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January 2016

# EQUITY VIEWPOINTS

## GLOBAL MARKET COMMENTARY

### DECEMBER 2015 – STOCKS LOWER ON GLOBAL GROWTH FEARS

Investor reactions to major central banks' policy decisions and further weakness in the natural resource sectors dragged stocks lower in December. Global equities sold off as the month began after the European Central Bank (ECB) announced a smaller-than-anticipated monetary expansion. Energy and commodity-related stocks declined after OPEC decided to maintain global production levels despite a supply glut, which sent oil prices tumbling to multi-year lows. U.S. economic data was generally favorable, however, clearing the way for the Federal Reserve to raise short-term interest rates on the 16th December.

The losses pushed most of the major US indices into the red on a price basis for 2015, but the large-cap benchmarks managed to end the year with gains on a total return basis (including dividend payments). The smaller-cap benchmarks underperformed and ended the calendar year with losses.

Emerging markets equities declined. China's official measure of national manufacturing activity declined in November for the fourth consecutive month to the lowest point in more than three years. Currency weakness was also a concern as the yuan sank to the lowest level versus the dollar in four years. Data showed that Brazil's GDP contracted 4.5% in the third quarter from a year ago. The appointment of a new finance minister also caused volatility as investors feared that instability in President Dilma Rousseff's administration could further delay much-needed reforms. In emerging Europe, Russian shares tumbled as the price of crude oil declined further, and the ruble fell more than 9.5% versus the dollar. The South African rand also weakened significantly after the president replaced his reform-minded finance minister, triggering a selloff in equities and sovereign bonds.

## GLOBAL EQUITY VIEWPOINTS – JANUARY 2016

**UNITED STATES:** The US economy continues to grow at a slow, but sustainable rate. Energy and the commodity complex continue to be under significant stress, but there have been enough signs of economic improvement for the Federal Reserve to increase rates. However, additional rate increases could be limited given the continued weakness in commodities and an uncertain global environment.

Overall, we continue to be constructive as valuations have now become more attractive following recent falls. Improving corporate profits could help drive stock performance in 2016. It is, however, still vital to continue to focus on investing in "all season" growth companies – those with leading market positions and seasoned management teams, that are well versed in allocating capital and managing expenses and whose growth is not heavily reliant on the overall direction of the economy.

**EUROPE:** Despite the unstable macroeconomic backdrop, we continue to be encouraged by economic data coming out of Europe. The composite PMI remains well above the level marking expansion, but on a country basis, economic conditions still remain varied.

Within the periphery, unemployment remains stubbornly high, although recent declines in Spain and Italy are notable developments. Progress on structural reforms and falling wages has led to improved competitiveness, which should provide a boost to external balances and aid economic activity in the region. It is also encouraging that consumers appear to be regaining a measure of confidence in most markets, and credit conditions appear to have improved. Inflation remains significantly below the ECB target, but the recent move by the ECB to extend its asset purchase program has somewhat improved the outlook for prices.

The theme of independence might well be important in 2016 as the UK moves closer towards holding a referendum on its membership of the European Union, while the Catalonia independence story continues to rumble on. Should the UK cut its ties with the European Union, we envisage a detrimental effect on a significant number of UK-listed companies who benefit from the reduced regulation of transacting across the union.

**JAPAN:** Japan has seen a record-breaking mild winter and the sluggishness of seasonal demand meant that the recovery in consumption was very weak in October-December. However, we expect consumption to be supported in 2016 by growth in nominal wages, more stable food prices and cheaper crude oil costs. The yen has recently strengthened against the US dollar, but if the firmness of the US comes into focus we think the yen could return to a rather weak trend. If the yen appreciated to under ¥118, additional easing by the Bank of Japan could become more likely.

However, while bonuses and overtime payments are rising, a base wage increase cycle, at least in inflation-adjusted terms, has been lacking. With Japan back in recession, we expect to see further measures from the Bank of Japan to stimulate the economy.

For those investors able to take a longer term view, we still believe there is a fruitful investment opportunity encapsulated within the Japanese journey. Our central scenario is that Abe's political will to make, in his own words, "Japan a great and robust country," is real. Policy efforts should provide further traction in the next 12-24 months – we will continue to look for further signs, beyond this time horizon, that Japan is turning into a durable improvement and self-help story.

Japan combines both a domestic and a later-cycle earnings growth story. Attach attractive valuations compared with other regions, along with some selective self-help reform that will structurally improve Japan's profitability and the result is a positive backdrop.

**EMERGING MARKETS:** We expect the growth premium over developed markets to continue to narrow, primarily because of the continued slowdown in the "BRIC" nations. Those countries that push forward with reforms should do well, while countries that do not will struggle. China's economy is transitioning away from an infrastructure and fixed asset investment-led growth model, to one more dependent on consumption and the services sector. Meanwhile, both Brazil and Russia are currently in recession, although Russia is showing signs of stabilization.

We feel like we have been here before, however, and we believe a growth slowdown should not be confused with a growth "crisis". China still has the resources to manage through this transition. Meanwhile, the outlook for other parts of the EM world remains positive. In South East Asia, for example, countries such as the Philippines, Indonesia and Thailand remain vibrant areas. Their governments have recently announced plans to spend billions of dollars on new infrastructure over the next few years to spur growth, as the traditional export-driven model loses steam.

We are also focused on countries that are implementing meaningful reforms that are aimed at improving the quality and sustainability of their growth. India, Mexico, Indonesia, and even China have begun to implement important and much needed reform programs. However, the varying pace and success of those efforts in each country will continue to drive greater divergence in relative performance.

Key to our broad outlook is that dispersion within EMs. Our approach has always been to look at economies and stocks in a very granular way. Despite the overall slowdown, we would encourage investors to see through the negative headlines about economic growth and instead focus on the prospects of individual companies. Valuations are compelling and remain at a discount relative to their history and to their developed-market peers.

Overall, we sense many risks are already priced into EMs, and certainly many of these countries now feel good value. Valuations are certainly attractive, both relative to history, and versus developed market counterparts. Indeed, the emerging versus developed market equity performance has been quite extreme. Often, it pays to be contrarian, with the best time to invest being when sentiment is at a low. If you are able to take a long-term view, and look through short-term market volatility, we believe there are rewards to be found within this more dispersed EM world.


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