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July 2015

EQUITY MARKETS UPDATE

JUNE 2015 – STOCKS MODESTLY HIGHER IN A LIGHT NEWS MONTH

Worries over a Greek debt default and its broader implications for the European common currency and financial system took a toll on global markets. The large-cap Dow Jones Industrial Average and S&P 500 Index fell, but the small-cap Russell 2000 Index defied the broader downdraft and managed a modest gain.

Elsewhere, most developed markets in Europe and Asia declined, while performance across emerging markets was mixed. Markets in emerging Europe and Asia fell sharply, while the Latin America region advanced.

GLOBAL OUTLOOK – JULY 2015

UNITED STATES: Markets have achieved minimal gains so far in 2015, and the environment has been volatile, which is not surprising at this point in the bull market. While we face several headwinds including anxiety about the impact of changes in Fed policy, weak industrial indicators, decelerating growth in emerging markets, and multiple geopolitical concerns, there are several positives as well. U.S. housing and labour markets continue to strengthen, earnings outside of the energy sector could be strong, and high levels of M&A activity and buybacks provide valuation support.

Overall, valuations for U.S. large-cap growth stocks seem neither particularly expensive nor attractive. Although some areas of investment have played out, opportunities remain in companies where we believe the market is underestimating the potential for growth over time. We do not expect events in Greece to have a major impact on global economies, or on the portfolio, but market volatility in China bears watching going forward.

EUROPE: While the past few months have been dominated by Greece's bid to stay within the Eurozone, the economic backdrop within Europe has continued to improve. The composite PMI has risen to well above the level marking expansion and gross domestic product accelerated in the first three months of the year. A return of growth in France and Italy helped boost the aggregate number to its fastest pace in nearly two years, rising 0.4% on the previous quarter. The weaker euro, cheaper oil, and the European Central Banks' expanded bond-purchasing program have all lifted expectations of growth this year.

While we acknowledge that a Greek exit from the Eurozone would likely result in increased risk aversion in the market, we are reluctant to place too much emphasis on this. Europe is much better placed to deal with a Greek exit than it was in 2012, given negligible private sector exposure.

The potential for tighter rates in 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 recent investor confidence has lifted valuations from their historic lows, on a cyclically adjusted basis, the P/E ratio for the European market is currently around 15 times versus a longer-term average of closer to 20 times. As this measure utilizes 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: While patience is necessary for Japanese investors, there are catalysts in the near term. We see scope for surprise versus consensus earnings estimates, given forecasts have not fully accounted for yen weakness while Japanese profit expectations look healthy versus most developed market peers. Less well documented is the operating leverage that is inherent in many Japanese business models, making potential sales growth a key driver of further profitability gains. From a valuation perspective, although the extreme undervaluation of Japanese equities has been rectified; current valuations remain well-below pre-crisis levels.

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 for further gains. However, at a stock level it is becoming increasingly harder to find good companies at cheap valuations. Therefore, it is important to do your research to focus on where companies' returns are going to improve as the structural and corporate improvements happen. This means investors will need to be selective, but as Japan begins to deliver on its promise, investors should continue to be rewarded.

EMERGING MARKETS: The backdrop for EM equities as a whole remains favourable. With indications that most central banks plan to maintain interest rates at lower levels for longer, this means the search for yield will continue. Some will point to the sell-off in EMs in the summer of 2013 on the announcement that the U.S. Federal Reserve's was 'tapering' its QE program, and many investors are now worrying over a repeat sell-off as we approach the long anticipated first hike in U.S. interest rates.

When U.S. interest rates do start to rise, EM stocks may indeed suffer a temporary pullback, but we do not expect the economic impact to be significant. Short term, it may create some uncertainty as the hunt for yield in EMs may start to look less attractive. However, much will depend on why rates are hiked, and at what pace. If rates rise at a moderate pace because the U.S. economy is doing well, it would be a good sign for the global economy, and should be positive for emerging markets.

With the continued dispersion and volatility within markets, careful stock selection will be important to long-term performance. Although valuations are not as compelling as they were a year ago, emerging markets overall are still trading at a discount relative to their history, and continue to look attractive versus their developed-market peers. However, investors will have to be much more granular in their approach.

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