

# reasons to be positive



October 2008

**Tom Digenan**, manager of the UBS US Equity Fund, believes there is real value to be found in the US.

August 2008 marked the first anniversary of an event which has defined the direction of global economies and stock markets ever since. The global credit crunch which followed the American sub-prime crisis has been painful for all involved and is one key factor behind the maligning of US equities over the last year.

A subsequent housing crisis, rising inflation, and a weak dollar has seen several investors turn their backs on investing in America. However the big challenge of investing is that the greatest opportunity is usually after the point of having experienced the greatest pain. Indeed many may view the events of last month as such a defining moment. The US Federal Reserve has had to step in to stop Freddie Mac, Fannie Mae and AIG from going into bankruptcy. The collapse of the fourth largest investment bank in the US, Lehman Brothers, has caused further market volatility. In fact, the market landscape continues to change almost daily at the time of writing.

Our pain in terms of performance was in the second half of last year, however we are confident that there are now a number of key reasons for investors to be more positive about investing in America.

## attractive valuations

As an investor my job is to try and distance myself from the noise in the stock market. To do this, I need clear and objective measures and for me this comes down to one thing – valuation. It is the valuation of the US equity market that is my first reason to be positive about things to come.

Based on the UBS valuation model, US equities currently look cheap. In fact, we believe that they are at their cheapest valuation in 15 years and this places us in the bull camp. According to our model (which is bottom-up stock picking, trying to estimate forward-looking cash flows) the US market is currently 24% undervalued. This compares well to global (ex US) equities which are 8% undervalued, and emerging market equities which we believe are 15% overvalued.<sup>1</sup> It must be stated that this is not a call on the direction of the economy, it is solely based on valuations.

## market inefficiencies

My second reason to be positive on the US is based on equity market inefficiencies. With the exception of the technology bubble in 1999/early 2000, the gap in our expected excess returns between underpriced stocks and

overpriced stocks is wider today than it has been at any time in the last 26-plus years that we have managed US equity portfolios.

Historically, our portfolio has performed well relative to the market coming out of periods of mis-pricing like the one we are in today. This mis-pricing is in many sectors; those which are overpriced include energy and materials, while banks, consumer discretionary and some healthcare stocks appear undervalued.

The most interesting stories are within the banks and financials. These stocks are not yet out of the danger zone, but they are very mis-priced. Their earnings stream is very different to the past and from a pure valuation perspective, they are very cheap. There is no doubt that financials will continue to be volatile, but as I mentioned earlier, my job is to try to distance myself from the noise of the stock market.

The boom in energy and materials was the biggest ever and going forward I am now more cautious on them given the oil price bubble. However, what many people do not realise is that materials and mining are a much smaller part of the US equity index than they are in the UK and Europe.



In America, mining represents just 0.8% of the FTSE North America index, meaning I am less exposed to this overvalued sector. It also acts as a good diversifier against the UK, where mining makes up 9.6% of the FTSE All-Share.<sup>2</sup>

### consumer spending

Given what has happened in the American economy over the past few years it's amazing that US consumers have managed to keep spending, but they have. The reason is cultural. Whereas European consumers froze their spending after 9/11, the Americans kept going, although the tax cuts that year could not have been timed any better to stimulate it. It is why the last US recession was not a consumer recession.

So, as the US has once again entered a recession, how will consumers cope this time? The third quarter started off with a fairly rapid fall in real consumption spending in July as inflation eroded spending power. Consumer confidence has shown tentative signs of an improvement but the degree of pessimism is still high. My worry is that people can borrow against their US pension scheme. If we see an increase in this borrowing it is a worrying sign that

consumers are as stretched as they can be, as their pension is the last place they can go for money. The recent fall in commodity prices is helping consumers a lot, with gas prices already falling at the pumps.

Some industries are being affected worse than others by the slowdown in spending and many won't survive. Homebuilders is one sector which is being devastated. The housing recovery in America will be slow and I am not sure we have yet hit the bottom. There also will not be a V-shaped recovery; instead it is likely it will be more of a slow-U. It primarily depends on the strength of the consumer.

### volatile times

The market continues to be volatile as investors cope with uncertainty about the economy, inflation and credit issues. The Russell 1000 was up in August, returning 10% in Sterling terms, but has dropped off significantly in September and so far in October. However, this volatility has played to the benefit of our portfolio.<sup>3</sup>

When performance picks up I always get asked whether or not we have reached an inflection point? For me, you can only tell if you reached an inflection three years

## UBS US Equity Fund

Benchmark:	Russell 1000
Sector:	IMA North America
Launch date:	14 October 2002
Ratings:	Standard & Poor's 'AA' and OBSR 'AA'

The UBS US Equity Fund is available through Skandia's Life, Pensions and MultiFUNDS fund ranges and the Selestia Investment Solutions investment platform.

after the event, but what I do know is valuations and it is these which are making me bullish right now. I am not aiming to be contrarian for contrarian's sake, but sticking to my model keeps me running from the herd when the herd is running off the cliff.

So on to my last reason to be positive on America and that is the cheapness of the US Dollar. If I were a British investor right now, I would want exposure to the Dollar given its cheapness relative to Sterling and the Euro.<sup>1</sup> ●

<sup>1</sup>Source: UBS Global Asset Management as at 30 June 2008.

<sup>2</sup>Source: Wilshire, FTSE North America Index and FTSE All-Share Index as at 12 September 2008.

<sup>3</sup>Source: Lipper Hindsight, Russell 1000 in Sterling terms from 1 August 2008 to 31 August 2008.

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