

The themes poised to prosper during US growth renaissance

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John Indellicate, Co-Portfolio Manager, Scout Investments, explains why he sees attractive opportunities in US mid-caps and the key investment themes poised to flourish in the near future.



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As investors in US equities, it is natural at this moment in time to be asked for views on the current administration. However, irrespective of where you fall on the political divide, as well as your personal view on President Donald Trump and his tweeting, it is important to remain objective about the economic policies.

In this regard, the tax reform bill passed late last year has provided another round of fiscal stimulus to the economy, even though we are in the later stages of the business cycle. While the first order effect of mathematically increasing earnings has been priced in, we do not believe the second-order effects of tax cuts are fully appreciated yet. These effects are showing up in higher capital expenditures, accelerating GDP and rising consumer confidence.

In addition to this, federal-level deregulation is also helping to extend the business cycle, helping to lower costs and speed up implementation of new projects. It is for these reasons we have been, and continue to be, bullish on the US economy.

The results of the midterm elections will not have material changes to our economic outlook. Results were mixed, with Democrats retaking control of the House of Representatives, while Republicans won seats in the Senate. With divided government, further tax cuts or spending measures are likely to be restrained as political compromise will be needed to pass legislation. We think this could be beneficial for bonds, due to lower odds of more tax cutting, and bonds rallied the morning following the election. Our overweight position in utilities could benefit if this trend continues. Divided government scenarios can be bullish for stocks, as it decreases the risk of extreme or unexpected government actions hitting markets. With no tax cuts expiring in the next two years, and deregulation firmly in the hands of the executive branch, we think the most important drivers are safe. If Democrats and Republicans find areas to compromise on in the areas of infrastructure spending or drug price reforms, stocks exposed to those themes may be affected, but those potential themes are very light on details.

Aside from the administration, central bank policy is another hot topic of discussion, and in our view monetary policy is more important today than fiscal policy. In response to strong growth and low unemployment, the Federal Reserve has been raising interest rates and, in our view, will likely overtighten at some point. Based on hawkish communications early in October, the market is pricing in this overtightening now, even though the yield curve typically does not invert until 18 months prior to a recession. Debt levels around the world remain high, so higher interest rates will be felt eventually.

Markets generally follow the direction of earnings, so as long as we have growing GDP and a positively sloped yield curve, we believe the outlook for both earnings and positive stock returns is encouraging. However, a softening of the hawkish tone from central bankers is required to change the current negative market sentiment.

At SYZ Asset Management, our US Equity Strategy has a bias towards mid caps, an often-overlooked area of the equity market. Despite investor affinity for high-flying small-cap stocks and blue-chip large caps, mid-cap stocks have provided more favourable risk/return characteristics than the larger and smaller segments of the market over the long-term.



Seeking stocks with an innovative edge

Within this mid-cap space, we have identified attractive stock-specific ideas within a number of key themes – namely innovation, travel and entertainment, defence and financials.

We continue to see major innovative advancements across many areas of the economy, with the technology and healthcare sectors at the forefront of this change. One company we are optimistic on right now is Arista Networks, which is increasing market share in routers and switches for data centres, an area witnessing tremendous demand growth. Arista routers achieve speeds of 100 gigabits, compared to legacy products of Cisco and Juniper of 10 gigabits. In healthcare, we see a strong opportunity in cardiovascular medical device company Abiomed, which has products to assist the heart in pumping blood during cardiac procedures. With an industry leading product in a space with a lack of innovative competition, we believe it can improve on its USD 600m of sales in this USD 10bn market.

Changes in consumer behaviour, which are increasingly biased towards experiences rather than goods, continue to heighten the appeal of the travel and entertainment space. We are focused on areas displaying strong pricing power, such as concert tickets increasing 10% year-on-year. Live Nation, the owner of Ticketmaster, is one such beneficiary of the changing consumption trend. Another group displaying pricing power is the Madison Square Garden Company, which owns a number of venues and organisations – such as the New York Knicks and the New York Rangers.

As for defence, spending is being increased under the current government. We favour the innovative companies in this space, such as IT defence contractor SAIC. Finally, we are optimistic about financials – particularly banks able to benefit from higher short-term rates. Our bullish position on banks is likely to have the shortest longevity of our themes, due to the aforementioned flattening yield curve.

Despite the positive recent path of the US economy, we are mindful of risks. We are continuing to pay a lot of attention to trade negotiations, particularly tensions between the US and China. We are positioning the portfolio to try and avoid companies likely to be the most exposed to the escalating discord. However, we are aware there may be good buying opportunities in companies impacted by the introduction of new tariffs. While these stocks could potentially sell off initially, management teams will need to adjust to the new paradigm by raising prices, shifting manufacturing locations, or finding other ways to avoid the tariffs.

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