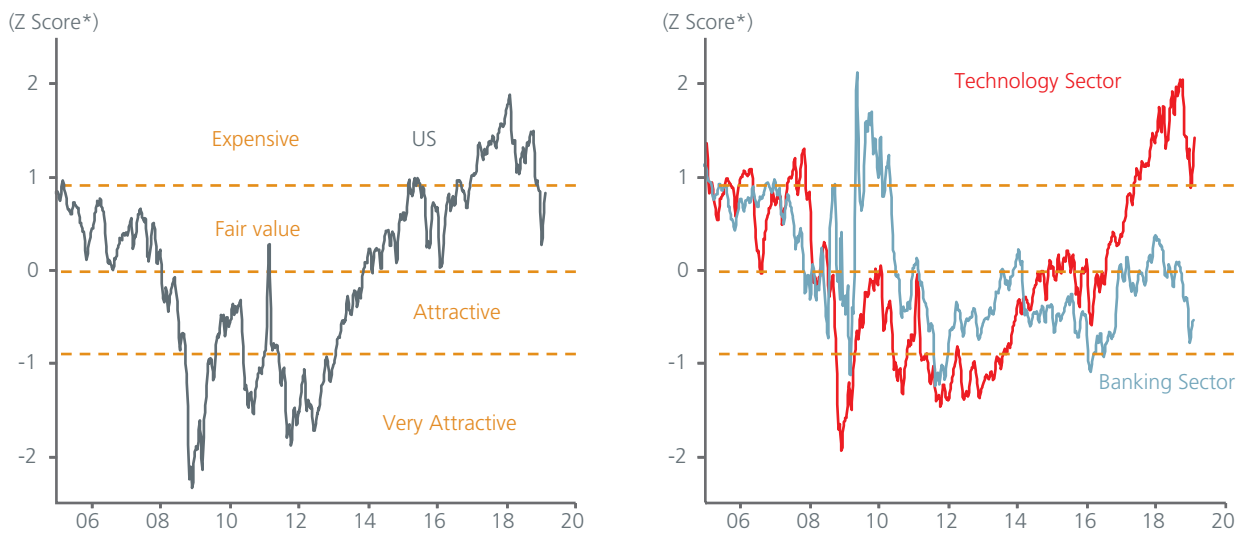
- Economic growth is forecast to be at a healthy "around trend" level[4]. Recessionary indicators are low.
- The economy is creating jobs, albeit not as many as we would like to see in the higher spending 25~54-year-old group.
- Earnings growth is forecast to be around 6%[5]. That this growth has slowed following 2018's tax cut boost is to be fully expected and perfectly healthy, in our view.
- Monetary conditions remain supportive. Investors now anticipate not only no further rate hikes but also rate cuts into 2020[6].
- US equities look cheap relative to cash and bonds In a low inflation world, equities' prospective dividend yield compares favorably with both the 2-year and 10-year benchmark yields. Equities look even more attractive when the 'buyback yield' is factored in.

While the case for US equities remains strong, we are not out of the woods yet. Trade war, China growth and liquidity uncertainties still lurk waiting to catch the unwary off-guard. Some analysts continue to shave their profit growth forecasts.

So, the roller-coaster rise is not over, it seems. But, given the still promising outlook, we're hanging tough.

We remain overweight US equities.

Fig.1: US equity valuations fall back into attractive territory[3]



Source: [1]As measured by the S&P 500 share index. [2]Based on the 12-month forward consensus price to earnings and the historical price to book ratios. [3]Eastspring Investments and MSCI from Datastream, as at 13 February 2019. *The "Z" valuation is a composite measure equally weighting the deviation of both the historical price to book and prospective price earnings ratios from their long-term trends. Around 70% of all world valuations by this measure lie within the outer dotted lines i.e. the dotted lines are based on world rather than US valuations to allow a global comparison. [4]Consensus Forecasts from Datastream as at 11 February 2019 are 2.5% and 1.8% for 2019 and 2020 respectively. [5]IBES consensus forecasts from Datastream as at 11 February 2019. [6]As suggested by the Fed Funds 30-day futures contract from Bloomberg as at 11 February 2019

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