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November 2015

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

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

Major equity markets finished October on a strong note. Equity bulls have been energised since the market's late summer swoon by among other things; waning angst over China's economy; a more relaxed attitude towards an approaching Federal Reserve rate hike; generally better than expected corporate results; the continuing boom in big M&A deals; and hopes for more stimulus from the central banks of Japan and the eurozone.

GLOBAL EQUITY VIEWPOINTS NOVEMBER 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.

The Federal Reserve has indicated that a December rate hike is likely, but the expectation is that it will be a modest increase, and the pace of future rate hikes will be determined by the strength of the economic data.

It is important to remember, however, that when interest rates do eventually begin the normalization process this will not necessarily be bad for stock prices. Higher rates often coincide with improved economic conditions, which in turn are supportive of corporate profit growth, and subsequently equity prices. History also shows that market valuations can rise along with nominal interest rates.

Given that backdrop and the strong returns seen since the market bottomed in 2009, the overall market is likely trading at fair valuations. Therefore, it is vital to continue to focus on investing in "all season" growth companies – those with leading market positions and seasoned management teams, that are well versed in allocating capital and managing expenses and whose growth is not heavily reliant on the overall direction of the economy.

EUROPE: We continue to be encouraged by economic data out of Europe. The Eurozone flash PMI released towards the end of November was 54.4, the highest level since May 2011. It indicates that Eurozone GDP growth has steadied around 1.6-1.8% annualised, a moderately strong but not spectacular pace.

Despite the slightly stronger pace of growth suggested by this report, we do not think it will be sufficient to sway the ECB from its plan to ease monetary policy in early December. Draghi plus the other influential ECB governors appear strongly committed to the easing path to offset risks emanating from slowing emerging markets. Moreover, the deflationary aspects of the PMI boost their case.

There is much speculation about what the ECB will announce in December versus market expectations. Our reading of consensus expectations is a 0.1% cut to the depo rate plus 1) a modest increase (€10-15 billion) in the monthly pace of buying, and 2) a lengthening of the purchase plan by 3-6 months.

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.

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: 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.

At the beginning of November, Abe instructed the government to come up with an action plan by the end of the month to help achieve his goal of expanding the economy by a fifth to 600 trillion yen ($4.95 trillion USD) over five years. Abe hopes that the measures should encourage Japanese firms to spend their record cash piles to boost investment on plants and equipment and raise wages in a bid to generate a cycle of growth led by the private sector.

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.

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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