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EQUITY MARKETS PULSE

GLOBAL COMMENTARY AND OUTLOOK

APRIL 2015

Q1 2015 - INTERNATIONAL STOCKS RALLY STRONGLY, BUT THE US HAS MORE MODEST GAINS

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Global equity markets rose over the quarter, driven by a rally in developed regions in response to aggressive quantitative easing (QE) measures in both Europe and Japan. US stocks rose in the first quarter of 2015 despite occasional bouts of risk aversion and volatility.

Developed European markets experienced an impressive rally, led by Denmark, Germany, and Portugal. To fend off falling inflation and weak economic growth, the European Central Bank launched a massive quantitative easing program in March. Developed Asian markets held up best, helped by impressive returns in Japan and Hong Kong. In Japan, the central bank continues its simulative measures to keep interest rates low, stimulate inflation, and keep the yen stable versus other economies. The Government Pension Investment Fund's reallocation of assets from government bonds to equities, which began in 2014, also helped stocks climb during the quarter.

Emerging market shares rose over the quarter as the Federal Reserve's repeated assurances that it would continue to keep interest rates low boosted investors' risk appetite. Asian markets fared best, led by the Philippines, China, and India. In emerging Europe, Russian stocks soared as investors shifted focus away from the Ukraine crisis and crude oil prices stabilized, but Greece sank amid continued concerns about the country's economic stability. In Latin America, Brazilian shares skidded following a steady stream of bad economic data and news of a major corruption scandal involving energy giant Petrobras.

OUTLOOK

UNITED STATES: The US economy is on sound footing heading into the second quarter, evidenced by steadiness in US job creation and GDP growth over the past few quarters. Despite subdued capital expenditures, solid revenue growth and improved efficiency and margins have the potential to support robust corporate earnings in most sectors, except energy, where earnings are expected to be much weaker. Interest rates remain low and will likely not rise until later in 2015, but are expected to remain at levels that continue to be favourable for stock performance.

Furthermore, the sharp decline in oil prices and rise in hiring has supported a high level of consumer spending and rising consumer confidence. However, the current environment is more complex and risk is higher than typical, meaning the significant level of uncertainty that is currently challenging markets is expected to persist.

Today, we believe valuations are best described as 'reasonable' for where we are in the economic cycle, although we would stress that this view is premised on the continued delivery of earnings growth.

There continues to be much debate about when the US Fed will raise interest rates. However, even when the Fed does begin to hike rates, it is most likely to be at a measured pace in order to assess the potential reverberations through financial markets and impact on growth. It is important to remember, however, that when interest rates do eventually normalise this will not necessarily be bad for stock prices. Higher rates often coincide with improved economic conditions, which typically bode well for equities.

Looking forward, the market continues to face some challenges. Questions remain over global growth, and whether the US can sustain its growth rate if conditions worsen overseas. On the positive side, the corporate sector remains in robust shape and the US is home to many industry leading innovative companies. Equity prices are though more likely to move in line with earnings growth rather than through any meaningful expansion in valuations. Importantly, we believe conditions are still supportive for further gains, although the upside is likely more limited due to fair valuations and already high profit margins.

EUROPE: European stock markets have continued to climb higher as QE and a lower euro have supported share prices. The weaker euro should continue to provide a huge boost to the export side of European businesses, and further increase the competitiveness of euro nations. Lower oil prices, more neutral fiscal policy, along with an easing of the deleveraging pressures should also prove beneficial.

On a country basis, economic conditions are varied and we continue to see areas of opportunity. Within the periphery, unemployment remains stubbornly high, although 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.

In the corporate space, the recent earnings season has developed generally as we expected, certainly for the companies we are invested in. However, pronounced downgrades in the energy and materials sectors, hurt by the collapse in the price of oil and other commodities, will affect the headline number for the market this year. Elsewhere, it is encouraging that more domestically-orientated companies seem to be at least meeting expectations. Although there have been some disappointments from companies more exposed to overseas, especially emerging markets (EM), consensus expectations now appear more appropriately calibrated.

Although recent investor confidence has lifted valuations from their historic lows, on a cyclically adjusted basis, the P/E ratio for the European market is currently around 16-times versus a longer-term average of closer to 20 times. As this measure utilises the average of the last 10 years' earnings, we believe it is a useful indication to the market's attractiveness assuming a normalised level of earnings. This measure is also attractive relative to other developed markets. On the same measure, Japan and the US trade at over 26- and 24-times respectively.

Our investment philosophy is clear: identify high-quality businesses in Europe that trade at attractive valuations. When we look across the broad universe available in Europe, we see numerous domestically oriented businesses that have been overlooked by investors and a number of global franchises that have de-rated amid emerging market growth concerns, and continue to find many attractive investment opportunities.

JAPAN: Japanese equities have continued to make strong gains as further QE and a weaker yen have boosted corporate earnings in many sectors. For a self-sustaining recovery, however, we believe domestic consumption needs to be the next growth engine.

We continue to see scope for further surprises in Japanese corporate earnings, given forecasts have not fully accounted for yen weakness. Less well documented is the operating leverage that is inherent in many Japanese business models, making potential sales growth a key driver of further profitability gains. Also, with margins and returns starting from a low base, we see ample room for expansion.

From a valuation perspective, although the extreme undervaluation of Japanese equities has been rectified; current valuations remain well-below pre-crisis levels so there remain opportunities for further gains.

Given the unchartered territory of Abenomics, there is every chance that sentiment will fluctuate as the efficacy and scope of Abe's reforms are called into question. For those investors able to take a longer term view, we believe there are good opportunities at this level. 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.

EMERGING MARKETS: Economic growth across many developing markets continues to be higher than in the developed world, although the growth premium is narrowing. Performance so far across emerging markets in 2015 has followed the same path as last year. Those countries that continue to push forward with reforms have been rewarded, while countries that do not have struggled. Valuations remain attractive overall for the EM world, with Latin America and especially emerging Europe looking especially cheap, even despite the recent gains in Russia. Asia by comparison is more fair value, although there are still good opportunities to be had. Importantly, valuations still remain at a discount relative to their history and to their developed-market peers.

There continue to be concerns over the EM world. The extent of the Chinese growth slowdown remains a key question, but policymakers are now focused on structural reforms that seek higher quality and more sustainable growth. There are also concerns over another temper tantrum when the US finally begins to raise interest rates. However, we believe the actual impact of interest rate increases on emerging markets will prove less significant than investors fear. When interest rates do start to rise, markets may suffer a mini sell-off as the hunt for higher yields pulls money out of emerging bonds and currencies. However, if rates move moderately higher because the US economy is doing well, that would be good for the global economy, including emerging markets.

Overall, the environment will remain complex, but this should provide a good opportunity for active investors to take advantage of valuation anomalies. The emerging consumer remains a powerful force and should continue to drive strong growth in a variety of industries and companies, including retail, banking, technology and the internet.

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