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US Equity Perspectives

US tactical playbook – What to do in the market now

Summary

We hold a more defensive view on the US equity market as we roll over to 2022, given the following developments/potential headwinds:

- **Peak liquidity/stimulus** – Tailwinds from aggressive fiscal stimulus and liquidity injection since the start of Covid will gradually fade as the economy re-opens.
- **Peak macro/earnings** – 1H21 earnings saw tremendous growth on easy year-ago comparisons, and we would look for this relative strength to decline starting 2H21.
- **Peak positive earnings revisions** – We see risk that earnings revisions (which have been overwhelmingly positive) will start to roll over.
- **High valuations** – There is room for derating as some of the above headwinds start to play out over the next couple of quarters.

As the US market recovers quickly after a short correction in September 2021, we review our tactical playbook into year end.

Stocks to focus on:

- Growth at a reasonable price (GARP) stocks – These include megacap tech, large cap software/hardware, and selected payment-related names, especially those that have pulled back sharply in recent weeks.
- Healthcare – A defensive sector with many names trading at attractive valuations (sector relative P/E remains at multi-year lows).

Stocks to buy on dips:

- Energy – Oil and gas prices surged due to tight global supply-demand dynamics. The sector offers better inflationary hedging characteristics than the broad equity market in the near term.
- Financials – We particularly like the big banks benefitting from tapering-led yield curve steepening and an earlier-than-anticipated rate hike.
- Semiconductors – We are starting to see mixed performance for different segments of the industry.

Stocks to avoid: Expensive growth names and consumer staples.

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The bank for a changing world

US tactical playbook – What to do in the market now?

We hold a more defensive view on the US equity market as we roll over to 2022, given the following developments/potential headwinds:

- **Peak liquidity/stimulus** – Tailwinds from aggressive fiscal stimulus since the start of Covid will gradually fade as the economy re-opens. Infrastructure stimulus is under negotiation, but the near-term fiscal impulse will likely be partially offset by tax hikes. On the liquidity front, the Fed has announced that it will begin tapering this month, scaling back its USD120 billion monthly bond-buying programme.

- **Peak macro/earnings** – 1H21 earnings saw tremendous growth and operating leverage on easy year-ago comparisons, and we would look for this relative strength to decline starting 2H21. Equities often struggle in the short term when strong economic growth begins to slow, as PMIs[1] peak and start to moderate.

- **Peak positive earnings revisions** – Supply chain disruptions, higher wages and commodity prices are already starting to impact companies' forward commentary. We see risk that earnings revisions (which have been overwhelmingly positive) will start to roll over.

- **High valuations** – The US equity market valuation remains high on many metrics. There is room for derating as some of the above headwinds start to play out over the next couple of quarters.

In the immediate term, we do not rule out that markets may continue its upward trajectory, but urge investors to remain nimble. We detail our tactical playbook below:

1 PMI = Purchasing Managers' Index

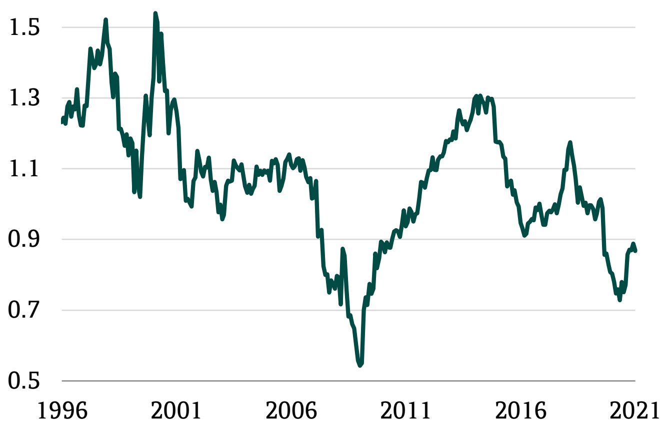
1. Stocks to focus on now – GARP and defensive healthcare stocks

Growth at a reasonable price (GARP) stocks – Valuations remain a key investment driver for us. We like GARP stocks as they have pulled back sharply in recent weeks. This includes megacap tech stocks, as well as selected large cap software/hardware and payment-related stocks.

For payment plays such as merchant acquirers and payment network providers, we think the recent weakness on fears of heightened competition, especially from buy-now-pay-later (BNPL) services, looks overblown. This is because BNPL providers make use of existing debit card payment networks to process transactions, with similar economics for both groups of companies. We think valuations look attractive taking into consideration expected earnings growth for 2022.

Healthcare is a defensive sector that has corrected as rates rose sharply in recent weeks. We see an interesting opportunity here, as the sector's relative P/E (against the S&P 500 Index) remains at multi-year lows (see Chart 1), and many healthcare stocks continue to trade at attractive valuations.

CHART 1. S&P 500 HEALTHCARE SECTOR P/E / S&P 500 INDEX P/E



Source: Bloomberg, as of 1 November 2021
Past performance is not indicative of current or future performance.

We like large cap pharmaceutical companies which play into both the vaccine and Covid treatment themes. We also like large-cap quality plays in the healthcare insurance, animal health, and medical diagnostics/device spaces.

Of note, many stocks in sectors such as software, internet, and healthcare have strong pricing power, which will play to their advantage in an environment of rising labour, transportation and raw materials costs.

2. Stocks to buy on dips – Energy, financials, and semiconductors

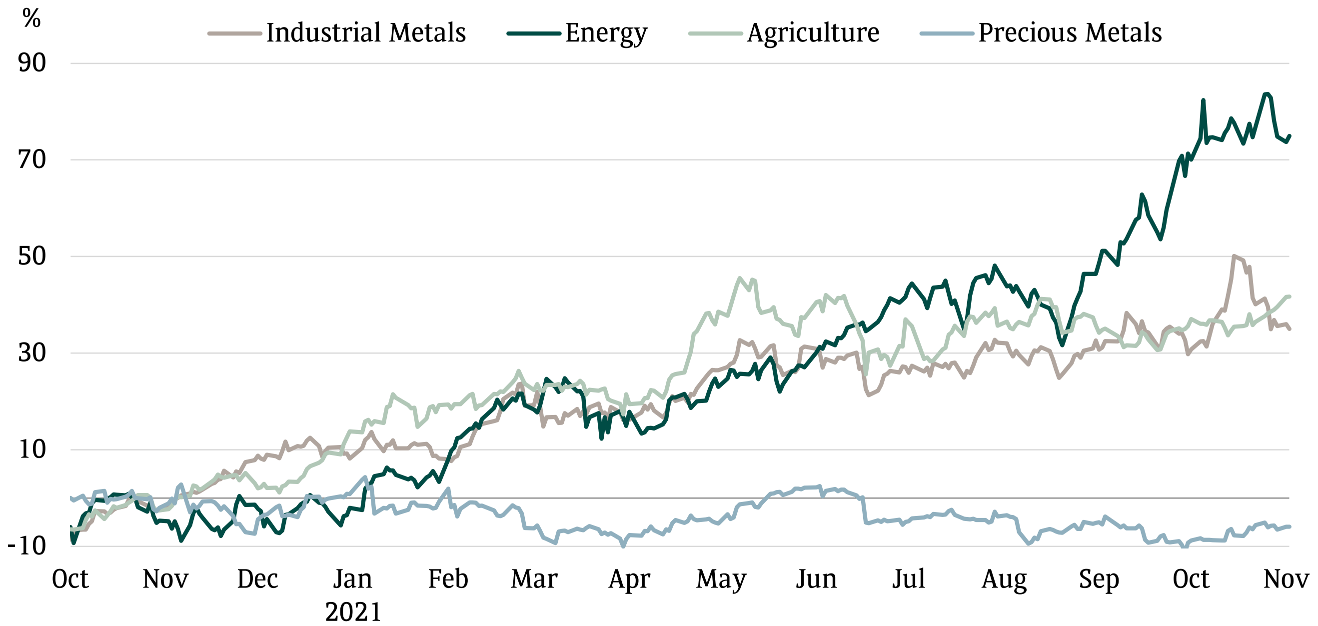
Energy is a sector that has benefitted from tight global supply-demand dynamics that have led to sharp spikes in natural gas and oil prices. Although questions remain surrounding the alignment of US names to the long-term energy transition theme, we would expect sector names to offer better inflationary hedging characteristics than the broad equity market in the near term.

We would be buyers of the majors on weakness, given the recent sharp rally has brought these names to technically overbought levels (see Chart 2). Oilfield services companies are also well placed to benefit from the cash flows generated by upstream oil producers in a higher-oil-price environment.

(More on the Energy sector on page 5)

Financials – Within the sector, we particularly like the big banks, where tapering could lead to supportive yield curve steepening, and an earlier-than-anticipated hike in interest rates could lead to revenue and earnings upside. We have also seen another bumper quarter in terms of results, with trading and investment banking activities buoyant, helping to offset challenges in loan growth. On the back of the Fed's recent stress test, banks are well placed to enhance shareholder payments through dividend increases and share buybacks going into 2022.

CHART 2. ENERGY HAS BEEN THE TOP-PERFORMING COMMODITY SECTOR IN 2021



Source: Bloomberg, as of 2 November 2021
Past performance is not indicative of current or future performance.

Semiconductors – Although the market consensus is that semiconductor shortages will likely last well into 2022, with order lead times continuing to stretch, the technical price movements of names in certain subsectors have begun to concern us. These include memory, auto semiconductors, and increasingly, semiconductor equipment names. Indeed, we are seeing mixed performance for different segments of the industry.

- Dynamic random access memory (DRAM) prices have been falling due to component shortages associated with the PC market, though we foresee this correction may be short-lived given indications of strong server demand of hyperscale customers in 2022.
- There are also market concerns on over-ordering due to the chip supply crunch (e.g. in the smartphone and auto sectors), which may result in unwelcomed inventory build-up down the road. On the auto front, auto semis are selling at above auto production rates, as the latter has been impacted by supply-driven shutdowns. On a brighter note, demand for auto semis can rebound once production normalises.
- We are most positive on cloud/compute semiconductors on expectations of strong server demand and pricing power.

Against the backdrop of uneven performance, semi valuations have rerated significantly with many stocks trading at the high end of their historical range.

Home improvement stocks are another sector to scoop up on dips. Although growth will slow as the economy reopens, we expect home improvement spending to remain resilient given its positive correlation to home prices. 3Q21 trends appear to be coming in above expectations.

3. Stocks to take profit on/avoid – Expensive growth names, consumer staples

We avoid expensive growth names with high valuations, especially unprofitable tech companies. These companies have potential to correct the most in a disorderly market correction, either sparked by higher rates or earnings disappointment.

Stocks with poor pricing power face margin pressure. Many consumer staples companies have benefitted from strong demand during the pandemic, including household products, cleaning and disinfectant products, snacks and other groceries. On re-opening, wallet share will likely shift to pent up demand for consumer services, rather than for goods. Rising commodity and transportation costs may also result in compressed margins for companies with commoditized products and little pricing power.

More on Energy – Winter is coming

What happened?

The energy complex has been hitting the headlines, with natural-gas prices around the world skyrocketing amid shortages. In addition, Brent crude broke USD80/barrel for first time in three years. This was in part due to disruptions in the Gulf of Mexico after Hurricane Ida but also the decision by OPEC+ to not extend pre-existing plans to raise production in November 2021 by 400,000 barrels/day.

The surging natural gas prices have also raised the prospect of greater demand for oil products for power generation. Given the global gas shortages, winter oil demand looks skewed to the upside. With the recovery in oil demand turning out to be faster than anticipated, there are signs that the global mismatch of demand relative to supply could be larger than expected.

Demand-side story

The recent oil price rally has been underpinned by signs the global market has been tightening as demand rebounds from the pandemic, and by strong gains in natural gas. We also see OPEC's spare capacity falling from its peak in 2020 (see Chart 3).

The sharp rise in natural gas prices has also played a role. According to independent energy research firm Rystad Energy, soaring natural gas prices are poised to boost oil purchases by Asian power generators by more than 40% as they seek cheaper alternative fuels. With gas traded in Asian markets commanding five times the US price, electricity producers may switch enough of their generators to crude to consume 400,000 barrels a day, the research firm said.

This all comes at a time when global oil consumption is expected to return to pre-pandemic levels in the third quarter of 2022, according to BP's estimates.

CHART 3. OPEC'S SPARE CAPACITY DECLINING FROM 2020 PEAK
(000'S BARRELS/DAY)

Source: Bloomberg estimates, as of 31 October 2021
Past performance is not indicative of current or future performance.

Supply-side story

Some analysts fear a supply shock for the oil market, with companies under-investing in fossil fuel projects amid a push towards cleaner energy. And the shortages that have caused natural gas prices to soar around the world are the product of a perfect storm of global issues.

These include under-stockpiling during summer in Europe due to more competition for LNG (liquefied natural gas) supplies from Asia, reflecting power shortages in China; uncertainty related to delays in the launch of the Nord Stream 2 pipeline from Russia; and colder-than-expected weather in many parts of continental Europe, including Russia itself.

Global oil supply was expected to be 1.2m barrels/day below demand in October 2021 and 900,000 barrels/day lower in the following month, according to an OPEC document. Even with OPEC+ sticking to its earlier agreed increase of 400,000 barrels/day in November 2021, it is unlikely to be enough to address demand growth.

Geopolitics may shift some of the supply narrative. The US has raised the prospect of releasing crude from its emergency strategic petroleum reserve, while Russia's President Putin has suggested that the country would boost gas supplies to Europe.

However, the idea of structurally higher oil prices in the medium term is gaining traction.

Our thoughts

For all the talk of a green energy transition, the unfolding near-term events show the global economy is still very much powered by traditional fossil fuels. "Greenflation" (rising prices in commodities reflecting the shift to renewable technologies) is the result.

With oil stocks having lagged oil prices for much of the year, the market is only now starting to revise stock price targets upwards. This trend of positive earnings revisions is additionally supported by earnings beats by many oil majors in the recent 3Q21 results season.

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