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The good, the bad and the ugly - three scenarios for the world's largest economy



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“We believe that America, being the first country into recession, will be the first out of it. Policy initiatives have been just as aggressive, if not more so, than those from any other country. More importantly, the response has been far swifter than that of Japan when it entered its own deflationary period during the 1990s.”

We are sometimes rather fortunate to be an American equities team based in London, because the time lag and distance has frequently allowed us to digest and analyse market events and newsflow at our own pace in the morning, before watching it all kick off unceremoniously when US trading starts in the afternoon.

As bottom-up managers, we base our decisions first and foremost on company valuations and we try not to get too obsessed with the macro view. However, the macro view is what everyone is talking about at present, and given the events of 2008, it remains at the forefront of everyone's thinking. We think events could pan out one of three ways this year:

Handshakes all round – the president-elect, Barack Obama, has pledged to do whatever it takes to pull America out of its recession. Infrastructure spending, zero interest rates, TARP and other policy initiatives start to drag the US out of its recession in the latter half of 2009. Should it work, they might have to start preparing a space for his likeness on Mount Rushmore.

Back to the 30's – government intervention, including tighter regulation on financials, fails to halt the slide into deflation and interest rates have nowhere further to go, leading to a constant newsflow of bankruptcies and higher unemployment: the 'doomsday macro scenario' currently being bandied about.

Overcooked economy – those policies and spending pledges now being put into place work a bit too well, bringing back an inflationary environment that will ultimately lead to the next bubble, and another round of boom and bust, in record time.

Which outlook is most likely? We could easily offer a coherent argument that all are still possible. There's very little in the way of discernible newsflow to discount any of them. However, the more that the Great Depression 'doomsday' scenario is given credence, the more comfortable we feel that it's not going to happen, at least not in this particular cycle.



The US government is pulling out all the stops to prevent a repeat of the 1930s Great Depression.

The view from the US



Will government stimulus do the trick?

We are inclined to believe that on the balance of probabilities, the American policy measures announced this year, including an economic stimulus package (currently valued at \$850 billion, but could ultimately be upwards of one trillion), will eventually start working. However, Obama's policies will create some winners and losers, and some sectors may start to feel a squeeze if the initiatives also come wrapped within a tightened regulatory structure.

The package is expected to include substantial spending on roads and other infrastructure projects, as well as energy-efficient renovation of schools and federal buildings, investment in greener technologies and in keeping to his pre-election promise, tax cuts for low and middle-income earners.

The stock selection outlook

Getting back to our bottom-up view, one of the more encouraging aspects of the recent downturn has been that we have found ourselves able to purchase companies that were previously 'out of sight' in terms of valuation. When a well-run company that ticks all your boxes (in terms of growth potential, balance sheet strength, management expertise and market share) is priced at 16 x earnings having previously traded at 28 x earnings, you try to look beyond the short-term noise and consider the long-term potential to be had in such a purchase.

However, earnings estimates for this year still look too high. Most analysts are notoriously slow to make adjustments to estimates, which ultimately leads to companies suffering death by a thousand cuts until a more realistic earnings consensus is reached.

Opportunities within a thinned-out market

We have been looking to strengthen the portfolios with companies that we think are able to increase their market share, or have been beneficiaries from the demise of their competitors. The insurance broker Aon, for example, is well placed following the collapse of AIG, in as much as it can place more insurance business at higher premiums. Similarly, Charles Schwab will benefit from the weakness of Merrill Lynch, Morgan Stanley Dean Witter and Smith Barney in the same space.

Outside of the financial sector, we believe a number of our holdings will show resilience through the downturn. Republic Services, a waste collection business, has just completed its merger with rival Allied Waste. At a time when volumes are feeling the impact of the recession, this merger will extend the recently improved pricing discipline of the industry, as well as yielding numerous cost saving opportunities for the newly-formed company.

2009 portfolio positioning

To recap, we think there could be some excellent domestic opportunities to be had within the US market in 2009, and we have been looking to add to those companies well-placed in a prolonged downturn, or to benefit from a market recovery, including:

- **Selective financials** such as Lazard, Charles Schwab and Aon.
- **Large caps** where we are seeing better risk/reward opportunities than in the past, such as AT&T, Comcast and Bristol-Myers Squibb
- **Companies with economic resilience** that can continue to grow market share, either through M&A (Republic Services, CVS Caremark), or through secular growth (Gamestop, Thermo Fisher).

The past twelve months have featured a procession of dramatic events that would have been considered unthinkable in previous years. It would be foolish to predict that the New Year will not bring with it its own set of challenges and surprises. We are inclined to believe that from here, provided earnings estimates become more realistic in the early half of 2009, there is more upside potential than downside in American equities.

Antony Gifford and Nick Cowley co-manage the Henderson Horizon American Equity SICAV Fund, with assets under management of over \$344 million (as at 30 November 2008). Antony joined Henderson in 2002, Nick joined in 2004. The North American Active Equity Team has a proven track record of generating returns and takes advantage of their involvement in Henderson's hedge fund products.



Henderson
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The view from the US



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