Schroders Outlook

2014: US Equities

Joanna Shatney, Head of US Large Cap Equities

- Shares have rebounded off low levels but do not look overvalued
- US companies are well positioned to deliver earnings growth next year
- The equity market offers secular growth, with large cap returns of up to 15% possible in 2014, and potentially less volatility than other markets.

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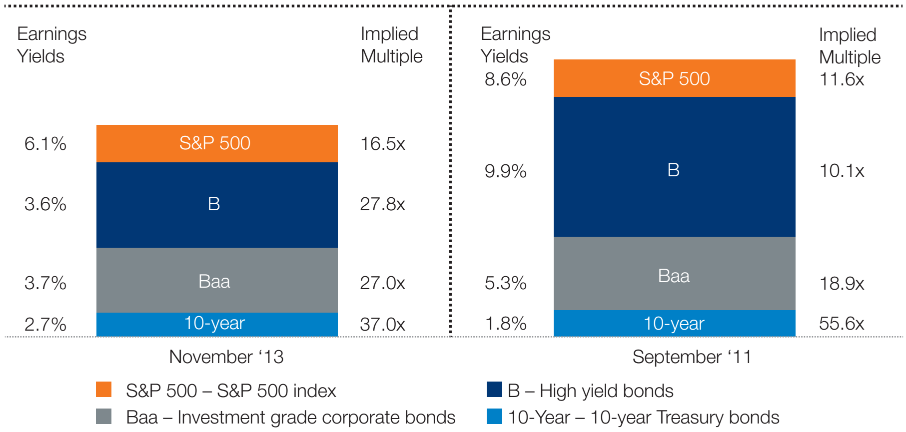
A stockpickers' market

We expect 2014 to be a stockpickers' market for US equities. Slow but positive growth should help active managers outperform, particularly as the 'wall of worry' over the economy and financial system is much smaller today than it was a year ago. Actions from the Federal Reserve (Fed) and other central banks could undermine this view, but we believe that, in a slow growth environment, separating the winners from the losers will be the key to outperformance in US equities in 2014.

While we are not value based investors, it is important to continue to point out that, despite the recent rise in the market, US equities still look very inexpensive relative to bonds (chart 1). Indeed, if bond returns turn negative – as they may next year – we expect equities to benefit. Moreover, given the more defensive growth characteristics of the US economy, companies in the S&P 500 index offer significant value compared to other developed equity markets (chart 2). The bears are arguing for 1%-2% GDP growth, while bulls are looking for over 3%. We think that, coupled with an accommodative Fed, both scenarios are positive for US Equities.

Chart 1

Bond Yields and Corresponding Multiples



Source: Federal Reserve, S&P, Moody's, BofA-ML, Thomson Financials, Haver and UBS, as at 20 November 2013.

Chart 2

Current P/E Ratios Compared with 20-year Average in Key Stockmarkets

October 2013	P/E	Normalised relative to 20-year history*	Rank
Japan	17.0	-1.19	1
US	16.6	-0.63	2
UK	16.7	-0.17	5
Europe ex-UK	21.1	0.01	6
Pacific ex-Japan	16.0	-0.23	4
EM	12.4	-0.37	3

Source: Bloomberg, Thomson Datastream, Schroders estimates as of 31 October 2013. *For data where duration is less than 20 years, it has been normalized. Data shown for illustrative purposes only and should not be viewed as a recommendation to buy/sell.

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Joanna Shatney
Head of US Large Cap Equities

Joanna joined Schroders' US Equity Team in 2005. She has managed Schroder International Selection Fund US Equity Alpha since launch. Prior to joining Schroders, Joanna worked as an equity analyst at Goldman Sachs, covering the machinery sector.

Her investment career began in 1995 when she joined Capital Investments International as an associate in the research team. She received a Bachelor of Science in Business Administration from American International College.

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Potential for double-digit equity returns in 2014

Our base case is for 8%-10% earnings growth and modest multiple expansion, implying a 10%-15% overall return for large capitalisation US equities in 2014. While this would represent a more modest return compared with the 26% or more we have seen thus far in 2013, we believe it means the US offers a significantly better risk/reward balance than other developed equity markets.

The market's main impetus will be a continued modest rise in GDP, which should translate into a 4%-5% increase in corporate sales growth. Along with a greater impact from margin expansion than in 2013, this should feed through to 6%-7% rise in operating earnings, with a further 2%-3% earnings growth coming from cash redeployment.

We disagree with the prevailing view that margins won't move higher. It is true that they are close to their peak for companies in the S&P 500 as a whole but, looking across sectors, we see room for further margin improvement. We believe that improved cost controls, increased pricing power, and the ability to spread operating costs across higher sales could enable companies to drive margins above their previous peak.

As for cash, while companies' cash balances are also at all time highs, spending in areas like dividends, share repurchases, and mergers and acquisitions (M&A) is still at very low levels. We think cash redeployment in 2014 will help differentiate stock returns, with activism providing an additional catalyst for companies to redeploy cash.

While the market is no longer as cheap as it was two years ago, we think the fundamentals continue to support current valuations. History suggests that earnings multiples similar to those seen today have generally led to double-digit returns for the S&P 500 over the following 12 months (chart 3). If we are right that earnings growth for next year might surprise on the upside, the market could easily outpace our low double-digit return forecast.

Chart 3
Initial Price-Earnings Ratios and Subsequent 12-Month Returns For US Equities

Forward P/E	<10x	10X -12X	12X -14X	14X -16X	16X -18X	18X -20X	20X -22X	>22X
Average return	15%	14.7%	12.6%	12.5%	9.9%	8.8%	5.4%	3.5%

Source: Goldman Sachs data from 1976 to 31 October 2013.

Outperforming companies set to shine

However, given our view that economic growth will be modest, we believe investors will need to be selective. The stocks that will outperform next year will either be companies that can outperform on the top line – companies that are already garnering a premium – or companies that will deliver earnings per share outperformance by driving margins higher or redeploying cash in the form of dividends or share repurchases.

We do not foresee big domestic economic and political risks next year. It is our belief that the proximity and importance of the elections in the third quarter will ensure there is no re-run of the political manoeuvring over the budget that we saw in 2013. Our biggest worry is the threat of a shock from outside the US, such as a monetary policy mistake, given the prominent role of central banks globally. In the US, we continue to believe that the Fed will be accommodative, though the bond markets could test the resolve of its Chairman-elect, Janet Yellen, in early 2014.