IS THE US RECOVERY SUSTAINABLE?

In recent weeks, the possible easing of monetary stimulus by the United States Federal Reserve has spooked markets and investors worldwide.

The Fed's third round of quantitative easing, also known as QE3, had led to a fresh flow of funds across the globe. Consequently, some of the best market rallies happened in the earlier part of this year.

All this came to an abrupt halt on June 19 - the day Fed chairman Ben Bernanke signalled a possible end to QE3.

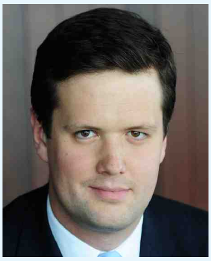
But experts say that the "tapering" of QE3 may not be altogether bad news.

"A recovering US economy is good for global growth, and a carefully orchestrated QE withdrawal is absolutely critical to ensure the fragile US recovery remains intact," says Mr Abel Lim, executive director and head of investment sales and advisory at UOB.

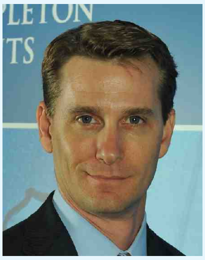
We speak to a panel of experts about how the US situation can affect your investment decisions.

THE PANELLISTS

ABEL LIM
Executive Director and Head of Investment Sales and Advisory, UOB



ANDREW WHEATLEY-HUBBARD
Vice President, Portfolio Manager, BlackRock Global Equity Team, BlackRock



GRANT BOWERS
Vice President, Franklin Equity Group, Franklin Templeton Investments

"A recovering US economy is good for global growth, and a carefully orchestrated QE withdrawal is absolutely critical to ensure the fragile US recovery remains intact."
– Abel Lim

SAM PETERS
Chief Investment Officer, Legg Mason Capital Management

BILL HENCH
Portfolio Manager, Royce & Associates

Given the timing of the Fed's announcement on QE "tapering", they seem to be a lot more confident on the state of the US economy. Are they seeing something which the rest of the market has missed?

BlackRock:
Tapering is not the same as exiting - the Fed will still be supporting the economy with QE, albeit at a slower pace, and will only taper if the economic data continues to meet expectations.

The "life-support" is still on, it is just being turned down a bit!

However, it is true that the US economy appears to be in better shape than elsewhere in the world - US equity valuations suggest that this has already been priced in so it does not seem that the market has "missed" anything.

Franklin Templeton:
The US economy has been quietly recovering for the last five years and is nearing an inflection point where we will transition from an economic recovery to a self-sustaining expansion.

As well, we believe that the impact of vast discoveries of natural gas supplies here in the US is supportive for US industrial and consumer businesses. Having this inexpensive source of energy, an important input cost for multiple industries, should allow us competitive advantages relative to our overseas counterparts.

Legg Mason:
Rising interest rates equate to a strengthening economy and this is positive for stocks. Higher rates would also have a positive effect on some of the US domestic sectors, such as community banks, which should enjoy higher profitability as a result.

Investors remain wary, despite the extraordinary market rally over much of the last four years, and investor preferences are still being dominated by the trauma of 2008. As a result, in the manager's view, investors in aggregate have set their risk profile too low.

What catalysts should we look out for?

BlackRock:
The two alternative scenarios to continuing QE, which we do not expect but are very aware of, depend on why the Fed ends the stimulus programme.

If US growth is stronger than we expect, for instance if non-farm payrolls is greater than 300,000 for several months, then 2013 will be seen as the turning point in post 2008 policy, similar to 1994.

Ending stimulus in this scenario would see the end of the bond bull market and more cyclical areas of the equity market would do well given the strength in the economy.

If the Fed pushes ahead with a QE exit despite mediocre global growth, this would be bearish for financial assets.

Our reading of Bernanke's likely policy is that, if we are wrong, the former of these two is more likely.

Franklin Templeton:
Various factors, such as higher productivity rates and low input costs, have contributed to improving corporate fundamentals which have been reflected in US companies' strong earnings results and growing cash levels. However, managements have been reticent to reinvest in their businesses.

As they gain comfort in the market environment going forward, we'll be watching for companies to allocate more capital to growth initiatives, increase research and development spending, and ultimately increase merger and acquisition activity.

Legg Mason:
Two interesting fundamental drivers of higher US rates are the bottoming in housing and low-energy prices.

When coupled with record household wealth in the US, lower commodity prices should help accelerate US growth above the 2 per cent real growth rate of the last several years.

The key metric to watch out for to gauge faster growth is US private loan growth, which is accelerating from historically low levels, and is expected to continue.

Are there any particular sectors you think should outperform, and will small cap stocks or dividend stocks outperform large cap stocks?

BlackRock:
In the low growth and volatile economies we expect, high-quality companies that can deliver sustainable and growing dividends will offer better returns and capital protection than broader equity exposure.

BlackRock Global Funds Global Equity Income Fund looks for companies with the ability to price strongly, defend margins and return cash - these are found across a range of sectors and market sizes - it is really a bottom up process.

Franklin Templeton:
We've been finding opportunities in the financials, materials and technology sectors.

In the financials sector, for example, we have invested in leading global banking franchises that are levered to increased lending and growth in consumer spending.

In the materials sector, we have found opportunities in the chemicals space. Hydraulic fracturing and shale natural gas discoveries have reshaped the energy markets, leading to structurally low natural gas prices. This is contributing to the often mentioned US manufacturing renaissance, especially for chemical companies which use natural gas to develop their products.

Within the technology sector, we've identified a few areas that we think offer strong growth potential in light of the shift toward cloud computing and consumer driven technology. One of these areas is consumer technology, such as Internet services.

Legg Mason:
The manager for the Legg Mason Capital Management Value Fund has avoided the relatively expensive defensive cash flow sectors that are likely to be pressured by a shift to higher rates, such as staples, utilities and telecoms. Conversely, the fund is overweight in cheap cyclical sectors, and especially financials, which should benefit from higher interest rates.

Royce and Associates, the manager for the Legg Mason Royce US Small Cap Opportunity Fund, likes the energy sector in light of the US shale gas boom; it still sees a number of good opportunities here, particularly in industries that can support drillers.

What is your top conviction call?

BlackRock: Pfizer
It has great cash flow generation ability, which gives the company great strategic flexibility.

Pfizer's cost control also gives the company ability to deliver profits at, or above, expectations even in volatile economic conditions.

It is also a compelling investment from an income perspective, currently yielding 3.2 per cent.

Franklin Templeton: Mastercard
We believe the shift away from cash and cheque-based payments will be a driver of a multi-year growth opportunity for the company.

With their long-standing and well established network, the company is a leading global franchise with significant market share and a strong brand.

Legg Mason: Apple
At the current valuation, this stock already reflects no future growth, so there is huge upside should the next product cycle be successful.

The company's recent plan to return capital to shareholders via share buybacks and increasing dividends is also encouraging and should help support the stock price.

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