

## Look through the turmoil and see the attractions of the world's largest market

### AT A GLANCE

- Fears that troubles in the eurozone will impact global – and US – economic recovery have hit global equity markets
- The US recovery appears resilient and on track to continue regardless of a slowdown in Europe
- Companies cut costs aggressively in the downturn and are now well-placed to grow earnings rapidly as the recovery gathers pace
- The breadth and diversity of the US equity landscape ensures attractive stocks can be found, playing both domestic recovery prospects and enjoying profit growth driven from overseas exposure
- Foreign investors in US assets will receive a further boost as the dollar strengthens as a safe haven amid global volatility

*“There is nothing wrong with America that cannot be cured by what is right with America.”*

Investors may be wise to consider the words of Bill Clinton in his inaugural address in 1993 as they ponder the state of the US economy and equity markets today. The drama may have been unfolding thousands of miles away, but US equity markets have still been rocked by the sovereign debt crisis in Europe. The S&P 500 has retrenched more than 10% from its April high\* and implied volatility, in the shape of the VIX, has almost tripled over the same period. There is a noticeable aversion to risk once more.

At times of uncertainty like these, it is inevitable that some investors will prefer to exit equity markets. However, now may not be the time to sell out of the US. In fact, there are good arguments for investing in what is still the world's largest economy and most influential equity market.

### ON THE ONE HAND, A PIIGS EAR...

The troubles facing the eurozone could undoubtedly affect the US recovery. On one level, US financial institutions are exposed to the eurozone debt markets and will have to reflect weakening asset quality and capital positions on their balance sheets. However, a recent federal report suggests that there are only ten large banks with exposure to peripheral European sovereigns and their balance sheet exposure of \$60 billion represents only 9% of their tier 1 capital – so arguably there is not much cause for concern on this front. Exposure to the wider eurozone economies, however, would be much larger and so persistent uncertainty surrounding the strength – or ongoing viability – of the euro may exact a greater toll on the financial sector. Nevertheless, US institutional balance sheets are now in a much stronger state to weather such risks, having raised significant equity over the past year.

However, a heightening of financial stresses in Europe could be transmitted to financial markets globally and may deter some US financials from lending once more, just as they did in the aftermath of the Lehman Brothers collapse. This could jeopardise the domestic US economic recovery at a time when it is beginning to gain traction.

A further threat to the economic recovery arises from the fact that a deterioration of the European economy would have consequences for global trade. Europe is an important trading partner for the US but even a reduction in trade amounting to 20% would only reduce US GDP by around 0.3%. The greater risk exists if a deep contraction in European demand has the potential to stall the recovery of the wider global economy. That would have more profound consequences for US trade and economic growth.

However, much of this presupposes that Europe fails to effectively tackle its debt crisis. The eurozone is arguably “too big to fail”. European GDP is likely to slow while adjustments are made within the eurozone economies but that doesn't mean it will be enough to derail the global recovery.

### ...ON THE OTHER, A SILK PURSE

So what of the US recovery as it stands today? It looks to be on a healthy growth trend once more. First quarter GDP grew at an annualised rate of 3.2% as consumers increased spending and industry continued to retool. The economy has now grown for three quarters in a row.

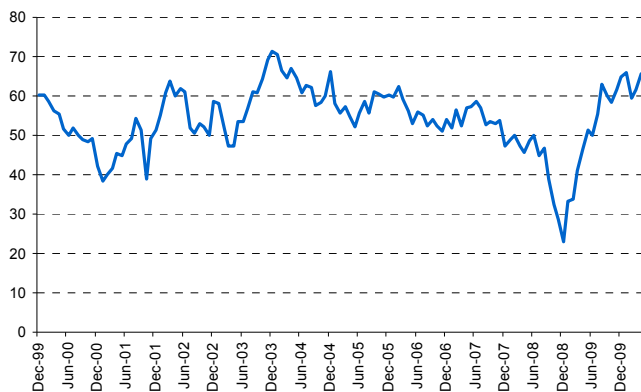
Driving the initial recovery was the rapid rebuilding of inventory slashed in anticipation of a much deeper recession than the one that arose. Now, capacity utilisation has rebounded to the highest level since November 2008 and industrial production is also expanding. Confidence is increasing as demand is expected to not just hold up, but grow. In anticipation of this, business inventories in March showed the sixth consecutive month of increase. The ISM Manufacturing Survey New Orders reading is now at its highest in more than five years.

Outside of the manufacturing sector, it's just as encouraging. Retail sales rose 0.4% in April, with upward revisions to both the March and February data. With consumer spending accounting for around 70% of US economic activity, more dollars being spent on Main Street is a big step towards a sustainable economic recovery.

Consumers may have good reason to be more willing to spend. Even though the recent new claims data might point to some uncertainty, the employment picture in the US is improving. The May ISM non-manufacturing payrolls came in at the highest level since 2005, while the employment components of both the manufacturing and non-manufacturing surveys continue to suggest things are getting better. Hours worked are also starting to increase after a period of decline during the recession.

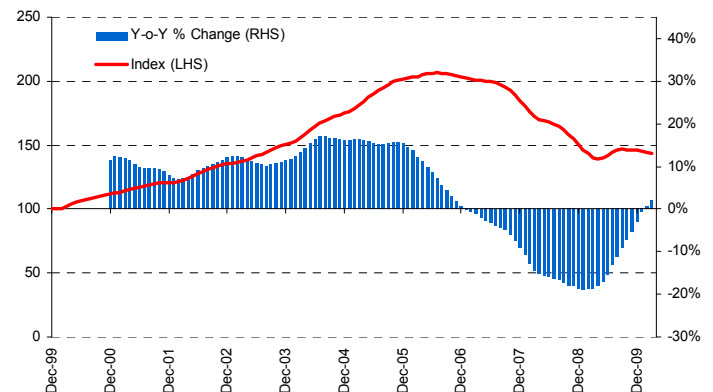
The residential property market is also seeing an improving trend, with both the S&P/Case-Shiller and median existing house prices posting year-on-year increases. Housing affordability is at, or near, an all-time high and mortgage approvals are on the up. If the employment situation can be sustained, that will create a further support under house prices. With the housing market central to the recent recession, rising house prices afford a psychological boost to the consumer through a recovery in their perceived wealth.

**ISM MANUFACTURING SURVEY NEW ORDERS**



Source: Datastream, 30.04.10

**S&P/ CASE-SHILLER HOME PRICE INDEX – 20 CITY COMPOSITE**



Source: Datastream, 30.04.10

## THE RECOVERY OF CORPORATE AMERICA

With the economy showing signs of life, corporate America looks in good shape too. When the recession took hold, US companies responded swiftly to cut their cost base. They were much more responsive to the crisis than their European counterparts. They reduced operating costs more than at any time in the past fifty years in order to preserve cash flows and margins. Consequently, firms have become more productive, are leaner than ever before, and are better placed to enjoy significantly higher levels of profitability as the economy recovers. While cost-cutting drove profit growth through the early stages of the recovery, now top line improvements are being seen as well.

With companies being more operationally geared towards a pick up in demand after cutting so much cost, most have exceeded analysts' expectations in Q1. Corporate operating profits rose 51% in the first quarter of this year, compared to an estimated 33% profit increase expected by a consensus of Wall Street analysts. Revenue growth – a key factor in gauging the underlying strength of the economic recovery – accelerated to 11% in Q1, from 6% in Q4 2009, marking the second straight quarter of overall sales growth. The year-on-year improvement in earnings is made much easier by the fact that last years' numbers were so poor and government stimulus will have had some effect that may not be repeated in the future, but profit growth has nonetheless been exceptionally strong and offers a good deal of support to the market.

These good numbers are also buoying confidence in management. More companies are now raising their earnings guidance for the year. Through the first four months of 2010, about 100 more companies (on average) have revised their future profits higher than those lowering guidance, compared to the same period in 2009 when about 300 more companies (on average) had projected declining profitability. Again, higher expectations for future earnings are likely to bode well for the direction of equity markets. The market is, after all, a discounting mechanism of future earnings.

## RICH PICKINGS AT HOME BUT ALSO ABROAD

For these reasons, the US market still looks attractive, therefore. What happens when you consider the US in the context of the rest of the world?

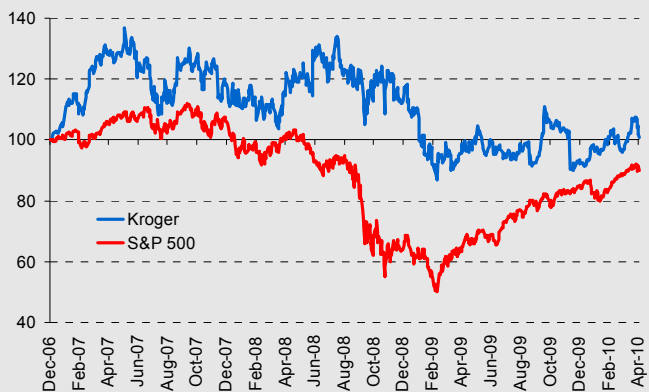
For much of the 20<sup>th</sup> century, the US provided the world with economic leadership and it is one of the most competitive markets in the world. The 'American dream' drives a great entrepreneurial spirit which, in turn, shapes an equity market with greater breadth and depth of opportunity than anywhere else. No other market has the same variety of stocks and sectors accessible through the private sector. That means that, at any point in time, there will always be fundamentally sound opportunities available to an active stock picker. Some play to the home market, others to an international audience.

The dominant role of the US is changing as the world becomes increasingly 'multi-polar' and the growth of emerging powers, especially India and China but also Brazil and Russia, is challenging the traditional uni-polar model based around the US as a single 'superpower'. At first glance, investors might think the shift in the global economic landscape looks like bad news for US companies but, in actual fact, it has the potential to be highly beneficial.

Ultimately, it means new markets and significant numbers of new consumers for US companies, many of which are established market leaders with global brands (eight of the top ten world brands are US companies) that are making significant inroads in emerging markets. Asia's rising middle class is thirsty for US brands as it begins to play catch up. US companies such as Nike, Intel, Coach, Buick, Coca Cola and McDonalds already have a strong foothold in Asian markets. For the companies that manage to establish themselves as a desirable brand in Asia, the growth potential through servicing more than two billion consumers is enormous.

### AT HOME...

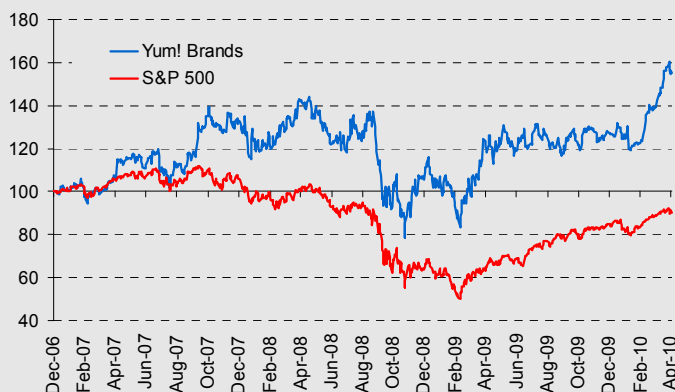
During the economic downturn, consumers have tended to migrate towards more price-competitive stores. An obvious beneficiary of that trend has been retail supermarket chain **Kroger**. 2009 sales rose to \$76.9 billion, up 2.1% on a like-for-like basis. That may not sound much but the company has grown market share during the recession.



Source: Datastream, 30.04.10. Share price total return in USD

### ...AND ABROAD

**Yum! Brands** operates fast food franchises for Pizza Hut, KFC and Taco Bell. Despite being a US company, Yum! Brands' fastest growing market is China. In 2009, operating profit for its China division was \$602 million (33% of the company total, up from 2% in 1998) and more than 500 new restaurants were opened last year in mainland China.



Source: Datastream, 30.04.10. Share price total return in USD

## DOWN BUT NOT OUT

All this shines a positive glow around the US but there is no escaping the fact that the market has corrected and that has unnerved investors. From its low-point on 9 March 2009 to its recent peak on 24 April 2010, the S&P had gained 80%. It's lost more than 10% since then.

The market correction may have felt severe because of its speed but its depth and timing is pretty typical of what's gone before. Analysis of the US market since 1928 shows that the first correction in a new bull market has, on average, come after a 57% gain and has resulted in a 12% decline. 80% up on last year's low, it would imply that this bull market was overdue a correction and, at a little more than 10% so far, it looks to be following past trends. Likewise, corrections have come, on average, 17 months on from the start of the bull market. April's high came in just shy of 14 months after the start of this bull market. Perhaps it would have been more worrying if the bull run continued unabated, pushing higher highs and richer valuations across the board. Then, it might have become much harder to justify further equity investments in the US market.

## THE DOLLAR DILEMMA

One consequence of growing risk aversion is appreciation of the dollar. The greenback is still the world's reserve currency of choice and is seen as a safe haven, more so since much of the drama is taking place within the confines of its challenger currency, the euro. While an appreciating dollar may stifle the US export market to some extent, it is good for foreign investors holding dollar assets. Their investments become more valuable when translated back into their local currency. That benefit should not be overlooked.

The negative comment about exporters is, moreover, a sweeping statement and doesn't perhaps reflect the true situation. The strength of the dollar may indeed be reflected in weaker sales for exporters if goods are headed to a country where there isn't any form of dollar peg in place. US goods will be more expensive for European and UK consumers but we mentioned earlier how small an impact on US GDP a slowdown in the eurozone would have.

Meanwhile, back in the US market, manufacturers will come under increasing competitive pressure from cheaper imports. But what's bad for some manufacturers could work to the benefit of retailers, many of whom source their goods from abroad. US retailers could see a margin boost as their costs come down.

What's more, many major markets for the US do carry some sort of dollar peg and so the currency movement in response to the European crisis is less of a competitive issue. Several Asian economies peg their currency to the greenback, for example. With government stimulus plans across Asia still to be deployed, just as they are in the US itself, this sets a favourable backdrop for companies in the capital goods business. Many US companies will, therefore, still be able to take advantage of the recovery in Asian and emerging markets by exporting their expertise to these nations. After all, the emerging markets story is not just about making investments directly in those markets as noted earlier in the case of Yum! Brands.

## CONCLUSION

One of the most common mistakes many investors make when they invest in equity markets is to buy when times are good and markets are high only to be shaken out in uncertain times when markets are lower. Investors should be prepared to ride out these fluctuations and take a longer term view. Sometimes the noise in the market can hide what's really going on. The fall in US equity markets has not been driven by causes local to it. Yes, we live in a globalised world but we live in one that is much stronger than it was in 2008 and in a better position to respond appropriately to the repercussions from the eurozone debt crisis. It need not derail the global recovery and need not derail the US recovery.

Corporate America has emerged stronger from the recession. It is leaner and more ready for business than ever before. That creates a positive starting point, even in the face of market volatility. The breadth of investment opportunity in the world's largest stockmarket is second to none. That creates unparalleled opportunity for investors to find undervalued investment opportunities. Investors still flock to the dollar as a safe haven at times of uncertainty. That creates an opportunity to benefit indirectly from the appreciation of dollar assets. There really are many reasons why the US market is still the one to watch – and the one to own.

## Disclaimer

This document is prepared by FIL Investment Management (Singapore) Limited ["FILS"] (Co. Reg. No.: 199006300E), a responsible entity for the fund(s) in Singapore. All views expressed cannot be construed as an offer or recommendation. Prospectus for the fund(s) is available from FILS or its distributors upon request. Potential investors should read the prospectus before deciding whether to invest in the fund(s). Reference to specific securities or fund(s) is included for illustration only, and should not be construed as a recommendation to buy or sell the same. This document is for information only and does not have regard to the specific investment objectives, financial situation and particular needs of any specific person who may receive it.

Potential investors should seek advice from a financial adviser before deciding to invest in the fund(s). If that potential investor chooses not to seek advice from a financial adviser, he should consider whether the fund(s) in question is suitable for him.

Past performance of the manager and the fund(s), and any forecasts on the economy, stock or bond market, or economic trends of the markets that are targeted by the fund(s), are not indicative of the future performance. Prices can go up and down. The value of the shares of the fund(s) and the income accruing to the shares, if any, may fall or rise. Investors investing in fund(s) denominated in a non-local currency should be aware of the risk of exchange rate fluctuation that may cause a loss of principal when foreign currency is converted back to the investors' home currency. Exchange controls may be applicable from time to time to certain foreign currencies.

Fidelity, Fidelity International and Fidelity International and Pyramid Logo are trademarks of FIL Limited.SG10/248.

