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EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

MARCH 2016 – STOCKS SURGE AS INVESTORS REGAIN APPETITE FOR RISK

Stocks surged in March, putting most of the major benchmarks into positive territory for 2016. The gains appeared driven in part by a rebound in the price of oil and other commodities. A renewed willingness to embrace riskier assets also helped smaller-cap stocks. In addition, investors returned to beaten-down technology shares, making the sector the second-best performer on the S&P 500.

Hopes for continued low interest rates also helped markets. Statements from Federal Reserve officials indicating that rate hikes were possible at upcoming meetings had unsettled investors, but the Fed's decision not to raise rates at its mid-March meeting was greeted with relief. But even more supportive of sentiment was policymakers' announcement that they expected only two or three rate increases in 2016, rather than three or four. Following a speech late in the month, Fed Chair Janet Yellen appeared to spark another rally after referring to the threats to the US from slowing growth overseas, while reiterating the Fed's plan to move slowly and carefully in raising rates.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: The Federal Reserve seemed to affirm our view that the backdrop remains uncertain, and because of that, the pace and timing of further interest rate rises will be measured. Talk of recession remains, but we would stress that the consumer is in a strong place. There has been a continual improvement in the labour market, moderate increases in wage inflation and the steady ongoing improvement in the housing market. Consumers also have lower debt levels than at the beginning of the global financial crisis and continue to benefit 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.

Valuations remain 'reasonable' 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.

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. 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: Europe's modest economic recovery continues, for now. Leading indicators such as the composite Purchasing Managers' Index still signal expansion. The weaker euro, falling energy prices and the ECB's economic stimulus measures are also helping in supporting economic growth.

While headline inflation remains low, we should start to see a pick up as oil prices fall out of year-on-year comparisons. Even so, confidence that central banks can maintain a positive financial market environment has waned in some quarters. Markets will be looking for evidence that the ECB's recent financial package of stimulus measures has enough fire power to spur the Eurozone forward.

The meaningful increase in the asset purchase program to €80bn from €60bn per month, the inclusion of investment-grade corporate bonds, and a comprehensive new bank lending program ("TLTRO") could potentially be quite stimulatory. These measures provide actual liquidity and aim to encourage greater investment and risk-taking behaviour. But the measures also highlight the concerns about the potential fragility of the current European economic recovery, given the current weaker trends in global demand and pervasive deflationary forces.

In addition, 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. Uncertainty is likely to increase as we near the UK vote in June, and this may be reflected in greater volatility in financial markets and potentially some shorter-term hiatus in economic activity.

Our focus on good-quality companies at attractive valuations continues to result in a tilt toward domestically generated revenues. However, in recent months, we have added a number of high-quality companies with exposure to emerging markets as we believe they have fallen too far.

JAPAN: Concerns about global economic growth, the outlook for China, and renewed yen strength, have caused some investors to re-evaluate the case for Japan in recent

months. However, we would remind investors how far Japan has come in a relatively short period of time, especially when you consider the quality of the Japan equity rally relative to other markets.

Japan's rally over the last three years has been backed by a real recovery in corporate profits, in contrast to being driven by the expansion of multiples (i.e., valuations rising). Such fundamental improvement has been a rare feature within global equity markets.

This trend should help investors feel that material change is happening in Japan, but the weakness of the yen has been front and centre for much of the last few months. While helpful to returns in US dollars in the near term, the year-to-date strength of the yen is also a significant change. The pattern of yen weakness over the past three years has stalled, and recent strengthening goes against many predictions of further weakness. This matters because equity returns have become increasingly correlated with the weakening currency. Central to this is the fact that currency weakness has boosted corporate earnings growth and, in turn, resulted in the high-quality equity market rally that has been so important to the case for Japan.

Having held a view since late 2012 that the Bank of Japan's (BoJ) policy decisions would likely weaken the yen, our perspective today is of an increasingly unpredictable currency outlook. While the yen first began to rise as a safe-haven asset amid January's market turmoil, unusually the currency strengthened even further when the BoJ intervened to cut interest rates into negative territory—a move that was designed to weaken the yen. While we struggle to see any reason why the yen should meaningfully strengthen from here based on economic fundamentals, we have been examining our earnings expectations and will continue to do so in the event of the currency strengthening further.

It is important to make clear that we firmly believe that the valuation case for Japan still holds and that Japanese corporate earnings growth is likely to exceed global peers. This view underlies many of our preferred stock ideas today. There is one note of caution, however, which is that further currency strength, if it transpires, will most likely begin to diminish expected growth in corporate earnings.

Japan remains cheap relative to peers, both in absolute terms and versus the previous cycle high in 2007. On this basis, we believe current levels offer an appealing entry point for investors who are capable of sifting through the volatility for attractive stocks unduly caught up in a period of worsening sentiment.

EMERGING MARKETS: Emerging markets have been on an improving trend. A weakening in the US dollar, sounds of more global monetary easing, and some cyclical recovery in oil and commodities have helped calm markets. We are also seeing the first tentative signs of acceleration in emerging market growth.

We are encouraged by this, but 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 emerging markets. 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 in, and certainly many of these countries we visit now feel good value. 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 emerging world.

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