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2H2016 INVESTMENT OUTLOOK
REASONS FOR OPTIMISM BUT DON'T GO OVERBOARD!

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2H2016 OUTLOOK
CONTENTS

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Robert Rountree joined Eastspring Investments (Singapore) Limited, the Asian asset management business of Prudential plc, as Global Strategist, in 2003.

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REASONS FOR OPTIMISM BUT DON'T GO OVERBOARD

Early 2016's turbulent seas have slowly given way to calmer waters[1] albeit with shock waves rippling into the June quarter.

It would be a mistake to assume that the turbulence is over; several large incoming waves have yet to hit. Centred on investors' radars will likely not only be the extent to which US interest rates are hiked (and when) but also a resumption of the US dollar's rising after the March quarter's fall - what are the implications for Asia?

Soft US (and world) productivity could again shake an already shaken profit growth outlook; the only questions seem to be "By how much?" and "Has it been discounted?", issues we address below.

In addition, China uncertainties should continue swirling as the economy transits from investment and export-led to domestic-led growth; these uncertainties will expose opportunities, but more on this later.

[1]As at the time of writing in early June.

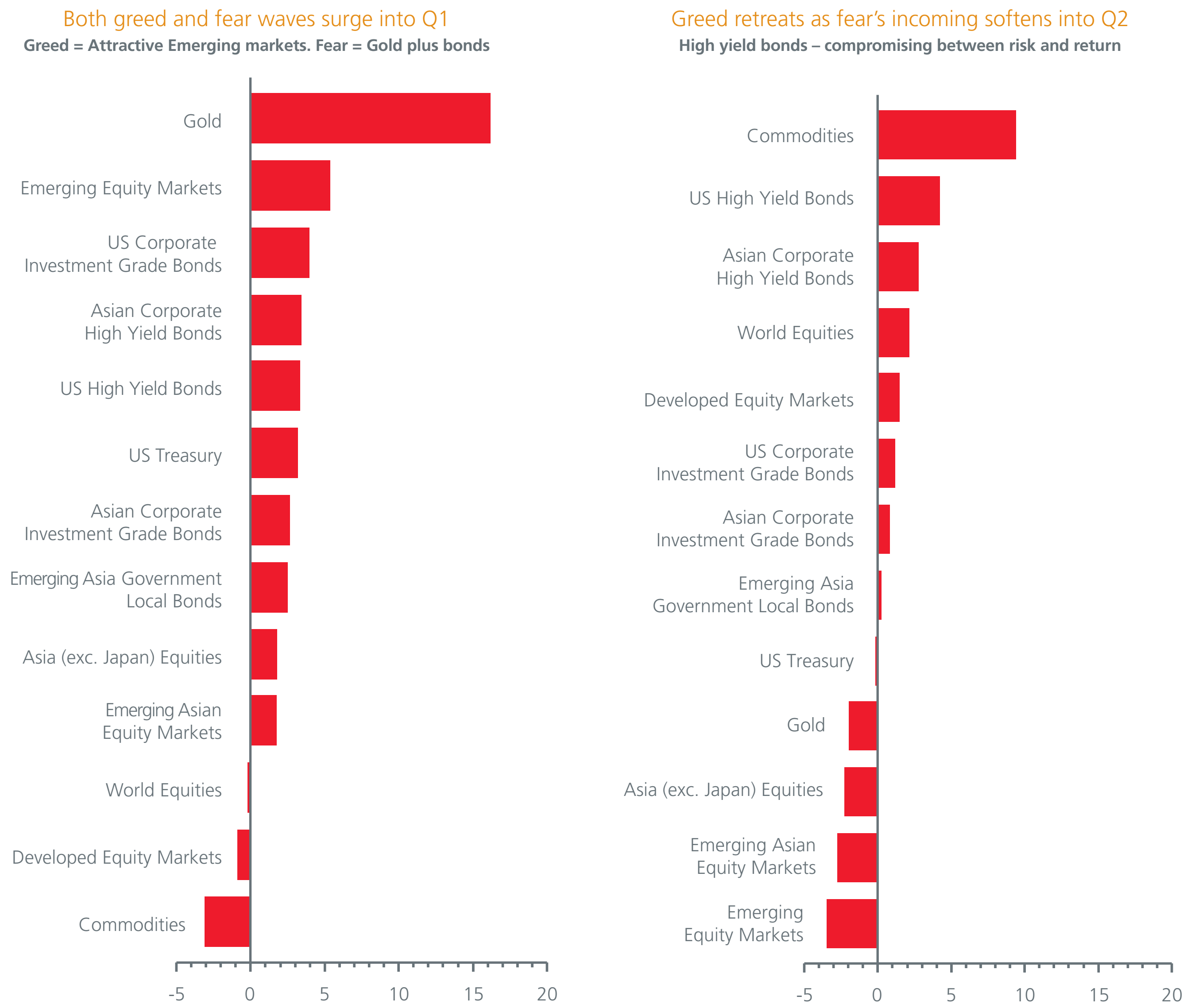
Global, not local, issues seem in the driver's seat for much of the coming six months

Adding to these factors are the uncertainties resulting from:

- The US November elections,
- The UK's June Brexit vote, and;
- The Bank of Japan's "Will they? Won't they?" stance on negative interest rates (probably post the Upper House July elections).

So 2016's turbulent seas are not stilled yet. Ebbing and flowing global fears ***will*** expose opportunities at the local level. Our "Buy Value (when it appears), Tuck Away, and Do not Chase the Markets" strategy remains in play.

Fig.1. Greed and fear waves ebb and flow



Source: Barclays Capital and JP Morgan bond indices, MSCI equity indices, TR Jefferies Commodity index, and gold bullion prices from Datastream as at 2 June, 2016. All charts are total returns (bar those relating to commodities). All series are in USD. Any opinion or forecast is subject to change without prior notice. Note that past performance is no indicator of present or future performance.

2H2016 OUTLOOK

US rate hikes – aging America could derail sustained rising US demand hopes

While the Federal Reserve Board (the "Fed") is focusing on the improving employment numbers and real wage growth, they are less concerned with the constituents of those data. It is herein that lays the devil as Fig.2 illustrates; the age profile of the jobs numbers will unlikely support the sustained consumer demand growth for which the Fed is looking. April's "rebound" in consumer spending does not convince; an increase in lower paying jobs will boost spending as consumers buy the "essentials".

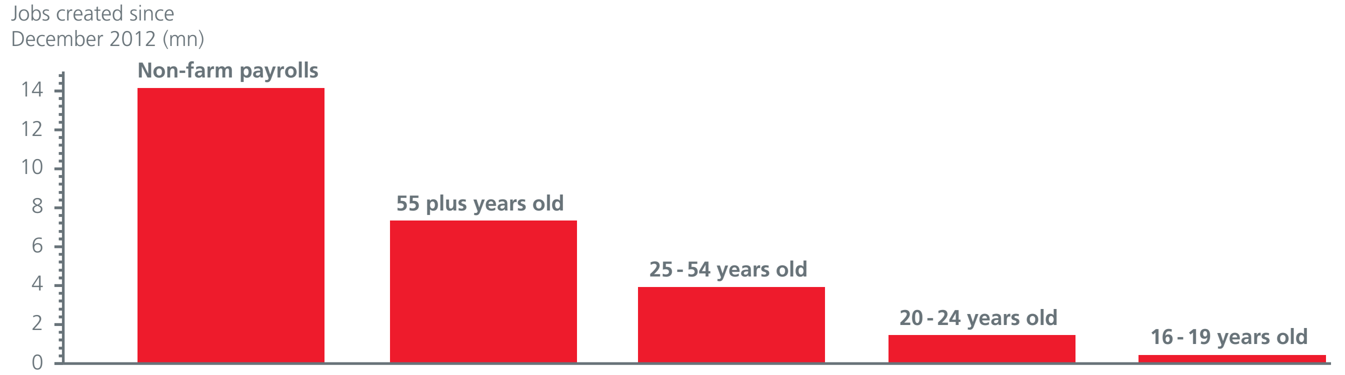
The argument for surging, sustainable discretionary spending looks weak especially as household debt servicing ratios are already rising. The genesis of another debt fuelled spending surge is evident.

Whether the Fed hikes rates in June or not is thus a moot point. We can probably assume a ¼% hike sometime this year[2]; the outlook is less certain after that.

The Fed's constraints in pushing rates significantly higher imply income investing is alive and kicking.

Fig.2. Skewed US jobs no recipe for sustained rise in demand*

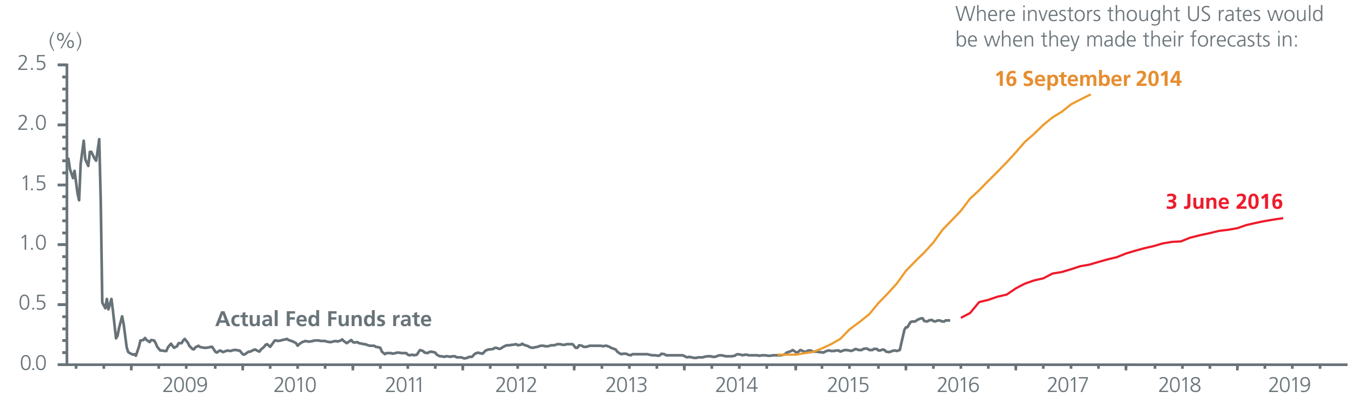
Jobs for "oldies" comprise 52% of jobs created since the December 2012 low.



Source: US Bureau of Labour Statistics from Datastream as at 2 June 2016. *The only jobs category which is higher than January 2008 prior to the start of the fall in jobs is the category "Aged 55 and above", which is some 30% higher. Despite their rise since December 2012, jobs for the "Aged 25~54" category are still some 3½% lower than when the crisis first hit.

Fig.3. Investors get US rate hikes badly wrong

Bond yields were (and are) attractive. Rate fears could trigger volatility.



Source: The Fed Funds 30 day futures from Bloomberg as at 3 June 2016.

[2]The most likely months in our view are July or September. If there is no cut by September, a 2016 reduction would be unlikely.

Asian monetary policy remains benign or on hold

Although conditions generally spell monetary stability for the rest of the year, the main exceptions are Korea and China.

It is easier to call a Korean rate cut given the state of the economy; growth will likely undershoot official targets. A rate cut may also occur so as to offset any negative implications of corporate restructuring.

It is less clear with China as the government balances its two policy objectives (of maintaining growth and currency stability). The Peoples' Daily early May article by "a person of authority" threw a spanner in the works in highlighting the negatives associated with debt-fuelled growth. This suggests neither a further reduction in the banks' reserve ratios per se nor reductions in rates but rather a continuation of the recent policy of focusing on "targeted" objectives (e.g. the bank specific reserve ratio requirements).

The Reserve Bank of India and Bank Indonesia are on "hold"; favourable domestic conditions could lead to some reductions by year end.

The investment implications? High yield bonds, Asia's high dividend equities and Real Estate Investment Trusts (the "REITs") beckon

The question remains, "Income from bonds or equities?" There are strong cases for both.

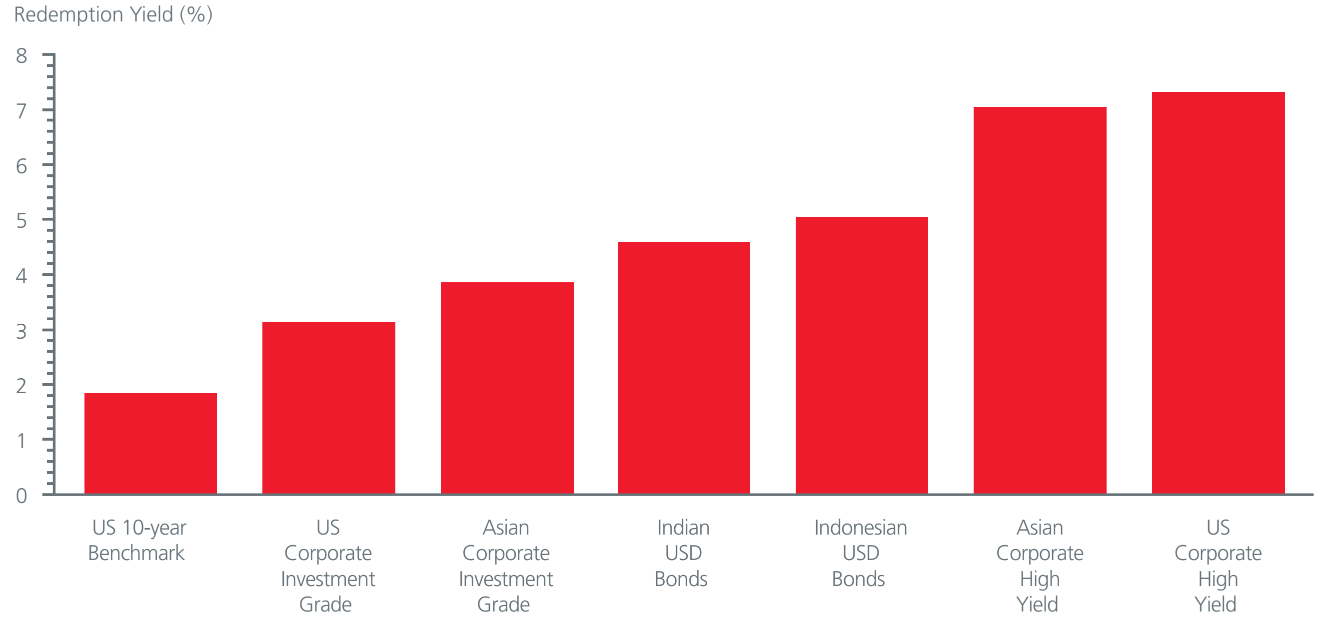
High yielding bonds, both US and Asia, look attractive though less so than several months ago (Fig.4). Asian credits per se look attractive for their yields especially Indonesian bonds. Indian bonds not only look attractive for their yield but also possess the potential for capital gains when rates do fall. The carry "pick-up" by switching from US corporate investment grade to Asian USD corporate investment grade bonds remains attractive.

The cases for Asian high yielding equities and REITs also remain compelling on valuation grounds (Fig.5). In addition, valuations of Asia's out-of-favour cyclical stocks not only look attractive but also offer significantly higher yields than the so-called "safe" non-cyclicals[3]. The valuation gap between the two has widened and is again flirting with historical "wides" (Fig.6).

Investors' reluctance to accept Asian growth and profit forecasts at face value is keeping the cyclicals out of favour despite their apparent deep value[4].

Fig.4. Asian and high yield bonds provide attractive yields

Income from bonds remains attractive as rates remain low.



Source: Barclays Capital and JP Morgan bond indices from Datastream as at 3 June 2016.

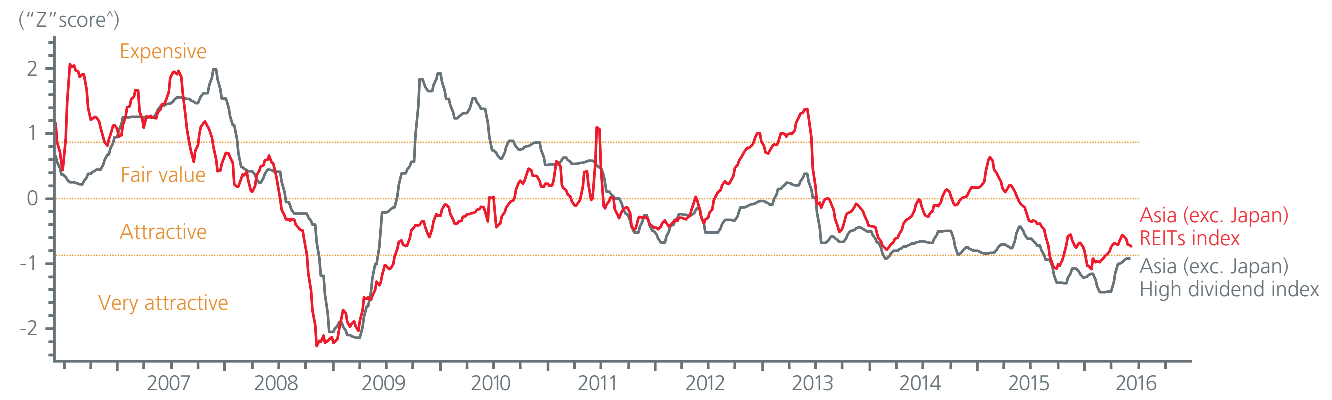
[3]Cyclicals historical dividend yield is around 3%, telecoms and utilities around 3½% and non-cyclicals (excluding telecom and utilities) around 1½% from Datastream as at 1 June 2016.
[4]On an historical price to book ratio.

An improvement in China's outlook is critical to unlocking this value; many investors are wary of investing in those markets exposed to China. But even on the reduced profit forecasts, valuations are sufficiently low to suggest that a lot of bad news has been discounted.

The buy and tuck away strategy seems written for this asset class with investors receiving higher yields while waiting.

Fig.5. Growth fears drive REITs and high dividend to value lows

Income from both attracts in a low rate world. Asia's high dividend stocks comprise many attractive cyclicals i.e. growth plus income.



Source: Eastspring Investments, MSCI and IBES from Datastream, as at 1 June 2016. ^The "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all values lie.

Fig.6. Asia's[†] out-of-favour cyclicals look very attractive

Investors can receive a dividend yield of around 3% while they wait[‡].

Source: Eastspring Investments and Datastream from Datastream as at 1 June 2016. The cyclical index includes the equally weighted basic materials, oils, industrials and financial sectors. The non-cyclical index (excluding telecom and utilities) consist of equally weighted consumer stable, consumer services and healthcare sectors. †Asia excluding Japan. ‡The historical dividend yield.

A US dollar rebound is likely – Its upside seems limited, and Asia's "Fear Factor" has diminished

Evidence is accruing that the US dollar should rebound further in the coming months (Fig.7) not least because both the European Central Bank and the Bank of Japan seem poised to push their currencies lower (although the Bank of Japan may delay any overt moves until after July's Upper House elections, given the poor public perception of negative interest rates and recent US pressure not to do so).

Adding to the dollar's upward pressure are not only growing fears surrounding the UK's Brexit vote in late June but also increased uncertainty surrounding the ramifications for China's currency policy emanating from the "person of authority" article; does this imply a weaker Renminbi?

A strong case can be made, however, that the dollar's rising this year will not mimic last year for one important reason – the drivers have changed!

Whereas 2015's rise was rooted in growing confidence in the strength of the US recovery and related concerns over Asia, 2016's rally is rooted in a "flight to safety". (Mind you, one should not overlook the fact that in a world of zero/negative interest rates, yields on US Treasuries look relatively attractive!)

Having argued the above, it is difficult to see the dollar move significantly higher; even at today's lower level, US companies cannot sell the goods they are producing; inventories to sales ratios are rising – not good (Fig.8).

A dollar trading band thus seems destined to emerge, with Asian currencies likely to follow suit.

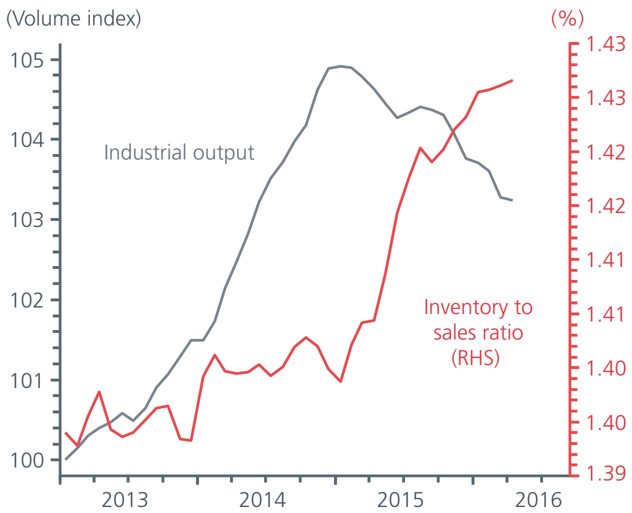
Fig.7. "Flight-to-safety" fears drive the dollar's 2016 rise

In contrast, rising US confidence lay behind the 2014/15 rally.

Source: The US Federal Reserve from Datastream as at 1 June 2016.

Fig.8. The US inventory/sales picture is not encouraging

Falling output and rising stockpiles spell "trouble ahoy".



Source: The US Federal Reserve Board and The Conference Board from Datastream as at 1 June 2016.

The investment implications? Asian markets are inoculated against the rising dollar virus

China is critical in this equation; if confidence in China were to stabilise and if the perception grows that higher US rates will not destabilise Asian markets, Asian currencies could outperform.

Until these conditions appear, investors will likely focus on the higher yielding currencies (e.g. India's Rupee, Indonesia's Rupiah, and – to a lesser extent - the Philippine Peso).

High on the list of Asian destabilisation factors is the Asian US dollar debt servicing fear.

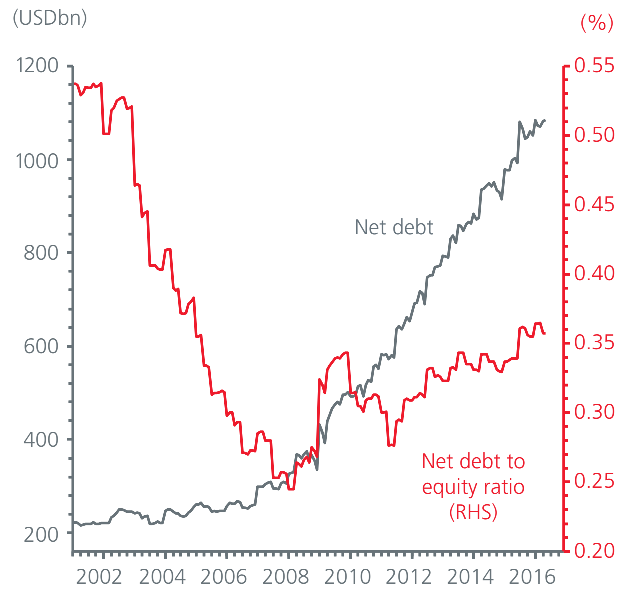
This fear seems exaggerated for two reasons. First, while net debt for Asian (excluding Japan) non-financial companies, has soared, the net debt to equity ratio has remained broadly stable since 2010[5] (Fig.9). The rise in debt largely reflects the rise in underlying business activity and profitability.

Moreover, Asian non-financial corporates' foreign exchange liabilities are broadly matched by foreign exchange earnings[6] (Fig.10).

The clear message is that if Asian equities fall on rising US dollar fears, this could be a "Buy and Tuck Away" moment.

Fig.9. Asia's Rising debt mirrors rising business activity

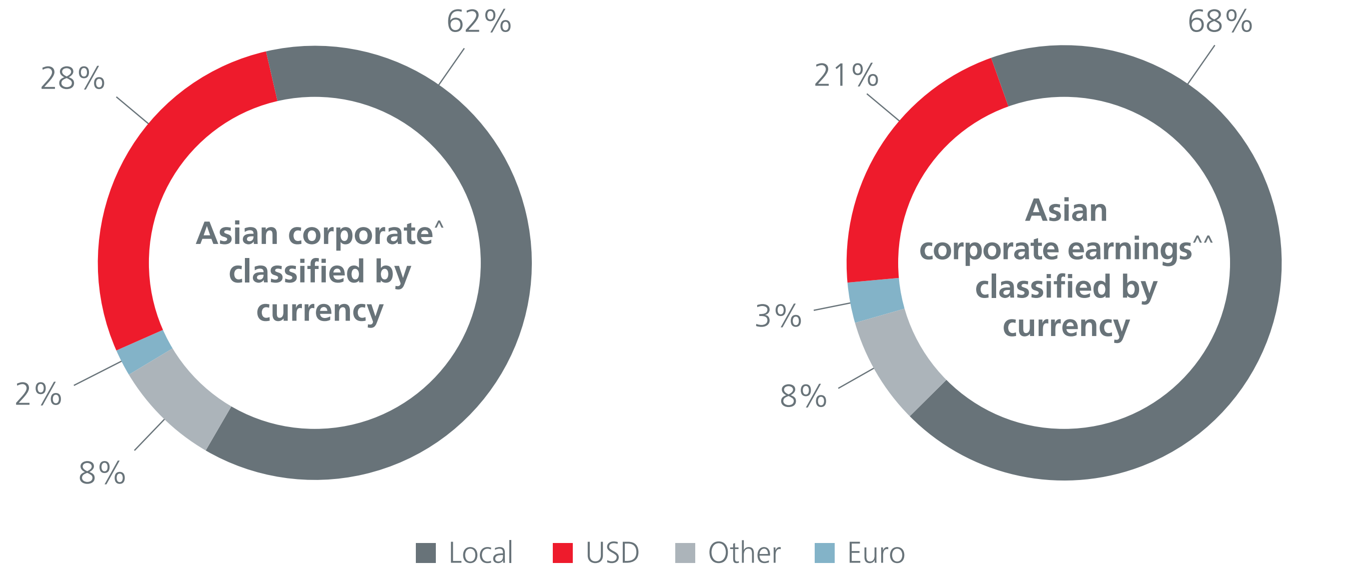
The stable debt/equity ratio says profits are rising at a similar rate.



Source: Worldscope and Datastream from Datastream as at 1 June 2016

Fig.10. Asia's^ foreign currency debt closely matches earnings

Asian companies FX earnings go a long way to servicing their FX debt.



LHS Chart Source: Bloomberg, Morgan Stanley Research, September 2015; RHS Chart Source: Bloomberg, Bank of America-Merrill Lynch, January 2016. ^A universe of 625 Asia ex Japan (ex-Australia and New Zealand) corporates covered by Morgan Stanley equity research. For all Hong Kong companies, all USD debt and earnings are treated as local currency debt and earnings, respectively. ^^Earnings before interest, tax and depreciation.

[5] To put this number into perspective, it was 0.80% at the height of the Asian crisis. [6] Morgan Stanley, as at 24 February 2015.

Profit forecasts recover after February's savaging

A major concern over the past 12 months has been the "softness" seen in the profit forecasts pretty much across the board. The analysts accelerated their forecast slashing earlier this year on global growth fears but have since concluded they over-reacted; some upgrading has been evident since early March (Fig.11).

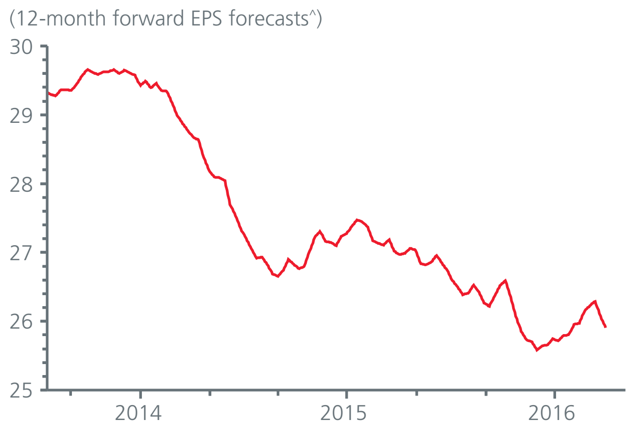
While this development is encouraging, investors are not in the clear yet. More downgrading could occur especially in the US. Not only have US earnings per share been boosted by buybacks but also inventory levels are rising towards record highs as sales remain sluggish, a recipe for future downgrades. That many US first quarter earnings exceeded expectations provides scant comfort; it merely indicates the analysts slashed forecasts too much.

In contrast, the outlook for Asian profits (Fig.12) seems more consistent with the forecasts, some of which remain among the highest globally. In particular, Asia's 2016 profit forecasts are backed by generally higher forecast sales growth[7].

Japan's sharp rise in profit growth forecasts needs some explanation. Many companies (particularly the trading companies and Toshiba) have made provisions for future oil, commodity and currency losses against their 2016 profits. These one-off write offs not only reduce 2016 profits leaving 2017 profit forecasts unchanged (hence the higher growth) but also result in stronger balance sheets. Corporate Japan remains attractive, we argue, despite this year's sharp selling as investors take fright from the many uncertainties surrounding "Abenomics".

Fig.11. Analysts prevaricate over their earnings forecasts

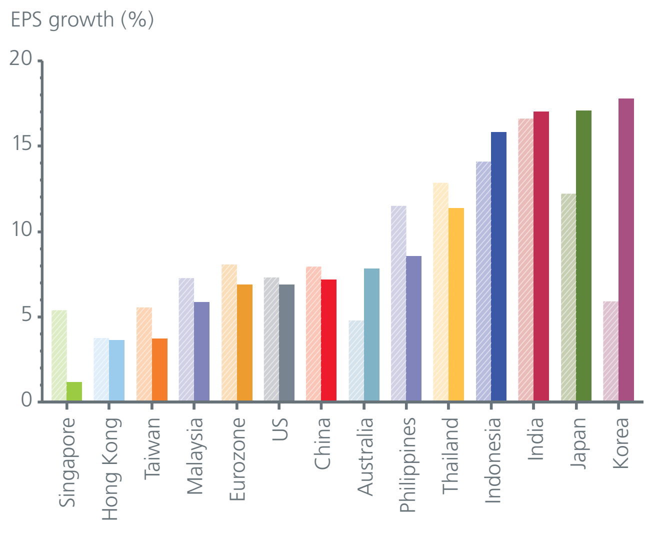
No wonder investors have serious concerns about valuations.



Source: IBES from Datastream as at 1 June, 2016. ^The consensus 12-month forward earnings per share forecasts for the world index based on the MSCI world index in US dollar terms.

Fig.12. Asian profit forecasts remain relatively attractive

Those low Asian profit forecasts seem deeply discounted.



Full colours bars - forecast as at 2 June 2016
Shadow bars - forecast as at 31 December 2015

Source: IBES consensus earnings per share growth forecasts from Datastream as at 2 June 2016.

[7]IBES consensus sales growth forecasts as at 1 June, 2016. In the 18 months to end 2017, US corporate sales are forecast to rise circa 6%, Asia (exc. Japan) circa 8½%, China circa 10½% and India circa 12½%.

At day's end, it is all about valuations – Asia equity and related strategies stand out

The chart (Fig.13) below says it all. Valuations[8] suggest a lot of bad news has been discounted. The critical activity remains spotting the trigger that will price out this value.

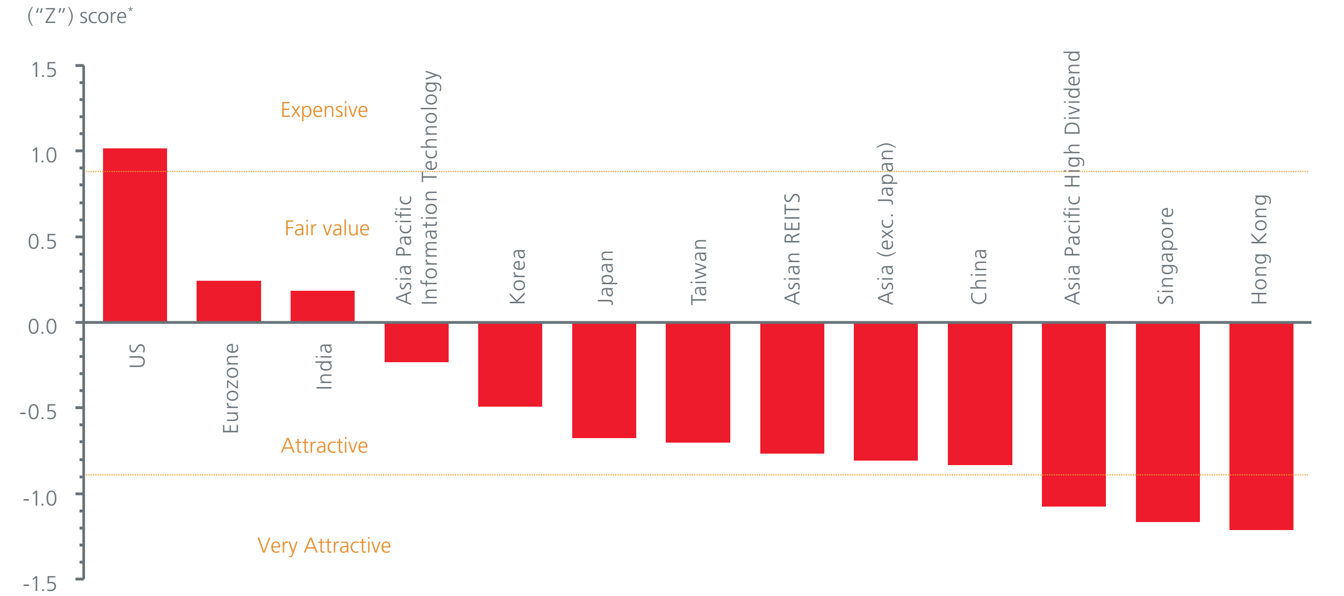
That trigger looks some way off given the incoming waves identified above. If the US equity market, for example, should tumble (and it could – high valuations have long outstripped profit growth, and while recent falls in the S&P500 index have taken it to lower levels, any rebounds have not taken it to new highs), it would drag down other markets. Cheap markets could get cheaper, but this could provide great entry points.

In a nutshell

There is plenty of value to be found especially within Asia, but the conditions to price it out are still missing. Given the incoming waves, that good value could become great value. The patience we counseled in early 2016 remains unchanged. Buy Value. Tuck Away. Do not Chase.

Fig.13. Investors will not flock to expensive US equities

Good value abounds. Macro fears deter investors – for how long?



Source: Eastspring Investments, MSCI and IBES from Datastream, 1 June, 2016. *The "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all world values lie.

[8]Based on the "Z" score as at 1 June 2016. The "Z" score is calculated over a rolling 10 year period and measures the deviation from the trend of an equally weighted forward book value and prospective price earnings multiple, which is based on the 12-month forward IBES consensus earnings per share forecasts.

2H2016 OUTLOOK

EASTSPRING INVESTMENTS' SUITE OF FUNDS

The funds listed below could be on the radar for investors seeking potential opportunities in today's choppy waters.

"HIGH YIELD BONDS AND ASIAN'S HIGH DIVIDEND EQUITIES BECKON"

Leong Wai Mei
Portfolio Manager

Eastspring Investments – Asian High Yield Bond Fund[9]

"After a weak initial start to the year, the Asian high yield bond market made a strong rebound on the back of stabilising commodity prices and positive global central bank action. High yield sovereigns led the outperformance, followed by corporates and then by quasi-sovereigns."

Margaret Weir
Portfolio Manager

Eastspring Investments – Asian Equity Income Fund

"As a region, valuations across Asia Pacific ex Japan remain below their historical average. As Asia develops, more Asian companies are returning a greater amount of dividends to shareholders."

"ASIA LOCAL BONDS OFFER SELECTIVE YIELDS"

Low Guan Yi
Portfolio Manager

Eastspring Investments – Asian Local Bond Fund

"Bond market returns were all positive in local currency terms amid the accommodative monetary policy environment. We remain positive on corporate credits and expect continued outperformance going into 2016 as global economic momentum has stabilised and credit spreads offer value."

"CORPORATE JAPAN REMAINS ATTRACTIVE DESPITE THIS YEAR'S SHARP SELLING"

Dean Cashman
Team Leader and Portfolio Manager

Eastspring Investments – Japan Dynamic Fund

"We note that there are many companies in strong financial health and observe that companies' restructuring efforts are continuing and in some cases have accelerated. We continue to observe supportive trend fundamentals at a company level, and this is a significant driving factor in the longer term re-rating for Japan."

[9]Investing in high yield bonds comes with risks and investors should seek advice from a financial adviser. In the event that an investor chooses not to seek advice from a financial advisor, he should consider carefully whether the fund question is suitable for him.

Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. An investment in the Fund involves a high degree of risk and is only appropriate for a person able and willing to take such as risk. Portfolio managers' commentaries as of 30 April 2016, unless otherwise stated.

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