MARKET INSIGHTS

SURFING THE VALUE WAVE

JANUARY 2016

2015's TURBULENT SEAS CRASH INTO EARLY 2016

They are exposing good value. Surfing the value wave looks an attractive strategy. Many investors seem braced to do this.

Six months ago, investors were asking, "When should I buy?" They are still asking. They see the value but not the triggers that will unleash it. Moreover, as falling commodity prices and 2016's China induced selling work themselves out, apparent value is becoming better value! Caution dominates, but it is precisely caution that often generates the best value. Despite today's concerns, we are overweight equities.

This is no time to "go wobbly" as UK Prime Minister Margaret Thatcher so famously advised President George H.W. Bush in the run-up to the first Gulf War. Neither is it time to be "gung ho".

It is abundantly clear that patience will be an early 2016 virtue. "Buying" and "Tucking Away" value seems to be "the" investment strategy for today. Japan falls into this category, we think, as well as selected Asian and Emerging European equities.

Moreover, given that global interest rates will unlikely rise significantly, investing in income type products (particularly dividends), remains attractive (a strategy that will no doubt be severely tested as 2016 rate hike fears ebb and flow). Asian dividend income strategies and Asian High Yield bonds stand out.

We have, however, adopted a more defensive stance towards a previous favourite, US High Yields, reducing, but maintaining, our overweight positions (more on this asset class overleaf).

Whichever strategy one chooses, we counsel a "Steady as she goes" approach; many of the tides preventing this value from being discounted have yet to run their respective courses. When they do turn, the value we see is disparate – not all attractively priced assets will rise with the incoming tide.

To further cloud matters, the on-going growth in already high global liquidity could result in additional choppiness, further muddying the investment sea.

So what are these macro tides? What value did they expose as they retreated? And what should we do? Read on.

Developed markets verses emerging markets – Investors' love affairs with the former are still flowing, it seems, but less aggressively than before. Some Asian emerging markets have been so beaten down (including China), their rebounds could be strong when the tides turn.

The rising US dollar has yet to run its course – The dollar could stay strong while investors bet on the pace of rising US rates and as other central banks keep to their easing programs. But cracks are appearing! The bulk of the dollar's rise may be over. Furthermore, value is apparent in some emerging market currencies; 2016 could well be the year these recoup some lost ground

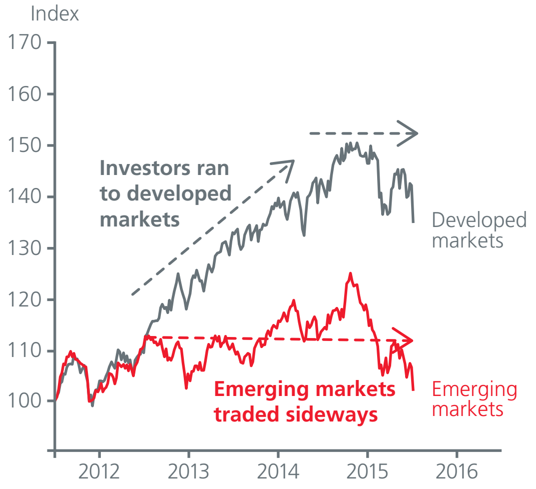
Declining global 2016 profit forecasts have yet to slow and reverse – While many Asia Pacific earnings fears seem discounted, equities may not react until convincing evidence emerges. Within Asia, this evidence could be an end to the fall in commodity prices.

Deflationary pressures may ease globally, but inflation seems restrained – This tide, in our view, seems likely to continue flowing, which is good news for bond prices. But many bonds are so aggressively priced that even a whiff of inflation could lead to high volatility. In this respect, Asian high yield bonds look better protected by their high yields.

DEVELOPED VERSES EMERGING MARKETS – 2016 COULD SEE INVESTORS CHANGE TACK

2016's big call will be in identifying just when investors tack back towards the emerging markets. Indeed, the grounds for a shift are slowly becoming evident, as illustrated in Fig.1 below.

Fig.1. Investors' ran to developed markets ...not *from* emerging markets. These mostly trended sideways



Source: MSCI World index (which covers the top developed markets) and the MSCI Emerging Market index from Datastream as at 14 December 2015. Both indices are in US dollars and indexed to 1 January 2015 = 100.

Between early 2013 and mid-2014, investors did not **run from** the emerging markets per se (individual markets excepted) as much as **run to** the developed markets (the short-lived bout of fear in mid-2015 being the exception)[1].

Developed markets have run a long way, as Fig. 2 illustrates. Even if US and Eurozone profit growth expectations are met, investors have already placed a high premium on the underlying profit forecasts[2].

[1]By the start of 2014, the bulk of the run towards the developed markets had already stalled in US dollar terms. The same picture emerges in local currency terms but starting in early 2015. [2]Defined as the 12-month forward price earnings multiple divided by (1 + the prospective earnings per share forecasts). Earnings forecasts are based on the IBES consensus forecasts from Datastream as at 5 December 2015.

There is little room for unpleasant surprises in either market. Japan is the exception[3] in displaying value.

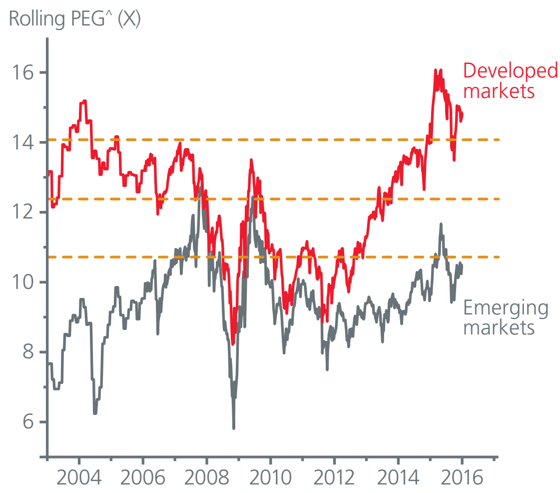
The overwhelming message of Fig.2 and Fig.3 is that the value lies in the emerging markets including China (where despite currency and growth fears, the 2016 profit forecasts have recently risen).

Once book value is taken into account (Fig.4), the waters clear; Japan stands out as being attractive.

And the bottom line? US and Eurozone equities per se look rich (unless earnings surprise significantly on the upside). In contrast, Japan looks good value. Within Asia, China, (and to a lesser extent), Korea and Taiwan are on our radar.

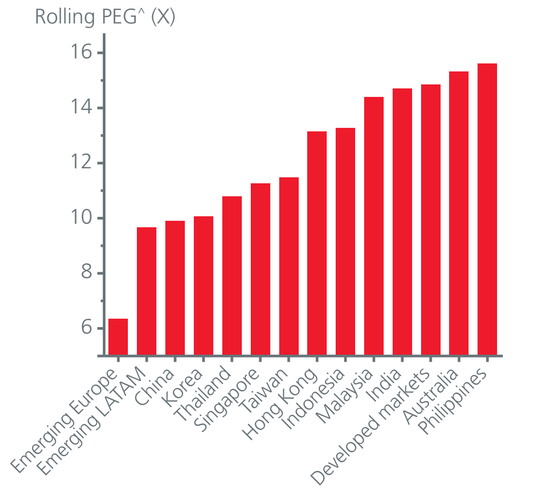
Any surprises? ASEAN equities and currencies could swing back into favour as Asian growth fears fade and as US valuations get “richer”.

Fig.2. Developed markets (bar Japan) have high premia. Emerging markets look better relative value on today's forecasts



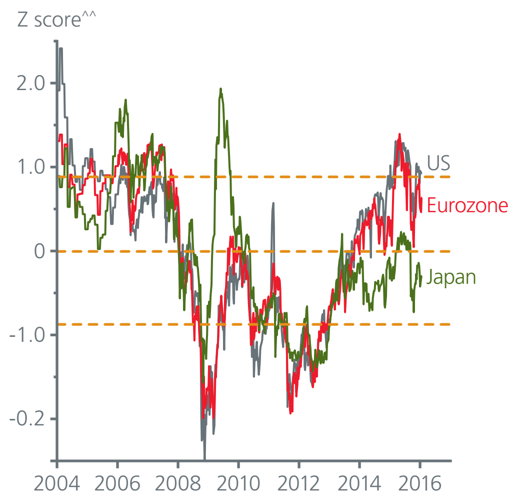
Source: Eastspring Investments, MSCI and IBES from Datastream as at 14 December 2015. ^Defined as the prospective price earnings multiple divided by (1 + 12-months forward consensus earnings per share growth). The middle dotted line is the average for the developed markets. The two out dotted lines mark the region within which around 70% of all values fall.

Fig.3. Asia looks attractive vs. developed markets. Asia's premia on eps forecasts are lower than developed markets



Source: Eastspring Investments, MSCI and IBES from Thomson Reuters Datastream as at 11 January 2016.

Fig.4. One third of Japan's listed companies trade below book value*



Source: Eastspring Investments, MSCI and IBES from Thomson Reuters Datastream as at 11 January 2016. *Based on the Russell Nomura index as at 15 November, 2015.

[3]By this measure, Japan, at 13¾X is the most attractive amongst the majors closely followed by the Eurozone at 14¼X. The US is least attractive at 16½X all as at 11 January 2016 as measured by IBES. Note on Fig.3: All data is in local currency other than developed markets, Emerging Europe and LATAM which are in US dollars. ^Defined as the prospective price earnings multiple divided by (1+ 12-months forward consensus earnings per share growth). Eastern Europe appears low because of the weak ruble. LATAM appears low given the 26.6%% rise forecast for 2016 profits. This looks overly aggressive to us even given the low base effect. Note on Fig.4: ^^The “Z” score is the equally weighted deviations of the 12 month forward price to earnings multiple (based on the consensus forecasts) and the historical price to book ratio, from their long term averages. The middle dotted line is the average while the two outer dotted lines represent the region within which around 70% of all values lie.

THE US DOLLAR COULD STILL RISE, BUT CRACKS ARE APPEARING. MANY ASIAN CURRENCIES LOOK ATTRACTIVE

Investors' love affairs with the US dollar seem set to continue (into early 2016 at least) on US interest rate hike hopes. Cracks are emerging, however; the strong currency is not only flirting with its historical peaks (Fig.5) but is also severely undermining declared corporate sales (Fig.6); these have fallen 3¾% from their November 2014 high with inventories surging[4].

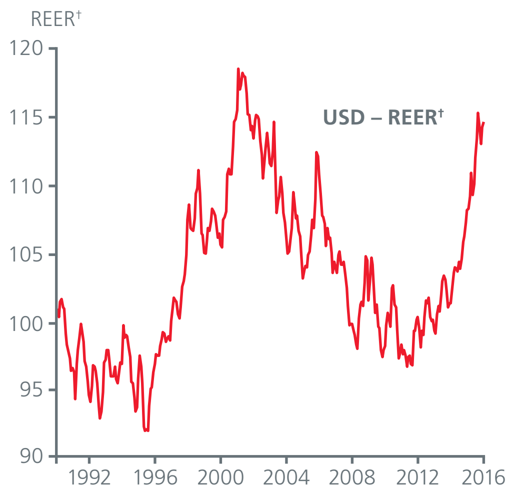
The pace at which the US Federal Reserve Board raises US rates will likely have a critical impact on the dollar's rising. Even though the Fed signaled an end to the low interest rate environment in mid-December, their ability to raise rates quickly in 2016 seems limited. Talk of four ¼% 2016 rate hikes seems just that – talk; while the "headline" data may look good, one has only to scratch the surface to see the underlying weaknesses.

The "encouraging" US jobs numbers, for example, quickly lose their lustre. Of the 4.5 million US jobs "created" since the crisis first hit in January 2008, 7.7 million have been for people aged 55 and over. Simple arithmetic shows that a net 3.2 million jobs have been lost elsewhere. That is not the sign of a healthy economy, the bounce-back since 2010 notwithstanding.

Moreover, actual hours worked for all non-farm business workers have fluctuated around a flat trend since 2000. No wonder wages per person are stagnant[5]. If the Fed is looking for a strong rise in demand over and above workforce growth, it might be waiting a long time.

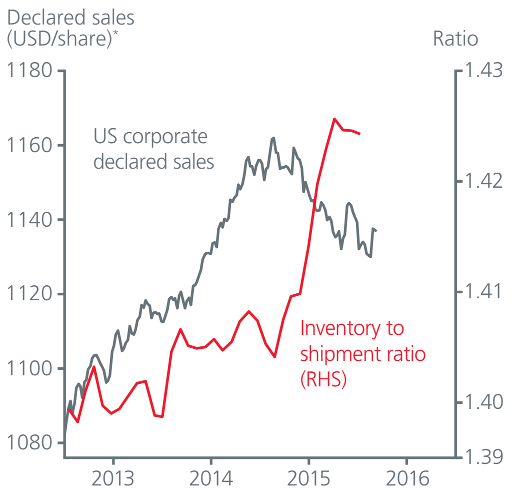
In contrast, owing to their sustained falls, attractive currencies can be found in Asia (India's rupee, the Philippine peso and Thailand's baht spring to mind. Malaysia's ringgit looks cheap but could stay so). And let us not forget that most Asian currencies are backed by strong fundamentals (Malaysia is the major exception)

Fig.5. The US dollar flirts with record highs – US exporters are under pressure Based on this PPI† measure



Source: JP Morgan from Datastream as at 11 January 2016. †The chart shows the real effective exchange rate for the US dollar based on the producers price index.

Fig.6. The US dollar "bites" – US sales suffer. US production hit as stagnant sales are met from high inventories



Source: IBES and US Census Bureau from Datastream as at 11 January 2016. Both series are exponentially smoothed using a weighting factor of 0.3. *Shows the real effective exchange rate for the US dollar based on the producers price index.

[4]The inventory to shipment ratio touched its July 2001 peak of 1.42 but has since eased back as stagnant sales have been met from inventory rather than production. This ratio soared to 1.51 at the peak of the financial crisis, but this peak was temporary. [5]All labour statistics are from the US Bureau of Labor Statistics from Datastream as at 9 December, 2015. They include the November 2015 data. Note on Fig.6: The inventory to shipment ratio is approaching its July 2001 peak of 1.42. This ratio soared to 1.51 at the peak of the financial crisis, but this peak was temporary.

that appear more solid than their emerging market counterparts.

The bottom line? While the dollar could remain strong vis a vis the yen and euro going into 2016, the end of its rise may be near. This could be the year in which attractive Asian currencies rebound.

THE WORST OF DECLINING 2016 PROFIT FORECASTS MAY BE OVER. ASIA MOSTLY DISCOUNTS LOWER PROFITS

While the strong dollar has undermined confidence in US profit forecasts, a slower 2016 economic growth outlook (particularly in China) has undermined confidence in profit growth generally. The bulk of the downgrading, however, could be nearing its end, especially as the analysts are running scared of late 2015's downturn in both Chinese imports and commodity prices.

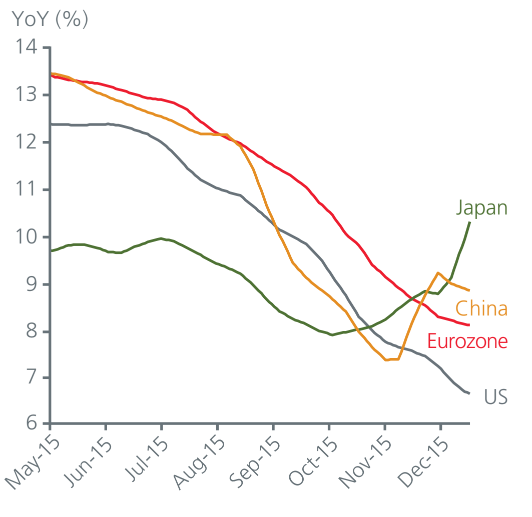
The path of the various profit downgrades (please refer to Fig.7) throw up some interesting messages.

Initially high 2016 profit growth expectations for the Eurozone, for example, have been dashed. While the same could have been said of China, a late 2015 surge in the 2016 profit forecasts support the view that many of the China related fears were overdone given the very low valuations. (We caution against excessive optimism; many of China's issues, the low return on capital being a prime example, remain).

The late-China-profit-upgrade (albeit partially retreating), is in stark comparison with the US, where downward pressure on earnings is on-going. As we have seen, US equities are expensive. China is not! (Investors will unlikely "bite" until currency and equity fears have fully run their respective courses).

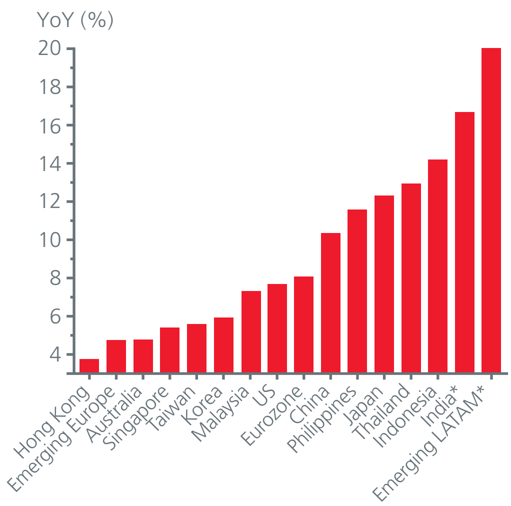
Standing out from the pack is Japan! Not only have the profit forecasts been more modest (realistic??) but also, Japan saw profit upgrades in late 2015. With a ferociously cheap yen, new orders trending upwards and analysts that have consistently under-estimated profit growth[6], the outlook is good.

Fig.7. Japan's 2016 profit growth forecasts surge – China bounces. US and Eurozone under pressure



Source: IBES from Datastream as at 11 January 2016. All series are exponentially smoothed using a weighting factor of 0.3. The series show the consensus earnings per share growth forecasts for 2016.

Fig.8. Asia's 2016 profit forecasts look OK. Emerging Asia, India and Japan lead the profit growth race



Source: IBES consensus EPS growth forecasts for 2016 from Datastream as at 11 January 2016.

[6]Over the past 12 quarters, declared earnings per share have beaten the forecasts. Source: Morgan Stanley from Bloomberg as at 17 November 2015. Note on Fig.8: Data is based on the MSCI indices for Emerging Europe, Malaysia, Philippines, India and LATAM, the Hang Seng index, the Straits Times, index, the Taiwan Weighted, the Australian All Ordinaries, Korea's KOSPI, the US' Standard and Poors 500 index, Eurozone's Euro Stoxx index, Japan's TOPIX index, Thailand's SET index, and Jakarta's Composite index. All series are in local currency except Emerging Europe and LATAM, which are in US dollars. *Both forecasts look high because of 2015's low base effect. Even allowing for this, LATAM 2016 forecast of 26.6% growth seems excessive .

The bottom line? The downgrades discount a lot of bad news. Nevertheless, we urge investors not to take their eyes off this important indicator. The critical message seems to be that within Asia, lower valuations have mostly been placed on lower profit forecasts (the Philippines is a major exception). In contrast, the US and Eurozone are placing high valuations on the lower forecasts and are thus more susceptible to any bad profit surprises.

DEFLATIONARY TIDES ARE PROVING STUBBORNLY DIFFICULT TO TURN – BUT TURNING THEY ARE (WE HOPE!)

Deflationary tides are proving difficult to turn decisively despite various central banks' best efforts to generate (limited) inflation (Fig.9)[7]. But it does look as though the tide is turning; 2016's global inflation is forecast to edge up to 2.5% from 2015's estimated 1.9%[8]. In addition, there is a good case to be made that oil prices could rise in the second half of 2016[9]. With many yields now in the positive range, this is encouraging (well, not bad) news for most bonds.

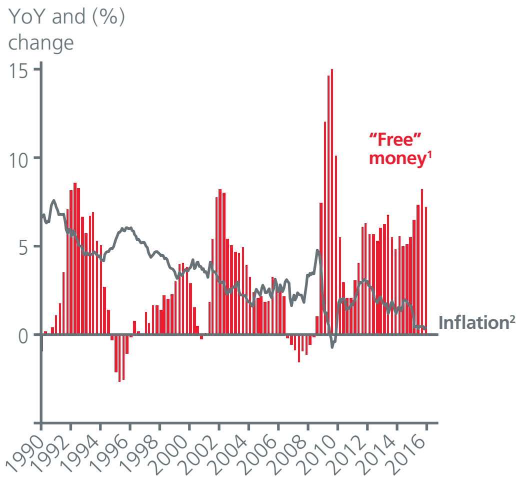
The big bond picture remains that the 35 year rally is nearing its end. Unless the deflationary tide surges, which seems unlikely, the capital upside for bonds is limited. The notable exception appears to be India, where structurally falling inflation could generate a strong 2016 bond rally.

The rally ending is not synonymous with the sell-off starting; given the low growth, low inflation environment being forecast, the case for buying bonds (specifically corporate bonds) for yield remains convincing. Rather than "Surfing the value wave", "Trading the value wave" seems more appropriate.

Within this broadly "stable" environment, bond selection, while always important, will become even more so. This is evident in Fig.10.

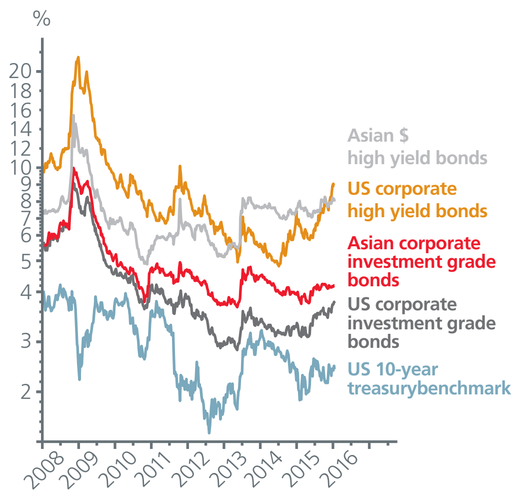
Despite their sell-off, we are unwilling to abandon US High Yields per se[10]. While acknowledging the risks, we recognise not only the extent to which these risks have

Fig.9. Global liquidity surges on ECB and BOJ policies. High liquidity should extend into 2016 even if us rates rise further



Source: OECD from Datastream as at 11 January, 2016. [1] Free money is defined as the gap between OECD M1 growth and nominal GDP growth. [2]Inflation is measured by the OECD consumer price index.

Fig.10. Corporate bonds look attractive for yield – US high yields face heavy seas. Steady US growth and rising rates historically blow wind in the sales



Source: Barclays Capital and JP Morgan from Datastream as at 11 January, 2016. All data are in USDs.

[7]As measured by OECD M1 growth less nominal OECD GDP growth. [8]Consensus Economics Inc., as at 9 November 2015. [9]The International Energy Agency in its November 2015 report forecasts that global supply and demand will meet in 2H, 2016 owing to a fall in non-OPEC oil production. [10]Our concern is that the sell-off in the oils and basic materials has spread into other un-related sectors – the "contagion" effect. Note on Fig.10: Past performance is no indicator of either present or future performance. Any views expressed above may alter without notification.

discounted[11] but also that high yields historically have performed well in low growth, rising rate environments.

In contrast, Asian high yields, with their greater exposure to China's recovering property market, held up.

Asian investment grade US dollar bonds outperformed their US counterparts being protected by, and offering, higher yields.

The bottom line? While bonds may have selective upside (Indian and Indonesian credits could be exceptions and rise more strongly), many corporate bonds will likely remain in play for yield in a low interest rate world. The fundamentals supporting US high yields still make them attractive for income even if there is more short-term volatility. The big decision for income seekers remains whether to seek income via credit yields and/or equity dividends.

IN A NUT SHELL

With no clear "break out" moment but with value to be found, we are building value stakes as and when they appear. We do not know when the tides will turn, but we know that when they do, we have to be positioned correctly. As a result, there has been little material difference in fund profiles. Our overweight in equities remains with the focus on Japan, China, Korea and Taiwan. We see selective value in Europe and Emerging Europe. Within bonds, we continue to focus on high yields within Asia and (with caution) US. Asian high dividend stocks remain good value, but as the cyclical stocks now provide many of the better dividend yields, investors may wait for concrete signs of an upturn before they react.

[11]The November selling drove the gap between HY valuations and the 12-month forward forecast default rate to over the 5 year average, which seems excessive. Source: BoAML and Moodys as at 30 September 2015.

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