» EQUITY INSIGHTS NOV: 2017

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STRONG COMPANY FUNDAMENTALS AND REFORM EFFORTS BODE WELL FOR 2018

Equity markets have been buoyed by improving company order books, a return to synchronized global growth, and central banks continuing to maintain a high level of monetary accommodation in the absence of any significant risk from inflation. But what has been remarkable this year is the strong improvement in company operating fundamentals.

November is already year-end for many asset managers, particularly in the alternatives world. It is also the season for portfolio managers to share their outlooks for the coming year, which provides a good opportunity to review what actually transpired in 2017 versus what managers expected coming into the year. While we did expect emerging markets, smaller cap stocks, and technology and financial stocks to outperform this year, few expected such stellar returns from equity markets and individual stocks.

Company fundamentals have strengthened. Valuations are high, in the context of synchronized global growth and low interest rates, but what has been remarkable is the strong improvement in company fundamentals throughout the course of this year. This has translated into an upward sloping curve for the ratio of company upgrades to downgrades across virtually all markets, and stocks seem increasingly likely to lower elevated P/E multiples through increased earnings. As stock correlations fell sharply during the year, the dispersion of valuations in equity markets has also risen, suggesting a good pay-off from skillful stock-picking.

The risks associated with political developments in Europe, though appearing significant this time last year, did not materialize (though they haven't entirely gone away due to recent developments in Germany) nor did the prospect of the incoming Trump administration imposing trade tariffs, which we noted was particularly problematic given an interconnected global supply chain.

US tax reform seems likely. Tax reform is currently at the forefront of the market's attention in the US, and expectations have gradually risen that Congress will pass legislation in early 2018. One element of the proposal included in both the House and Senate versions is that interest deductibility for companies would be limited to less than 30% of earnings before interest, taxes, depreciation, and amortization. We have estimate that this would affect less than 3% of the market value of the top 900 companies, and that those companies would lose some 6% of their earnings. While this is only a screening based estimate, and individual companies are likely to feel more acute impacts, this does give us some confidence that the interest deductibility proposal is unlikely to cause material problems for equity markets overall.

In China, consumption grows more conspicuous. We have been keenly watching progress in China following the culmination of the 19th National Congress. Our interpretation is that one of China's highest priorities is to have strong macroprudential systems in place to mitigate systemic risk. In that context, total social debt has stabilized at approximately 270% of GDP, up from 150% in 2007. While a slowdown in China's property markets is likely, the authorities have proven themselves to be skilled at implementing tools at their disposal to avoid a sharp contraction. In the meantime, the economy continues to shift toward consumption. One clear

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.

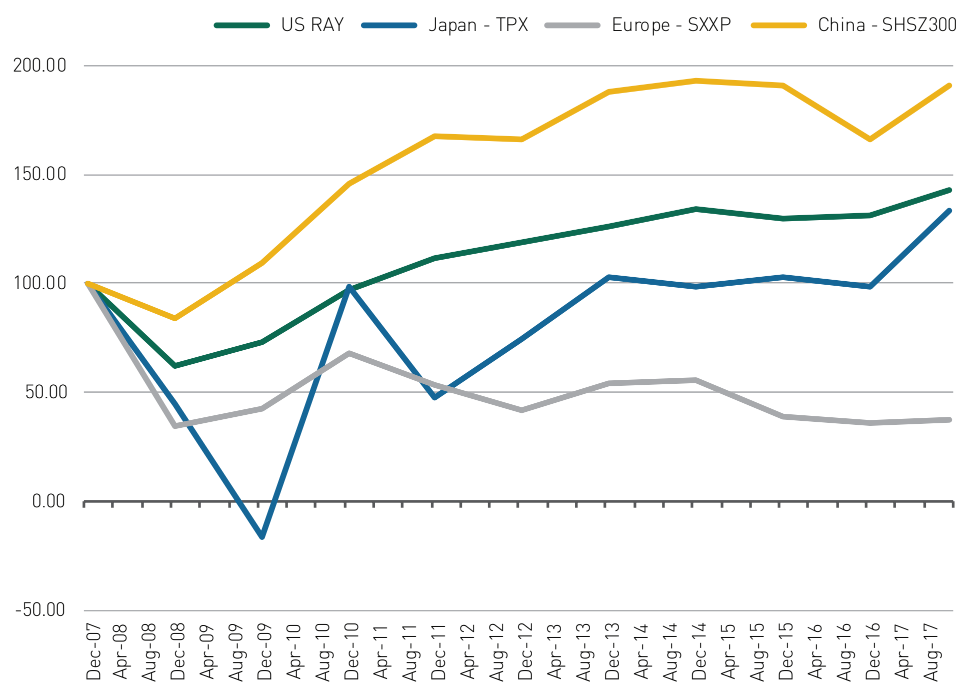
sign of this was the 39% year-on-year sales growth on Alibaba's "Single's Day" – now the largest shopping day in the world. And in terms of technological advances, Alipay set a world record by processing 256 thousand payment transactions per second on that day. Overall, we remain very constructive on equity investment opportunities in the New China sectors (consumption and service-oriented industries), notably technology and ecommerce, as well as in materials, due to on-going supply-side reforms.

In India, reforms are taking hold. Our positive long-term outlook on India equities remains undimmed. The government embarked on an ambitious reform plan with demonetization in 2016and a goods and services tax this year. It has also enacted a new bankruptcy law and had made progress in affordable housing. Activity is likely to slow down as the economy adjusts to a more efficient tax collection system. However, we believe that this slowdown will prove to be transitory because of a strong underlying economy and political stability. Although markets have applauded the recently announced bank recapitalization plan, we await the details. Our experience with bank recaps in other regions is that the details are key to a successful outcome for shareholders. Still, the authorities are clearly aiming to unclog the bank credit channel to ensure long-term growth.

The expansion looks to spread. Our proprietary US cyclical indicator supports our view. We note the continued upward trend in many of its components, particularly in the trucking data. In this context, a study of cumulative growth in earnings per share (EPS) since the peak in 2007 shows that Japan has made the most impressive progress in catching up to the US expansion. The same study reveals the potential for European companies to experience a more meaningful pick-up in growth. We remain constructive on both the Japanese and European equity markets, but as always we remain highly selective.

Since 2007, the latest peak in EPS, the Japanese equity market has staged a sharp comeback and has almost caught up to the US. Meanwhile, the lag in Europe shows that there are plenty of catch-up opportunities through pent-up demand.

EPS Growth Since 2007 (in USD)



Source: PineBridge Investments and Bloomberg. As of 15 November 2017.

A few of our convictions have changed. We derive our sector and regional views, shown in the matrix below, from bottom-up analysis of stocks within each sector and region.

This month, we made several changes within Latin America, where we have turned positive on the outlook for consumer stocks, in particular for the consumer discretionary sector, as well as for materials. Also within Latin America, we have lowered our expectations for telecoms and for health care to neutral, and have shifted to a negative stance on utilities. Despite these changes, our overall ranking for Latin America remains unchanged.

Europe and Japan continue to occupy the top rank among the major regions where we see attractive investment opportunities. Information technology retains our top high conviction rank by sector, while our view on utilities has become more negative.

SECTOR AND REGIONAL CONVICTIONS

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