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June 2016

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

MAY 2016 – MIXED PERFORMANCE FOR EQUITY MARKETS

In the US, stocks generated modest gains in May. The technology-heavy Nasdaq Composite Index performed best, although it remained the only major US benchmark in negative territory for the year to date. Technology stocks were the strongest performers within the large-cap S&P 500 Index, while energy, industrials, and materials recorded modest losses. Energy stocks remained among the best performers for the year to date.

Elsewhere, international equities slipped into negative territory in May, ending a rally that began in late February. Europe, Asian, and emerging markets, as measured by the MSCI EAFE Index declined amid weak metals prices, lower manufacturing output and increased political risk. Brazil was the leading drag on emerging markets as the country grappled with the fallout of the impeachment of President Dilma Rousseff. Corporate earnings for eurozone-based companies were, for the most part, trending positively as consumer spending helped to shore up profits. However, companies heavily dependent on exports, especially to China, posted lacklustre results and reported tepid profit outlooks. Uncertainty about Britain's exit from the European Union remained a key feature, despite bookmakers reflecting that most voters would support staying in the EU. None of the major central banks made significant policy changes, as expected.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: As was widely anticipated, the FOMC voted to keep the Federal funds rate at 0.25%-0.5% on the 15th June, with no dissents. In particular, the Fed noted that improvement in labour markets had slowed and "Although the unemployment rate has declined, job gains have diminished." Most notably, the FOMC members significantly lowered their forecasts of the Federal funds rate deemed appropriate and consistent with the individual members' economic and inflation forecasts for year-end 2017 and 2018. The FOMC's median Fed funds rate estimate was lowered to 1.6% from 1.9% for year-end 2017 and 2.4% from 3.0% for year-end 2018. The median longer-run "dot" was lowered to 3.0% from 3.3%.

During the last several years, the Fed's forecasts have consistently projected that the economy would continue to grow at a slightly faster pace than its official estimate of longer-run potential growth even as it raises rates. The Fed's delay in normalizing interest rates—which is seemingly inconsistent with those forecasts—presumably reflects the Fed's response to a wide array of economic, financial and international trends, and its fear that raising rates would upset financial markets. However, the consumer still remains in a strong place with lower debt levels and falling energy bills helping to boost sentiment.

Valuations remain 'reasonable' considering where we are in the economic cycle. The current dividend yield of roughly 2.3% is also superior to the yield of U.S. 10-year treasuries, and the S&P 500 is trading at a higher earnings yield than investment grade corporate bonds.

On balance, the health of corporate America remains strong, with balance sheets in aggregate having been meaningfully strengthened over the past several years. While it may be reasonable to expect recent wage growth to negatively impact overall levels of corporate profitability, we do not anticipate a meaningful decline.

Bull markets usually end with recession or due to valuation bubbles - we see no signs of either. The economy continues to grow, albeit at a slower pace than previous cycles, so we remain reasonably constructive, but the outlook going forward is inherently more stock-specific than it has been for some time.

EUROPE: European markets continue to suffer higher volatility, but there are definite signs of a modest economic recovery underway. Leading indicators such as the composite Purchasing Managers' Index still signal expansion. The weaker euro, falling energy prices and the ECB's economic stimulus measures are also helping in supporting economic growth.

The meaningful increase in the asset purchase program to €80bn from €60bn per month, the inclusion of investment-grade corporate bonds, and a comprehensive new bank lending program ("TLTRO") could potentially be quite stimulatory. These measures provide actual liquidity and aim to encourage greater investment and risk-taking behaviour. But the measures also highlight the concerns about the potential fragility of the current European economic recovery, given the current weaker trends in global demand and pervasive deflationary forces.

The UK's upcoming referendum on EU membership on 23 June has dominated the headlines, which has taken away from positive company news. Uncertainty is likely to

increase as we near the UK vote, and this may be reflected in greater volatility.

Our focus on good-quality companies at attractive valuations continues to result in a tilt toward domestically generated revenues in Europe. However, in recent months, we have added a number of high-quality companies with exposure to emerging markets after some steep falls.

JAPAN: Japan has come a long way in a relatively short period of time, especially when you consider the quality of the Japan equity rally relative to other markets. Japan's rally over the last three years has been backed by a real recovery in corporate profits, in contrast to being driven by the expansion of multiples (i.e., valuations rising). Such fundamental improvement has been a rare feature within global equity markets.

This trend should help investors feel that material change is happening in Japan, but the strength of the yen more recently has negatively impacted markets. The pattern of yen weakness over the past three years has stalled, and recent strengthening goes against many predictions of further weakness. This matters because equity returns have become increasingly correlated with the weakening currency. Central to this is the fact that currency weakness has boosted corporate earnings growth and, in turn, resulted in the high-quality equity market rally that has been so important to the case for Japan.

Having held a view since late 2012 that the Bank of Japan's (BoJ) policy decisions would likely weaken the yen, our perspective today is of an increasingly unpredictable currency outlook. While we struggle to see any reason why the yen should meaningfully strengthen from here based on economic fundamentals, we have been examining our earnings expectations and will continue to do so in the event of the currency strengthening further.

It is important to make clear that we firmly believe that the valuation case for Japan still holds, and that Japanese corporate earnings growth is likely to exceed global peers. This view underlies many of our preferred stock ideas today. There is one note of caution, however, which is that further currency strength, if it transpires, will most likely begin to diminish expected growth in corporate earnings.

Japan remains cheap relative to peers, both in absolute terms and versus the previous cycle high in 2007. On this basis, current levels offer an appealing entry point for investors who are capable of sifting through the volatility for attractive stocks unduly caught up in a period of worsening sentiment.

EMERGING MARKETS: Emerging markets have begun to perform better, with some delivering stronger returns than developed markets so far in 2016. The main question for investors is if the recent move in emerging equities is the beginning of a more sustainable period of better performance or just a short term bounce.

There are a number of factors that help explain the recent move. Aggregate valuations had reached very cheap levels in January, as concerns over the slowdown in China, the pace of U.S interest rate increases, and the depressed levels of oil and commodities pushed stocks even lower. However the announcement of China's policy stimulus, a rebound in the price of oil and a more dovish U.S Federal Reserve prompted a bounce in emerging currencies and stock markets, with the biggest moves in those countries that were down the most last year (Brazil, Russia, South Africa and Turkey).

The fear that rising U.S. rates would spell doom for the emerging world also seems to have dissipated somewhat, particularly now that we are past the first U.S. rate rise. With the Fed signalling that the pace of increases in 2016 will be measured, this uncertainty has decreased. More important, many emerging economies have continued to improve their fiscal and current account deficits, debt positions, leaving them in a much better macroeconomic position and more able to absorb shocks.

As important, economic growth relative to developed markets is now showing signs of stabilizing. The Brazilian and Russian economies are still weak, but are expected to start turning around towards the end of the year. India's economic outlook is strong, particularly for the second half of 2016, assuming the country experiences a normal monsoon season. Meanwhile, the Philippines are experiencing healthy growth, while Indonesia and Thailand are showing signs of strengthening. China is the one exception, as its economy continues to slow. This improved economic growth should provide a healthier environment for emerging market corporate earnings, particularly if margins begin to improve, as we expect.

Valuations are attractive relative to historic averages and to developed markets. At the same time, as economies and earnings begin to advance, it should encourage investments back into these markets. While returns for emerging markets may improve, there will continue to be great dispersion within both countries and sectors.

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