The after effects of the US ‘sugar rush’

By Philip Smeaton, Chief Investment Officer

We’ve all experienced the consequences of a sugar rush: lethargy, sluggishness and plenty of volatility. But can the same principles be applied to economies and their own versions of artificial stimulus?

In the US, fiscal incentives have given the economy its very own sugar high. Corporate tax cuts, relatively low interest rates and increased fiscal spending have culminated in significant economic growth:

- US gross domestic product (GDP) increased by 2.4% in the first three quarters of 2018, versus 0.7% in Germany and 1.1% in the UK. Indeed, Germany’s most recent quarterly GDP release showed a contraction of 0.2%.
- The purchasing manufacturing index (PMI) – an indicator of economic health for manufacturing and service sectors – shows the US economy has considerably outperformed the rest of the world for most of this year.
- Unemployment has fallen to below 4% – the lowest level since the early 1970s.

Is the US economy on the turn?

But is all that set to change? Early signs suggest the economic incentives are no longer having the desired effect. US capital expenditure (capex), which is the money businesses spend to fuel growth, has tailed off in recent weeks, and the PMI score has fallen back from previous highs (albeit still well above the rest of the world).

Ironically, this downturn could be a consequence of a burgeoning economy. A tight labour market gives rise to wage growth as businesses are forced to pay more for the right people. This in turn fuels inflation, which forces an increase in interest rates. As financial conditions become more restrictive, risks to company growth increase, as does the cost of financing it. It looks like these risks are starting to counteract the incentives, and as investment spending is one of the most volatile components of GDP, weaker investment would lead to weaker overall growth.

The impact on US equities

In recent years, US equities have been priced for high growth and low risk, and we’ve increasingly struggled to find value in this market. The price/earnings ratio of US equities has been considered high since 2015, meaning investors have expected good future growth – and valued stocks accordingly.

But, like capex and PMI, in recent months that has started to tail off, which implies investors are questioning longer-term growth potential. At the same time, rising bond yields and inflation could result in further volatility as investors seek lower-risk returns elsewhere.

The Sanlam view

We’ve been underweight in US equities because valuations just haven’t made sense. That doesn’t mean we’ve not had exposure to the US. Client portfolios have benefited considerably over the course of the bull market, but we’ve had to cherry-pick opportunities and work hard to find reasonable valuations.

While the US economy has enjoyed a tremendous 10 years of growth and opportunity, policy makers should always remember that, in the long run, too much of a good thing is never a good thing. Something for all of us to bear in mind as we approach the festive season!