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IS THIS ANOTHER EMERGING MARKET CRISIS? OR JUST A SETBACK?

Global equity markets have fallen sharply since the new year. And emerging market (EM) equity and credit portfolios have experienced substantial outflows since 2015. In our 2016 Outlook, we envisioned a year of generally low and volatile returns. But now, the key question is whether we are facing a new EM crisis – which could have contagion effects on the global economy – or a more benign outlook for growth.

As a $10.3 trillion economy, China is now significantly larger than both Asia in the 1997 crisis and peripheral Europe in its 2011 crisis. The faltering actions by the Chinese authorities to de-lever and to control markets, as well as to avoid a hard landing by loosening monetary conditions, have increased the pressure on the yuan to devalue as China shifts its currency peg away from the US dollar to a trade-weighted basket of currencies. The depreciating yuan, which is around 20% of the US dollar trade basket, has resulted in the trade-weighted US dollar rising to its highest level since its 2008 lows. Due to the negative correlation of oil prices to the dollar, market participants have used more liquid markets – such as oil and related risk assets like equities and high yield – as proxy trades on the yuan.

We think these pressures on risk assets will abate once the currency market stabilizes. The time to reach a market-clearing level for the yuan is uncertain. The world's major central banks are almost surely alarmed, so we continue to expect high global central bank coordination. While market technicals can decouple from fundamentals briefly, prolonged high volatility and uncertainty will weaken fundamentals in the real economy through a loss of consumer and investor confidence. This is already evident in the valuation of bank stocks in developed markets: The de-rating of future earnings is, in effect, the start of the market's pricing in higher provisions for commercial lending and higher-risk consumer elements of bank loan books. In tandem, credit spreads for bank-issued junior debt instruments in the form of loss-absorbing capital have widened significantly.

It's uncertain how China will attempt to break this downward spiral. Some capital control measures are possible, but we think China will likely be prudent on the use of reserves for currency intervention. In the US, the recovery after the financial crisis in 2008 was engineered by both the Federal Reserve and the Treasury acting swiftly and by deploying a fiscal and monetary bazooka that was several times bigger than the banking problem. In the eurozone crisis in 2011, the EU was not able to act swiftly, resulting in the slow, fragile recovery that continues today. We believe China has the means and the willingness to act to reinstate the loss of confidence.

Overall, EM economies are in a significantly stronger financial position than back in 1997, with reserves covering external short-term debt by 2x-4x for Asian economies and by more than 6x for China. The US consumer remains resilient, and The European Central Bank (ECB) and the Bank of Japan (BOJ) remain vigilant and on target with their quantitative easing programs. The US and European banking systems now have 2x- 3x the level of loss-absorbing capital than before the financial crisis. Therefore, we do not expect to see a 1997-style Asian contagion scenario for the global economy.

ABOUT THIS REPORT

Equity Insights is a monthly publication encapsulating the sector and regional views of our global investment professionals. Combined with an examination of fundamental trends, the debate and exchange of ideas results in actionable portfolio positioning and implementation across our platform.

Graeme Bencke,
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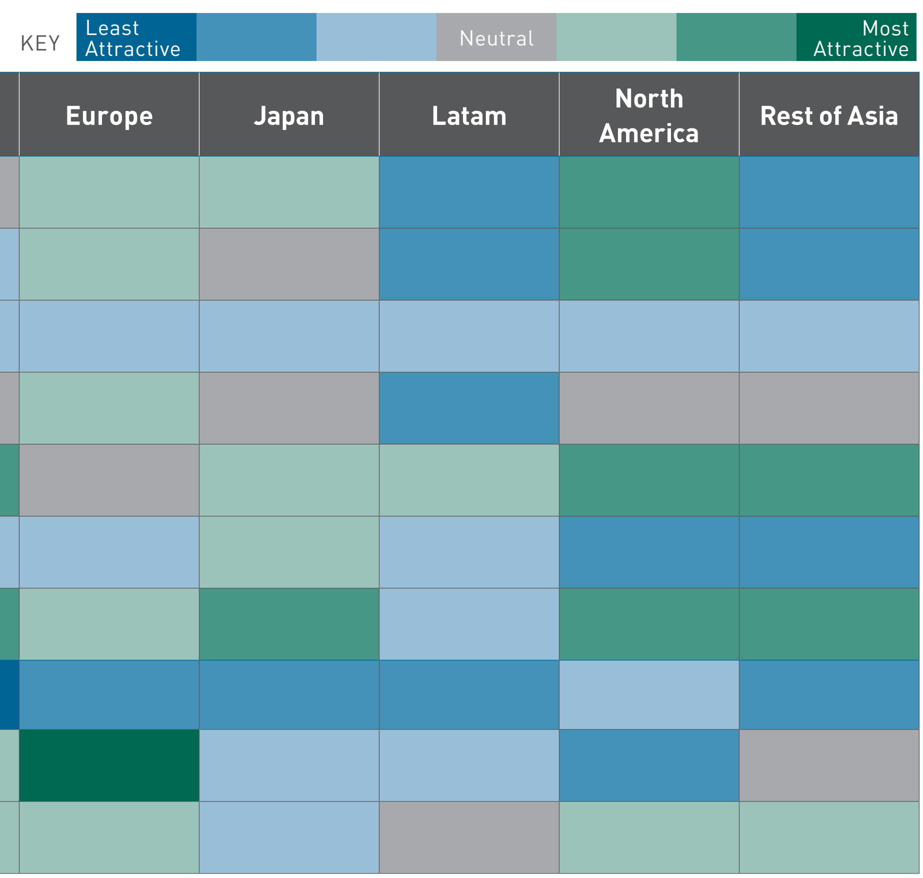
IN GLOBAL EQUITIES, SEEK SECTORS WITH TAILWINDS

Our strategic positioning reflects our somewhat cautious outlook for equity markets in 2016. A serious economic deceleration in EM appears unlikely, but economic dynamics also do not suggest any significant upside for financial markets. We continue to favor sectors that benefit from relative tailwinds. For example, in technology, the transition to mobile and cloud networks is driving corporate spending. And in health care, demand is growing consistently above GDP. We find the industrial, materials, and energy sectors unattractive due to their less favorable outlooks. A significant resurgence in demand for commodities does not seem likely over our investment horizon, and much of the industrials sector is closely linked to spending across commodities. Until the affected industries restructure appropriately, we expect returns to remain depressed.

Europe is a region of interest across a number of sectors. Telecoms stand out, with recent consolidation likely to improve margins across the industry. The consumer discretionary sector is also attractive in Europe and in North America, and we are focusing on the growing market share of "new economy" companies in retail and media in particular. We see more attractive valuations in pockets around Asia, with the health care and IT sectors again standing with an appealing risk/reward tradeoff as demographic trends and rising affluence will help to close spending gaps with the West.

SECTOR AND REGIONAL CONVICTIONS



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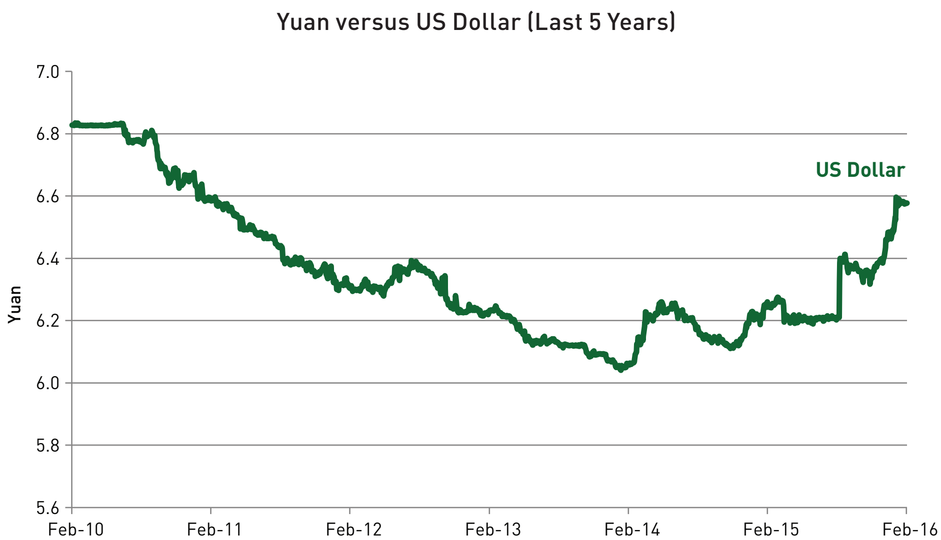
EMERGING ASIA GRAPPLES WITH HEIGHTENED VOLATILITY

Many factors led to a negative scenario for emerging Asian markets in 2016. With oil prices at lows not been seen in decades, the longer term effect of very low oil prices, if sustained, will negatively affect countries like the Philippines that depend on worker remittances and further weakness in trade.

In China, we expect the yuan will modestly depreciate at a measured pace. Chinese authorities are committed to sustainable growth by rebalancing the economy away from manufacturing and fixed asset investments, but the recent extreme regulatory measures have caused volatility in financial markets. Timing has been unfortunate as it coincides with the Fed's desire to set a path toward normalized interest rates, while Europe and Japan continue to struggle to drive growth and inflation. The yuan's depreciation has led to greater falls in other Asian currencies.

Sector and stock selection will drive alpha rather than broader country-level allocation given the unusually uncertain environment. We believe consumers and health care industries hold the potential for attractive growth. Valuations have now reached recessionary levels, which we consider unwarranted. We would, however, want to see more stability measures from regulators before advocating for a more risk-on approach.



We Expect More Depreciation With Impact on Equities Globally

Source: Bloomberg. As of 3 February 2016.