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2016 GLOBAL ASSET ALLOCATION OUTLOOK

SURFING THE VALUE WAVE

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Kelvin is responsible for the Global Asset Allocation team, based in Singapore at Eastspring Investments.

He has a total of 25 years investment experience across a wide range of asset classes and markets. Having lived in Asia for the last 18 years, he brings a deep understanding of the region and the issues of investing in these markets.

Over his 14 year tenure at Eastspring, Kelvin has had responsibility for the fixed income team, derivatives and structured products as well as alternative assets.

Prior to joining Eastspring, Kelvin worked for 11 years at Schroder Investment Management, in various roles within the global fixed income team based in London, Hong Kong and Singapore.

He holds a Bachelor of Science (First Class Hons) in Mathematical Sciences from University of Strathclyde, Glasgow, Scotland (1989). He has also earned a Charted Financial Analyst (UK) designation.

CHALLENGING CYCLICAL PROFIT OUTLOOK AND THE IMPLICATIONS FOR INVESTORS

The past year has been a relatively challenging one for investors.

At the time of writing (October 2015), most global equity markets have declined on the year, while many emerging markets (EM) have fallen by more than 10% in US dollar terms. The poor returns were due to the growth scare in China and EM that triggered a panic in risk assets through August-October 2015 and sharp declines in commodities and commodity linked markets over the year. Sadly, there has also been very little diversification for investors. Returns on sovereign bonds and most credit markets have been equally dismal.

> Looking forward, the key question for investors is whether weakness in global growth will develop into a genuine profit recession, or, whether the episode has reduced valuations to the point where investors ought to increase the risk allocation in portfolios?

There are four key points to consider:

Global equities, while not cheap, still offer better value than bonds

First, in contrast to the episode in 2012, global equities are currently not that cheap in aggregate on an absolute basis. The MSCI World Index earnings yield (the inverse of the price-to-earnings ratio and a proxy for the expected real return) trades at 6.8% compared to over 11% in 2012 (refer to Fig.4). To be fair, the outright valuation of Asia and EM is more attractive at 9% and 9.8% respectively. On the whole, equities are not that cheap in absolute terms. However, the earnings yield on global equities is still considerably more attractive relative to the yield on a basket of sovereign bonds (1.1%).

Beach and sunbeam, Kanagawa Prefecture, Honshu, Japan

Keep an eye on the profit cycle

Second, equity valuation is always conditional on earnings or profits. Estimated earnings on the MSCI World Index are now falling relative to one year ago and are the weakest since the last recession (refer to Fig.5). Our fear is that the correction in global equities reflects a genuine deterioration in the profit cycle. While the weakness at a global aggregate level probably reflects the cyclical deterioration in manufacturing and trade, it is possible that there are also structural conditions weighing on profits in select markets. If profits keep falling, world equity markets will probably perform poorly from here.

EM weakness may linger

Third, this trend of underperformance in EM is not new and has been underway since 2011. It probably reflects the secular slowdown in China's trend growth and shift in growth composition from manufacturing and infrastructure to services. As a result, there has been reduced demand for commodities, basic materials and capital goods that has been exacerbated by the dramatic increase or excess supply in these goods over the past five years. The ongoing weakness in global manufacturing, trade, Asian exports, and commodity and producer prices is evidence of this trend. While this condition is well appreciated, our fear is that it is legitimate and not fully played out nor priced into all related assets (refer to Fig.6).

US and Europe show firmer growth trends

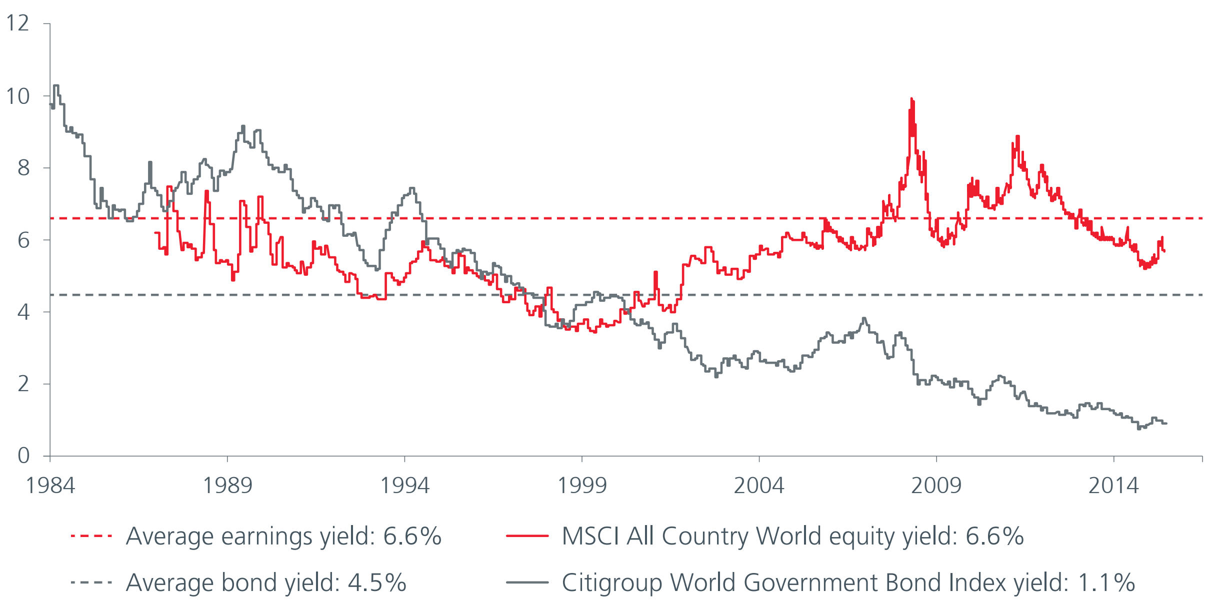
Fourth, the good news is that growth in the domestic US economy and Europe remains firm. The US unemployment rate is near full employment (5.1%) and housing activity is contributing to growth. In Europe, loan growth is expanding for the first time in ten years. At the same time, low headline and core inflation is likely to maintain interest rates at extremely accommodative levels.

High yields and EM could face more challenging times

The challenges noted above have also been evident in the credit markets with widening high yield spreads in the US corporate bond market largely as the energy sector got sold off. That sector represents around 17% of the US high yield debt market. While high yield spreads offer above average levels of spread (or risk) compensation, a genuine profit recession would be challenging for the sector's fundamentals. A rise in default rates is also plausible next year.

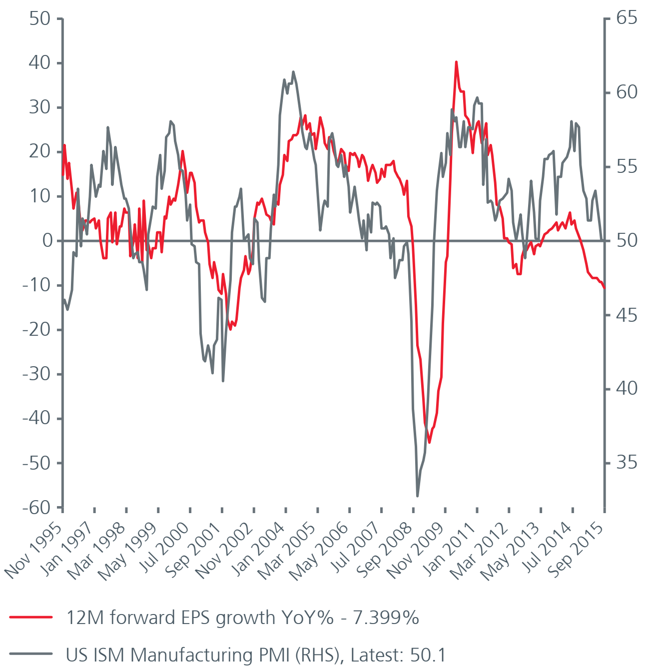
Similarly, the weakness in commodity prices and the US dollar strength has exacerbated and contributed to the material declines in commodity linked EM currencies; a number are trading at 2002 trough levels in nominal terms and while external sovereign debt and imbalances are lower than in the past, private sector credit has increased since the last crisis and might contribute to a challenging phase for EM next year if US dollar strength and/or commodity price weakness persists.

Fig.4. World equity risk premium (%)



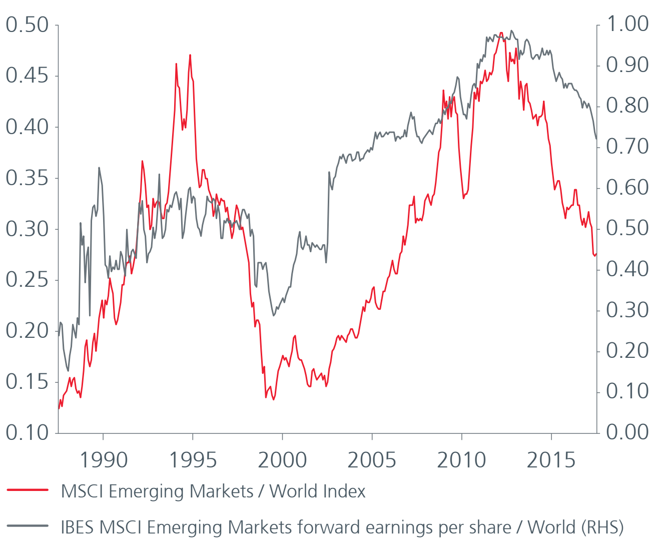
Source: Thomson Routers Datastream, as at 4 November 2015.

Fig.5. MSCI All Country World forward earnings per share growth year on year % vs US Institute for Supply Management



Source: Thomson Routers Datastream, as at 3 October 2015.

Fig.6. MSCI Emerging Market Index and forward earnings per share relative to World



Source: Thomson Routers Datastream, as at 1 October 2015.

What's in store for 2016?

Challenges warrant a neutral outlook. We enter 2016 with a modest overweight to equities relative to fixed income. Global equities offer only modest outright valuation support relative to history with a 6.8% earnings yield.

On the positive side, the gap between the earnings yield on equities and the yield on sovereign bonds suggests that equities should outperform sovereign bonds over the medium term.

Hence for multi asset funds we have a modest overview to equities from bonds.

Within equities, while the valuation in Asia and EM equities is becoming attractive, we suspect that this partly reflects a genuine deterioration in trend profits that might still not be fully priced. We have a modest preference for high yield credit based on credit risk compensation. Given the move seen in the US dollar over the past year and the undervaluation of many EM currencies, we have a neutral outlook in 2016. We remain very selective in EM sovereign credit.

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