This is for investment professionals only and should not be relied upon by private investors

PERSPECTIVES

APRIL 2014

The strength of the US resurgence will surprise investors

Some investors are beginning to question whether the US economy and stock market can continue to provide leadership to global equity markets after a strong run during which valuations have rerated.

In my view, the answer is a firm yes. While the US economy has had a subdued start to 2014, I believe the strength and duration of its resurgence will surprise investors. Market volatility remains anchored, valuations are not expensive and profits can move higher despite concerns over 'peak' profitability. With the prospect of supportive liquidity conditions, I believe a return to the 'cult-of-equity' can support a multi-year bull market in stocks.

DOMINIC ROSSI is Global Chief Investment Officer, Equities at Fidelity Worldwide Investment.

AT A GLANCE:

- A multi-year bull market in US equities and a return to the cult of equity
- Obama will end his term with a fiscal surplus - capital will flow to equities not the government.
- US profit margins can go higher, providing support to share prices
- A correction due to rising rates would be a mid-cycle buying opportunity
- We could see the S&P move to 2000-2300 in this multi-year bull market.

ANCHORED VOLATILITY IS ALLOWING VALUATIONS TO EXPAND

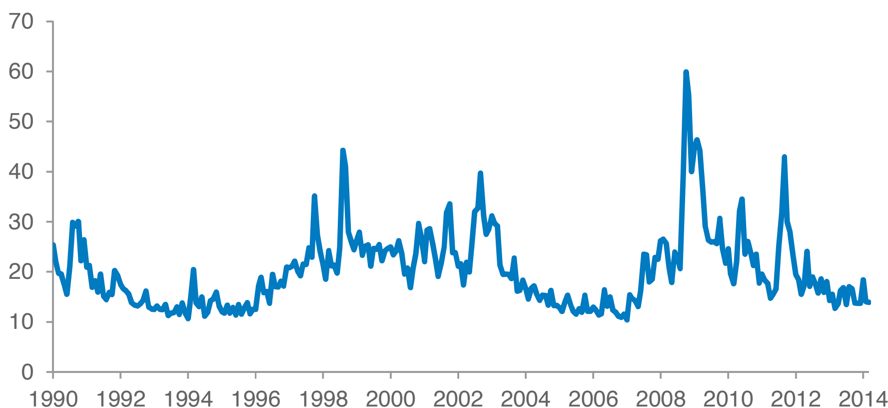
It has been a solid first quarter for equity markets after a strong 2013. The resilience of markets has been particularly impressive given they had ample opportunity to take fright. Despite uncertainty over the crisis in Ukraine and the fact that US growth was weak (largely due to bad weather), equity markets have shrugged off these issues. Notably, although there was enough reason for investors to sell, it was striking how resilient equity markets proved to be and how contained volatility stayed during this period.

I believe equity market volatility is being anchored at low levels by confidence in the positive structural outlook for the US economy. When implied volatility (VIX) falls below 20 (its long-term average since 1990), we have a favourable environment that allows valuations to expand. Lower volatility was a pre-requisite for the rerating in markets that we saw in 2013 (since when volatility has averaged 14.3). While many investors got used to elevated volatility through 2008-12, I believe volatility can stay low for a sustained period, much like it did in the 1990s. Investors should be wary of only looking at the recent past.

In terms of what might trigger volatility, the interest rate cycle has become the key focus. US Federal Reserve president, Janet Yellen recently let slip at a press conference the phrase "6 months" in response to how soon the interest rate cycle could start after tapering is completed. While there was a small spike in volatility and equities fell on the news, there was no reaction from US 10-year Treasuries, indicating the lack of concern among bond investors about inflation risk. Inflation is extremely benign with little prospect of pressure building. Tapering is now well understood and Yellen is doveish on the US unemployment market, so I think we will continue to have a supportive Fed.

Volatility is anchored again like it was for much of the 1990s

CBOE Volatility Index (VIX)



Source: DataStream, CBOE Volatility Index (VIX), 30.03.2014

A RESURGENT US WILL CONTINUE TO LEAD GLOBAL STOCK MARKETS

In the US, I feel the news is only going to get brighter – I think we are at an inflection point in the US economy. I am not convinced the market is fully recognising how rapidly the US economy is strengthening. The data is improving across the board, whether it is loans data, manufacturing PMIs, services PMIs, or consumer confidence data. US growth is going to surprise on the upside and we will be discussing 3% plus growth again.

The speed of the improvement in the budget deficit is remarkable. Since 2009, the fiscal deficit has shrunk to around $600 billion from $1.5 trillion. It is not implausible that President Obama will finish his term with a fiscal surplus. In which case, I think we are looking at a US equity market that is similar to the late 1990s (when we had the Clinton fiscal surplus), where equities should be well supported by liquidity. When a government has a surplus, domestic savings flow to the equity market allowing valuations to rise. As a result of this supportive liquidity, I think we could see the cult of equity return and ultimately, certain sectors and stock markets may well become expensive.

In terms of other geographies, most emerging markets have their structural problems in front of them. There will be a significant bifurcation of performance between emerging markets which argues for active, discriminating investment strategies. Those economies responding to their structural challenges, such as China, are the key markets to focus on. European economies and markets still face real headwinds, despite the improvement we have seen in investor sentiment. Meanwhile, the UK has some political issues to work through and Japan has to deliver on structural reform amid its own political inertia.

VALUATIONS AND EARNINGS CAN GO HIGHER

Equity markets are no longer cheap, but nor are they expensive either. In the US market, we have a slightly unusual situation in earnings expectations at present. Usually, we start the year with high and unrealistic earnings forecasts which have to be revised down. The opposite is the case this year and we are likely to have a strong earnings season versus subdued expectations.

Beyond that, it is prudent to consider the standard counter-argument to the buy case for the US, which has lately become commonplace. This argument points out that the US is on a PE of 16 times yet corporate profitability is at record highs. And if we cyclically adjust for peak profits, then the PE is 22 times. Given that we are approaching an interest rate tightening cycle, the argument is that this makes the US market a sell.

This is naïve in my view. Profit margins may well be at record highs, but I think they can move higher. I think the distribution of profits between capital and labour in the US is going through a fundamental shift. I don't see why margins need to mean revert; for this to happen, labour's share of profits would have to move higher and unless we go back to highly unionised workforces, which is unlikely, profits are going to remain at high levels.

There are a number of reasons why profit margins can stay high, such as the globalisation of labour forces, less organisation of labour, technological change and the ability of markets to press companies to focus on profit margins in a way that just didn't happen 30 years ago. Clearly, if labour's share of profits was to fall further, we could expect to see some political pressure. Overall, however, I think the outlook for corporate earnings remains favourable. Combined with healthy liquidity, these two drivers should sustain a multi-year bull market in US equities.

FINAL THOUGHTS

I believe the US market is going to break out strongly on the upside from its current period of consolidation. With compressed yields on US and Euro credit, equities will look attractive versus credit as earnings come through. The danger in my view is that US equities have a too-strong rather than a too-weak a year, given the positive outlook for both liquidity and earnings.

It is evident that some investors have been left a little traumatised by the bear market in equities and are still relatively fearful. However, in my view, we are in the midst of a bull market and in a bull market you buy the dips. In this light, if we get a mid-cycle correction based on the expected onset of the interest rate tightening cycle in 2015, then this would be a buying opportunity. I believe the S&P 500 could move to 2000-2300 from its current level of 1,800.

Important Information: This information is for Investment Professionals only and should not be relied upon by private investors. It must not be reproduced or circulated without prior permission.

This communication is not directed at, and must not be acted upon by persons inside the United States and is otherwise only directed at persons residing in jurisdictions where the relevant funds are authorised for distribution or where no such authorisation is required. Fidelity/Fidelity Worldwide Investment means FIL Limited and its subsidiary companies. Unless otherwise stated, all views are those of Fidelity. Fidelity, Fidelity Worldwide Investment, the Fidelity Worldwide Investment logo and F symbol are trademarks of FIL Limited. Fidelity only offers information on products and services and does not provide investment advice based on an individual's circumstances. Past performance is not a reliable indicator of future results.

Issued by FIL Investments International (FCA registered number 122170) a firm authorised and regulated by the Financial Conduct Authority. FIL Investments International is a member of the Fidelity Worldwide Investment group of companies and is registered in England and Wales under the company number 1448245. The registered office of the company is Oakhill House, 130 Tonbridge Road, Hildenborough, Tonbridge, Kent TN11 9DZ, United Kingdom. Fidelity Worldwide Investment's VAT identification number is 395 3090 35.

Fidelity™
WORLDWIDE INVESTMENT

IC14/28