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August 2016

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

JULY 2016 – STOCKS ADVANCE DESPITE MIXED ECONOMIC DATA

Stocks recorded solid gains in July as investors responded favorably to the prospect of an extended low interest rate environment. In the US, the advance brought the large-cap benchmarks and the S&P MidCap 400 Index above the record highs that they had established in mid-2015.

The technology-heavy Nasdaq Composite performed best, helped by strong performance from tech heavyweights Microsoft, Amazon, and Alphabet (parent company of Google). International stocks also performed well despite the poorer macroeconomic backdrop.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: We expect the overall pace of economic growth to be slower than we anticipated. However, year-on-year comparisons should get easier towards the end of the year as we lap the impacts from the collapse in energy and the strength of the US dollar. We are also encouraged by the fact that consumer confidence, employment and housing continue to show signs of strength.

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. However, with expectations largely reflecting a gradual improvement in growth, there is the possibility that we could remain in a choppy market environment in the near term.

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: The outlook for Europe remains uncertain and there is fear that economic growth may lose momentum, due to a slowdown in the UK, and the broader uncertainty of Brexit. Despite these top-down concerns, we retain our conviction that the best way to ride out any volatility and instability is to focus on high-quality businesses that trade at attractive valuations.

Meanwhile, economic continue to still show modest growth in Europe, for now. Leading indicators such as the composite Purchasing Managers' Index still signal expansion. The weaker euro, lower energy prices and the ECB's economic stimulus measures are still helping to support economic growth.

Our focus on good-quality companies at attractive valuations continues to result in a tilt toward domestically generated revenues in Europe. We have also taken the opportunity to add to a number of companies which had been de-rated amid the market volatility created by Brexit.

JAPAN: The Shinzo Abe-led Liberal Democratic Party (LDP) has successfully broken the long-held tradition of policy inertia via its attempts to jump-start the economy and equity markets with the magnitude of its policy intent. Abe is also attempting to deal with the economy's structural challenges; corporate tax rates have been lowered, an enhanced corporate governance code has been implemented, while initiatives to encourage married women and foreign workers into the labour force have also been announced.

The instance of companies defying the sceptics by transforming business practices and governance standards is growing. This should help to deliver profit growth and generate shareholder returns. The volume of shareholder buybacks is increasing, while merger and acquisition activity is slowly emerging. Where implemented effectively, we expect transformational actions to be rewarded through higher valuations. We firmly believe that the valuation case for Japan still holds despite recent falls 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.

As well as market-specific drivers, the condition of the global economy remains a crucial factor in terms of support for the Japanese equity market. On this point, our view is that we remain in an environment of low, mildly improving global

growth, which should still help the best of corporate Japan to perform reasonably well. This is particularly the case for the highest-quality stocks.

Increasing dispersion and elevated volatility will likely have to be navigated in the near term, however, as the market digests subtle changes in the top-down investment case. Over the medium term, we remain upbeat, especially regarding those stocks central to Japan's evolution.

EMERGING MARKETS: Emerging markets have begun to perform better, with some delivering stronger returns than developed markets so far in 2016. The main question for investors is if the recent move in emerging equities is the beginning of a more sustainable period of better performance or just a short term bounce.

Importantly, the fear that rising U.S. rates would spell doom for the emerging world seems to have dissipated somewhat, particularly now that we are past the first U.S. rate rise. With the Fed signaling that the pace of increases in 2016 will be measured, this uncertainty has decreased. The recent "Brexit" referendum vote in the UK is also likely to put a brake on any further tightening measures. Many emerging economies have also continued to improve their fiscal and current account deficits, debt positions and inflation levels since the 'taper tantrum' of 2013, 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, assuming the country experiences 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. Overall, emerging markets growth should look brighter versus a lacklustre pace in developed markets. This improved economic growth should provide a healthier environment for emerging market corporate earnings, particularly if margins begin to improve, as we expect.

China remains a significant concern for investors. Two main worries have been the currency and the amount of debt in the financial system. The potential for a further unexpected and sharp decline in the renminbi is a risk as this could hasten capital outflows and put more pressure on the economy. Our expectation is that the renminbi may weaken but only modestly throughout the rest of the year. However, managing that devaluation process will be challenging.

In terms of debt, China has experienced a massive build-up since the 2008 financial crisis and a significant portion is owed by companies that are struggling, which is causing an increase in non-performing loans. Unfortunately the banks have been slow to recognize and provide reserves for these non-performing assets, which only increases the level of investor concern. If China were to suddenly recognize all of those bad debts, it could prove highly disruptive to the economy and potentially trigger a financial crisis. We believe that outcome is extremely unlikely given the government control of the banking system and the financial system more broadly. A much more likely outcome is a more gradual process whereby debt is either rolled over or restructured over the next few years.

Overall, valuations are attractive relative to historic averages and to developed markets. At the same time, as economies and earnings begin to advance, it should encourage investments back into these markets. While returns for emerging markets may improve, there will continue to be great dispersion within both countries and sectors.

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