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GLOBAL ASSET MANAGEMENT

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ASIA CONVERSATION

This week we catch up with Kathleen Anderson, Director at Legg Mason affiliate, ClearBridge Investments. Based in the US, she covers US equity strategies and has over 20 years of investment industry experience.

Key Takeaways

1) The US economy is overwhelmingly firm but keep an eye on the yield curve and money supply.
2) Domestic fiscal stimulus outweighs the burden of global trade tariffs for US companies.
3) Valuations of Energy and Healthcare sectors are attractive, but Technology looks extended.
4) Active management will play an increasingly more important role when the crowded trades of ETFs unwind.

Q1) How do you assess the current US economic environment? Do you see any vulnerability?

We continue to see strength across the broad economy. Unemployment is at decade lows, wages are picking up and companies are experiencing rising operating profits. A quarter ago, we were concerned that operating profits might dip but companies (large and small) have done well from a topline perspective and not just boosts from tax cuts or repatriated profits. We also see rising wages translating into increased productivity lending a good measure of support to higher profitability.

However, to be even keeled, we have an eye on the spread between the yields of the US 10 year and 90 day Treasury. The flattening and the inversion using the yield differential between these two instruments have been highly accurate leading up to the last seven recessions. Another issue that could complicate the on-going strength is the gradual reduction in money supply through balance sheet unwinding and the raising of interest rates. Both of which have been very well communicated but could nonetheless depress corporate activity and weigh on investor sentiment.

Q2) Is the trade war going to disrupt US economic strength?

The back and forth between the two countries are distracting investors from what is actually being enacted. Our calculations indicate that there is currently 138 USD billion worth of tariffs (announced and enacted) that US companies will have to bear. However, that figure is dwarfed by the fiscal boost the US is currently and will be experiencing. It started with the 200 USD billion corporate and personal tax cuts, followed by a 100 USD billion spending bill. The largest chunk of the fiscal boost has actually come from repatriated profits. As of the second quarter, the US Bureau of Economic Analysis reported about one-fifth of the estimated 3 USD Trillion has been on-shored. This has resulted in more tax collected by the government, a wave of increased corporate capital expenditure and a second order effect of higher disposable income for consumers. If we put it all together, the fiscal stimulus far outweighs the burden of US tariffs on domestic companies **[CHART 1]** .

Q3) What are favourable sectors in the current environment?

Amongst prospective sectors, Energy and Healthcare companies stand out. Energy companies have not tracked the rise in the commodity's price in recent times, creating a disconnect that we can exploit. A reason for that uncoupling is that energy companies have become more frugal and are living within their means. It is only until recently, that you see more activity in terms of exploration and production. Healthcare is still trading at a relatively attractive discount to the market. Within Healthcare, there are sub-sectors with cheaper valuations that can also be found. The growth focus of investors has left the sure-footed but "boring" healthcare companies behind but as valuations begin to widen, investors might take a closer look. Additionally, the biotech area could be ripe for further consolidation as larger companies seek external sources to increase niche expertise, grow and diversify revenue lines. Certain parts of the technology sector (some names will soon be reclassified Communications Services) look the least attractive not because they have poor business models, but the extended valuation makes it relatively unattractive when compared to the likes of Energy and Healthcare.

Q4) As ETF providers lower fees to attract flows, why should investors still consider actively managed portfolios?

Passive investing has definitely enabled more market participation by retail investors. However, because of the nature of these vehicles, you get the majority of the market chasing a very narrow breath of holdings, creating extended valuations and crowded trades. The concept of the future value of a company also gets muddled when flows push the company prices too high, too quickly. An active investment process can identify growth leaders and who are not yet appreciated by the market. As we mature in the economic cycle, an increase in volatility could make sell-offs more violent. Hence when the crowded trade eventually unwinds, an actively managed portfolio could benefit from redirected flows and also have the ability to re-evaluate buying companies who were once too expensive.

Source: Legg Mason, Clearbridge Investments, as at 27 September 2018. All data and estimates as at 31 August 2018 unless otherwise stated.

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CHART 1: Fiscal stimulus outweighs trade concerns

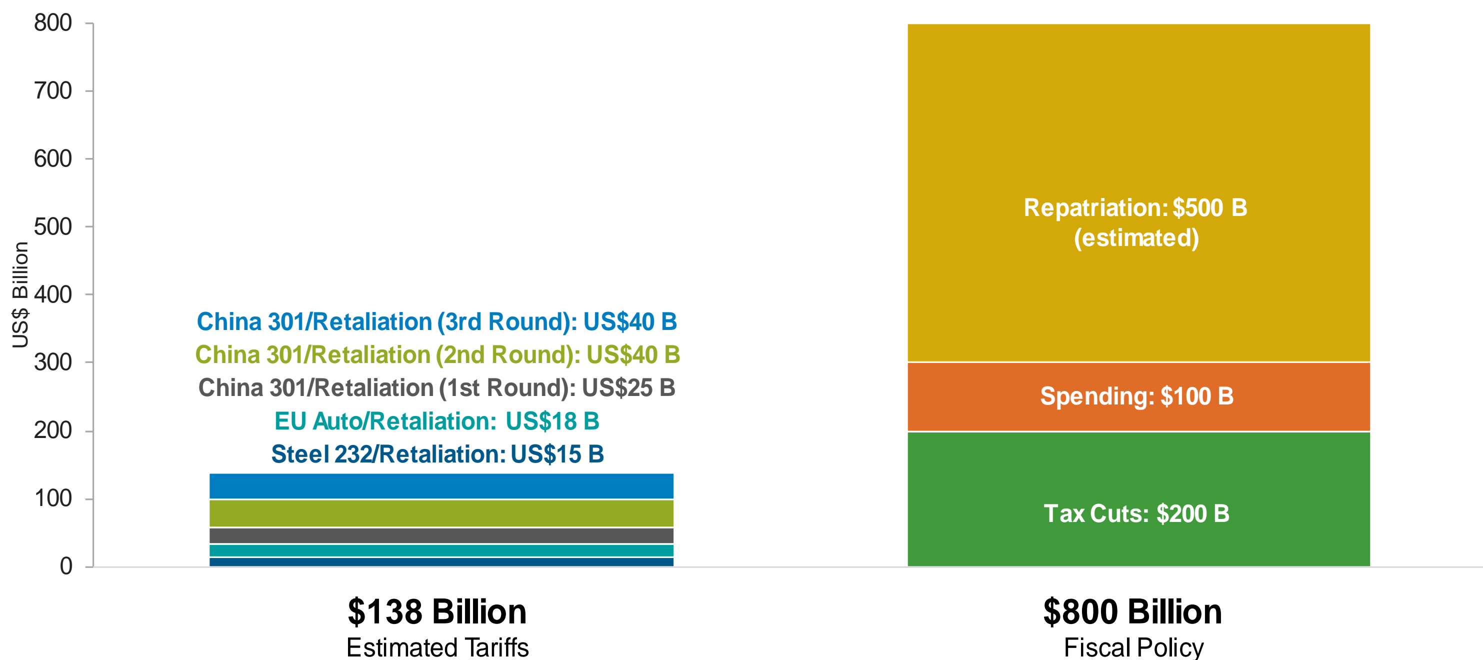

Chart Sources: Legg Mason, Strategas Research Partners, US Bureau of Economic Analysis. Data as of 30 June 2018 in US$ billions.

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