

Harnessing the bright spot

Franklin Templeton's Grant Bowers gives his take on what's ahead for the US market

THE US market has been virtually the single bright spot among global equity markets with its extended run of strong returns since 2009. What lies ahead? Grant Bowers, portfolio manager for Franklin Templeton's Franklin US Opportunities Fund, shares his views.

Q: What do you see as the positive underpinnings for US equities, and what risks are you most mindful of?

We see two primary tailwinds in the US market – consumer spending and corporate earnings – which we think will continue to be supported by a modest economic growth environment in the United States. We maintain confidence in the strength of the US economy as employment gains have been solid, consumer spending has been robust, the housing market is doing well and corporate earnings have largely exceeded expectations.

From our perspective, US consumers appear to be generally healthy, the economy is operating near full employment, wages are starting to rise and consumer debt levels are low. As we look for opportunities in the consumer discretionary space, we do so with the belief that consumers will become more comfortable with lower energy prices, likely resulting in increased spending on discretionary goods. Presently, companies levered to US consumer spending look attractive to us, specifically in areas such as apparel, restaurants, beverages and housing.

We believe the technology and healthcare sectors continue to have a solid growth outlook with significant changes taking place in the next few years. Despite the pullback in these sectors, we still have a positive long-term outlook for both technology and healthcare companies.

In the technology sector, the outlook for spending remains strong, as many companies have realised that investments in technology improvements are required to remain competitive in the global marketplace. New software, factory automation and data analytics can improve productivity and lower the production costs for companies, keeping them ahead of the competition. Some areas of technology we are focused on include cyber security, Software as a Service (SaaS), cloud computing, digital payments and smart devices.

In the healthcare sector, we believe an ageing global population will drive increased consumption of healthcare services and demand for improved treatments and cures. This demographic tailwind combined with innovation in drug development and medical technology is creating numerous investment opportunities as well.

In addition to watching the US economic data for any signs of a potential slowdown, we are also closely monitoring the impacts of various negative interest rate policies by various central banks, the consequences of which to the global economy are still unknown.

Q: How challenging or attractive are valuations today for the sectors that the US Opportunities Fund is most exposed to, such as technology, consumer and financials?

Valuation concerns in the US arose in the second quarter as investors began discussing the possibility of an “earnings recession” given four consecutive quarters of corporate earnings declines. While the earnings growth rate for the S&P 500 was in fact negative, that was largely due to the energy sector, which continues to grapple with low oil prices, and a few outsized companies, such as Apple, which were experiencing challenging environments. Excluding these extraordinary areas and companies revealed a more positive picture.

With the vast majority of companies now done reporting Q2 earnings, it looks like concerns were somewhat exaggerated. Most companies,

particularly in growth areas such as information technology, healthcare and consumer discretionary, beat earnings estimates and those (earnings) were of high quality, driven by increases in top line revenue rather than cost cutting. Projections for Q3 earnings and revenue also look to be generally positive outside of pockets such as energy.

We believe that well-positioned companies poised to benefit from multi-year secular growth trends in the market can outperform the broader market regardless of the direction of P/E (price-earnings) levels going forward, and that investors will be willing to pay for growth in a low growth environment should it materialise. While P/E ratios are at the higher end of normal, many sectors and individual companies still have attractive valuations, particularly when one views them in the context of their long-term growth prospects.

Q: Please give us an idea of how you go about picking stocks and sectors for the fund.

Franklin US Opportunities looks for companies we believe possess sustainable growth characteristics which meet growth, quality and valuation criteria.

We prefer companies demonstrating (Growth) sustainable earnings and cash flow generation, targeting companies with at least 15 per cent revenue, earnings, or cash flow growth over the next three to five years; (Quality) strong competitive positions and talented management we believe can execute a vision; and (Valuation) current prices which do not reflect the growth opportunities we see, with attractive risk/reward profiles.

Our portfolio is conviction weighted and tends to have a smaller number of holdings with larger portfolio representation in its top positions. Sector positioning is a result of our bottom-up stock selection, but our criteria often leads us to high growth sectors such as information technology, healthcare and consumer discretionary although the portfolio is broadly diversified across sectors. Identifying high-quality companies early in their growth phase leads to a portfolio with a mid and large-cap bias.

Q: What are your expectations in terms of how the US election outcome may affect the market?

Politics and elections are not a large part of our fundamental analysis; we like to focus on tangible factors such as earnings, free cash flow and identifying great potential growth opportunities. However, anytime you change the status quo you create uncertainty, and the markets don't like uncertainty.

The 2016 US presidential election cycle has clearly contributed to some of the volatility we have seen year-to-date as we worked through the nominating process, and we will likely continue to see volatility in the markets as the candidates outline their policy positions and markets weigh their potential impacts up through the election itself. **W**

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