» EQUITY INSIGHTS OCT: 2016

Anik Sen, Global Head of Equities

WHEN POLITICAL RISK RISES, DIVE DEEPER FOR ALPHA

The political calendar for major economies is full. Each key event has the power to significantly change expectations. Yet this risk is not currently priced in, with markets generally assuming the status quo will continue.

The US presidential election on 8 November will be followed by the Italian referendum on constitutional reform (4 December, with Prime Minister Matteo Renzi's leadership at stake), a general election in the Netherlands (15 March), French presidential elections (23 April and 7 May), and the German federal election (starting in late August). The UK's Conservative Party appears to have made a decision to trigger Article 50 of the Lisbon Treaty to exit the EU by March 2017, but there are many execution difficulties. China will hold its fifth plenary session on 26-29 October, and the Central Committee will likely craft the next five-year plan, with the Committee's five-year term expiring in November 2017.

The common denominator across both sides of the Atlantic, and Brexit is an example, is the wave of anti-establishment sentiment. Additionally, market risk is now asymmetric to the downside, given the muted response to heightened negative interest rate policies, quantitative easing, and yield curve targeting. So central banks are unlikely to risk any change in messaging for some time to come, in our view – and that is good news.

In addition to political uncertainty, the outlook for the trend rate of US nominal economic growth has been on a downward trajectory for the longer term. The Federal Reserve's "dot plot" of long-run policy rate expectations exemplifies this trend. While this acted as a short-term fillip to markets recently, overall equity index return expectations are now also low. Active equity managers need to dive deeper to seek true alpha, anticipating changes at the company or industry levels well before they become visible to markets. Indeed, the deeper the dive below the mega caps in the index (which have been acutely driven by "style factor" investors and liquidity), the greater the return opportunity in a broad range of stocks that are benefiting from secular changes and offer attractive valuations. The concurrent challenge for all portfolio managers will be to maintain a balanced portfolio – in what are likely to be more unstable market conditions – in the context of fair-to-high overall valuations.

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 result in actionable portfolio positioning and implementation across our platform.

Graeme Bencke, ASIP, Portfolio Manager and Global Strategist

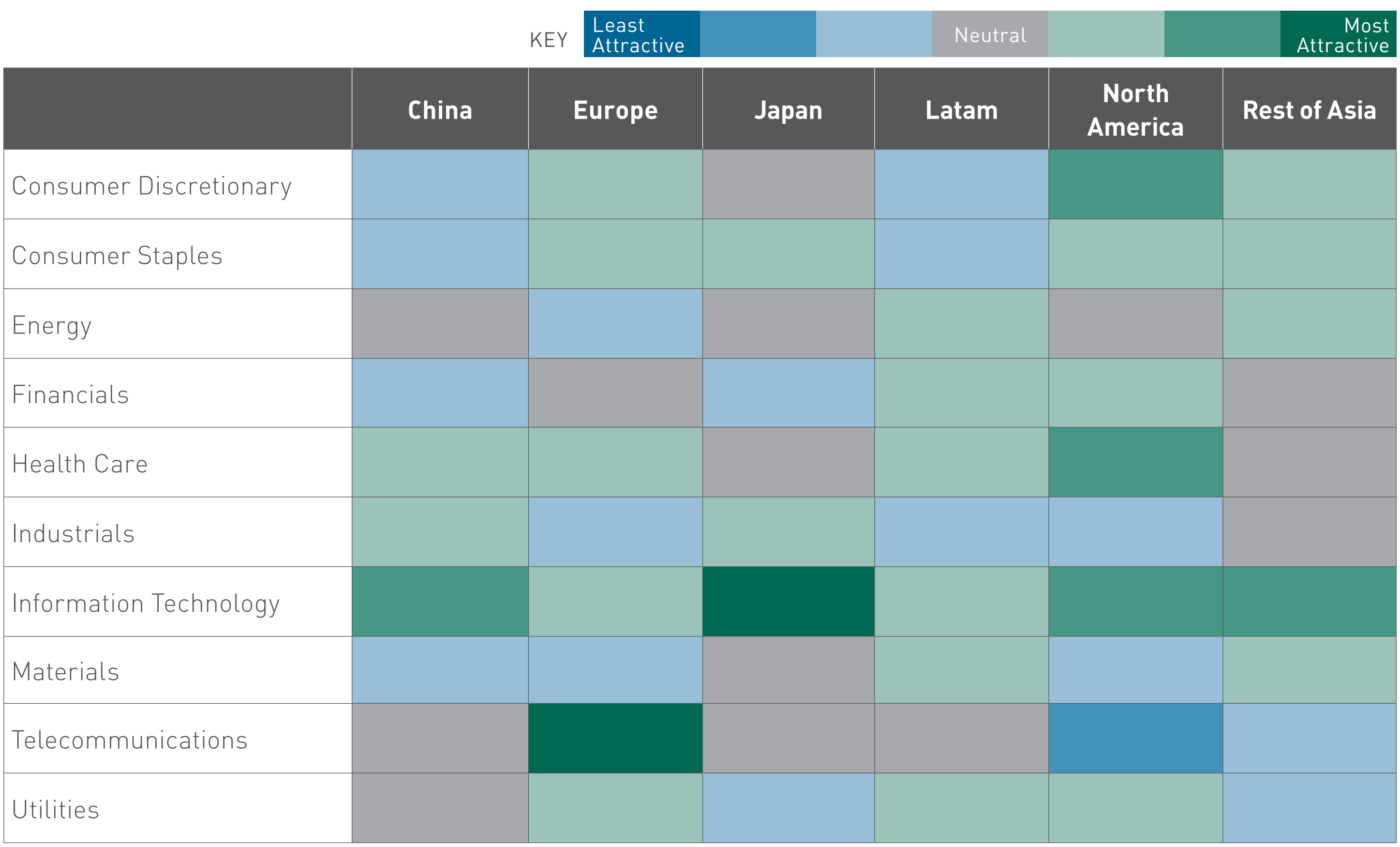
GLOBAL ALLOCATION

Private investment continues to be weak in both India and China. While strong local financial sector performance could light a fire under cash-rich companies in India, we are waiting for such investments to materialize. In China, our preferred area for Asian investment, heavy state infrastructure spending more than compensates for low private investment. In recent comments, Jean-Sebastien Jacques, CEO of Rio Tinto, suggests an inflection point ahead as "China seems to have plateaued."

Increasing political risks further cloud the uncertain economic picture. This, along with many global equity markets priced near all-time highs, is unsettling for fundamental investors. Despite signs of improved bank lending in the US and Europe, we continue to see greater incremental opportunity in the East, where valuations are more supportive.

While the central bank distortion of capital markets will continue to influence equities, PineBridge focuses on company fundamentals rather than attempting to predict political outcomes.

SECTOR AND REGIONAL CONVICTIONS



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Wilfred Son Keng Po, Portfolio Manager, Asia ex-Japan
Elizabeth Soon, CFA, Portfolio Manager, Asia ex-Japan Small Cap

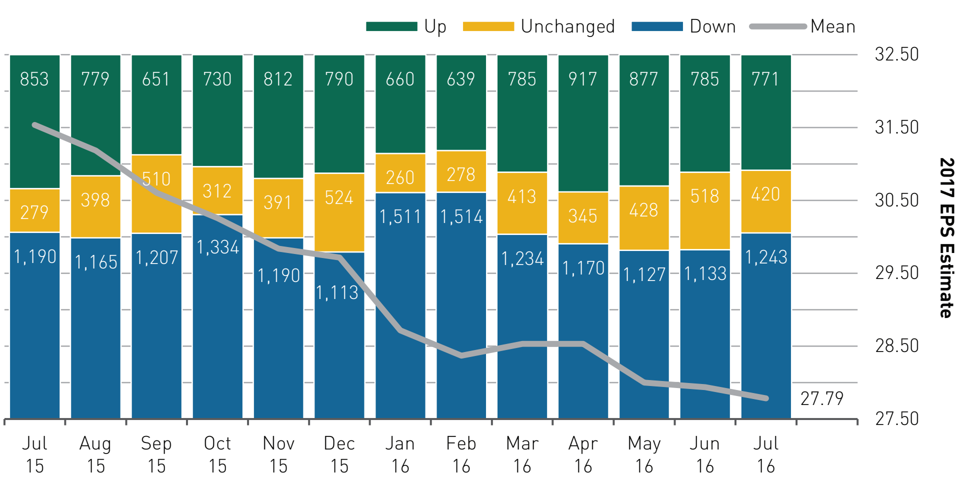
REGIONAL ALLOCATION: ASIA

Cyclical industries led the recent rally in Asia ex Japan equity markets, with the MSCI Asia ex-Japan (MXAPJ) index gaining 3.5%. Earnings were mostly in line in the second quarter, with more companies beating expectations than missing them. Risk appetite came off early highs and foreign buying moderated. Asian currencies generally weakened against the US dollar on increasing rate hike expectations following Fed Chair Janet Yellen's hawkish speech in late August.

Confirming anecdotal company commentary on signs of economic stability in China, actual six-month 2016 earnings are tracking 50% of full-year estimates, matching historical averages (Bloomberg consensus); reported calendar year 2016 second-quarter profits declined 3% year over year but increased 9% quarter over quarter. Excluding financials, calendar year second-quarter sales revenue grew 2% year over year, but net margin was down 40 basis points. For the 262 companies that have second-quarter and first-half 2016 estimates and have reported (mostly those in China, India, Korea, Taiwan, and Thailand), 41% beat consensus, 25% reported in-line results, and 34% missed.

In China, the actions of the authorities to control liquidity – which drives property prices in the various tiers of cities – should produce results in the coming quarters. This is key for investor sentiment as well as for asset quality in the banking system, where banks appear to be following a strategy of gradualism by charging off approximately 2% of their loan books each year. The massive credit impulse earlier in the year appears to have stabilized growth prospects in the near term. We remain positive on the "New China" stocks, as well as on the beneficiaries of government policies. For Asia in general, a stabilizing China and the prospect of increased fiscal spending in the US following the presidential election should help increase risk appetite.

MSCI ACWI Earnings Estimate History



Source: FactSet.
Reflects the statistics of the MSCI AC World Index (ACWI) in USD, as of 9 September 2016.
Revision history reflects the number of companies with upward/downward/unchanged 2017 EPS revisions.
Mean reflects consensus 2017 EPS estimates.

Now that earnings have stabilized, investors are seeking more risk

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