Heartwood Investment Management

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Investment Insight

Weekly Insight

US equities: Why should investors look anywhere else?

2018 is proving to be a somewhat unusual year for equity markets. While most major markets failing to make any real headway is not so unusual in itself, the contrasting strength of the US market is of note.

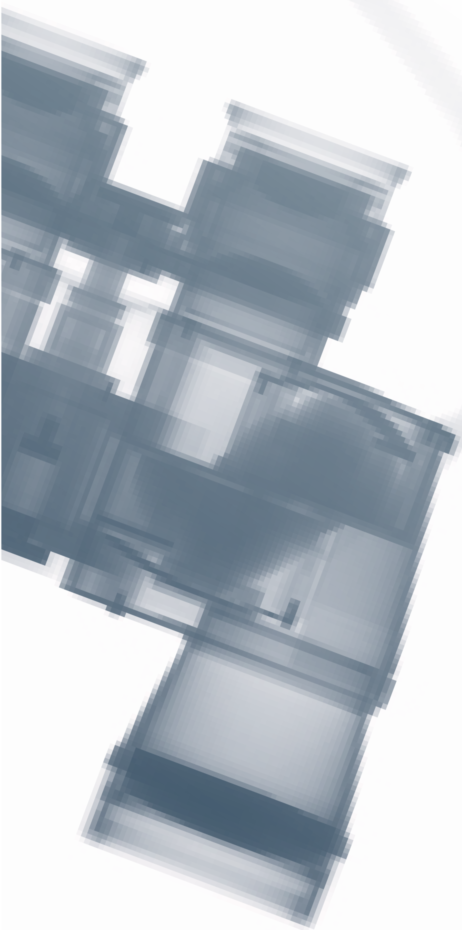
Why have US equities performed so well?

The US has driven global equity market returns almost single-handedly in 2018, and is up more than 10% for 2018 so far. It has been even more rewarding (almost 15%) for sterling-based investors, thanks to the translation effect of a stronger dollar and a weaker pound.

US equities have risen markedly since May onwards

S&P 500 performance index, 2018

Source: Bloomberg Past performance is not a reliable indicator of future results.



Though the US stock market began the year as one of the most expensive among its large developed world peers (a feature of the shape of the market and its exposure to large successful tech firms) a number of key factors have combined to push the market still higher. Most of this outperformance has come from May onwards, with President Trump's tax cuts providing a sugar rush to US businesses. In turn, this has supported already elevated merger and acquisition activity, as well as continued share buyback activity as companies have repatriated overseas cash holdings.

Even setting Trump's tax cuts aside though, the US economy has shown robust economic growth this year. This week, the Bureau of Economic Analysis confirmed second quarter GDP growth of above 4% (annualised) – the highest rate in four years. What's more, while non-US investors can be unnerved by the apparently expensive nature of US equities, US investors themselves tend to be very focused on their domestic market, further supporting its higher price tag. Poor returns in 2018 from overseas investments for US-based investors can prolong this bias.

Little surprise, then, that the degree of US exposure has been particularly relevant to investors' equity market returns in 2018 so far. Within our own strategies, US equity positioning has been broadly neutral over the course of the year, with tilts to the growth potential offered in areas like biotechnology and oil and gas exploration. This places the US among our largest regional exposures, second only to the UK. Our neutral stance reflects the supportive factors of US growth, the tax stimulus and strong corporate profits, which we believe should carry the market forward for the time being. However we have an eye to high US equity market valuations and are watchful of the relative attractiveness of other markets as they lag this US outperformance.

Clear Thinking

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Where else can investors look for potential returns?

Over the course of 2018 so far, other equity markets around the world have been somewhat subdued, pressured by a range of challenges, both economic and political. Ongoing Brexit concerns have dominated sterling, with the currency serving as a barometer for market sentiment, while European equity markets have been affected by issues in Turkey and in Italy. The US-China trade dispute has held back Chinese equities (and has adversely impacted Asian markets more broadly), while a stronger US dollar has proven problematic for emerging market equities in general.

While it is clear that US equities have been the star of the show so far in 2018, we believe there are opportunities to be found among the other players on the stage. Markets outside the US have been fretting about a number of possible issues, and should this continue are likely to mask genuine investment potential in the process.

For example, more accommodative policies and a depressed stock market have led us to believe in a growing opportunity in onshore Chinese equities, while cyclical underperformers in European stock markets make this a contrarian call. The biotechnology and oil and gas exploration themes we are playing across portfolios are also seen as offering attractive potential relative to more buoyant parts of the US equity market. Put simply, while the US has deserved its starring role in 2018, investors should not think of it as the only show in town.

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