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October 2015

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

SEPTEMBER 2015 – STOCKS ENDURE FURTHER LOSSES, BUT PACE OF DECLINE MODERATES

US stock markets continued to decline in September, although not as steeply as they had the previous month. The technology-heavy Nasdaq Composite Index fared especially poorly, although it ended with the smallest loss for the year-to-date period. The energy and materials sectors performed worst among S&P 500 sectors, hurt by worries about falling Chinese commodities demand. Health care stocks were also particularly weak due to concerns about elevated valuations, especially in the biotechnology industry, and the prospect of new drug price regulations. The defensive consumer staples and utilities sectors were the sole segments to record gains for the period.

International and emerging market equities continued to be negatively impacted by concerns over a slowdown in China. The uncertainty about a U.S. Federal Reserve interest rate hike also added to the volatility in markets.

GLOBAL EQUITY VIEWPOINTS OCTOBER 2015

UNITED STATES: The current environment is less supportive of corporate earnings growth than many of the environments we have seen since the global financial crisis. The US economy has also become bifurcated in nature. The industrials sector remains in a broad profits recession due to weak global-end markets and a stronger dollar. Meanwhile, the commodity complex remains under tremendous amounts of stress. Nevertheless, consumption – the largest part of the US economy – appears to be doing well. Given these factors, we expect the domestic economy to continue to grow at a modest rate, with inflation remaining in check.

We now potentially see the Fed pushing a rate rise further out, but December is still a possibility. Meanwhile, commodities are currently at their lowest since 1999, which is effectively a huge dividend for both US consumers and companies.

Generally speaking, stocks are fairly valued relative to their historic levels. They have the potential for modest upside if we continue to stay in a low interest rate and low inflation environment, particularly to the extent that operating earnings in the S&P 500 grow.

EUROPE: We continue to be encouraged by economic data out of Europe. The composite PMI remains well above the level marking expansion, while gross domestic product rose steadily, up 0.4% on the previous quarter and 1.5% for the year. The weaker euro, cheaper oil, and the ECB's expanded bond-purchasing program have all lifted expectations of growth this year.

On a country basis, economic conditions are varied and we continue to see areas of opportunity. 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. Divergent monetary policy with the US and UK has led to a sharp correction in the euro, providing a boost to companies with offshore earnings and further increasing the competitiveness of euro nations. It is also encouraging that consumers appear to be regaining a measure of confidence in most markets, and credit conditions appear to have improved. Although inflation remains significantly below target, the recent move by the ECB to step up its asset purchase program has improved the outlook for prices.

The recent earnings season was generally positive, with the proportion of companies beating expectations increasing on the previous quarter. Perhaps more importantly, earnings momentum remains constructive with guidance upgrades for many companies and broadly positive earnings revisions. Elsewhere, it is also encouraging that more domestically-orientated companies are meeting expectations. Our preference for high-quality companies with greater domestic exposure, both to the European core and the periphery, has helped to negate the slowdown in emerging markets.

The recent derating has served to increase the attractiveness of European equities, with the forward P/E ratio falling to levels not seen since before the ECB began quantitative easing earlier in the year. On a cyclically adjusted basis, the P/E ratio for the European market is currently around 14-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.

JAPAN: The Shinzo Abe-led Liberal Democratic Party (LDP) has successfully broken the long held tradition of policy inertia via its attempts to jump-start the economy and equity markets with the magnitude of its policy intent. Past central bank and government leaders have made noise about stoking inflation

and economic growth, only to see these efforts flounder when their commitment to change and policy implementation was tested. However, monetary policy delivery has continually surpassed expectations; the yen has declined materially and real wage inflation expectations are slowly rising, while Abe has delivered a positive wealth effect on the back of a rising stock market.

For a sustained recovery, domestic consumption needs to be the next growth engine. For this to evolve, we need real wage inflation to take hold. Abe has been applying intense pressure on corporations to raise wages in order to support the Japanese consumer and reverse a 20-year cycle of wage and price deflation. Signs of labour market tightening and a healthier corporate profits environment are certainly supportive of wage increases. Indications of economic growth in Japan, together with corporate tax incentives, should also favour an increase in salaries. However, while bonuses and overtime payments are rising, a base wage increase cycle, at least in inflation-adjusted terms, has been lacking.

Abe is also attempting to deal with the economy's structural challenges—including Japan's energy import dependency and its reliance on export-driven growth instead of domestic consumption. Signs of change will be necessary for investors to be assured that Japan is capable of leaving its 'lost decades' behind. We are mindful that it will be a multi-year process and in the meantime, market volatility will be an ongoing feature of Japanese equity investing.

We believe that the instance of companies defying the sceptics by transforming business practices and governance standards is growing. This should help to deliver profit growth and generate shareholder returns. The volume of shareholder buybacks is increasing, while mergers and acquisitions activity is slowly emerging. Where implemented effectively, we expect transformational actions to be rewarded through higher valuations. This change in corporate mentality is certainly a longer term theme that should reward investors' patience.

Given the unchartered territory of Abenomics and the likelihood of near term disappointments, that sentiment will fluctuate as the efficacy and scope of Abe's reforms are called into question. Indeed, the recent announcement that Abenomics was entering a second stage (arguably before stage one has been proven) was a negative surprise to some, especially coming at a key point where investors are searching for tangible signs of growth and improvement.

Regardless of the interpretation of some that Abe's new targets were more politically oriented as opposed to economically meaningful, 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.

While patience is necessary, there are catalysts in the nearer term. We see scope for surprise versus consensus estimates, given forecasts have not fully accounted for yen weakness. Also, with margins and returns starting from a low base, we see ample room for expansion.

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: Economic growth across many developing markets should continue to be higher than in the developed world in the near future, although that gap will in all likelihood continue to narrow. Those countries that push forward with reforms should do well, while countries that do not will struggle.

We are likely to see a much more uneven EM world going forward, with less correlation and divergence in performance among countries and in stocks within those countries. Investors will have to therefore be much more granular in their approach. We are focused on high-quality companies as when you are dealing with a tough environment, as we saw in the nineties and in 08/09, the strong tend to get stronger, while the weaker ones tend to fall by the way side.

In terms of valuations, we sense much is already priced into EMs (economics, interest rates, FX). Many of these countries now feel cheap when we visit. Valuations also remain at a discount relative to their history and to their developed-market peers. However, for EMs to progress we need the start of the normalisation process of U.S. interest rates to begin. This will remove the uncertainty around EMs.

Near-term risks include a worse-than-expected slowdown in China or a breakdown in its financial system; a sharper than anticipated rise in U.S. interest rates; and an unexpected bout of risk aversion due to geopolitical events.

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.

With investors sceptical, valuations attractive and fundamentals bottoming, the environment appears positive for emerging markets equities and ripe for stock picking.

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