



SURFING THE VALUE TSUNAMI

MARCH 2016

“Surfing the Value Tsunami” (rather than “Surfing the Value Wave”) would have been a more appropriate title for our 2016 outlook article written only three short months ago. While the seas were rougher than anticipated, we were acutely aware that the tides feeding 2015’s turbulence had still to run their respective courses – hence our “Buy Value, Tuck Away, Do Not Chase” strategy for early 2016.

Despite the first quarter’s buffeting, our investment ship looks in pretty good shape. The four themes¹ dominating our 2016 strategy are emerging (if in a somewhat shaken state) and the value we saw remains, although in some cases, having become even better value!

The only wave that really caught us amidships was the swing by various central banks (particularly Japan) towards implementing negative interest rate policies – a point discussed in more detail below.

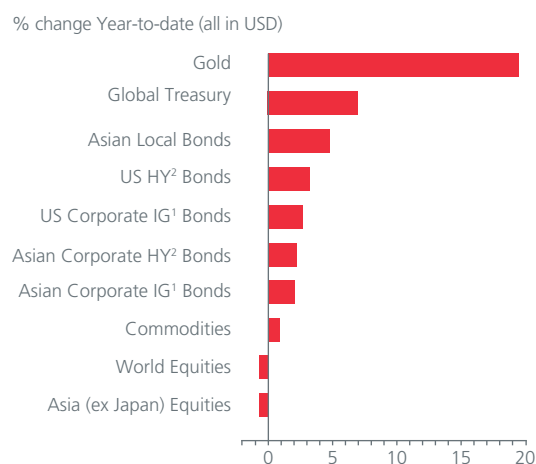
One hugely significant feature of the March quarter’s trading, for us, was the sharp swing towards gold. This is the first time since 2012 that investors have shown any real panic (even if momentarily) and suggests an element of capitulation – investors throwing in the towel. The run to Global Treasuries is consistent with this view.

If investors were throwing in the towel, we can convincingly argue that the reasons for selling are being increasingly discounted. When that happens, an investor can more aggressively accumulate the (in some cases deep)

value the turmoil has exposed. We may not be at the bottom yet. We could still see more turbulence. But the grounds for strong rebounds look to be falling into place. And plenty of value is to be found.

Are we staying with our “Buy, Tuck Away, Do Not Chase” strategy? You bet we are.

Fig.1. Japan and Asia suffer European banking and US recession fears



Source: Barclays Capital bond indices, MSCI World Equity and Asia (exc. Japan) indices, HSBC Local Asian Bond index, TR Jefferies Commodity index, JP Morgan, and gold bullion prices from Datastream as of 18 March 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. ¹Investment Grade. ²High Yield.

¹These were; (1) A swing back from developed market equities to emerging markets especially within Asia with a 2016 “surprise” being a rebound in the ASEAN markets, (2) Cracks were appearing in the US dollar; 2016 could see a reversal with Asian currencies rebounding, (3) The fall in 2016 profit forecasts was not over but this was not only largely discounted in Asia, Asian forecasts were generally better than most, and (4) Bonds, especially Asian bonds, looked attractive for their yields in an on-going low interest rate world.

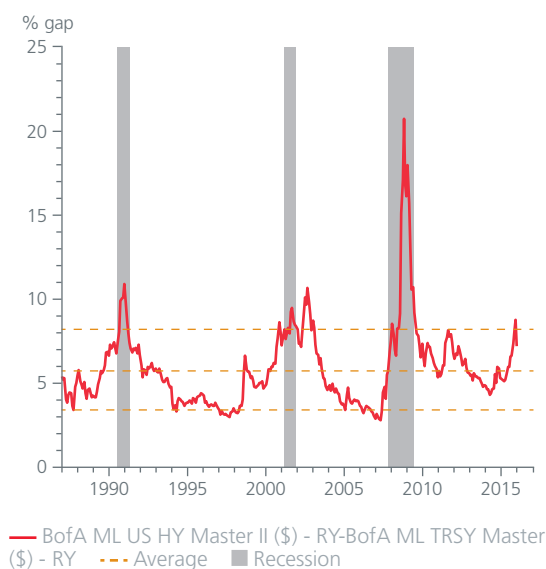


The element of capitulation, however, was not the only trade of interest evident over the March quarter. Hot on its heels was the bounce back in US high yield bonds.

These had hitherto sold off aggressively for well documented reasons not least being the collapse in oil prices. While the sell-off in the oil related high yield bonds was to be expected, the sell-off in beneficiaries of lower oil prices (e.g. the airlines) was not. But it occurred; US high yields sold off across-the-board as broader economic growth fears took hold.

This “contagion” selling drove yields to levels that normally suggest an imminent recession, as Fig.2 illustrates. The fly in the ointment was (is) that no economist (as far as we can see) is forecasting a 2016 recession. The consensus is for 2.0% growth with the forecasts ranging between 1.5 and 2.4%².

Fig.2. Weak growth, not recession, is widely forecast for US in 2016



Source: Bank of America Merrill Lynch from Datastream as at 18 March 2016. The chart shows the yield gap between the redemption yield for the High Yield Master II and the Treasury Master. Note that past performance is no indicator of either present or future performance. Any views expressed above may alter without notification. The dotted lines show the average and the one standard deviation boundaries.

So the March quarter dynamics were:

- ▶ Investors rushed to the “safety” of gold and treasuries while, at the same time,
- ▶ Bought back into “high risk” US high yields on the grounds they had fallen too far.

At its simplest, investors rushed to safety while simultaneously rushing to danger or high risk. The recent rally in oil prices probably triggered the bounce back in US high yields, but it is difficult to escape the conclusion that investors are feeling for the bottom. When they see value, and few reasons for selling, they are returning aggressively. The game at this stage is all about positioning for any future rallies.

The relative strength of Asian local bonds was another trade of interest. Asian local bonds had underperformed in recent years partially reflecting the weakness of Asian currencies as the US dollar strengthened.

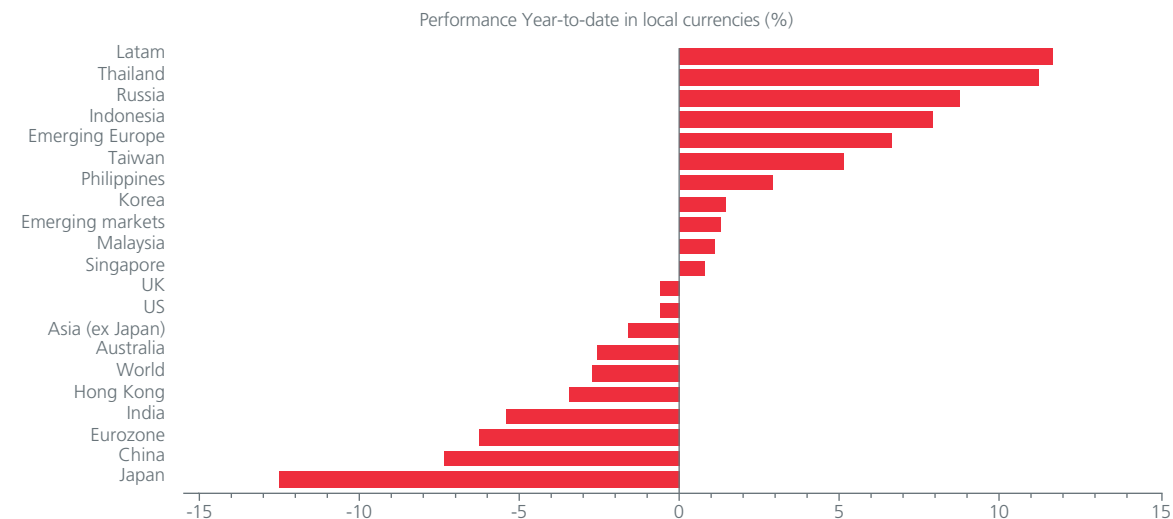
We have argued in many instances³, that the dollar's near peak high⁴ is biting into US corporate sales and profits; even if it does not fall, the dollar's rising seems over. If so, one of the major drags on Asian local bonds will have eased.

We reiterate our January assessment that 2016 could be the year in which Asian local bonds rebound.

WHILE INVESTORS SEEMED CONTENT TO BUY QUASI-EQUITIES, IN THE FORM OF HIGH YIELDING BONDS, BUYING EQUITIES PER SE PROVED A STEP TOO FAR, IN MOST INSTANCES.

Equities generally underperformed over the quarter (in local currency terms) despite some end-quarter rallies. Nevertheless, some interesting trends and “trades” emerged.

²Consensus Economics as at 7 March, 2016. ³e.g. As in “Surfing the Value Wave” as at 11 January 2016. ⁴As measured by the JP Morgan real effective exchange rate producer price index based on Datastream as at 16 March 2016.

**Fig.3. Japan and Eurozone hit by negative interest rate concerns**

Source: MSCI Equity indices from Datastream as of 18 March 2016. All charts are total returns. All series are in local currencies. Any opinion or forecast is subject to change without prior notice. Note that past performance is no indicator of present or future performance.

First was the bounce back of the emerging markets – prominent among our 2016 themes¹ referred to above. While we harbor suspicions about the LATAM bounce back (owing not only to Brazil's political issues but also some dubious profit forecasts), we feel on more solid ground in heralding the rallies in Thailand, Indonesia, the Philippines and, to a far lesser extent, Malaysia and Singapore. Our view that 2016's "surprise" could be the return of the ASEAN markets seems to be shaping up. Again, it's one to watch.

Of more critical concern to us, were the sharp under performances of both China and Japan. Should we be sticking with our view or should we back off?

THE FACTORS DRAGGING CHINA WERE NOT TOO DIFFERENT FROM THOSE THAT DRAGGED FOR MOST OF 2015;

weaker renminbi concerns, stalling growth fears, the two-tiered "old" and "new" economy growth divergences and the poor return on capital investment to list some of the usual suspects.

In all, we do not detect any major change to those factors holding the market back.

Equally, we admit that while we see (in some cases deep) value, we do not see the triggers (yet) that will price this value out. One main concern (the return on equity) shows few signs of rising.

Economic growth fears, however, seem overdone. Even if China's real growth is "only" 4.8%⁵ in 2016, this would still add RMB 3.2tr⁶ to overall demand, which is far greater than the RMB 1~2tr rise recorded when China was growing at 8~10%.

Moreover, there is much bigger story behind the lurid headlines surrounding the closely monitored fall in China's imports of materials.

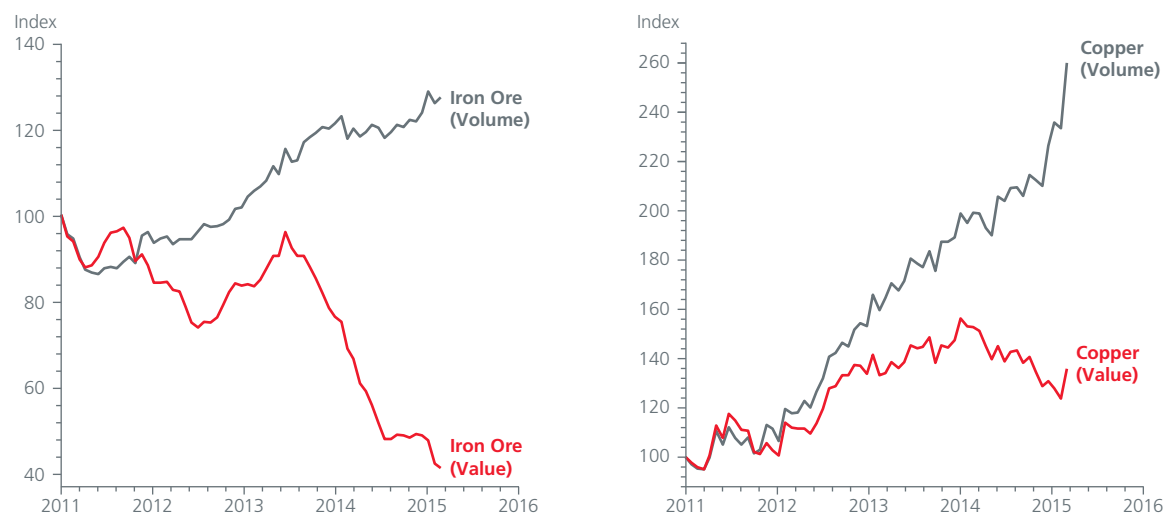
The value of such imports has either slumped (iron ore) or stalled (copper) leading many analysts to conclude that China's demand is falling. Hmmmmmmm.

⁵The consensus forecast recorded by Consensus Economics (January 2016) when they asked respondents what they thought China's growth really was. ⁶Based on the lower consensus estimate of 2015 growth of 4.3%.



If one looks at the volume of said imports, one gets a slightly different picture as Fig.4 illustrates.

Fig.4. China's material imports rise in volume terms



Source: National Bureau of Statistics and China Customs from Datastream as of 18 March 2016. Any opinion or forecast is subject to change without prior notice. Note that past performance is no indicator of present or future performance.

One could easily come to the conclusion that falling China demand is less of a culprit behind falling commodity prices than is industry overcapacity.

While detractors will no doubt argue that rising import volumes reflect stock building (correct), we would retort that one seldom hears the argument, "The outlook is so bad, we should stock up on lots of stuff we do not need". Stockpiling, when prices are low, is a vote of confidence in the future, it seems to us.

In short, we stick with our "Buy and Tuck Away" China strategy. But, we may need patience.

WHAT ARE WE TO MAKE OF JAPAN'S MOVE TOWARDS NEGATIVE INTEREST RATES? DESPITE THE BANK OF JAPAN'S RATE "SHOKU", WE REMAIN UNREPENTANT BUYERS.

Japanese equities, we argue, were, are and will remain (for the foreseeable future) a corporate restructuring story. It is not an "Abenomics" success (or failure) story.

But this restructuring story is only emerging in fits and starts as investors' fears ebb and flow in line with the current stance on the effectiveness of "Abenomics". If successive strong corporate results cannot break this link, we do not know what will. Patiently building positions is critical, in our view.

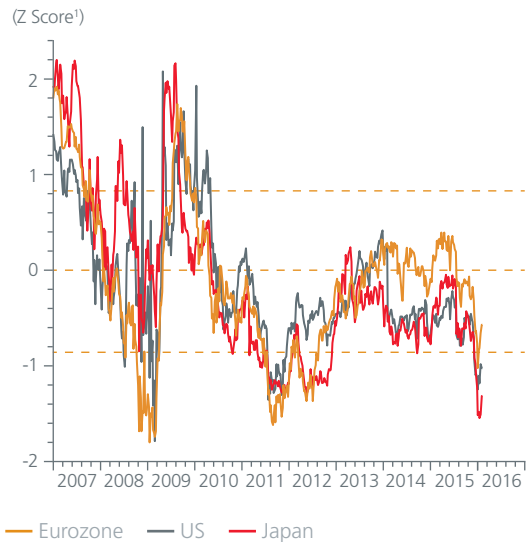
The introduction of negative interest rates has, we argue, exposed a good entry point. Rather than boosting investor confidence on hopes that the measures would boost lending (and thus growth), investors' knee-jerk reaction was to focus on the negative impact on bank profits, and head for the hills. Bank shares sold off aggressively dragging down the rest of the market.

In reality, the negative impact on bank profits is quite small⁷ and yet the fear that profits would suffer has pushed valuations down to very attractive levels, as Fig.5 illustrates. (Similar fears drove European bank valuations down with US banks being caught in the wash).

⁷With less than 30% of Japan's bank net interest income being derived domestically, the impact of negative rates amounts to only a few percent of net profits according to Eastspring Investment's Japan fund managers.



Fig.5. The selling drives Japan's bank valuations down to financial crisis lows



Source: Eastspring Investments, MSCI and IBES from Datastream, 18 March 2016. ¹The "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.

We give short shrift to the argument that the recently rising yen will stymie Japan's corporations. Corporate Japan is running a cash earnings yield of 14.2% against only 8.4% for the US⁸. (On this score, Asia, excluding Japan, measures 12.7%). The yen would have to rally a lot to erode this kind of margin!

We reiterate Japan is a corporate restructuring story. We remain buyers.

In a nutshell, after the rocky start to 2016, our underlying strategy remains on course. We retain our overweight exposures to Japan, Korea, Taiwan, selected European markets and US high yield bonds. China's apparent value attracts, but patience is required. Our focus on Asian bonds for yield seems justified with Asian local bonds showing renewed signs of life as dollar strength abates. Signs of returning life are also evident in the ASEAN markets, which could provide 2016's surprise.

Last, but not least, Asian high dividend stocks are now mostly to be found in the cyclical stocks thus providing both growth and income.

⁸Eastspring Investments, IBES MSCI Indices, Thomson Reuters Datastream, as at 29 February 2016.



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