

US: Attractive stocks at bargain prices

Recent stock market falls in the US have understandably unnerved investors. But the US market has become more attractive as a result, argues Jane Trust, executive director at Legg Mason Capital Management.

The US fiscal problem, while real and concerning, is still several years away. The European crisis is unfolding right now. While the US debt ceiling debate delivered some colourful political drama, the European problem is much tougher to solve. Risk indicators in Europe have been exploding upwards, with some of the larger European Union countries being dragged into the morass with their smaller cousins.

Both yields and CDS spreads for Spain and Italy have moved sharply higher over the last five weeks, with the yields on the 10-year debt of both countries over 6%, compared to the 3.1% yield on France's 10-year bonds or the 2.3% of Germany's bunds¹. In our view, the European Central Bank (ECB) worsened the crisis and triggered a global equity rout on the 4th of August by announcing that it would maintain its key lending rate at 1.5%, a level we believe is much too restrictive. As the pundits like to quip, "Spain and Italy are too big to bail," a clever way of saying that the ECB would likely be unable to fund a rescue of either country with existing resources. With the European sovereign debt problems escalating and seemingly without a near-term resolution, the markets are likely to remain unsettled in the face of broad uncertainty.

Stocks at post Lehman Brothers levels

While the recent market declines are certainly unnerving, to the extent the sell-off in US equities exceeds the change in the intrinsic value of the issuing companies, the market has become more, not less, attractive. The US market has returned to the level seen after the collapse of Lehman Brothers in late 2008, when the credit system was imploding and conditions were worsening. Now, in the US, corporate profits are near all-time highs, corporate balance sheets are cash-rich, banks have been recapitalised, and the economy is growing, although slower than we would hope for.

In addition, the recent slowdown in economic data and the market correction are likely to push out the eventual US monetary tightening into 2013. As always, the question is what is discounted in current

prices. With the free cash flow yield on the S&P at 7.4% and forward and trailing P/Es in the bottom 5% of their approximate 20-year ranges, it would seem that very modest growth is priced in at current levels, an observation that is supported by our own stock-specific research. The uncertainty of the current environment has created the opportunity to buy many stocks at bargain valuations, with dividend yields above that of the US 10-year Treasury note and with a risk profile below that of the US government, as indicated by CDS spreads. In addition, with the US market valued at around 10x next year's earnings, anticipated returns over a three- to five-year horizon seem very attractive to us.

¹ Source: Bloomberg August 2011

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