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September 2015

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

AUGUST 2015 – CHINA AND GLOBAL GROWTH WORRIES SPARK MARKET CORRECTION

Much of the concerns in markets have centered on global growth, especially the slowdown in China. The subsequent fall in commodity prices, especially oil prices, along with the prospect of a less accommodative Federal Reserve has seen huge bouts of volatility in global markets.

The large-cap S&P 500 Index endured its sharpest monthly decline in over three years, while the narrowly focused Dow Jones Industrial Average fell the most since May 2010, the month of the so-called "flash crash." All of the major benchmarks entered correction territory—commonly defined as a drop of at least 10% from the recent peak—and the Nasdaq Composite was the only one that managed to end August with a gain for the year-to-date period. Within the S&P 500, the telecommunication services and utilities sectors held up best, while health care, financials, and consumer discretionary shares declined the most. Despite the plunge in oil prices during the month, the energy sector held up better than the broader market thanks to a month-end rally in both the price of oil and energy shares.

International and emerging markets equities fell sharply, in many cases erasing all of their year-to-date gains. Rather than a steady decline, stocks zig-zagged throughout the month, but strong rallies failed to match tumbles. However, the selling intensified in mid-August, leaving the indices much lower by the end of August and this trend has continued into September.

GLOBAL EQUITY VIEWPOINTS SEPTEMBER 2015

UNITED STATES: U.S. equities continue to look vulnerable to corrections, and the ongoing uncertainty regarding interest rates will remain a cause for further concern. While the scale of the recent volatility has been extraordinary, we are not surprised to see a market pullback following several years of significant gains that pushed stock valuations to above-average levels. As noted in previous months, we had become more cautious and expressed concerns about stock valuations.

Some investors may be afraid that the current downturn will become worse—which, of course, no one knows for certain. Historically, corrections happen on a regular basis, but we do not envisage the U.S. entering a bear market, as the economy and companies are in general in good shape.

We now potentially see the Fed pushing a rate rise further out, but December is still a possibility. Meanwhile, commodities are currently at their lowest since 1999, which is effectively a huge dividend for U.S., and other countries. Generally speaking we believe many stocks are oversold, and this has created some interesting opportunities. Market tops tend to occur when you get 1. An economic recession; 2. Extreme valuations; or 3. An interest rate pick up. There are concerns around all of these, but we feel valuations after the recent falls give us more comfort that long-term investors will ultimately gain from recent volatility.

EUROPE: Despite recent falls, there is much support for Europe and there are a number of countries that are reflecting resurgence in economic strength. The recent earnings season also saw much better results, driven by domestics, with earnings momentum accelerating. Events in China and the U.S. may well cause Europe to slow, but valuations are still supported and there is positive momentum. It is also encouraging that consumers appear to be regaining a measure of confidence in most markets, and credit conditions appear to have improved.

JAPAN: For a sustained economic recovery, we believe domestic consumption needs to be the next growth engine. To expect this, we need 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 the healthier corporate profits environment are now becoming more supportive of wage increases.

However, given the unchartered territory of Abenomics and the likelihood of near term disappointments, there is every chance that sentiment will fluctuate as the efficacy and scope of Abe's reforms are called into question. For those investors able to take a longer term view, we 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, and we may even see further QE if the markets are to be believed.

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: We are optimistic about the long-term outlook for emerging markets. Rising consumption, an expanding middle class, and real wage growth are the drivers of huge economic potential in the developing world. Emerging markets are trading at a significant discount on an absolute and relative basis, making current valuations compelling for long-term investors. Most emerging markets have stronger financial positions, larger currency reserves, and more flexible foreign exchange policies than they did a decade ago. Finally, most emerging markets are still expanding faster than developed ones and offer solid long-term growth opportunities.

In recent years, however, we have noted significant dispersion in the returns of emerging markets stocks even within the same country and industry. We anticipate further divergence in the performance of countries and companies, and we believe that careful stock selection will be crucial for producing good returns over time.

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