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October 2016

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

SEPTEMBER 2016 – STOCKS LITTLE CHANGED IN LIGHT TRADING VOLUME

US stocks were little changed in September as trading volumes and volatility picked up following a quiet August. The US Federal Reserve remained on hold with Fed Chair Janet Yellen noting that slowing productivity growth had caused officials to lower their long-term growth expectations for the economy, even as she noted that economic conditions had improved and that the case for raising rates "has strengthened" in recent months. Small-cap stocks outperformed large- and mid-caps. In the large-cap universe, as measured by the S&P 500, energy stocks outperformed, thanks in part to a rally in oil prices stemming from an OPEC agreement to cut production starting in November. By contrast, financial stocks declined on the back of inaction from the Fed and heightened regulatory scrutiny following the scandal at banking giant Wells Fargo.

International markets enjoyed reasonable gains. Japanese shares advanced as the Bank of Japan (BoJ) decided to tweak the terms of its quantitative and qualitative easing program instead of pushing short-term interest rates further into negative territory. European markets were mostly higher as the effects of Brexit have yet to materialise. Emerging markets performed in line with developed equity markets.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: The FOMC kept policy unchanged at its September meeting, but appear to be preparing the market for a December rate hike, saying that the case for an increase in the fed funds rate has strengthened with near-term risks to the outlook roughly balanced.

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. 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. The problem with trying to gauge the potential long-term impact is the myriad of potential outcomes, ranging from a hard exit to a more conciliatory end. However, in talking to the management of our cyclical UK company holdings, they have so far felt no discernible impact from the Brexit decision. Similarly, the impact on consumer confidence has been minimal. In Europe, the UK boasted the highest consumer confidence levels going into the vote, and this has not changed since.

Policy action is another key consideration in Europe given the confusing landscape of government/central bank action seen so far. We do not expect inflation to get close to the European Central Bank's target within the next two to three years. The current accommodative policy will likely continue.

However, central bank actions have created a very difficult environment for equity investors, with markets becoming much more rotational and highly dependent on the next central bank/government statement. However, rotation is good for bottom-up, stock-picking investors, creating mispricing opportunities as stocks go in and out of favour.

Valuations in Europe currently look reasonably fair. The market is trading at almost 15-times earnings, which is above average, but it is quite attractive relative to other major markets.

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 markets.

One interesting development has been the decision by the BoJ to target the yield curve. Having faced domestic criticism over its NIRP policy, the BoJ have decided to keep its benchmark interest rate unchanged at -0.1%, but has altered its policy framework, renaming it "QQE with Yield Curve Control." The BoJ will target a 0% yield on the 10-year JGB rather than an explicit expansion of the monetary base. Importantly, the BoJ pledged to continue asset purchases until CPI is consistently above its 2% target.

The direction of the currency remains important given that the Japanese equity market has become increasingly (inversely)

correlated with the yen. The strong appreciation over the past year has been a surprise, especially the magnitude of the strength. Even direct action by the BoJ, intervening to cut interest rates into negative territory – a move specifically designed to weaken the currency – has failed to contain the appreciation.

Overall, we maintain a positive view on Japan. Central to this 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 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.

We continue to anticipate further volatility and increasing dispersion of stock returns. However, 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. Given attractive valuation levels, and the many pockets of growth and improvement still present, 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. 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 as they experienced 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 and leverage remains high. However, emerging markets growth looks brighter versus a lacklustre pace in developed markets. This improved economic growth should provide a healthier environment for corporate earnings, particularly if margins begin to improve, as we expect. Valuations, even after recent gains remain attractive. While returns for emerging markets may improve, there will continue to be great dispersion within both countries and sectors.

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