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July 2016

# EQUITY VIEWPOINTS

## GLOBAL MARKET COMMENTARY

### JUNE 2016 – STOCKS MIXED AFTER LATE BOUT OF BREXIT-INSPIRED VOLATILITY

Stock markets generated mixed performance after enduring extreme volatility on the back of the result of the UK referendum on European Union (EU) membership. Following the decision to leave the EU, markets initially fell sharply, although regained some composure towards the end of the month.

The financials sector took the brunt of the sell-off. By contrast, the energy sector rallied during the month as oil prices climbed on the back of tighter supply. Currencies were extremely volatile, particularly the British pound and the euro, as both fell following the results of the referendum vote.

## GLOBAL EQUITY VIEWPOINTS

**UNITED STATES:** 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:** The outlook for Europe has become more uncertain since the UK's referendum result in favour of leaving the European Union. The fear is that economic growth may lose momentum, due to a slowdown in the UK, and the broader uncertainty as the relationship is renegotiated.

Despite these top-down concerns, we retain our conviction that the best way to ride out any volatility and instability is to focus on high-quality businesses that trade at attractive valuations.

Meanwhile, economic continue to still show modest growth in Europe, for now. Leading indicators such as the composite Purchasing Managers' Index still signal expansion. The weaker euro, lower energy prices and the ECB's economic stimulus measures are still helping to support economic growth.

Our focus on good-quality companies at attractive valuations continues to result in a tilt toward domestically generated revenues in Europe. We have also taken the opportunity to add to a number of companies which had been de-rated amid the market volatility created by Brexit.

**JAPAN:** We remain confident on Japan's ability to come through this period of poor performance. 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 continues to negatively impact 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.

Importantly, the fear that rising U.S. rates would spell doom for the emerging world seems to have dissipated somewhat, particularly now that we are past the first U.S. rate rise. With the Fed signaling that the pace of increases in 2016 will be measured, this uncertainty has decreased. The recent "Brexit" referendum vote in the UK is also likely to put a brake on any further tightening measures. Many emerging economies have also continued to improve their fiscal and current account deficits, debt positions and inflation levels since the 'taper tantrum' of 2013, 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. Overall, emerging markets growth should look brighter versus a lacklustre pace in developed markets. This improved economic growth should provide a healthier environment for emerging market corporate earnings, particularly if margins begin to improve, as we expect.

China remains a significant concern for investors. Two main worries have been the currency and the amount of debt in the financial system. The potential for a further unexpected and sharp decline in the renminbi is a risk as this could hasten capital outflows and put more pressure on the economy. Our expectation is that the renminbi may weaken but only modestly throughout the rest of the year. However, managing that devaluation process will be challenging.

In terms of debt, China has experienced a massive build-up since the 2008 financial crisis and a significant portion is owed by companies that are struggling, which is causing an increase in non-performing loans. Unfortunately the banks have been slow to recognize and provide reserves for these non-performing assets, which only increases the level of investor concern. If China were to suddenly recognize all of those bad debts, it could prove highly disruptive to the economy and potentially trigger a financial crisis. We believe that outcome is extremely unlikely given the government control of the banking system and the financial system more broadly. A much more likely outcome is a more gradual process whereby debt is either rolled over or restructured over the next few years.

Overall, 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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