FROM OUR EQUITY DESKS

Market Outlook 2017

Global Equity

Previously, capital markets had become highly conditioned to a "lower for longer" world, with the search for yield having implications both within and across risk asset classes. Even before the US election result, markets had started to factor in a more inflationary outlook. The exact cause of this more conducive pricing environment can be debated, but the rate of growth within China and its knock-on implications for commodity prices is certainly one contributing factor.

With this as a context, the ascendancy of Donald Trump to US president is certainly a push on a door that was already ajar. His election promises, whatever the ultimate reality, would appear more inflationary than the current status quo. When combined with ongoing optimism regarding US growth and a reasonably firm US labour market, we are clearly set for a significant test of bond investors' nerves. This has implications for how investors appraise companies within the equity markets.

Global growth prospects

Will renewed optimism be matched by reality? This is the key question we need to answer. We would summarise the case for cyclical optimism as follows:

- The election of Trump and success in both houses will result in policy promises having a reasonable probability of being delivered. Higher fiscal spending combined with possible protectionism and easier regulation on businesses are all inflationary in nature.
- Existing economic trends in the US are suggestive of a tightening labour market, making any growth surprise likely to be more inflationary.
- Chinese credit conditions, albeit too focused on the old state-owned enterprises, have been much easier than expected, with an impact on both global demand and commodity prices while this remains in place.
- While willingness to borrow has been a challenge to date, the impact of greater government borrowing in the US is driving the yield curve steeper, increasing margin opportunities for banks and hence the propensity to lend.
- Economic stagnation is the default setting for many investors, and hence there remains potential for reappraising the relative merits of equities and those businesses more reliant on a conducive economy.

However, we would counterbalance these views with the following observations:

- Quantitative easing (QE) has not convincingly changed the behavior of the private sector in most developed economies. Borrowing for investment and expansion has been limited, while refinancing to boost equity valuations has been rife. Fiscal profligacy has been attempted in countries such as Japan with limited lasting effect.
- Low rates have ensured the survivability of poorer corporations, and the sensitivity to rising rates and resulting defaults may be greater than in the past.
- Risk assets in aggregate have been elevated by QE. The willingness to direct growth through fiscal means suggests that valuation support for financial assets is now diminishing. The point where inflation becomes negative for overall valuations may be closer at hand than would be typical, despite the still low level of rates.
- While central bank policy has dampened market volatility, political turmoil and its uncertainty have been unleashed. Mr Trump's policies would appear to be harder to predict than most, particularly in the global sphere, making geopolitical issues an unknown headwind.
- The renewed rise in the US dollar will be a challenge for certain emerging markets, and with the UK already having taken a lead in the currency devaluation race, the prospects for growth in the global economy when measured in US dollars is less convincing.

In summary, the cumulative positioning of investors in companies and asset classes that are deemed safe in a "lower for longer" environment is undergoing a significant test at present. The scale and duration of changes to date would suggest that more capitulation is likely if the policy measures being promised by Mr. Trump are enacted. However, rotational mean reversion of risk premiums is not a new phenomenon and a fair degree of convergence has been enacted by the market post-election. The rate of growth in the real economy will remain a frustration for investors in 2017 and beyond, and hence profit delivery rather than hope will matter again over time. We continue to focus our portfolios where we have conviction on profit growth being delivered by business franchises we trust and are not necessarily dependent on a cyclical tailwind.

Asia ex Japan Equity

Much of 2016 was driven by significant macro events. From monetary and fiscal stimulus in China to the US Federal Reserve (Fed)'s dot-plot and global geopolitical events, stock and bond markets danced to the varied tunes. Asia clawed its way back from a poor start to 2016 as China stabilised and significantly, saw its producer price index turn positive (on a monthly basis) after four years of consecutive declines. This probably set the mood for better trading sentiment through much of the second and third quarters, which culminated in a broad sell-off in November for both Asian stocks and currencies, triggered by the unexpected result of the US presidential elections.

As we look forward to next year, we have global asset markets adjusting to real economic improvements, higher consumer prices and arguably mostly to perceived fiscal stimulus as the new preferred policy tool. We do not doubt that fiscal stimulus will make a meaningful impact in Asia as the likes of Philippines, Thailand, Indonesia, India and China have articulated plans for new infrastructure.

Checking optimism in Asia are the strong USD, higher interest rates and potential trade barriers. Asia has traditionally not performed well in an environment of USD strength, given its export-oriented nature and, more unpredictably, the intensity of fund flows away from Asian assets towards USD assets. However, we would argue that Asian markets can be resilient against a fundamentally improving economic backdrop.

Economically, we expect Asia region GDP growth to be moderate, with the likelihood that a better 2016 print for China will lead to a slightly lower rate in 2017 as both monetary and fiscal stimulus wane slightly. The rest of Asia will see marginal changes, though at the stock level, aggregate corporate earnings will be one of the strongest in several years (c.12-14% growth) with supportive forward valuations of 12x price-to-earnings and 1.25x price-to-book.

Our outlook is mixed for North Asia with Hong Kong, Korea and Taiwan lagging against an incrementally more positive China. Politics in both Korea and Taiwan are headwinds but for different reasons. While a stronger Korean Won versus the Japanese Yen will pose challenges to Korea's exports, Taiwan's dependence on the Apple gravy train is an inherent risk.

Despite the challenges posed by higher US rates and the US dollar, our outlook for Thailand, Philippines and Indonesia is more sanguine with domestic demand and government support readily available. Malaysia remains the black sheep with a continued absence of reforms and political undercurrents while Singapore is far too dependent on externalities to generate its own direction. Despite the massive upheaval caused by India's decision to remove large denomination notes from circulation, we believe the very real anguish suffered will be temporary until old notes are replaced by the new. India remains a favourite alongside China.

At the bottom-up sector level, our preference remains firmly anchored in Healthcare with a mix of hospitals and pharmaceuticals. Earnings will likely be immune (no pun intended) to higher interest rates and a stronger USD. Within Financials, we are even more bullish on Insurance due to recent curve steepening moves in the bond markets and are beginning to favour larger domestic banks across Asia that normally benefit from upward moves in interest rates. Within the Consumer space, we believe consumption patterns will remain supported by stable employment and high savings. Our selective preference is for names in India, China and Korea.

While 2016 can be characterised as a recovery year, when sentiment initially plumbed on a slowing China bleeding reserves, then climbed on the combination of a dovish US Fed and a nascent China recovery, 2017 is likely to be an affirmation of the belief that expansionary policies in the US will spill over to the rest of the world with an attendant rise in consumer prices and increasingly more vigilant central banks. The phrase "lower for longer" could well become unfashionable very quickly after years of central banks combating the forces of deflation and wishing for inflation instead. Therefore, the clear risk is a rapid rise in consumer prices.

As they say, be careful what you wish for.

Japan Equity

Japan stands to benefit from Trump policies

Watching the Japanese equity market on 8 November 2016, we had a sense of déjà vu from the Brexit vote that shocked the world in June. But as the poll results for the US Senate and House of Representatives became clearer, we were encouraged by the emergence of a new Republican president who will benefit from full Republican control of Congress.

Other than the US itself, we believe that the country which will benefit most from the policies to be implemented by the incoming Trump Administration would be Japan. The three pillars of Trump's policies are: tax reform, deregulation and infrastructure spending. We think that these measures are highly likely to be implemented—in particular the tax reform—given that there will be an absence of political gridlock in Washington.

These policies are expected to boost US GDP growth over the next few years, and, given Japan's dependence on the US, which is the largest economic partner for Japan (20% of total exports, valued at JPY 15 trillion in 2015, and outbound direct investment into the US totaling USD 419 billion as of end 2015), it stands to benefit a great deal from the policies' implementation.

Changing policy mix in US to drive yen lower

Looking at US monetary policy, the Federal Reserve has been in a rate hike cycle since December 2015, implying that the US economy is recovering steadily. The job market is also tightening, as evidenced by the unemployment rate dropping to 4.6% in November 2016 – its lowest level since 2007 (before the Global Financial Crisis).

Fiscal stimulus under the leadership of the incoming US president in the current environment is likely to cause interest rates to rise, resulting in the US dollar strengthening against all other major currencies. If investors make decisions based on fundamentals (i.e. if the currency market is driven by interest rate differentials), we think that the currency likely to see its value drop the most is the Japanese yen.

This is because the differential between US and Japan interest rates will widen as the US rate rises and that of Japan remains anchored at a low level due to the Bank of Japan (BOJ)'s new policy framework. Under the framework, introduced in September 2016, the central bank commits itself to keeping the 10-year JGB yield around 0% through its "yield curve control" policy.

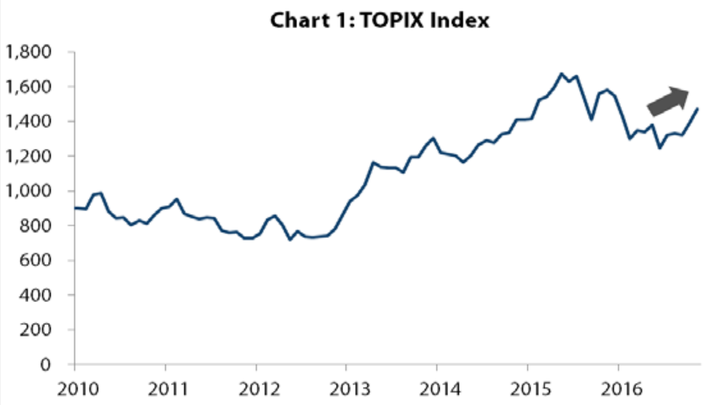
As an excessively strong US dollar may dampen US exporter earnings, "one-sided" strength in the greenback could trigger a political intervention. Having said that, the US already has a large trade deficit, and a stronger US dollar will result in lower import prices, boosting disposable income. This will likely have a positive impact on US GDP growth.

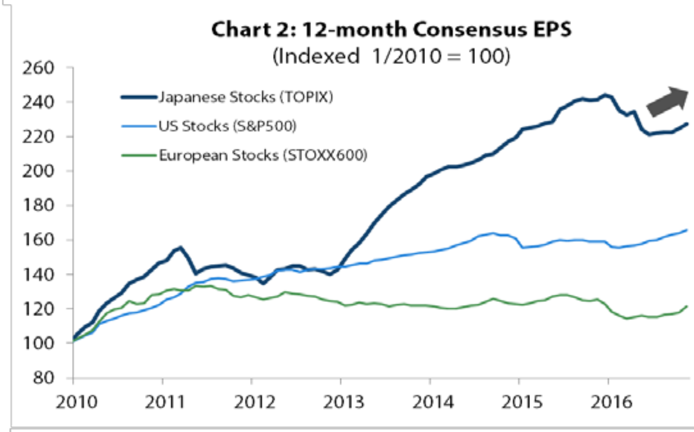
Outlook for Japan equities

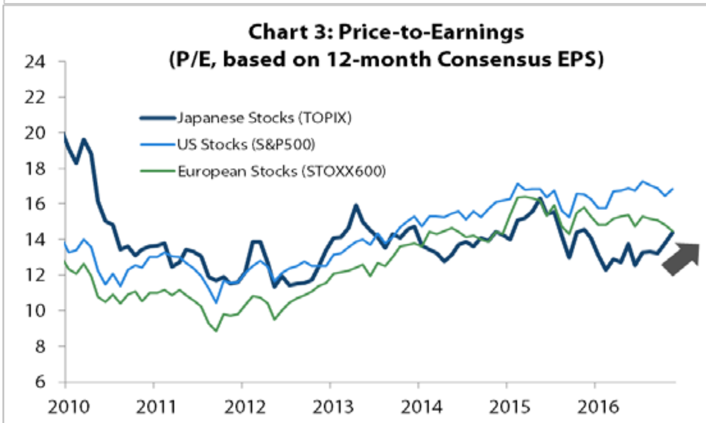
Looking at the corporate earnings trend for Japan, revenues and profits fell year-on-year in the first half of the fiscal year (April through September 2016) for the first time in five years due to the yen's strengthening from USD/JPY=112.57 to USD/JPY=101.35.

However, despite the stronger yen, net profit margin is on the rise and is poised to surpass market expectations by reaching an all-time high this fiscal year (ending March 2017) thanks to companies' aggressive cost-cutting efforts. As major companies are still assuming a USD/JPY of around 100-105, if the yen remains weaker than what these firms expect (with the USD/JPY above 110), we expect EPS growth to accelerate, driving the equity market higher. We believe this is especially likely given that recent currency movements have been very rapid and have yet to be priced in by the equity market.

Valuation-wise, the price-to-earnings (P/E) multiple for the broad market TOPIX is attractive. In fact, multiples had been driven down by foreign investors through the end of September 2016 (see Chart 3), as a strengthening of the yen triggered skepticism of the government's "Abenomics" economic policies. Foreign investors have sold a net JPY 6 trillion worth of Japanese equities year to date through the end of September, the largest amount of foreign investor selling since the Tokyo Stock Exchange started collecting such data in 1982. However, with yields bottoming out globally and the yen now weakening against the US dollar, foreign investors have come back to buy a net JPY 2 trillion in October and November alone. The supply/demand conditions in the market are clearly improving. The BOJ's program for purchasing ETFs was expanded to JPY 6 trillion per year last July and we are also expecting about JPY 6 trillion in corporate buybacks this fiscal year.







Source: Factset, December 2016

Lastly, we believe that further improvement in corporate governance at Japanese companies will translate into higher stock prices. Among the significant successes of Abenomics has been the implementation of Japan's Stewardship Code in 2014 and of Japan's Corporate Governance Code in 2015. A few years following the introduction of the codes, we are seeing a significantly positive change in the way corporate managers are engaging with shareholders. We believe this trend will only accelerate from here on in. The Stewardship Code is expected to be revised in 2017 to enhance asset management firms' monitoring of and engagement with portfolio companies in order to help enhance shareholder value.

In conclusion, we believe that in an increasingly uncertain world, Japan's less uncertain market will provide a compelling opportunity for serious investors.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor a guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).