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EQUITY MARKETS COMMENTARY

STOCKS RISE AS EARNINGS RELIEF OUTWEIGHS GLOBAL CONCERNS

U.S. markets closed higher as global macroeconomic concerns appeared to be offset by some better-than-expected earnings reports. The narrowly focused Dow Jones Industrial Average underperformed the broader Standard & Poor's 500 Index, which in mid-July approached its record high reached in May. The technology-focused Nasdaq Composite reached an all-time high, helped by the strong performance of some major internet stocks. Smaller-cap shares lagged their larger counterparts, and the small-cap Russell 2000 was the only major index to suffer a loss for the period.

Developed European markets generated solid gains in July, despite early-month volatility in Chinese stocks and uncertainty about Greece's future in the eurozone. In the Asia-Pacific region, developed markets generated flat to modestly lower performance, although Japanese stocks continued to trend higher. Emerging markets stocks in Latin America, Asia, and Eastern Europe fell as the largest emerging markets dragged the broad emerging markets index lower. Although India generated a solid gain, stocks in China posted steep losses, as did shares in Russia and Brazil due in large part to currency weakness versus the U.S. dollar.

GLOBAL OUTLOOK – JULY 2015

UNITED STATES: U.S. equities fell sharply towards the end of August in response to weakening economic growth in China and falling emerging markets currencies. Plunging commodity prices and expectations that the Federal Reserve will begin to raise short-term interest rates by the end of the year may also have created investor anxiety. While the scale of the recent volatility has been extraordinary, we are not surprised to see a market pullback following several years of significant gains that pushed stock valuations to above-average levels. As noted in previous months, we had become more cautious and expressed concerns about stock valuations.

Some investors may be afraid that the current downturn will become worse—which, of course, no one knows for certain. Historically, corrections happen on a regular basis; the last one for the S&P 500 Index lasted from late April through early October 2011. But not all corrections turn into bear markets, which are declines of 20% or more. Over many years, history indicates that corrections and bear markets, as well as bull markets, will occur on a regular basis.

On the positive side, macroeconomic data continues to surprise on the positive side. Economic growth has just been revised sharply upwards. Economic expansion quickened to a 3.7% annualised pace in the second quarter. That was much higher than the initial estimate of 2.3%.

We now see little scope for the Fed to do anything in September, and probably even for the rest of the year. Commodities are currently at their lowest since 1999 which is effectively a huge dividend for U.S., and other countries. Generally speaking we believe many stocks are oversold, but it has been the summer and markets are seasonally thin. We have had sharp flashes in August before, which have often corrected once volumes return. Market tops tend to occur when you get 1. An economic recession; 2. Extreme valuations; or 3. An interest rate pick up. There are concerns around all of these, but we feel valuations after the recent falls give us more comfort.

EUROPE: Despite recent falls, there is much support for Europe. The earnings season saw 15% net beats, driven by domestics, with earnings momentum accelerating and it remains 20% below its earnings power of 2007. Events in China and the U.S. may well cause Europe to slow, but valuations are still supported and there is positive momentum. It is also encouraging that consumers appear to be regaining a measure of confidence in most markets, and credit conditions appear to have improved.

JAPAN: Japan combines both a domestic and a later-cycle earnings growth story. Attach attractive valuations compared with other regions, along with some selective self-help reform that will structurally improve Japan's profitability and the result is a positive backdrop. However, at a stock level it is becoming increasingly harder to find good companies at cheap valuations. Therefore, it is important to do your research to focus on where companies' returns are going to improve as the structural and corporate improvements happen. This means investors will need to be selective, but as Japan begins to deliver on its promise, investors should continue to be rewarded.

EMERGING MARKETS: The backdrop for EM equities as a whole remains favourable, despite the headlines. With indications that most central banks plan to maintain interest rates at lower levels for longer, this means the search for yield will continue.

With the continued dispersion and volatility within markets, careful stock selection will be important to long-term performance. Valuations are now even more compelling and emerging markets overall are still trading at a discount relative to their history. They also look very attractive versus their developed-market peers. However, investors will have to be much more granular in their approach.