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September 2016

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

AUGUST 2016 – STOCKS LITTLE CHANGED IN LIGHT TRADING VOLUME

Major U.S. stock indexes were little changed in August amid low trading volume – as is typical of late summer – and unusually low volatility. Most of the major indexes reached all-time highs during the month, however. Second quarter earnings season wound down, and although corporate profits were generally better than originally expected, it was still the fifth consecutive quarter of negative earnings growth, according to FactSet. Small-cap stocks outperformed their large-cap peers. In the large-cap universe, as measured by S&P, financials stocks did best, helped by increasing expectations that the Fed will raise rates at some point in the months ahead. Information technology stocks also did well, and energy stocks were lifted by gains in oil prices amid speculation that an informal gathering of OPEC nations in late September could result in a production freeze. International stocks rose marginally with financials rallying during the month as uncertainty around Brexit eased. Emerging markets continued to outperform.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: At its annual economic symposium at Jackson Hole, Fed Chair Janet Yellen indicated that she believes that "the case for an increase in the federal funds rate has strengthened in recent months." Many market watchers believe this means the Fed will raise rates at either the September or December meeting. However, this is not a certainty, and even if they hike rates it is only expected to be 25bps, and after that we would expect a reasonable pause in monetary tightening.

Meanwhile, corporate earnings are likely to remain under pressure in the near term, but we anticipate there will be a modest pick up in growth by the end of 2016. However, with expectations largely reflecting a gradual improvement in growth, there is the possibility that we could remain in a choppy market environment up until then.

Valuations remain 'reasonable' however 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.

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 remains uncertain and there is fear that economic growth may lose momentum due to the broader uncertainty of Brexit. Despite the 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.

On a positive note, 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.

JAPAN: Equity market sentiment has been shifting in 2016. Given renewed uncertainty on several fronts, Japanese equity markets have experienced heightened volatility, which has shaken out some of the short term capital that had flowed into Japanese equities.

The direction of the currency, and the advantage that a weakening yen has provided since 2012, is one element of the investment thesis that has clearly shifted, at least for now. The strong appreciation over the past year has been a surprise, especially the magnitude of the strength. Even direct action by the Bank of Japan (BoJ), intervening to cut interest rates into negative territory – a move specifically designed to weaken the currency – has failed to contain the appreciation. The value of the yen is especially important given that Japanese equity market returns have become increasingly (inversely) correlated with the currency.

One positive to emerge from this period of uncertainty it is that policymakers in Japan have been reminded that the effectiveness of monetary policy alone is finite and ongoing support via the other 'arrows' of policy will need to be maintained.

Central to our positive view has been the real recovery in corporate profits. While Abenomics has stolen the headlines, the recovery in company profits has been the fundamental fuel that has driven Japan's equity rally since 2012. However, with the global outlook weakening in 2016, the momentum

in Japanese corporate profit growth has waned, at least for now. On a market-wide basis, profit growth is likely to be broadly flat over the next fiscal year, with downside risk to this view if the yen remains strong. This slowing profit growth has been quickly priced into the market, hence Japan's underperformance so far this year. Given this backdrop, we retain a particular bias towards companies that can continue to generate profit growth in the current environment.

We continue to anticipate further volatility and increasing dispersion of stock returns as the investment thesis surrounding the Japanese equity market evolves. While Japan's place as a cyclical equity market implies a greater level of volatility than peers, it is not the only market that is transitioning through a period clouded by heightened uncertainty. However, the injection of fiscal stimulus, alongside existing monetary policy, marks a significant shift in strategy for policymakers and should prove supportive for the equity market and Japanese consumer, if afforded time. Given attractive valuation levels, and the many pockets of growth and improvement still present in Japan, we remain constructive.

EMERGING MARKETS: Emerging markets continue to perform well, even despite concerns over a rate hike in the US. The fear that rising U.S. rates would spell doom for the emerging world seems to have dissipated somewhat. 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 aggressive tightening measures. Meanwhile, many emerging economies have continued to improve their fiscal and current account deficits, debt positions and inflation levels, 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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