LION GLOBAL INVESTORS

FOR PROFESSIONAL INVESTORS ONLY

April 2014

SECOND QUARTER 2014 OUTLOOK

TURNING THE CORNER ON EQUITIES

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TURNING THE CORNER ON EQUITIES

The second quarter of 2014 brings greater clarity to markets and we are positioned to take advantage of the shifts.

- We continue to favour equities over bonds in the second quarter as we expect economic momentum to pick up
- US economic growth to recover after a slow first quarter; Europe and Japan ready to stimulate their economies further and Chinese authorities to put a floor to the on-going economic slowdown
- The Russian-Ukraine crisis lingers at the background and tensions may simmer longer

We enter the second quarter of 2014 with cautious optimism and we continue to overweight equities over bonds. While our strategy within bonds has not changed, we feel there is now more upside potential in equities to justify an increased weighting.

Macro conditions are generally supportive, and negative economic surprises have begun to recede. US economic growth should pick up in the second quarter after an extremely weak first quarter (0.1% year-on-year seasonally adjusted annual rate). US private consumption has been surprisingly strong and jobs data are encouraging. Europe's recovery is on track amidst benign inflation and the European Central Bank stands ready to reflate the Eurozone region. Japan is expected to consolidate after implementing consumption tax in April. The BOJ (Bank of Japan) is looking out for further deterioration in economic momentum before deciding on further stimulus. China's deterioration in economic activity is concerning, but we believe the government will manage growth while instituting longer term reforms. With inflation generally low for many economies, central banks are likely to be accommodative.

The current environment is difficult to navigate as many markets are fairly valued. With the equity market rally looking quite mature, dispersion in style, sectors and markets are going to be important drivers of returns going forward.

The risks we face in 2014 are broadly similar to those we identified in the first quarter of 2014. Given the strong run up in the first quarter, Internet and gaming stocks have risen to expensive levels, and there is the possibility of an expensive stock-led correction that could spread into the broader equity market.

The risk of potential defaults in China is another risk we continue to watch closely as the bulk of trust products mature in the second and third quarters of 2014. Some estimates show the impact of defaults on the Chinese financial sector is manageable. Share prices of Chinese banks have mostly priced in these risks significantly. We believe the Chinese regulators would avoid any systemic risk eventhough some defaults are inevitable.

Over in Europe, while we are concerned about the escalating Russia-Ukraine tensions, we think the probability of a widespread catastrophic event is low. Oil prices, US treasuries and gold to a certain extent are pricing in some risk aversion. Roughly 32% of Europe's gas is imported from Russia and around 40% of that is transported by pipes running through Ukraine. We think the stakes are too high for either party to engage in any outright confrontation.

Our second quarter 2014 outlook is overweight equities while underweight bonds.

MORE TO COME FROM ASIAN EQUITIES

- Broad market valuations mask underlying divergence
- Political situation in India and Indonesia are improving
- Japan and China undertaking a process of reform, but not neglecting economic growth

After being underweight Asia ex-Japan for several months, we now hold a more positive view on the region. This is not to say we are homogeneously positive on the region. Performance and valuations have been fairly divergent, with the TIPs markets of Thailand, Indonesia and the Philippines leading performance since the start of 2014, while China has been the worst performer this year.

While Asia as a region is fairly valued, valuations diverge across markets. North Asia is relatively cheap; India is fairly valued; Australia and much of Southeast Asia is relatively expensive. Chinese reforms will expose SOEs (state owned enterprise) to greater competition. With pressure on earnings and profit margins, we expect an initial downturn in earnings of SOEs – among the biggest members on China's stock exchanges – adjust to a more competitive landscape.

However, as reforms continue, government statements suggest policy response to stabilise economic growth and this includes bringing forward fixed asset investment into high speed rail, city metros, environmental reform and shanty town redevelopment.

Japan's consumption tax hike in the second quarter has dampened sentiment on Abe's reform agenda. While history has shown prior tax hikes have little impact on market performance, Japanese corporates are generally cautious going into the second quarter. We believe the negative sentiment is overdone, and once economic data improves or BOJ stimulates, sentiment could turn very quickly.

Political developments in India and Indonesia hold promise for greater clarity for market participants. The Indian market is focused on the results of the general election in the second quarter of 2014, with expectations for a BJP (Bharatiya Janata Party) victory to benefit businesses. Indonesia, heads into the second quarter of 2014 with presidential and general elections, and despite improvements in current accounts, reforms are much needed to maintain the economy's competitiveness.

HOLDING STRONG ON BONDS

- Janet Yellen's comments at the FOMC meeting indicate a 6-month timeframe for rising rates
- A rising rate environment, while broadly negative for bonds, presents opportunities in credit selection
- Generally, Asian currencies are likely to weaken against developed currencies with the CNY (Reminbi) being an exception

While economic data remains relatively soft from poor weather conditions; US ISM (Institute for Supply Management) manufacturing data improved in March 2014, and New York and Philadelphia Fed March manufacturing surveys indicate companies are planning to increase capex in the coming six months.

With economic data picking up, we expect 10-year US Treasuries to range between 2.5% to 3.2% with an upward bias. As US Treasury yields rise amidst the Fed taper, we maintain our neutral to negative outlook on Asian credits, where we expect coupon carry to drive returns. In this environment, credit selection remains vital. Similarly, the combination of rising US Treasury yields and Fed tapering is expected to contribute to the underperformance of Asian currencies against the USD.

The exception is the CNY, where we continue to expect long-term currency strength against the USD. While the recent CNY trading band widening has contributed to CNY underperforming the USD, policy measures in selected areas such as urbanisation, social housing, infrastructure and environment are likely to put a floor on economic growth, supporting the long-term story for the CNY.

We remain positive on Chinese bonds and cognisant of potentially higher default rates from trust products maturing in the coming 6 months. Although SOEs and LGFV (Local Government Finance Vehicle) bonds are unlikely to default, we expect small scale defaults that are unlikely to pose any systemic risk to the Chinese financial system.

While broad EM outflow concerns have added to the negative sentiment surrounding Chinese markets, we believe these risks are priced into China and Hong Kong bond markets, and we are taking advantage of attractive valuations to add to selected bonds.

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