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March 2016

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

FEBRUARY 2016 – STOCKS REGAIN SOME COMPOSURE, BUT STILL END LOWER

After beginning the year with steep losses, indices regained some exposure, but still ended down on the month. Elsewhere, some markets slipped into bear market territory early in the month as concerns about stubbornly low oil prices, a slowdown in China's growth, and negative interest rates continued to weigh on investor sentiment. Adding to investor fears is the uncertainty surrounding when – or if – there will be another interest rate move by the US Federal Reserve.

The banking sector was particularly volatile, amid a climate of negative interest rate policies adopted by central banks in Japan and Europe, and concerns about their exposure to the energy sector. Heavy losses reported in corporate earnings reports within the metals and mining sector and energy-related stocks also weighed on equity markets. As February came to a close, international stocks staged a short-lived rally on the back of a rise in oil prices and data showing that the US economy grew faster than expected in the fourth quarter. Though the rally erased some losses from earlier in the month, it was not enough to lift global stocks out of negative territory for February.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: Given the uncertain backdrop, the pace and timing of further interest rate rises remains a hot topic of debate. While being aware of the global economic environment, the Fed is also aware of the continual improvement in the labor market, moderate increases in wage inflation and the steady ongoing improvement in the housing market. The US consumer has lower debt levels than at the beginning of the global financial crisis and is benefiting from lower energy prices. Given this, and notwithstanding the slow GDP growth reported for the last quarter of 2015, we do not believe that a recession is imminent.

While some commentators have argued that the decline in oil prices is symptomatic of flagging demand and possibly even a precursor to more generalized demand shortfalls that may lead to a recession, we would note that these recent sharp price declines are more to do with excess supply caused by ongoing productivity improvements in shale oil production.

Therefore, with the FOMC's penchant to react to financial market conditions and the rapidly decreasing prospect of inflation reaching their 2% target any time soon, it is likely that the previously anticipated rate hikes for at least the first half of 2016 will be delayed.

Given the market's pullback, valuations have become more attractive and we view current levels as 'reasonable' considering where we are in the economic cycle. The current dividend yield of roughly 2.3% is 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. Valuations are reasonable, while the economy continues to grow, albeit at a slower pace than previous cycles. We remain reasonably constructive, but the outlook going forward is inherently more stock-specific than it has been for some time.

As we have witnessed for the last few years, sentiment is likely to ebb and flow. This will again likely provide opportunities to invest on bouts of stock-specific volatility. Inevitably, there will also be data points for market bears to point to, but these should be seen as opportunity to add to your highest conviction areas.

EUROPE: The weaker euro, falling energy prices and the ECB's economic stimulus measures have helped to support economic growth, but Europe is not a homogenous entity and economic conditions vary by country. Eurozone unemployment as a whole remains stubbornly high, particularly in peripheral countries, although recent declines in Spain, Italy, and Germany–to a record low–are notable developments. Progress on structural reforms and falling wages, however, have sharpened competitiveness, which should increase external balances and aid economic activity.

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The euro has fallen sharply as the ECB's efforts to boost the economy have diverged from US and UK policy. This is helping companies with offshore earnings and making eurozone nations even more competitive. The ECB's economic stimulus has also helped brighten the outlook for prices. By extending the €60 billion-per-month program rather than increasing it, the ECB has kept ammunition in reserve should a sustained pick up in prices fail to materialise.

However, moves to assert sovereign independence in Europe, notably the UK's referendum on EU membership and efforts by Catalans to separate from Spain, may continue to unsettle investors as the year progresses. Should the UK cut its ties with the European Union, a whole range of agreements – impacting such areas as market access and regulation – will need to be reframed.

Market valuations are reasonable in the context of the current level of earnings. The current earnings cycle has been subdued versus history. There remains scope for a meaningful recovery, although a range of global influences are currently conspiring to drag down near term expectations. When one applies a 10-year cyclically adjusted P/E ratio, which reflects the scope for earnings to recover over the medium term, values are still low not only compared with historical levels but also against other markets. On this measure, the European market currently trades around 14-times earnings versus a longer-term average of closer to 20-times.

JAPAN: The Bank of Japan (BoJ) recently joined the central banks of Sweden, Denmark and Switzerland in imposing negative rates on excess commercial bank reserves. The BoJ's announcement is in direct response to disappointing economic performance, worries about low inflation and weak bank lending. The negative 10 basis point interest rate will augment the BoJ's ongoing massive quantitative-qualitative easing (QQE).

The coming year will likely be driven a potentially weaker currency, progress on structural reform, but hopefully better corporate governance coming through in higher dividends and share buybacks. With an election coming up in the summer, the government will be incentivised to keep the market as positive as best they can, at least through the summer.

For those investors able to take a longer term view, we still believe there is a positive investment story. 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: Emerging markets have recently been on an improving trend. Indeed, since the year-to-date low on 21st January markets have recovered around 15%. Is this the turn in EM fortunes we have been waiting for? A weakening in the US dollar, sounds of more global monetary easing, and some cyclical recovery in oil and commodities have at least calmed the markets.

We have been of the view that most of the bad news had been priced into Brazil, and that seems to have been recognised more recently. Last week we had 'good' news, in that the Lava Jato corruption investigation reached ex-president Lula, fuelling speculation that support will grow to impeach president Dilma. The naughty pupil of EM has now rallied 43% since late January with a very sharp uplift post Lula's arrest last week.

Staying in South America, Argentina's new president Mauricio Macri has really 'hit the ground running' and looks to be on track to deliver on promises to return Argentina to normalcy – already lifting FX controls, devaluing the currency, eliminating most export taxes, adjusting electricity tariffs and is close to negotiating a solution with the debt 'holdouts', enabling Argentina to re-access international debt markets. The path will not be easy, as the fiscal deficit remains challenging and inflation is high, but if Macri can retain confidence and attract investments then there is room for Argentina to have several years of above trend growth. From an investment point of view, the challenge is the limited selection of liquid securities, and the fact that the market has already rallied significantly from its late 2012 bottom.

More generally, we remain focused on countries implementing meaningful reforms that are aimed at improving the quality and sustainability of their growth. India, Mexico, Indonesia, and even China have begun to implement important and much needed reform programs. However, the varying pace and success of those efforts in each country will continue to drive greater divergence in relative performance.

Key to our broad outlook is that dispersion within EMs. Our approach has always been to look at economies and stocks in a very granular way. Despite the overall slowdown, we would encourage investors to see through the negative headlines about economic growth and instead focus on the prospects of individual companies.

Overall, we sense many risks are already priced into EMs, and certainly many of these countries we visit now feel good value. Valuations are certainly attractive, both relative to history, and versus developed market counterparts. Often, it pays to be contrarian, with the best time to invest being when sentiment is at a low. If you are able to take a long-term view, and look through short-term market volatility, we believe there are rewards to be found within this more dispersed EM world.

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