US equities: two major themes in a stabilising economy

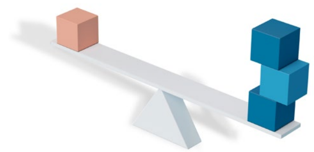
Nicolas Janvier, Head of US Equities, EMEA

- As we enter the recovery phase, the US equity team is working closely with our Fundamental Research team to analyse two major themes that will drive our sector positioning and stock picks over the coming months.

- The first is consumer spending. Household balance sheets are in much better shape than they have been emerging from previous recessions, but the pattern of consumer spending that we see in 2021 will be different to the pre-pandemic trend. The "experience economy", which emerged strongly in the decade from 2010, will exhibit the strongest growth. This means tourism, out-of-home entertainment and leisure spending will benefit. But a significant proportion of business travel – perhaps as much as 50% – will not return.

- Our second theme is how changes in corporate costs will feed into increased operational leverage and improved profitability as revenues rebound. We will be looking to identify those that have succeeded in permanently reducing their operating costs during the pandemic.

- A Joe Biden presidency, but with a divided government, could be positive for utilities (where the push towards generating cleaner power is likely to continue and should benefit regulated companies), real estate, consumer staples and materials. But the outlook is arguably weaker for healthcare, energy and financials, where the likelihood of higher corporate taxes is now lower, which would be a positive for the sector, but the odds of new, more stringent regulatory initiatives may act as a drag.



With the prospect of early access to effective vaccines getting steadily stronger, the major question for investors in US equity markets is how to position their portfolios for an economy returning to normal after the Covid-19 shock?

This question begs many others. How long will the normalisation process take? To what extent will this be a "new normal" rather than a reversion to the pre-pandemic status quo? What difference, if any, might a new US administration make?

Against this background, the US equity team is working closely with our Fundamental Research team to analyse two major themes that will drive our sector positioning and stock picks over the coming months.

> ***The rebound will look different to previous phases when economies were emerging from recession, because this time household balance sheets are in much better shape***

The US consumer

The first of these is the recovery in consumer spending. We believe the rebound after the pandemic will look different to previous phases when economies were emerging from recession, because this time household balance sheets are in much better shape. Despite the significant hardship that Covid-19 has caused among lower-income groups, many middle- and upper-income households are emerging from the downturn in excellent financial health. The savings rate in the US rocketed during 2020 to reach the unprecedented level of 32% in April[1], reflecting the lack of spending opportunities during the pandemic as consumers' freedom of movement was restricted and many businesses temporarily closed.

However, we believe the pattern of consumer spending that emerges during 2021 will be different to the pre-Covid world. During the pandemic, consumers unable to travel and spend on hospitality and leisure activities started spending more heavily on goods for their homes. We expect this trend will reverse as the "experience economy", which emerged strongly in the decade from 2010, returns to growth. Tourism, out-of-home entertainment and leisure spending will all benefit.

However, consumer demand in other areas will most likely be curtailed by the acceleration in the "virtual economy" seen during the pandemic, with activities such as video conferencing becoming a feature of everyday life. We believe remote working will remain at elevated levels and a significant proportion of business travel – perhaps as much as 50% – will not return.

This may have major impacts in many areas. Patterns of mass transit usage and office occupancy will most likely change, and city centre services that cater for office-based workers might see revenues contract. Airlines and hotel chains that have positioned themselves to benefit from pre-Covid trends in business travel may face big challenges.

One to watch: operational leverage

A long-term decline in business travel is part of the second major theme we have identified: changes in corporate costs that will feed into increased operational leverage and improved profitability as revenues rebound. During the crisis companies made deep cost cuts, deferred capital spending and reworked business processes to protect profits and liquidity. Our research suggests that while some will have to add costs back as their revenues grow, others have reorganised in ways that will result in permanently lower operating expenses.

[1] Source: Bureau of Economic Analysis.

One of our key areas of analysis over the coming quarters, therefore, will be to identify those companies that have succeeded in permanently reducing their operating costs during the pandemic. This may be a result of restructuring and changing working practices in response to an unprecedented crisis, or it could be due to greater use of data and technology to optimise operations.

Either way, the improved operating leverage these companies have created will fuel sustained improvements in profitability through the next business cycle. It is also our job as investors to analyse which companies will not succeed in this way – and our research intensity enables us to look through the short term to find these longer-term winners and losers.

Naturally, the incoming US administration will also affect the business environment, although we expect a divided Congress to limit its scope for action. However, we are paying close attention to President-elect Biden's cabinet nominations and his picks for the heads of the regulatory agencies for any indications of the new policy direction.

Our research does indicate that there will be clear sector winners and losers in a Biden presidency. For example, among the winners will likely be utilities, where the push towards generating cleaner power is likely to continue and should benefit regulated companies in this sector. Divided government creates a more challenging path for tax reform, but even with lower rises in the corporate tax rate, regulated utilities can pass the costs on to customers.

> *The incoming US administration will affect the business environment, although we expect a divided Congress to limit its scope for action*

We also see winners in the consumer staples, real estate and tech sectors, but are not as bullish on healthcare, utilities and financials where, in the case of the latter, the picture is somewhat mixed. The likelihood of higher corporate taxes has decreased, which would be a positive for the sector, but the odds of new, more stringent regulatory initiatives may act as a drag.

Much about the political backdrop remains unresolved. But we are confident that understanding how individual companies are likely to perform in an environment dominated by the two major themes that we have identified – the consumer spending rebound and changes in companies' operating leverage – will yield significant opportunities over the coming quarters. This is a situation that strongly favours an active, bottom-up approach to stock selection based on fundamental research.

To find out more visit

columbiathreadneedle.com

Important Information:

For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients).

Issued 12.20 | Valid to 06.21 | J31065 | 3354535