LION GLOBAL INVESTORS

FOR PROFESSIONAL INVESTORS ONLY

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THIRD QUARTER 2014 OUTLOOK
GLOBAL GROWTH STABILISES

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RISK ON AS GLOBAL GROWTH BROADENS OUT

- Lion Global Investors expects the positive economic momentum in the US to continue into the third quarter.
- This sets a positive backdrop for equities markets as the Federal Reserve is expected to maintain an accommodative monetary policy to ensure a sustainable economic recovery.
- In this risk on environment, we favour equities over bonds

The US economy has rebounded and recent data points to a stronger economic momentum in the second half of 2014. The Fed has maintained its dovish stance although improving jobs creation and higher inflation suggest that policy may need to be tightened in due course.

In Europe, the ECB remains vigilant in the fight against deflationary pressures and supporting economic growth. It has announced a targeted longer-term refinancing operations, or TLTROs to encourage lending to areas of the economies with the greatest need. The ECB president, Mario Draghi, has also signalled that policy makers are willing to act again if needed.

Japan's recent positive economic data showed resilience despite the consumption rate hike in April. Our observation is that Mr Abe's third arrow is in the making and we expect the Japanese market to be well supported by positive earnings revisions, government stimulus and pension fund buying.

The Chinese economy has stabilised after a slow first half. Recent data points suggest that economic activity is picking up as credit has eased to selected sectors and fiscal spending has also increased. SOE reforms and Hong Kong-Shanghai "Stock Connect" programme may be further catalysts for the markets. We favour an overweight in equities vs bonds as we expect the broadening out of global economic growth to support equities markets. US and European equities appear fairly valued. On the other hand, valuations of Asian and Japanese equities are more attractive in comparison. Bonds have less upside, as interest rates could potentially spike up due to an increase in inflationary expectations, a change in the Fed's dovish stance or the market re-pricing its rate expectations.

ASIAN FIXED INCOME SEES BRIGHT SPOTS AMID DISMAL US FIRST QUARTER GDP

- While the US GDP miss has made headlines, there are hints of strength in the economy
- The Federal Reserve maintains its dovish stance, and will focus on a broader set of economic indicators
- We remain short duration and overweight high-yield while compensating for the loss of carry with credit exposure

As markets adjust to the unexpectedly poor GDP figures from the US, hints of strength remain for the US economy.

The primary cause of the US GDP miss was an overestimate in healthcare spending, which was distorted by the implementation of Obamacare. With healthcare now adjusted downwards, weaker exports and stronger imports led to the revision of 2014 full-year GDP down to 1.7% from 2.4%

However, we see hints of strength, with income growth and savings rate increases which bode well for future consumption data. Furthermore, strong non-farm payrolls and improvements in unemployment figures suggest a more mixed picture than the downward GDP revision would suggest.

The Fed continues to taper, and while forward guidance remains dovish, there's been a gradual shift to lower rates in the long-run. With unemployment figures improving rapidly, the Fed indicated it is looking to a broader set of economic indicators, rather than narrow unemployment targets, and appears to be in no rush to hike rates.

Within Asia credit we have seen a continued and consistent tightening of credit spreads to the point where we question how much further spreads can tighten. While not standing against the tide of liquidity, our strategy is to remain neutral and participate in the carry. While we believe rates will move higher, they are likely to do so at a gradual pace as economic indicators provide little incentive for rapid rate hikes. Our strategy is to remain short duration and overweight high-yield, while compensating for the loss of carry with credit exposure.

ASIA PACIFIC EARNINGS STABILISING AMID DEBT WORRIES

- Earnings of Asian equities have stabilised and suggests an end to earnings downgrades
- Debt levels in Asia Pacific ex Japan have risen and we avoid companies with high leverage
- Policy risk continues to add uncertainty to the markets

After months of downward revisions, Asia Pacific ex-Japan (APxJ) earnings now look stable while sentiment improves, which suggests we are near the bottom of analyst earnings downgrades. Earnings growth should come in around 13% by end-2014, backed by upgrades from Korea and Hong Kong.

Earnings momentum in select tech companies in Korea is expected to be strong, backed by demand for DRAM chips and the launch of new online games. However, a stronger Korean won could negatively impact export-dependent industries.

In the coming months we see several issues shaping our investment decisions in APxJ markets.

Debt levels in APxJ have been rising among households and non-financial companies. While it varies across economies, governments and banks have generally not seen the same increases in debt as individuals and private companies. If the global recovery continues, as we believe it will, then when interest rates rise, highly-leveraged companies will face greater challenges.

The implication for us is to continue focusing on companies with strong balance sheets and exposure to the global recovery.

On the political front, Indonesia's elections hold the economy and investors in suspense. We see a Jokowi-win as positive for markets, while a Prabowo-win resounds with his rhetoric for a more nationalist populism that characterised the Suharto era.

China's corruption purge by Xi Jinping continues, consolidating more power under Xi than any leader in recent history. The issue with the corruption purge is the slowdown in economic activity. Money earmarked for infrastructure projects is not getting spent for fear of corruption allegations, and this has contributed to the disappointing data coming from China.

JAPANESE EQUITIES RECOVER FROM TAX HIKE CONCERNS

- Japanese equities have recovered from tax hike concerns and lack of further Bank of Japan stimulus
- Further growth strategies include corporate tax cuts and a focus on improving corporate governance
- We remain positive on globally competitive companies and firms that can establish themselves in emerging markets

The Japanese market started the quarter on a positive note as tensions eased in Ukraine and China posted improving PMI numbers. However, the market weakened ahead of the results reporting season starting end-April as investors were wary of conservative forecasts for FY2014.

As the reporting season came to a close by end-May, the market shrugged off the conservative forecasts for FY2014 and became more optimistic as April and May sales and orders numbers from individual companies came in fairly good. Manufacturing PMIs from US and China continued to improve through the quarter. The market also shrugged off worries from the Iraq insurgency crisis. The Bank of Japan (BoJ) did not expand its asset purchase program during the period but it was within expectations of the market. The second round of growth strategy announcements by the Abe administration in June provided little positive catalysts for the market but continued to move in the right direction with promises of corporate tax cuts in the coming years and reinforcing corporate governance. The best performing sectors were non-bank financials (+15%), energy (+15%) and construction (+12.8%). The worst performing sectors were paper (-9.1%), shipping (-3.7%) and tires (-1.2%).

The market has recovered well from the initial disappointment of a lack of further easing by BoJ and concerns over post-tax hike demand. The market is once again waiting for further catalysts to lift sentiment. A potential catalyst could be positive earnings revisions by companies as global demand outstrip conservative forecasts. The recent positive economic data out from the US and China as well as better-than-expected post-tax demand in Japan provide a good basis for optimism. We favour the structural growth themes of factory automation, auto-related industries, and consumer brands, while we remain positive on globally-competitive companies and companies that can establish themselves in emerging markets with secular demand growth.

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