» EQUITY INSIGHTS JUN: 2017

Anik Sen, Global Head of Equities

WITH MARKET EXPECTATIONS RIDING HIGH, STOCK SELECTIVITY IS KEY

It is high time to scrutinize individual stock-level expectations that are embedded in the price of stocks and to shift away from crowded positions toward stocks with low or reasonable market expectations. Monthly data releases from US companies show that, on an aggregate basis, the cyclical expansion is continuing, and it is our view that macroeconomic data will eventually confirm this trend. However, since mid-March, US economic data, on average, has been weaker than expected. This has coincided with the downward drift in long-term bond yields, with US Treasury 10-year yields declining from a high of 2.63% on 13 March to 2.12% as of 14 June. Conversely, earnings expectations of companies continue to be either stable or on the rise. For example, a recent sell-side survey of CFOs in the highly cyclical US machinery sector pointed to increased capital expenditures to replace equipment and improve productivity via technology upgrades.

As we've pointed out before, in this third and final step in the market's normalization, earnings revisions will be the prime mover for returns. We estimate that at the current valuation, the median expectation for positive earnings revisions are between two to three standard deviations above the forecast mean for the US, Europe and India. Our discounted cash flow (DCF)-based valuation at the equity index level shows that since January, the cost of equity has declined to below average pre-2008 levels for US and European indexes. Our own categorization of the investment universe finds two categories of cyclical stocks attractive – growth and mature – as well as certain emerging markets, notably China.

Key to China's growth is whether consumers are likely to increase spending, which is critical for the economy's successful handover from manufacturing as the dominant growth driver. The share in total economic growth from consumption has increased from around 50% three to four years ago to 70% recently. The middle-high income groups in China are largely the millennials who come from the 4-2-1 (grandparents-parents-single child) family structure with a vastly different propensity to spend on premium products and services than their parsimonious parents and grandparents. They have enormous spending power, with a high savings rate of around 30% (compared with 5% in the US), good wage growth, and strong household balance sheets. Property accounts for 60% of assets, and the steady rise in real estate prices has created a strong wealth effect in recent years. The anti-corruption campaign by the authorities in China that began in 2012 may have resulted in slower luxury sales, but that effect is now waning, in our view, based on recent company results. For the longer run, the number of workers in China is likely to shrink from over 900 million to about 700 million by 2050 according to China's Ministry of Human Resources and Social Security. This means that it will strive to increase both productivity and consumption, and the growth in spending is likely to be secular rather than cyclical.

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

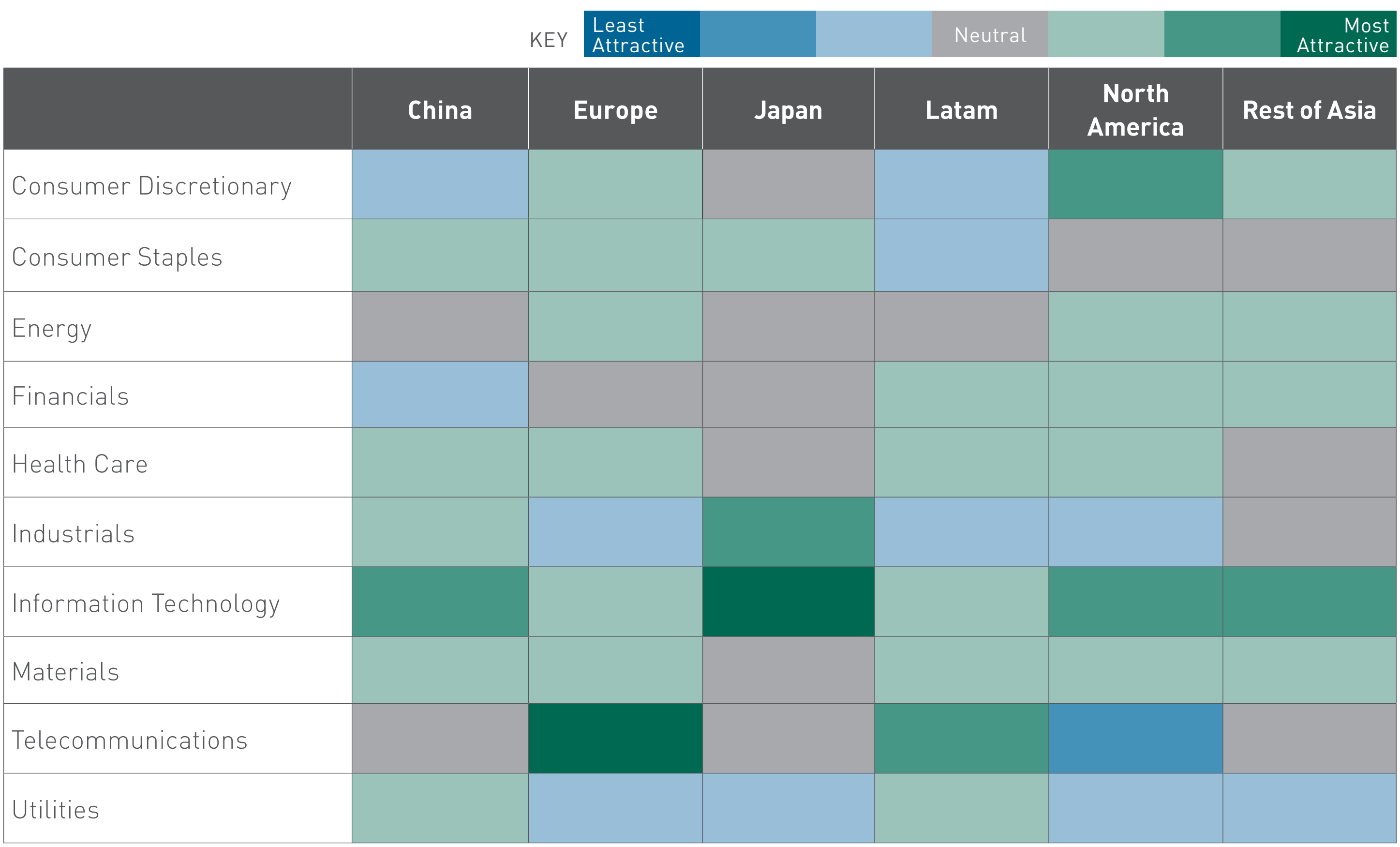
GLOBAL ALLOCATION

China remains an important engine for the global economic recovery as the country transitions from the older, export-driven model to more inward-focused growth from consumption. Concerns over a hard landing and a currency collapse have receded over the past year, as the government responded well to the challenges it faced. The local housing market remains a crucial component of the outlook. Weakness could drive local investors to look to international opportunities and consequently put pressure on the currency. The discussion at our most recent equity investment forum suggested that the situation remains well controlled. Short-term disruption resulting from a more restricted use of wealth management products demonstrates the country's on-going transition to a more transparent system of credit provision, and as a result, our emerging market (EM) Asian outlook remains favorable.

Supporting this view is positive news elsewhere in the region – for instance, the election of South Korean President Moon Jae-in, given his more conciliatory approach to the North. South Korea's relations with China also appear to have thawed somewhat, leading to improved demand growth for local exporters. This has been helping to drive improving investment flows into the country. India remains one of our top areas for investment over the coming years. Investment has picked up with more infrastructure construction sanctioned, including roads and metro projects. And the Reserve Bank of India has taken early steps to address capitalization shortfalls across much of the local banking sector – a crucial process in order to regain international trust in the system.

We continue to favor Europe, and see attractive upside in the region. The outcome of the French presidential election has helped to dampen political concerns across the Continent, and solidly improving sentiment indicators, suggesting demand growth, are helping to provide a much-needed boost to confidence.

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

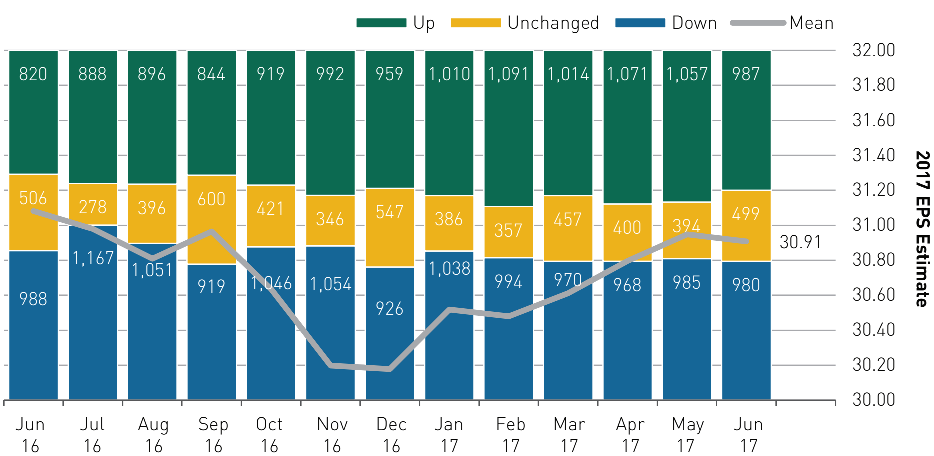
The Asia region's flows have turned more positive, with investors gaining momentum, especially in Taiwan and South Korea. Technology remains a strong sector, led by semiconductors and mobile gaming. Profitability is stronger than it has been in six years. Further earnings upgrades last month resulted in the tenth consecutive month of upgrades to the 2017 estimated consensus earnings per share (EPS).

As for South Korea, the new president is expected to launch populist policies. Hence, in the near term, we are likely to see positive catalysts for the market with continuing upgrades to the 2017 estimated consensus EPS. South Korea's export growth has been stronger, inventory/shipment has improved, and corporate results have been better than expected. The consumer sentiment index recently rose to over 100, and the earnings revision cycle is likely to remain strong throughout the year.

Selected ASEAN economies are likely to benefit from China's spending. Malaysia may be the top beneficiary, followed by Indonesia and the Philippines. However, some local businesses in the region are facing foreign competition, many for the first time since 1998. For example, Chinese developers plan to build 2000 mid- to- low-end apartments units in Jakarta in third-quarter 2017. Two countries that won't benefit directly from China's One Belt One Road initiative to improve regional infrastructure are Thailand and Singapore. However, the trade inflow from China will be favorable for Singapore.

Valuations still favor North Asia, which trades at a larger than historical discount to the Asia region. While North Asia has had eight consecutive months of upgrades to 2017 estimated consensus EPS, ASEAN has seen downgrades or flat revisions over this period.

MSCI ACWI Earnings Estimate History



Broad-based positive earnings surprises for the first quarter supports positive outlook

Source: FactSet.
Reflects the statistics of the MSCI AC World Index (ACWI) in USD, as of 9 June 2017. GIC Sector classifications reports Real Estate separately, effective 31 August 2016.
Revision history reflects the number of companies with upward/downward/unchanged 2018 EPS revisions.
Mean reflects consensus 2018 EPS estimates.

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